

FOREIGN CHARITIES ACTIVE IN THE U.S. – PUBLIC? OR PRIVATE FOUNDATIONS?

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BACKGROUND

Generally, a charity¹ is exempt from U.S. tax on its income, provided that such income is not treated as unrelated business taxable income (“U.B.T.I.”). This rule applies to both domestic and foreign charities and nonprofit organizations.

In recent years, foreign charities and nonprofit organizations have become more active in the U.S. in support of their missions. Such activities include performances in the U.S. by not-for-profit foreign artists and importation of foreign organizations’ unique knowledge in certain fields. It is becoming increasingly common for foreign charities to earn fees that could be subject to U.S. income or withholding taxes. Federal tax can be avoided or reduced if the exempt entity can furnish the U.S. payor (*i.e.*, withholding agent) with a Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting.

Attached to Form W-8EXP is either a determination letter from the I.R.S. as to the foreign organization’s status as a public charity or a private foundation, or an opinion of counsel. Domestic organizations generally are required to obtain an I.R.S. determination letter; foreign organizations generally are not, if substantially all of the organization’s support (other than gross investment income) is from non-U.S. sources.² Withholding agents can rely on a submitted Form W-8EXP if the foreign organization provides a legal opinion certifying its exempt status and, further, its status as a public charity or a private foundation.

The distinction between private foundation and public charity status affects the need for special withholding in the case of a foreign private foundation. Foreign private foundations are subject to 4% excise tax on their gross investment income, generally U.S.-source interest, dividends, rents, payments with respect to securities loans, and royalties.

Generally, charities organized and registered under the charitable laws of a foreign jurisdiction would meet the U.S. standards for charitable status. What is often more difficult to determine is whether a charity is a public charity or private foundation.

PUBLIC CHARITY V. PRIVATE FOUNDATION

Code §509 provides that all organizations, domestic or foreign, described in Code §501(c)(3) are presumed to be private foundations except those organizations meeting special tests for public charity status.

¹ A charity is an organization described in §501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”).

² Code §508 and Code §4948(b).

Assuming a foreign organization has not obtained an exemption letter from the I.R.S., Form W-8EXP must also include an affidavit from the organization setting forth sufficient facts for the I.R.S. to determine that the organization is not a private foundation.

One test described in Code §509(a)(1) generally includes organizations that are educational institutions, churches, certain organizations related to colleges and universities, governmental units, and organizations receiving substantial support from a governmental unit or from the general public. Another test described in Code §509(a)(2) generally includes organizations that are supported by their exempt function, meaning that they derive most of their gross receipts from activity related to their exempt function.³

Code §509(a)(1) Test

Under the Code §509(a)(1) test the organization must receive its support from the “public.” This requirement is satisfied by having 33⅓% of the “total support” received from the general public.⁴ The numerator consists of the organization’s public support (subject to certain limitations and exclusions), and the denominator consists of the organization’s total support (also subject to some exclusions).⁵

Total support includes

- gifts, grants, and contributions (but not contributions of services, for which no deduction is allowed, nor unusual grants⁶);
- net income from unrelated business activities,
- gross investment income (e.g., dividends, interest, rent, and royalties but not capital gains),
- tax revenues levied for the benefit of an organization and paid to or expended on behalf of the organization (but not the value of any exemptions from tax, e.g., Federal, state, and local), and
- the value of services or facilities furnished by a governmental unit to the organization without charge.

Total support does not include amounts received from the exercise or performance

³ For a summary and comparison of public support, total support, and limitations for each test see <https://www.irs.gov/irm/part4/33239010.html> and <https://www.irs.gov/irm/part4/33239011.html>.

⁴ There is an alternative “facts and circumstances” test that requires 10% of the total support to be provided by the general public. However, due to the factual nature of the test it will not be discussed in this article.

⁵ The support computation test must be met for the aggregate of the four taxable years preceding the year under examination. If the organization satisfies the test, it is considered to have also met the test for the current and next taxable years.

⁶ An “unusual grant” may be excluded from both the numerator and denominator. An unusual grant is a substantial contribution or bequest from a disinterested party that is attracted by reason of the publicly supported nature of the organization. If significant in amount, an unusual grant may make the difference between a public or private foundation determination and, thus, is ignored.

