

G. FOREIGN INCOME OF DOMESTIC EXEMPT ORGANIZATIONS

Domestic exempt organizations may receive income from investments and operations in foreign countries and U.S. possessions. For the most part, the treatment of such income is no different from the treatment afforded income from domestic assets. The fact that the income was derived from a foreign source generally has no significance for most provisions of the Internal Revenue Code dealing with exempt organizations. However, some complications may arise when the organization has paid taxes to a foreign government on its foreign income.

Under IRC 515, any exempt organization is allowed to take a dollar for dollar tax credit against its unrelated business income tax for certain foreign (or U.S. possession) taxes paid. The rules and limitations of the foreign tax credit are found in IRC 901 *et seq.* The tax credit is optional with the organization; an election to take the credit does not have to be made. The credit can be claimed only against the taxes imposed by Chapter 1 of the Code.

Not all foreign taxes paid may be taken as a credit. The IRC 901 foreign tax credit applies only to foreign income taxes, war profits taxes, and excess profit taxes, or to foreign taxes that are imposed in lieu of such taxes. Thus, no tax credit can be taken for a real property tax or a sales tax imposed by a foreign government.

An election to take a foreign tax credit under IRC 901 may have certain drawbacks. First, if the election is made to any extent, it will apply to all income, war profits, or excess profits taxes of all foreign countries and U.S. possessions for that year, and no portion of these taxes can be taken as a deduction in computing the organization's unrelated business income tax or, in the case of a private foundation, in computing its net investment income for purposes of the excise tax of IRC 4940. Reg. 1.901-1(c). Also, the foreign tax credit can be no greater than the percentage of the organization's total U.S. unrelated business income tax that the organization's foreign unrelated taxable income represents to its total unrelated taxable income. IRC 515 and 904(a). Thus, an organization that has a foreign unrelated business income that is 10% of its total unrelated business income on its Form 990-T, can take a foreign tax credit of no more than 10% of its tax liability on Form 990-T.

1. Income Derived from Exempt Activities

An exempt organization that derives income from activities directly related to its exempt purpose in foreign countries is not taxed on that income under the Internal Revenue Code. However, the tax laws of a foreign country might require tax payments that U.S. law does not require. If the income derived from the organization's exempt activities is taxed, and the foreign tax is an income, war profits, or excess profits tax, then the exempt organization may elect to take the foreign tax credit under IRC 901 against any unrelated business income tax it may have for that year on Form 990-T, subject to the limitations of IRC 901.

2. Unrelated Business Income

The unrelated business income (and the applicable tax) of an exempt organization from both foreign and domestic sources is determined under the provisions of IRC 511 through IRC 515, and is reported on Form 990-T. The expenses allocable to the receipt of unrelated business taxable income (including taxes paid) are taken as a deduction against unrelated business gross income.

In performing the allocation, those expenses allocable to income that is not unrelated business taxable income cannot be taken as deductions in arriving at unrelated business taxable income. Thus, except for special rules applicable to IRC 501(c)(7) and IRC 501(c)(9) organizations, expenses allocable to the receipt of dividends, interest, royalties, and rents are not reported on Form 990-T.

Unless a tax credit is claimed under IRC 901, the above allocation is used when foreign taxes have been paid. Those foreign taxes allocable to income that is taxable under IRC 511 are deducted from unrelated business gross income on Form 990-T. Even if a foreign tax credit is claimed, those foreign taxes that are not income, war profits, or excess profits taxes are subject to the same rules of allocation and deduction discussed above.

When a foreign tax credit is elected, foreign income taxes, war profits taxes, and excess profits taxes (or taxes imposed in lieu of these) cannot be deducted from gross income on Form 990-T. The amount of the tax is instead taken as a tax credit on that form to the extent allowed by IRC 901.

3. Investment Income

Dividends, interest, rents, royalties, and payments with respect to securities loans that are not taxed under IRC 511, and are not income derived from exempt activities, are taxable to all domestic private foundations except exempt operating

foundations (EOF's) under IRC 4940. The tax is 2% of net investment income (or 1%, if the provisions of new IRC 4940(e) are applicable). In computing net investment income, the amount of those foreign taxes paid that is allocable to the receipt of dividends, interest, rents, or other investment income not taxed under IRC 511, and that is not allocable to income derived from exempt activities, is taken as a deduction against gross investment income.

The IRC 901 foreign tax credit is not applicable to the IRC 4940 excise tax since it is not a tax imposed by Chapter 1 of the Code. Thus, a foundation cannot use foreign income, war profits, or excess profits taxes paid on its income derived from exempt activities, or on its unrelated business taxable income, to reduce its liability under IRC 4940. It may, however, use such of these taxes as are allocable to its gross investment income as a deduction in arriving at IRC 4940 net investment income, but only if it does not elect to apply the foreign tax credit under IRC 901 on its 990-T. If the foreign tax credit is taken, the foreign income, war profits, or excess profits taxes cannot be used as a deduction for purposes of IRC 4940, but will instead be taken as a credit against the unrelated business income tax on Form 990-T.

This is relevant also to the investment income of public charities. To the extent that a foreign government applies an income, war profits, or excess profits tax to the investment income of any domestic exempt organization, the IRC 901 credit may, at the option of the organization, be applied against the unrelated business income tax, if any, of the organization.

4. IRC 4942 Implications

A private operating foundation is required under IRC 4942(j)(3) to make qualifying distributions directly for the active conduct of its exempt activities in an amount equal to substantially all of the lesser of its adjusted net income or its minimum investment return. In computing its adjusted net income, as defined in IRC 4942(f), the amount of foreign taxes paid on its gross income would be deductible. Again, however, if an IRC 901 tax credit is taken for foreign income, war profits, or excess profits taxes, no deduction can be taken for these taxes in arriving at adjusted net income.