

***Nutter***

# The Real Impact

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10 FAQs for Charitable Organizations and Their Donors**



# Drinking From the D.C. Firehose: 10 FAQs for Charitable Organizations and Their Donors

President Trump's second term has been marked by his administration's reliance on governance by proclamation. Instead of advocating for Congressional legislation or executive agency rulemaking that would effectuate his policy goals, Trump has leaned heavily on the issuance of executive orders to implement his agenda. He has also utilized press releases and social media statements to target specific institutions, policies, or practices that he finds reprehensible or in conflict with his administration's priorities. Although the administration's executive orders and media statements have left few groups unaffected, recent reports regarding the President's desire to revoke the tax-exempt status of certain charitable organizations have specifically put nonprofits on edge.

The frequently asked questions (FAQs) answered below are intended to help charitable organizations and their donors understand the legal force and practical impact of the administration's policy objectives or agency directives targeted at or tangentially affecting the nonprofit sector. These FAQs provide a general outline of the existing legal and regulatory framework under which charitable organizations operate and identify how the administration's actions may affect key stakeholders in the nonprofit community.

## 1. What activities qualify as "charitable" under section 501(c)(3)?

To be exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code (the "Code"), an organization must:

- i. Be "organized and operated exclusively"<sup>1</sup> for charitable purposes;
- ii. Not engage in illegal conduct; and
- iii. Not operate in violation of "established public policy."<sup>2</sup>

### Organized and Operated Exclusively for Charitable Purposes

The first requirement comes from the Code and the corresponding Treasury Regulations. Although there is no precise definition of "charitable," the Treasury Regulations provide various examples of charitable activities:<sup>3</sup>

- Relief of the poor and distressed or underprivileged;
- Advancement of religion;
- Advancement of education or science;





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- Erection or maintenance of public buildings, monuments, or works;
- Lessening the burdens of government; or
- Promotion of social welfare by organizations designed to accomplish any of the above purposes, to lessen neighborhood tensions, to eliminate prejudice and discrimination, to defend human and civil rights secured by law, or to combat community deterioration and juvenile delinquency.

## Absence of Illegal Conduct

The second requirement, that tax-exempt organizations not engage in illegal activities, comes from common law principles, various court rulings, and guidance issued by the Internal Revenue Service (the “IRS”). It is most commonly tied to charitable trust law and is perpetuated in the Treasury Regulations, as illegal activities would increase, not lessen, the burdens of government.

## Consistent with Established Public Policy

The landmark Supreme Court decision, *Bob Jones University v. United States*,<sup>4</sup> is most often cited for establishing the third requirement. In that case, the Court considered the definition of “charitable” for purposes of section 501(c)(3) of the Code in deciding whether the IRS correctly denied tax-exempt status to a university that maintained certain racially discriminatory policies. Specifically, the university, citing religious reasons, prohibited interracial dating. In siding with the IRS, the Court stated that “an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy.”<sup>5</sup>

## 2. How does a section 501(c)(3) tax-exemption get revoked?

The first step in the process of revoking a section 501(c)(3) organization’s tax exemption is that the IRS needs to undertake an audit. During an audit, the tax-exempt organization presents its case and responds to the auditor’s concerns, often through a long series of exchanges between the auditor and representatives of the organization.<sup>6</sup> If given an adverse determination, the organization can file a protest or request a conference with the IRS Office of Tax Appeals. If the final administrative decision within the Internal Revenue Service is unfavorable for the organization, it can seek a declaratory judgment from the United States Tax Court, the United States Court of Federal Claims, or the district court of the United States for the District of Columbia and appeal further the declaratory judgment, potentially all the way to the Supreme Court.

## 3. Does an executive order create law?

A lawfully issued executive order is binding on federal agencies. It is not, however, legislation that has been passed by Congress and signed by the president. As a result, an executive order can be overturned by a subsequent administration without action by Congress.

## 4. Could the current administration, through an executive order, change the definition of charitable?

Currently, no. Any changes to the Code would need to go through appropriate legislative processes, and under current law, policy, and procedures, any changes to the Treasury Regulations would need to come through an orderly administrative process at the Department of Treasury.



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## 5. Could the current administration, through an executive order, revoke an organization's tax-exempt status?

