CHARITABLE TRUSTS: AN IRS EXAMINATION OF NONEXEMPT PHILANTHROPIC ORGANIZATIONS

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Charitable activity is generally assumed to be carried out as a result of two influences: altruism and tax incentives. From an economic perspective, altruism implies that the welfare of others is important to oneself. In this sense, providing funds for charity is a means of obtaining economic satisfaction not unlike that derived from other types of economic transactions. Tax incentives, in this context, are legislative enactments to encourage philanthropy by granting exemption from taxation to institutions and by lowering the effective net cost to a donor of making a charitable contribution. The Internal Revenue Code specifically defines several types of philanthropic organizations, each with requirements, regulations, and tax incentives that provide benefits to either the philanthropic organizations, their donors, or both. In this paper two types of these organizations, nonexempt charitable trusts and nonexempt split-interest trusts, are examined. In section 1, some background information on these organizations is provided. In section 2, data from a first-time study of these organizations are examined with particular attention to their philanthropic activity and their financial composition. Section 3 contains an overview of Internal Revenue Service studies concerning tax-exemption, trusts, and wealth taxation. Finally, an appendix on the method of estimation in the Internal Revenue Service Statistics of Income (SOI) 1979 nonexempt charitable and split-interest trust study is provided.

1. PHILANTHROPY AND NONEXEMPT TRUSTS

Despite indications that the economic stagnation which has been characteristic of the 1980's will soon abate, human deprivation remains high. The presence of and forecasts for further record budget deficits has tempered the Federal government's inclination to directly address these increased social needs. Furthermore, rebuilding national defense has augmented the existing pressures on Federal expenditures. On the other hand, Federal entitlement programs, most notably Social Security, continue to expand due to demographics and regulations that index payments to inflation, encourage early retirement, and pay for ever-increasing medical services.

Since the Federal government has resisted an expansion of funding for the increased social needs, except for the entitlement programs, the private sector is being looked upon to help fill this gap. However, the private sector, and State and local governments as well, have clearly played a secondary role to that of the Federal government in the provision of social welfare expenditures [8,10]. Therefore, the capacity that the private sector has to meet this increased demand is likely to be limited.

To encourage private philanthropy, the Federal government has granted exemption from taxation to certain organizations that engage in charitable activities. Although the origins of tax-exempt status go back to the latter part of the nineteenth century, the purpose of this status was best put forth in the House Ways and Means Committee report on the Revenue Act of 1938:

"The exemption from taxation of money or property devoted to charitable or other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from the financial burden which would otherwise have to be made by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare [8]."

Another benefit that directly aids charitable donors and indirectly assists the philanthropic tax-exempt organizations was established in 1917. This benefit is the allowance of deductions for charitable contributions from the tax base of individuals, and it effectively lowers the donor cost of a deduction by the amount of the deduction times the marginal tax rate of the donor. This benefit has been extended to corporate and estate donors.

In short, private sector philanthropy consists of the following:

1. Donors who are the sources of philanthropic resources and who are generally allowed to deduct the amount of their contributions from their taxable income.
2. Institutions that solicit funds from donors and channel these funds to those in need, and who generally are required to establish their tax-exempt status with the Internal Revenue Service.
3. Donees who are the recipients of philanthropy.

Although donors are generally individuals, business enterprises can likewise be sources of philanthropic funds. Institutions include all types of intermediaries that raise and disburse funds and include churches, foundations, and public charities. They can either be actively involved in philanthropic activities or simply conduits for philanthropic funds. Furthermore, they can have large financial reserves with substantial property income, or they can be essentially "pay-as-you-go" organizations that distribute amounts for charitable purposes comparable to what they receive in contributions.

