Taxation of charitable organizations

Mark A. Loyd, Esq., CPA

Charitable organizations enjoy exemptions from several Kentucky taxes: income tax; sales & use tax, primarily on their purchases; and, property tax. The federal government and the Commonwealth also encourage charitable giving. Those generous individuals giving to charitable organizations, like the Educational Foundation of the Kentucky Society of CPAs, among others, get federal and state income tax deductions and can, for certain qualifying donations, also benefit from the Endow Kentucky Credit, a generous 20% income tax credit.

Income tax-exempt

Many charitable organizations are exempt from federal income tax purposes. Under the Internal Revenue Code of 1986, as amended, "[c]orporations…organized and operated exclusively for… charitable…purposes…, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation…and in which does not participate in, or intervene in,…any political campaign on behalf of (or in opposition to) any candidate for public office." 26 U.S.C. § 501(c)(3). Federally tax-exempt charitable organizations are often referred to as 501(c)(3) corporations and file Form 990 with the Internal Revenue Service.

Kentucky also provides an exemption for 501(c)(3) charitable corporations. KRS 141.040(1)(f). Likewise, "charitable, or like corporations not organized or conducted for pecuniary profit" are similarly exempt from Kentucky corporation income tax. KRS 141.040(1)(g). So, it is possible that a corporation could be subject to federal income tax under the Code, but exempt from Kentucky corporation income tax. These charitable organizations are likewise exempt from the Limited Liability Entity Tax ("LLET") under provisions that mirror those of the corporation income tax. *See* KRS 141.0401(6)(f)&(g). Moreover, any limited liability pass-through entity owned by a "qualified exempt organization," such as a charitable organization, excludes the proportionate share of its Kentucky gross receipts or gross profits attributable to that ownership interest. *See* KRS 141.0401(7). So, for example, when a non-profit owns a portion of a partnership, that portion of the partnership's Kentucky gross receipts or gross profits are excluded from its LLET computation.

Sales & Use tax-exempt

Kentucky-resident 501(c)(3) charitable organizations are exempt from sales & use tax on their sales of otherwise non-exempt, taxable tangible personal property, digital property or services, provided that these are used solely within their charitable function. KRS 139.495(1). There is a similar exemption for sales to out-of-state exempt organizations. *See* KRS 139.470(10).

There are exemptions for sales tax on sales made by charitable organizations; however, these are somewhat limited and generally school-related. *See* KRS 139.495(2)-(4). So, when a charitable organization sells things, it must register for and collect sales tax as required, like most other retailers. KRS 139.495(7). Charitable organizations should be cognizant of the distinction between acting as a purchaser and acting as a seller.

Charitable organizations selling donated goods may qualify for a 25% refund of the tax collected on its sale of donated goods if the refund is used exclusively as reimbursement for capital construction costs of additional retail locations in Kentucky. KRS 139.495(5). To qualify, the charitable organization must: routinely sell donated items; provide job training and employment to individuals with work place disadvantages and disabilities; spend at least 75% of its annual revenue on job training, job placement or other related community services; submit a refund application within 60 days after the new retail location opens for business; and provide records of capital construction costs for that location to the Kentucky Department of Revenue. *Id.* The maximum refund is $1 million and is subject to audit by Revenue. *Id.* This is a very generous credit for qualifying charities.

Property tax-exempt

Section 170 of the Kentucky Constitution, rather than a statute enacted by the Kentucky General Assembly, provides an exemption from property tax for "institutions of purely public charity." Although the Section 170 exemption's application to ad valorem property tax is settled, its application to other taxes on property has recently been disputed by Revenue. This is curious in that several cases can be read to have held that the Section 170 exemption applies to use tax on property. For example, *Marcum v. Louisville Municipal Housing Commission*, 374 S.W.2d 865 (Ky. Ct. App. 1963), held that Section 170 applied to exempt use tax on purchases of property, but not on sales tax. Similar conclusions were reached in *City of Covington v. State Tax Commission*, 77 S.W.2d 386 (Ky. Ct. App. 1934) and *Commonwealth ex rel. Luckett v. City of Elizabethtown*, 435 S.W.2d 78 (Ky. Ct. App. 1968). *Children's Psychiatric Hospital of Northern Kentucky, Inc. v. Revenue Cabinet*, 989 S.W.2d 583 (Ky. 1999) held that the Section 170 exemption did not apply to the hospital provider tax. Revenue apparently reads this case more broadly, but one could simply read *Children's Psychiatric* for the proposition that Section 170 exempts only use tax on property and not on services, which would be consistent with the case law. The dispute between Revenue and taxpayers as to the scope of Section 170 with regard to its application to taxes on property is currently playing out in *Interstate Gas*

