TAX PLANNING AND COMPLIANCE for TAX-EXEMPT ORGANIZATIONS

Rules, Checklists, Procedures

FOURTH EDITION

JODY BLAZEK

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Fourth Edition

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John Wiley & Sons, Inc.

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Dedication

To all my wonderful nonprofit clients and seminar participants,
and to my fellow CPAs and lawyers who serve nonprofits,
for asking the questions that provide fuel for this book.

About the Author

Jody Blazek is a partner in Blazek & Vetterling, LLP, a Houston CPA firm focusing on tax and financial planning for exempt organizations and the individuals who create, fund, and work with them. BV serves over 250 nonprofit organizations providing financial reports and tax compliance and planning services.

Jody began her professional career at KPMG, then Peat, Marwick, Mitchell & Co. Her concentration on exempt organizations began in 1969; she was assigned to study the Tax Reform Act that completely revamped the taxation of charities and created private foundations. From 1972 to 1981, she gained nonprofit management experience as treasurer of the Menil Interests, where she worked with John and Dominique de Menil to plan the Menil Collection, The Rothko Chapel, and other projects of the Menil Foundation. She reentered public practice in 1981 to found the firm she now serves.

She is the author of five books in the Wiley Nonprofit Series: *IRS Form 990 Tax Preparation Guide for Nonprofits* (2004), *Tax Planning and Compliance for Tax-Exempt Organizations*, and *Financial Planning for Nonprofit Organizations* (1996); and *Private Foundations: Tax Law and Compliance,* (2003), and *The Legal Answer Book for Private Foundations* (2002), both co-authored with Bruce R. Hopkins.

Jody is immediate past chair of the Tax-Exempt Organizations Resource Panel, and a member of Form 1023 and 999 Revision Task Forces for the American Institute of Certified Public Accountants, on the national editorial board of Tax Analysts' *The Exempt Organization Tax Review,* and the AICPA's *The Tax Advisor,* and the Volunteer Service Committee of the Houston Chapter of Certified Public Accountants. She is a founding director of Texas Accountants and Lawyers for the Arts and a member of the board of the Anchorage Foundations, Houston Artists Fund, and the River Pierce Foundation. She is a frequent speaker at nonprofit symposia, including AICPA Not-For-Profit Industry Conference; University of Texas Law School Nonprofit Organizations Institute; Texas, New York, and Washington State CPA Societies' Nonprofit Conferences; Institute for Board Development; and Nonprofit Resource Center's Nonprofit Legal and Accounting Institute, among others.

Blazek received her BBA from University of Texas at Austin in 1964 and took selected taxation courses at South Texas School of Law. She and her husband, David Crossley, nurture two sons, Austin and Jay Blazek Crossley.

Preface

Tax-exempt organizations comprised between 10-12 percent of the gross domestic product of the United States during the past 20 years. Revenues and assets of exempts during that period tripled according to the IRS Statistics of Income Division. The sector's size naturally brings scrutiny from Congress and others. Undoubtedly during 2003, many of you read the news articles about lavish compensation and perks provided to private foundation insiders and tracked the consequential CARE bill proposals to limit such payments. Admittedly, there may be a few who take advantage, but the vast majority of nonprofits organizations and their managers do not. This book, and its companion books on Forms 990 and 1023, are designed to aid nonprofit organizations to face any challenges and pass any tests that come their way in obtaining and maintaining tax-exempt status.

One of my goals in writing this book is to remind the nonprofit community that tax-exempt organizations really are taxpayers. Although tax privileges are afforded to organizations determined to be exempt under Internal Revenue Code (IRC) §501(c), the tax code imposes a wide variety of income and excise taxes and penalties for late filings and noncompliance when the rules are broken. As with most tax provisions, however, the rules are often gray and the impact based upon the particular facts and circumstances of the organization in question.