From an Internal Revenue Service perspective, philanthropic institutions are composed of the following groups:

1. Organizations that must formally apply for and be recognized as tax-exempt under a specific section of the Internal Revenue Code.
2. Organizations that are presumed to be tax-exempt by the nature of their activities and are not required to apply for tax-exempt status. This group includes:
   a. Organizations, such as churches, that are not required to file annual information returns.
   b. Organizations that closely resemble

tax-exempt organizations and are required to file annual information returns. Included in this group are nonexempt charitable trusts and nonexempt split-interests trusts.

A nonexempt trust is a legal instrument established by an individual or organization with funds placed in trust with either income or remainder interests (or both) devoted to charitable purposes [4]. The term "nonexempt", in this context is somewhat of a misnomer. While nonexempt trusts are "nonexempt" in the sense that they are not required to be formally recognized as tax-exempt in the Internal Revenue Code, they are exempt from income taxation. There are two types of nonexempt trusts: charitable trusts and split-interest trusts. Charitable trusts are intended exclusively for charitable purposes. Split-interest trusts have both charitable and noncharitable beneficiaries.

Nonexempt trusts were created in the Tax Reform Act of 1969 to fill what would have been a substantial loophole in the law. Trusts are generally treated as conduits for tax purposes and, as such, are taxable only on their undistributed income. Since donors are allowed an unlimited deduction for contributions to charitable and split-interest trusts, they would have had all of the tax incentives available to private foundations without having to apply for tax-exempt status and without the additional regulations and requirements imposed on private foundations in the Tax Reform Act of 1969. Therefore, Congress provided that charitable trusts be treated as private foundations and that certain provisions applicable to private foundations would also apply to split-interest trusts [17].

2. NONEXEMPT TRUST DATA

In this section, data from a first-time Statistics of Income (SOI) study of charitable and split-interest trusts are presented and analyzed. Initially, some perspective on the philanthropic activities of charitable and split-interest trusts is provided by comparing the volume of their charitable activities to those of other charitable organizations and the social welfare portion of government spending. In 1979 charitable and split-interest trusts together provided a total of $118 million in charitable contributions. Of this total, $56 million was made by charitable trusts and $61 million by split-interest trusts. Also during 1979, private foundations contributed $3.2 billion to charities [9], and for 1978 (the latest year for which data are available), other charitable tax-exempt organizations (i.e., "public charities") contributed a total of $30.4 billion toward philanthropic pursuits [15]. In 1979, government spending for social welfare purposes, which includes transfer payments and public investment in schools, hospitals, and other similar facilities, totaled $440.3 billion [13].

Clearly, from an aggregate perspective, nonexempt trust philanthropic expenditures are a very small portion of total philanthropic spending as well as private sector charitable expenditures. The private sector, in general, is dwarfed by public social welfare funding. However, nonexempt trusts are significant in that they are organizations that are afforded the privileges of other charitable tax-exempt organizations without having to apply for this advantageous status. Furthermore, the current study of nonexempt trusts represents the last portion of a series of recent studies of the nonprofit sector by the SOI Division [5,6,8,9,10,15,16].

Data on the numbers of nonexempt charitable and split-interest trust and their assets are presented in Figure 1. For comparative purposes, similar data on private foundations are included. Functionally, private foundations are very similar to charitable trusts, but unlike charitable trusts, they are required to formally apply for tax-exempt status. The number of charitable trusts and their total assets are considerably less than those for both split-interest trusts and private foundations. The nearly 14 thousand split-interest trusts are only half the number of foundations, but are over six times the number of charitable trusts. The $2.5 billion in split-interest trust assets are only 7 percent of total foundation assets, but are almost three times the $0.9 billion in assets for charitable trusts. On the average, however, charitable trusts are over twice as large as split-interest trusts with a mean asset value of $425,000 to $180,000 respectively. Private foundations, on the other hand, have a mean asset value of $1,239,000.