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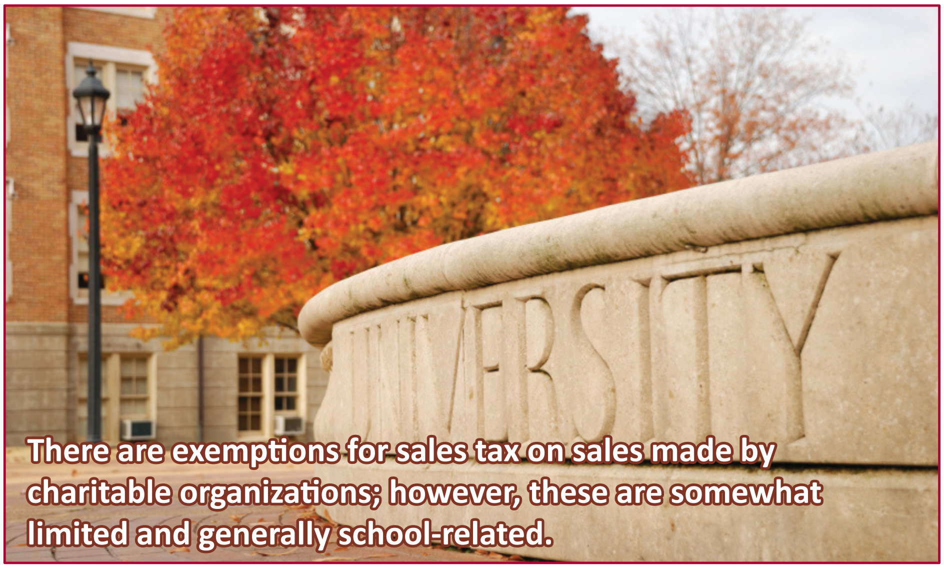

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Supply, Inc. v. Dep't of Revenue, Civil Action No. 12-CI-00947 (Franklin Cr. Ct. July 20, 2012), *on appeal from* File No. K10-R-27, Order No. K-22157 (KBTA June 20th, 2012) in which the Kentucky Board of Tax Appeals found that Section 170 did not apply to use tax on purchases of natural gas by an institution of purely public charity.

Often, it is readily apparent whether or not a charitable organization is an institute of purely public charity, especially in the case of 501(c)(3)s. However, on occasion, this becomes an issue. An example of this is *Cleveland Frost Post No. 50 American Legion v. Madison Co. Property Valuation Administrator*, File No. K12-S-01, Order No. K-23032 (KBTA Mar. 27, 2013), in which the Board determined that the dispensing of charity was the "central purpose of this small Post's program and that Post members spend most of their time carrying out charity work on behalf of the Post." The determination as to whether an organization is an institution of purely public charity is generally a fact-specific determination.

Tax incentives for charitable giving

Most tax practitioners are familiar with the federal income tax deduction for charitable contributions, cash or property and limitations thereof provided by Section 170 of the Code. Kentucky likewise extends this treatment of charitable deductions to individuals and corporations. *See* KRS 141.010(11)&(13).

Kentucky goes one step further, however, and provides for a non-refundable 20% credit of the value of an endowment gift, capped at $10,000, which is called the "Endow Kentucky Credit." *See* KRS 141.438. The maximum amount of Endow Kentucky Credits is limited to $500,000 in each fiscal year. *Id.* To obtain a credit, taxpayer must: file an application for preliminary authorization; after receiving such authorization from the Kentucky Department of Revenue, provide an endowment gift to a qualified certified community foundation, certified county-specific component fund, or certified affiliate community foundation within 30 days; and, report proof of the endowment gift to Revenue within 10 days. *Id.*

This is a generous incentive for charitable giving, as it stretches the charitable dollar significantly, particularly when combined with the federal and state income tax deductions.

"Render therefore to Caesar the things that are Caesar's, and to God the things that are God's." Matthew 22:21.

There are secular charities, and there are those that are not; but, all do good works. By providing tax exemptions, the United States and the Commonwealth of Kentucky have increased the money that charitable organizations have to spend on such good works. And, by providing deductions and credits, they have increased the money available to their citizens to give to fund them. Charitable organizations and donors should keep these tax incentives in mind so that they render unto "Caesar" only that which "Caesar" seeks, and thus, good works get funded as "Caesar" intended.

About the author: Mark A. Loyd, Esq., CPA, is a member of Bingham Greenebaum Doll in Louisville and chairs its tax and finance practice group. He is co-chair of the KyCPA Educational Foundation Trustees and chairs the Society's Editorial Board. He can be reached at MLoyd@bgdlegal.com; 502.587.3552.