To compound the wealth of information necessary to comply with the rules, Congress, the courts, and the IRS have in past years reformed the rules pertaining to exempt organizations. It is amazing how new developments have expanded the girth of this book each year as the annual supplements are prepared. When you combine that fact with the accessibility of the Internet, you find this book should be fragmented. The process actually began in 2001 with the publication of the *990 Handbook*, when Chapter 27 of the third edition was spun off into a separate book. Readers will find no Chapter 27 in this edition, but by spring 2004 will find *IRS Form 990 Tax Preparation Guide for Nonprofits*, (Hoboken: Wiley, 2004) with a companion web site available with the latest IRS forms accompanied by line-by-line suggestions for completing the form.

As this book is being prepared, the IRS has redesigned the Form 1023 with a view to its completion on-line. Again a third edition chapter dear to my heart has been excised from this book in anticipation of an on-line version. Drafts of a redesigned Form1023 were posted on the IRS web site in the fall of 2003 until folks began to use and submit the yet-to-be-released-form. The approval processing required by the OMB and IRS officials are expected to be complete by the summer of 2004 when readers can look out for the reincarnation of Chapter 18 with an on-line *IRS Form 1023 Preparation Guide.*

A parallel objective of this book, now being achieved with the *IRS Form 990 Tax Preparation Guide for Nonprofits,* is to aid nonprofit organizations and their advisors to prepare the best way possible to satisfy their public disclosure requirements. If you, your clients, your board, or anybody else is questioning why a nonprofit organization should give top priority to the correct completion of Form 990, be aware that the form must be made available to anyone who asks to see it. They can also ask for a copy to take home if they are willing to pay a modest fee. For §501(c)(3) organizations, the form is also posted on the Internet at www.guidestar.org. An organization's public reporting responsibilities have a new dimension and deserve careful attention.

I applaud the IRS project to develop an electronic filing system for 990s. The intention is to eliminate the paperwork altogether and allow the agency to monitor exempts in a statistical and focused fashion. The goal, in response to a Congressional mandate, is to have about 80 percent of the Forms 990 filed electronically by the year 2007. Chapter 18 describes IRS organizational changes and summarizes the filing requirements of an exempt organization from its birth to its demise.

Part I: Qualifications of Tax-Exempt Organizations

Starting with Chapter 1, this book describes the characteristics of tax-exempt organizations and distinguishes them from for-profit organizations. Checklists designed to gauge the suitability of a project for tax-exempt status, along with other start-up tax and financial considerations, are provided—types of organizations that can qualify are compared to those that cannot. The characteristics that distinguish programs that qualify from those that do not are presented. Throughout these chapters, I try to explain the rationale underlying the distinctions.

Chapter 2 deserves study by anyone working with an organization that seeks to obtain and maintain exemption as a charity under IRC §501(c)(3). The standards for serving a charitable class, for meeting the commensurate test (devoting enough money to charitable programs), for being educational (versus action oriented), and other issues should be carefully studied. An understanding of the vague and sometimes contradictory meaning of these tests is very useful in applying the rules.

Chapters 3 through 10 provide a framework for determining an organization's qualification for exempt status. Churches, schools, civic associations, social clubs, business leagues, labor unions, and title-holding companies are compared and the particular requirements of each of the major §501(c) exemption sections are fleshed out. Lists of the revenue rulings and procedures that contain the standards and definitions applicable to the many different types of organizations within each category allow one to discern a project's qualification for exemption. Readers may be amazed by the seemingly outdated footnotes from the 1960s and 1970s, yet they still serve as the governing guidance. Between 1974 and 1990, over 400 revenue rulings concerning exempt organizations were issued; precious few were issued between 1991 and 2003. Private letter rulings (PLRs) are often the only source of IRS thinking on an issue. Even though they do not set precedent, they are discussed throughout the text because they often provide a reasonable basis for decision making.

Civic associations, unions, and business leagues operate to serve the common interests of their members, but may not function to serve the private interests of the members. Examples are provided to compare and contrast services and programs that can be conducted versus those that represent unrelated activity. Section §501(c)(4), (5), and (6) organizations must calculate the portion of the dues they spend on lobbying activities. The portion of member dues attributable to such expenditures are not tax deductible for members unless the league chooses to pay a proxy tax on such expenditures. Making this important choice involves following intricate rules found in Chapter 6. The IRS's battle to tax certain associate members dues for labor unions is chronicled in Chapter 7. The somewhat different criteria for identifying members of business leagues and the impact on revenues collected for rendering member services are reviewed and updated in Chapter 8. The somewhat different standards applied to social clubs are found in Chapter 9.