Figure 1.--Numbers of Nonexempt Trusts and Private Foundations, and Amounts of Total Assets, by Size of Total Assets for Tax Year 1979

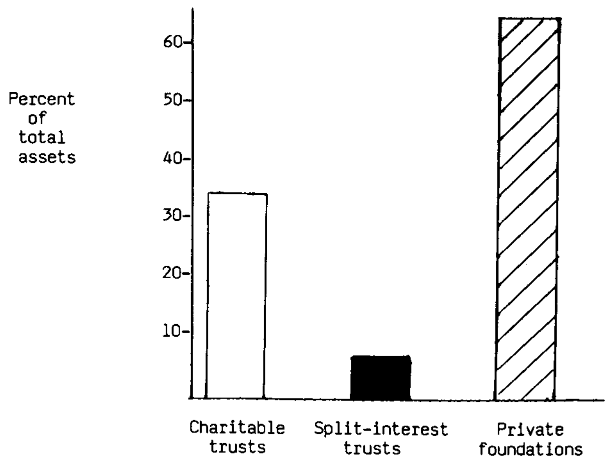
[All figures are estimates based on samples--money amounts are in millions of dollars]

Size of total assets	Numbers of organizations	Total assets
	(1)	(2)
Charitable trusts, total	2,103	$894
Under $100,000	1,175	34
$100,000 under $1,000,000	782	247
$1,000,000 under $10,000,000	134	309
$10,000,000 or more	11	304
Split-interest trusts, total	13,743	$2,467
Under $100,000	9,092	258
$100,000 under $1,000,000	4,251	1,184
$1,000,000 under $10,000,000	388	838
$10,000,000 or more	11	188
Private foundations, total	27,980	$34,668
Under $100,000	15,747	397
$100,000 under $1,000,000	8,717	2,998
$1,000,000 under $10,000,000	3,026	8,815
$10,000,000 or more	490	22,459

SOURCES: Data are from unpublished tabulations from the 1979 IRS Statistics of Income Nonexempt Charitable and Split-interest Trust Study and [9].

The greater concentration of trust assets among charitable trusts is clearly evident in the asset concentration percentages (see Figure 2). The 11 largest charitable trusts, each with assets of $10 million or more, account for 34 percent of total charitable trust assets. The 11 largest split-interest trusts, which also include all those with at least $10 million in total assets, account for only 8 percent of total split-interest trust assets. The 490 foundations with assets of $10 million or more account for 65 percent of total foundation assets.

Figure 2. -- Percent of Assets Accounted for by Organizations with at least $10 million in Total Assets



In Figure 3 the composition of nonexempt trust assets, liabilities, and net worth are presented. Although corporate stock is the largest asset item for both charitable and split-interest trusts, it is relatively more important for charitable trusts. Corporate bonds and government obligations are the next two largest asset items. Total liabilities are relatively small for both charitable and split-interest trusts, and mortgages and notes payable is the largest identifiable liability item.

The composition of nonexempt trust receipts and deductions are provided in Figure 4. Contributions, gifts, and grants received is the largest receipt item for split-interest trusts.

Figure 3.--The Composition of Nonexempt Trust Total Assets, Liabilities, and Net Worth for Tax Year 1979

[Money amounts are in millions of dollars]

Item	Total	Charitable trusts	Split-interest trusts
	(1)	(2)	(3)
Number of trusts	15,846	2,103	13,743
Total assets	3,362.0	894.2	2,467.7
Corporate stock	1,082.7	350.1	732.6
Corporate bonds	514.0	171.5	342.5
Government obligations	514.1	79.1	435.0
Cash	162.8	46.5	116.3
Accounts and notes receivable	50.0	12.8	37.3
Land	75.4	14.4	61.0
Net depreciable assets	44.8	23.7	21.0
Other assets	918.1	196.1	722.1
Total liabilities	61.1	24.4	36.8
Contributions, gifts, grants payable	2.1	0.4	1.8
Mortgages and notes payable	30.4	17.5	12.8
Accounts payable	10.3	2.2	8.1
Other liabilities	18.4	4.3	14.1
Net worth	3,300.8	869.9	2,430.9

SOURCE: Unpublished tabulations from the 1979 IRS Statistics of Income Nonexempt Charitable and Split-interest Trust Study.