Under current law, no. As explained above, revoking an organization's tax-exempt status requires a well-defined process involving review by the IRS, subject to court review, that the organization no longer qualifies as charitable under section 501(c)(3). Further, under current law<sup>7</sup>, the executive branch is prohibited from requesting a specific IRS audit or investigation.

## 6. How may the recent executive orders affect an organization's section 501(c)(3) tax-exempt status?

As discussed above, an organization that either conducts illegal activities or operates against "fundamental public policy" is not eligible for tax exemption. The language of certain recent executive orders appear to rely on this principle in directing other federal agencies. For example, in an executive order on March 7<sup>th</sup> regarding the Public Service Loan Forgiveness ("PSLF") Program, the President directed the Secretary of Education to propose revisions to the PSLF Program to "ensure the definition of 'public service' excludes organizations that engage in activities that have a substantial illegal purpose." The executive order specifically lists the following examples of "substantial illegal purpose[s]":

- a. aiding or abetting violations of 8 U.S.C. 1325 or other federal immigration laws;
- b. supporting terrorism, including by facilitating funding to, or the operations of, cartels designated as Foreign Terrorist Organizations consistent with 8 U.S.C. 1189, or by engaging in violence for the purpose of obstructing or influencing federal government policy;
- c. child abuse, including the chemical and surgical castration or mutilation of children or the trafficking of children to so-called transgender sanctuary states for purposes of emancipation from their lawful parents, in violation of applicable law;
- d. engaging in a pattern of aiding and abetting illegal discrimination; or
- e. engaging in a pattern of violating state tort laws, including laws against trespassing, disorderly conduct, public nuisance, vandalism, and obstruction of highways.

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In an executive order on January 20<sup>th</sup>, the President referred to DEI programs as “illegal and immoral discrimination programs,” potentially paving the way to fight for a *Bob Jones*-type court decision declaring such programs to be in violation of fundamental public policy and thus threatening to revoke an organization’s tax-exempt status. The executive order cannot in and of itself make DEI programs illegal, though. Once again, executive orders do not have the power to override federal law and declare what fundamental public policy is: the Trump Administration may describe DEI programs as illegal, but that does not make them so. As of right now, a subsequent administration may easily change course with another executive order declaring DEI programs to be legal and moral.

## 7. How will the upcoming tax bill potentially impact charitable organizations?

The tax bill expected to be unveiled by Congress shortly likely will extend many of the provisions of the 2017 Tax Cuts and Jobs Act (“TCJA”), which would add an estimated \$4.6 trillion to the federal deficit over the next decade. Seeking to recoup some of this lost revenue, the Trump Administration may pursue legislation to generate tax revenue from tax-exempt organizations. Below is a sampling of proposals that have been floated.

### Endowment Tax

Currently, certain university endowments are subject to a 1.4% excise tax on the net investment income of the endowment: universities that (a) have at least 500 tuition-paying students, more than 50% of whom are located in the United States and (b) have assets with a fair market value of \$500,000 or greater per student. Several legislative proposals are under consideration, although it is unclear which, if any, have sufficient support in Congress to become law. The adoption of any one of these proposals, however, would increase the endowment tax considerably to between 10% and 21%, and some broaden the scope of charitable organizations subject to the tax.

### Eliminating Tax-Exemption for Hospitals and Credit Unions

If the tax-exempt status of hospitals and credit unions is eliminated, these organizations would be subject to federal income tax. As 501(c)(3) organizations, hospitals would lose the benefit of having donations to them be deductible.

### Eliminating Deduction for Charitable Contributions to Health Organizations

On a related note, some have suggested preventing taxpayers from deducting contributions to qualifying health organizations, even if they retain 501(c)(3) status. This provision could affect a broader range of charitable organizations than just hospitals, such as patient advocacy groups and professional medical associations.

### Eliminating Ability to Issue Tax-Exempt Bonds

The interest on state and local bonds as well as other bonds, such as private activity and Build America bonds, currently is exempt from income tax. One potential proposal is to eliminate this exemption from income tax. While this provision would raise revenue for the federal government, it would make the cost of borrowing more expensive.

## 8. How may the recent executive orders affect an organization’s grantmaking?

The answer is still unclear. There has been speculation about executive orders threatening organizations that make charitable grants abroad but, to date, we have not seen any such executive orders come to fruition. As for how recent executive orders may impact domestic grantmaking, we continue to rely on the law as it stands today. Each situation will have its own fact-specific considerations. Please contact a member of Nutter’s Nonprofit and Social Impact practice group for guidance on how your organization may be affected or steps it should consider.