How a charitable organization can qualify for and maintain status as a public charity is presented in Chapter 11. The impact of the distinctions between public and private tax-exempt organizations is discussed, along with a presentation comparing and contrasting the various types of public charities. You will discover how the IRS distinguishes government grants treated as donations from grants considered fees for services, how a membership fee is classified, and the kinds of donations that are not counted as public support. Support organizations and the labyrinth of tests that apply to them are illustrated. Retention of public status is vitally important to those charities that seek funding from foundations and other public sources.

Part II: Standards for Private Foundations

Privately funded charities are subject to complex sanctions imposed by the Congress in 1969 when it set out to discourage the formation of private foundations and to strictly curtail their activities. Despite the absolute tone of the sanctions, many exceptions apply. The dizzying array of excise taxes, definitions, and applicability can be simplified by following the discussion, checklists, and examples in Chapters 12 through 17.

Techniques for calculating the excise tax private foundations pay on investment income are presented in Chapter 13. The self-dealing rules outlined in Chapter 14 sound absolutely draconian and essentially say no money can ever be paid to a disqualified person by a private foundation. Through the years, however, the rules have evolved as the IRS has used a very practical approach to permit transactions that benefit the foundation. Applicable exceptions are presented by type of financial transaction: sales or leases of property, loans, compensation, payments on behalf of officers and directors, and nonmonetary payments. A private foundation must make "minimum distributions," or pay out a percentage of certain assets annually, and Chapter 15 discusses which assets are included in the formula and various methods of valuation. Restraints are placed on business ownership by a private foundation with the prohibition on "excess business holdings." Chapter 16 presents the permitted holdings and disposition periods for excesses received as gifts, along with a discussion of the types of speculative investments considered to be jeopardizing for a foundation.

Chapter 17 discusses the "taxable expenditure" rules that govern the manner in which a private foundation spends its money. This chapter shows that a foundation's spending parameters are actually very broad if enhanced documentation is maintained. As long as charitable purposes are served, a private charity can conduct a breadth of activity similar to a public charity.

Part III: Obtaining and Maintaining Tax-Exempt Status

The task of communicating successfully with the IRS to achieve recognition of exempt status may be made easier by consulting Chapter 18. The requirements for seeking recognition of exemption are explored along with filing and timing issues. Who has to file which Forms 990 and why is outlined along with other important filing issues including changes in fiscal year or accounting methods, group exemptions, reporting changes in public charity status, and amended returns. The IRS process for examination of returns, along with suggestions for achieving a good answer can be found. The various reasons why an exempt organization might report back to or might hear from the IRS subsequent to initial qualification for exempt status are outlined.

It has been my experience that the IRS EO Branch is staffed with folks who mirror those working in the nonprofit community. They view their job as facilitating projects of publicly spirited citizens wishing to benefit society.

Marcus Owens, then-chief of the IRS EO Division, in 1997 at an ABA meeting said, "Absence of documentation is at the heart of just about every inurement and private benefit case that is pending in my division now and is a problem we constantly see with unrelated business income (UBI) cases."[1] This refrain formed the structure of the long-awaited published guidance on incentive compensation paid by hospitals reported in Chapter 4 and regulations on Intermediate Sanctions discussed in Chapter 20. Organizations that conduct activities similar to those performed by commercial companies, such as healthcare providers, consulting or referral services, and research programs, present a challenge for professionals representing them. Particularly for those entities, Marcus' words are still valid years later—the contemporaneous documentation of the process used to determine the tax-exempt purposes served by activities is crucial.

After securing initial IRS approval, annual compliance measures assure ongoing exemption and can aid in accumulating appropriate documentation of process. Chapter 19 contains checklists for use by both public and private charities and for non(c)(3) organizations. I recommend the use of these checklists for annual review of a client's local, state, and federal filing matters, evaluation of reporting and documentation requirements, and to early discovery of any troublesome activity.