For charitable trusts, dividends and interest are the largest, and together they account for over 60 percent of total receipts. Contributions, gifts, and grants paid is by far the largest deduction item for both types of trusts. For charitable trusts, it accounts for 72 percent of total deductions, while for split-interest trusts, it accounts for 45 percent of the total.

The percentage compositions of trust assets by size of assets are presented in Table 1. Corporate stock, the largest asset item for both charitable and split-interest trusts, increases in its composition share with increasing asset size. For charitable trusts, however, this increase is more pronounced and more consistent than for split-interest trusts. Corporate bonds and government obligations, the next two largest asset items for both charitable and split-interest trusts, indicate less stable composition trends across the asset size classes. Corporate bonds increases markedly for

Figure 4.--The Composition of Nonexempt Trust Total Receipts and Deductions for Tax Year 1979

[Money amounts are in millions of dollars]

Item	Total	Charitable trusts	Split-interest trusts
	(1)	(2)	(3)
Number of trusts	15,846	2,103	13,743
Total receipts	508.6	98.5	410.1
Contributions, gifts, grants	162.4	10.9	151.5
Dividends	94.9	29.7	65.2
Interest	122.7	30.5	92.2
Net gain from sale of assets	79.8	10.4	69.4
Gross rents and royalties	14.8	4.7	10.0
Gross profits from business	3.2	0.1	3.1
Other receipts	30.9	12.1	18.8
Total deductions	215.0	78.7	136.2
Contributions, gifts, grants	117.8	56.5	61.3
Employee wages and benefits	7.1	6.6	0.5
Taxes	5.2	2.0	3.3
Professional services	6.5	2.1	4.4
Compensation of officers	6.8	3.0	3.8
Depreciation, amortization, depletion	2.0	1.2	0.8
Interest	2.2	0.3	1.9
Other expenses	67.4	7.1	60.3

SOURCE: Unpublished tabulations from the 1979 IRS Statistics of Income Nonexempt Charitable and Split-interest Trust Study.

charitable trusts but levels off in the 20 percent range, while for split-interest trusts it exhibits an erratic decline. Government obligations, on the other hand, generally declines in importance with increasing asset size for charitable trusts, but it increases in importance with increasing asset size for split-interest trusts for most asset size classes except the largest.

In Table 2 the trust receipt compositions by size of assets are displayed. Contributions, gifts, and grants received decreases significantly with increases in asset size for charitable trusts, but for split-interest trusts it is very large for all but the smallest and largest trusts. Dividends exhibit a relatively stable composition share for most asset size classes of both charitable and split-interest trusts. Interest, likewise, shows a relatively stable composition share except for the smallest and largest asset size classes of split-interest trusts.

3. RELATED IRS STUDIES

The 1979 nonexempt trust study, which was economically "piggybacked" onto the 1979 private foundation study because of the similarities in both form and content, is one small part of the Statistics of Income Division efforts to develop a database for the analysis of the maintenance and transfer of large wealthholdings. Other studies have directly examined private foundations [5,8, 9,10], other tax-exempt organizations [15,16], fiduciaries [6], and personal wealth [11,12]. While each of these studies provides information on the separate tax filing populations, none has been able to model the "dynamics" of wealthholding which is essential to measure effective rates of wealth taxation. In a study completed several years ago, data from a small sample of decedents' estate tax returns were collated with individual income tax return data of the decedents (before death) and their beneficiaries (both before and after decedents' deaths). This match enabled the examination of the interrelationships between income and the underlying value of the assets that produced that income for decedents [14]. Further analysis will explore the influences of bequests on recipients' behavior.