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## 9. How could the above affect my charitable contribution income tax deduction?

A donor may rely on a charitable organization's 501(c)(3) status in taking an income tax deduction unless the donor is aware that the entity does not qualify. Absent actual knowledge to the contrary, a donor may rely on the organization's status as published by the IRS in [IRS Publication 78](#). In certain circumstances, such as with houses of worship, charitable organizations do not have a Determination Letter because they are not required to obtain one. In these instances, a donor or grantor also may conduct its own independent diligence by requesting a certification from the charity of its 501(c)(3) status.

## 10. How should tax-exempt organizations and donors prepare in light of these developments?

We understand that the existing and potential changes may be having a significant effect on the daily operations of, and decisions being made by, tax-exempt organizations and their donors – from grantmaking foundations to operating charities to individual donors. Making decisions in an ever-changing regulatory and legal environment is never easy or desirable. Staying informed on current developments is Step 1. We are tracking these developments and encourage you to contact our team for guidance in navigating any challenges.

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<sup>1</sup>IRC § 501(c)(3).

<sup>2</sup>*Bob Jones Univ. v. U.S.*, 461 U.S. 574 (1983).

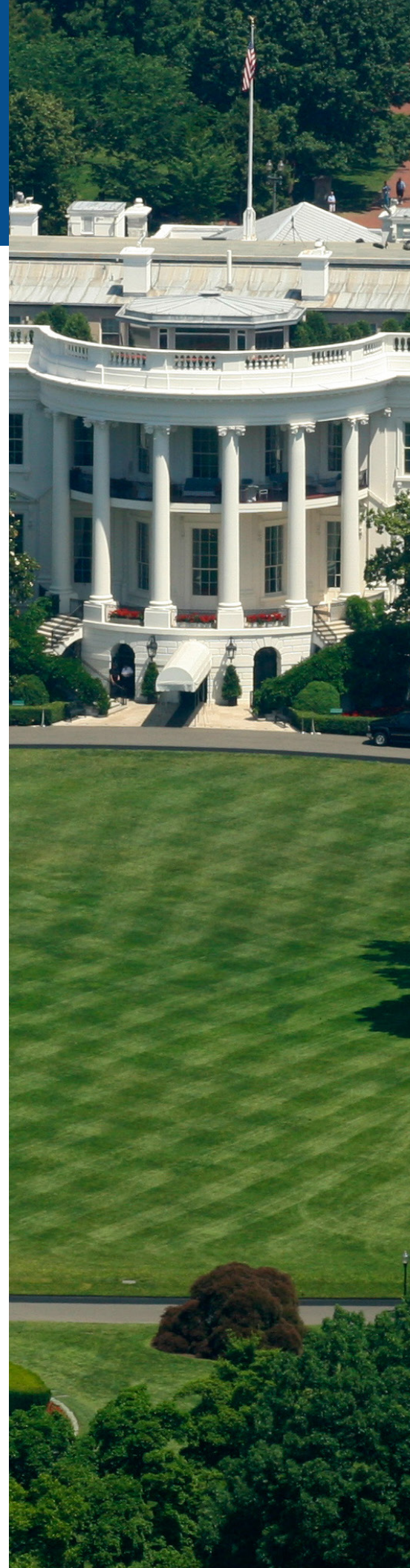
<sup>3</sup>Treas. Reg. 1.501(c)(3)-1(d)(2).

<sup>4</sup>*Bob Jones Univ. v. U.S.*, 461 U.S. 574 (1983).

<sup>5</sup>*Id.* at 586.

<sup>6</sup>This process does not apply to exemptions that are revoked for failure to file information returns for three consecutive years.

<sup>7</sup>IRC § 7217.



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## About Nutter's Nonprofit and Social Impact Practice Group

[Nutter's Nonprofit and Social Impact Practice Group](#) provides a wide range of services to nonprofit organizations, individuals, and businesses utilizing an interdisciplinary team approach that focuses on each client's specific needs. We counsel healthcare, educational, human services, religious, and cultural institutions, as well as donor advised funds, corporate and family foundations, and generations of philanthropic families. Our reach expands beyond charitable organizations to include trade associations, chambers of commerce, social welfare organizations, social clubs, and for-profit enterprises intent on developing or enhancing their philanthropic strategies.

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