To qualify for and maintain its status as a tax-exempt organization, one must operate to benefit one's exempt constituency, not one's creators, directors, or other self-interested persons. Chapter 20 defines impermissible private inurement or benefit. The application of these tax doctrines is discussed with an explanation of how the rules apply to different types of financial transactions. Yes, a salary can be paid to a member of the board of directors, but only to the extent such compensation is reasonable. Factors that determine when other finan-

[1] Remarks at a meeting of the American Bar Association Exempt Organization Committee, May 9, 1997.

cial transactions—loans, asset sales and purchases, or joint ventures, for example—are appropriate are outlined. Factors to consider in a conversion of a for-profit organization into a nonprofit and vice versa and other financial arrangements are discussed. The Intermediate Sanction rules, applicable to public charities and civic associations, that can cause a manager to repay that portion of his or her salary deemed to represent "excess benefits" are presented.

As a source of funding, many exempt organizations charge for services they provide or goods they produce—students pay tuition and opera goers pay admission. Tax-exempt organizations are not necessarily prohibited from conducting such income-producing activity, particularly if the revenue stems from an activity that accomplishes its exempt purposes. When an activity is unrelated to the mission, however, income tax may be due on the profits. A commerciality test is applied to decide when the level of income-producing activity is similar to a commercial business indicating the organization's underlying exempt status could be challenged. Chapter 21 describes the unrelated business income tax and its endless exceptions and modifications. The convoluted nature of the relevant code sections and the number of conflicting guidelines behoove organizations and their advisors to continually seek up-to-date information on this subject and to pay attention to potential new legislation on the subject of UBI. The small business lobby continues to make suggestions in this regard, as when they asked for enhanced requirements for travel tours. Exclusive marketing agreements and management service agreements are also the subject of recent IRS initiatives.

Creation of an affiliated organization of another exemption category, spin-off of an activity into a for-profit subsidiary organization, hiring a manager under a profit-sharing agreement, and forming a joint venture with a business organization are astute survival methods an organization might need to take in today's economic climate. These important options are available to exempts seeking enhanced efficiency and economies of scale. Forms 990 now request "Information Regarding Transfers, Transactions, and Relationships with Other Organizations" to enable the IRS to scrutinize such relationships. Chapter 22 addresses the issues involved when a tax-exempt organization has such relationships and helps understand why the form asks questions.

To accomplish their goals, many nonprofit organizations engage in lobbying or otherwise attempt to influence the making of laws. Participation in the election of the lawmakers—political intervention—is allowed for certain types of exempt organizations and strictly prohibited for others. The restraints on lobbying and electioneering are discussed in Chapter 23 and must be carefully studied before an organization contemplates such actions. Charitable organizations other than private foundations can spend an insubstantial part of their resources on attempts to influence elected officials to change the laws of the land. Permissible amount of such a lobbying effort is, however, limited by one of two very different tests. The pros and cons of making the IRC §501(h) election and the fate of an organization whose purposes can only be accomplished through the passage of legislation (cannot qualify for charitable exemption) must be studied.

Back in 1988, the IRS conducted an Exempt Organization Charitable Solicitations Compliance Improvement Program that emphasized the fact that the tax deduction for a donation to charity needed to be reduced by the value of any goods and services received by the donor in connection with the gift. First the IRS examined fund-raising programs in which premiums, free admissions, dinners, raffles, and other benefits were used to entice donors. Once the list of such events was compiled from the charity's records, the IRS examined the donors to find out whether the tax deduction was overstated. The results were poor. The Congress eventually enacted strict disclosure requirements that cause charities to value and report benefits provided to those who sponsor them and support charitable events. The now familiar substantiation requirements and suggestions for their implementation can be found in Chapter 24.

Prior to the 1990s, IRS exempt organization examiners did not review payroll tax matters. When they began to look, the results of their examinations caused concern; they found too many employees classified as independent contractors. Millions of dollars of taxes were assessed when the IRS examined colleges and hospitals during the 1990s. For any size organization, payroll tax and associated employee benefit costs represent a significant cost and thus provide a significant temptation to treat workers as non-employees. Chapter 25 outlines the issues and reporting requirements on this important issue.