While this study was a major improvement in modelling the dynamics of wealth transfer and taxation, it suffered from a number of methodological problems. Currently, we are initiating another estate-income collation study. For this study, we will select a sample of estate tax returns for 1982 decedents, and match individual income tax return data (Form 1040) for decedents (for two years prior to death) and beneficiaries (for one preceding year and three years after the year of death). Furthermore, gift tax returns (Forms 709), reflecting transfers of the decedents occurring within two years of death, and fiduciary income tax returns (Forms 1041), reflecting transfers to trusts taking effect at time of death, will also be linked to the primary estate.

Through this procedure, it will be possible to follow the transfer of ownership of large wealthholdings between generations. It has been said that estate taxation borders on a voluntary tax since the opportunities for avoidance are readily available, and the incentives to do so increase with increases in the size of wealthholdings [2]. Further work on the estate-income collation studies will test this hypothesis.

A commitment is being made in the Statistics of Income Division to employ efficient techniques to address the complex problems of wealth taxation. Although some of this work is relatively new, we believe that the approaches we are pursuing will produce data that will permit the examination of some aspects of the Internal Revenue Code which, until recently, could not be addressed.

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The data in this paper are estimates based on a random, stratified sample of Forms 5227, Return of Nonexempt Charitable or Split-interest Trust Treated as a Private Foundation. All returns were selected before audit.

A. Sample Selection and Method of Estimation

Nonexempt trust returns processed during 1980 were computer stratified based on the size of total book value of assets. Within each sample stratum, returns were randomly selected based on a transformed value of digits in the Employer Identification Number (EIN). The sampling rates increased with increasing asset size and varied from 2 to 100 percent. All returns with $1 million or more in assets were in the 100 percent portion of the sample.

A summary of data on the population, sample, and method of estimation is provided in Figure 5. The 16,564 returns processed in 1980 (column (1)) were sampled, and a total of 2,562 returns were selected (column (2)). This sample included duplicate returns (column (3)), prior year returns of selected entities (column (5)), and amended returns (column (6)). A total of 35 duplicate returns were excluded from the file, and weighting factors were derived by dividing the number of returns processed for each stratum by the sample count (column (4)), which consists of the sampled returns less identical returns for that stratum. The weighting factors (column (8)) were applied to the accepted records (column (7)), which consist of the sample counts less the prior year duplicate entity returns and amended returns for each stratum.

B. Response and Other Nonsampling Errors

Various checks were imposed to improve the quality of the information taken from the returns in the sample. During statistical editing, editors were instructed to correct tax return errors whenever possible through reference to the actual return form and accompanying schedules. The quality of editing was controlled by means of a continuous subsampling verification system, and the Statistics of Income Division independently reprocessed a small sample of returns to evaluate the quality of the editing after verification to determine adherence to the processing instructions.

All records in the sample were subjected to a series of 86 tests to determine their internal consistency, balance, and completeness. If a record failed any of these tests, it was printed in its entirety on an error register. The type and incidence of the errors were evaluated, and corrections were applied either automatically by computer, or by clerical or professional review, depending on the nature of the error. Finally, all tabular material was reviewed for accuracy and reasonableness in light of provision of the tax laws, taxpayer reporting variations and limitations, economic conditions, and comparability with other statistical information.

Figure 5.--Returns Processed, Sample Counts, Accepted Records, Weight Determination, and Number of Trusts in the 1979 Nonexempt Trust Study

Size of total assets	Returns processed in 1980 (1)	Sampled returns (2)	Duplicate returns (3)	Sample counts (4)	Prior year duplicate returns (5)	Amended returns (6)	Accepted records (7)	Weight (8)	Number of trusts (9)
Total	16,564	2,562	35	2,527	120	5	2,402	--	15,846
Under $25,000	6,061	144	--	144	2	--	142	42.09	5,911
$25,000 under $100,000	4,652	731	13	718	47	2	669	6.46	4358
$100,000 under $500,000	4,483	890	12	878	40	2	836	5.09	4,281
$500,000 under $1,000,000	791	220	1	219	12	--	207	3.61	752
$1,000,000 or more	577	577	9	568	19	1	548	1.00	544

SOURCE: Unpublished tabulations from the 1979 IRS Statistics of Income Nonexempt Charitable and Split-interest Trust Study. Detail may not add due to rounding.