“The organization must not normally receive more than 33⅓% of its total support from gross investment income.”

by the organization of its charitable, educational, or other Code §501(c)(3) purposes constituting the basis for its exemption. Any payment of money or transfer of property without adequate consideration is defined as a gift or contribution. Where payment is made in exchange for admissions, merchandise sales, services performed, or facilities furnished to the donor, payment is considered a gift or contribution only to the extent it exceeds the value of the exchange. Where property constitutes the gift or contribution, the amount includible in computing public support is the property's fair market value or rental value on the date the donor makes the gift.

Out of the total support, the organization must demonstrate that 33⅓% of its support is from the public. Public support consists of gifts, grants, and contributions from the general public (e.g., individuals, corporations, and trusts), from other public charities, certain private foundations, governmental units, and membership fees that are made for purposes of the organization's support only. The amount of public support that is includible for purposes of the test is modified by limiting contributions, gifts, and grants from certain individuals, corporations, trusts, and organizations to 2% of total support, meaning that to the extent that a single donor's contribution exceeds 2% of the organization's total support, it is not considered public support. A husband and wife would be treated as one person for purposes of the 2% limitation, as well as any person or an entity related to them. The excess, and only the excess, is excluded from the numerator of the public support fraction.⁷ However, the 2% limitation does not apply to support from certain governmental units and from organizations that are normally supported directly or indirectly by the public or governmental units, provided that such contribution, gift, or grant is not earmarked for the recipient organization.

Code §509(a)(2) Test

Under a second test, the Code §509(a)(2) test, an organization must typically derive most of its gross receipts from an activity related to its exempt function. To meet this test an organization must satisfy two tests:

- It must normally receive more than 33⅓% of its support from any combination of gifts, grants, contributions, membership fees, and gross receipts from permitted sources.
- It must not receive more than 33⅓% of its support from gross investment income and U.B.T.I.

The terms “gifts” and “contributions” in the context of this test have the same meaning as under the Code §509(a)(1) test.

The permitted sources are similar to those included in the public support of Code §509(a)(1) with the following changes:

- Public support includes membership fees (for admissions, merchandise, etc.).
- Public support includes gross receipts from a related activity (e.g., admission fees, merchandise sales, services performed, furnishing facilities), except if the related activity generates receipts from one person, bureau, or similar

⁷ However, the entire amount of the contribution is included in the denominator of the fraction.

governmental unit, only \$5,000 or 1% (whichever is greater) of the organization's total support in any taxable year can be included. The limitation is applied on a year-to-year basis and is not cumulative.⁸

- Public support also includes rents from related activity.
- Public support does *not* include dividend or interest.⁹
- Public support does *not* include amounts from any "disqualified person."

A disqualified person generally means a substantial contributor, who is an individual, trust, estate, partnership, association, company, or corporation who contributed or bequeathed an aggregate of \$5,000 (providing the \$5,000 is more than 2% of the total contributions the organization received in the taxable year). Once a person becomes a substantial contributor, the individual forever remains such, even if contributions become less than 2% in following years.

According to the second prong for the Code §509(a)(2) test, the organization must not normally receive more than 33⅓% of its total support from gross investment income (*i.e.*, income from interest, dividends, rents, and royalties) and U.B.T.I. (*i.e.*, gross income from a trade or business that is not substantially related to the organization's exempt purposes).

CONCLUSION

Foreign charities, many of which are not required to obtain recognition of tax-exempt status from the I.R.S., must be mindful of the potential for U.S. tax on income earned in the U.S. It is possible for such charities to receive U.S. income without the imposition of U.S. Federal income or withholding tax if the requirements of Form W-8EXP can be satisfied. Those requirements include an opinion of counsel as to the exempt status of the charity, as well as financial information to determine whether the charity is a public charity or private foundation.



⁸ The entire amount, however, is included in the total support (*i.e.*, in the denominator).

⁹ Unlike the Code §509(a)(1) test, in this test, dividends and interest are also excluded from the total support.