Table 1.--The Percentage Composition of Nonexempt Trust Assets by Size of Assets for Tax Year 1979

Item	Total	Size of total assets					
		Under $25,000	$25,000 under $100,000	$100,000 under $500,000	$500,000 under $1,000,000	$1,000,000 under $10,000,000	$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Number of charitable trusts:	2,103	679	496	628	154	134	11
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Corporate stock	39.1	5.3	19.6	30.8	33.8	38.2	48.3
Corporate bonds	19.2	6.7	18.1	17.4	19.2	18.5	20.9
Government obligations	8.8	17.8	10.1	9.7	5.1	12.9	5.4
Cash	5.2	6.5	5.8	2.9	6.6	4.6	6.2
Accounts and notes	1.4	--	0.1	0.2	2.4	1.9	1.2
Land	1.6	--	--	1.9	5.4	0.9	1.0
Net depreciable assets	2.7	--	--	0.2	2.1	0.8	6.2
Other assets	21.9	63.8	46.2	36.8	25.5	22.2	10.7
Number of split-interest trusts:	13,743	5,230	3,862	3,653	598	388	11
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Corporate stock	29.7	18.8	23.3	25.3	33.5	34.9	26.3
Corporate bonds	13.9	19.0	20.0	13.4	11.6	15.4	5.7
Government obligations	17.6	8.5	14.8	14.6	19.3	22.0	12.2
Cash	4.7	5.9	8.4	4.8	3.4	3.9	6.3
Accounts and notes receivable	1.7	0.5	1.8	1.2	1.9	1.3	2.9
Land	2.5	--	2.2	2.6	3.7	2.4	0.5
Net depreciable assets	0.9	--	0.5	0.4	1.8	1.1	--
Other assets	29.3	47.3	28.9	37.8	24.8	19.0	46.1

SOURCE: Unpublished tabulations from the 1979 IRS Statistics of Income Nonexempt Charitable and Split-interest Trust Study.

Table 2.--The Percentage Composition of Nonexempt Trust Receipts by Size of Assets for Tax Year 1979

Item	Total	Size of total assets					
		Under $25,000	$25,000 under $100,000	$100,000 under $500,000	$500,000 under $1,000,000	$1,000,000 under $10,000,000	$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Number of charitable trusts:	2,103	679	496	628	154	134	11
Total receipts	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Contributions, gifts, grants	11.1	32.0	32.8	26.5	5.5	12.3	2.4
Dividends	30.2	29.2	18.5	27.4	26.4	33.9	29.7
Interest	30.9	36.2	35.8	35.8	31.7	29.6	29.5
Gross rents and royalties	4.8	--	--	2.5	20.0	2.3	4.0
Gross profit from business	0.1	--	--	0.3	0.2	--	--
Net gain from sale of assets	10.6	-33.5	9.5	2.3	10.1	14.5	10.9
Other receipts	12.3	36.1	3.4	5.1	6.2	7.3	23.4
Number of split-interest trusts	13,743	5,230	3,862	3,653	598	388	11
Total receipts	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Contributions, gifts, grants	36.9	12.6	43.9	42.6	34.0	36.7	2.2
Dividends	15.9	18.7	15.3	15.1	17.7	15.9	15.9
Interest	22.5	39.5	23.0	20.4	23.9	17.7	66.1
Gross rents and royalties	2.4	5.8	1.4	1.0	3.8	3.4	0.9
Gross profit from business	0.8	--	--	0.2	4.6	--	--
Net gain from sale of assets	16.9	21.6	11.0	16.9	12.8	21.2	3.6
Other receipts	4.6	1.7	5.3	3.7	3.2	5.1	11.3

SOURCE: Unpublished tabulations from the 1979 IRS Statistics of Income Nonexempt Charitable and Split-interest Trust Study.