Significant organizational changes, such as a merger or other combination with another nonprofit, bankruptcy, or termination, are not anticipated in the heyday of an organization's formation and plenty and are uncommon for most tax-exempt organizations. Nevertheless, such changes may be necessary—the unthinkable does happen. Chapter 26 reviews the tax consequences and filing requirements during such life changes for an exempt organization and considers the consequences, both on the organization and its contributors, when an EO loses its exempt status.

I hope readers will find this new edition and its companions useful in working with nonprofits throughout their tax-exempt life. I welcome this opportunity to contribute to our great nonprofit sector.

JODY BLAZEK
Houston, Texas
February 1, 2004

Acknowledgments

The response to the third edition of this book was positive and encouraging; I am grateful for the opportunity to comprehensively update and to consider many issues in more depth. In 1969, when KPGM assigned me the task of studying, interpreting, and communicating the new private foundation rules to our Houston clients, I began a search for information to interpret the nonprofit organization tax laws and procedures and often found it lacking. This book represents a compendium of checklists, client memoranda, and interpretive materials developed over the years to provide guideposts for compliance and tax planning for exempt organizations.

My experience has been enriched by a myriad of wonderful people with ideas for improving the human condition and saving the earth. The wealth of altruism and kindness shared by benefactors and volunteers in the nonprofit community is an inspiration. From the vantage of the funder who wants to create a private foundation, the healer who senses the ability to cure a disease, and the artist who wants to paint a public mural, among many others, I have had the privilege of responding to a mandate to figure out the best financial and tax mode in which to establish an entity that can accomplish those goals. My years as a KPGM tax specialist under the able tutelage of John Herzfeld and Lloyd Jard taught me that tax rules are not black and white; answers are complex and often gray. Achieving the best tax answer requires an exacting search, an ability to weigh alternatives, and the willingness to defend your choice.

As treasurer and chief financial officer of the Menil Foundation and The Rothko Chapel—the Houston based charitable ventures of Dominique and John de Menil—I had a unique hands-on opportunity to manage nonprofit organizations. Returning to public practice in 1981, I continued my commitment to nonprofit organizations and started an accounting firm that focuses on exempt organizations and the people who work with and create them. In the early eighties, a group of professionals created the Texas Accountants and Lawyers for the Arts. Our purpose was to improve the technical expertise and expand the body of law applicable to nonprofit organizations. With this goal in mind, seminars were organized and technical issues researched and reported. Since that time, the number of trained and willing volunteers with TALA and other pro-bono organizations has multiplied many times. This book is partly a result of the questions asked as I teach continuing education seminars. It is intended to be a practical guide to establishing and maintaining tax-exempt status for nonprofit organizations.

I also acknowledge the people who played an instrumental role in making this book possible. Bruce Hopkins, my co-author and the Wiley Nonprofit Series editor, in 1988, found merit in materials I proposed for the first edition of this book. Susan McDermott, my current editor, pushed me to prepare this fourth edition and provided encouragement and invaluable assistance. Rose Sullivan performed miracles in overseeing the production, and Ginny Carroll combed through the maze of checklists, exhibits, and appendices, greatly facilitating the process. Thanks to you all.

On a professional level, I am particularly indebted to my colleagues at Blazek & Vetterling who with me serve our more than 250 nonprofit clients. The countless questions our clients and other professionals present to us provide the fuel for materials considered and I thank them as well. Since 2001, I have had the enriching experience of serving as an advisor to Foundation Source. Working with their Sr. Vice President for Legal Affairs, Jeff Haskell, I have been confronted with a wonderful array of private foundation questions. Assisting them to develop policies and procedures for an on-line administrative system for foundations has been a challenging and invaluable learning experience.

Lastly, I am forever indebted to my husband, my sons, my friends, and my clients for their patience and support while I devoted time to this project.

Contents

Because of the rapidly changing nature of information in this field, this product may be updated with annual supplements or with future editions. Please call 1-877-762-2974 or email us at *subscriber@wiley.com* to receive any current update at no additional charge. We will send on approval any future supplements or new editions when they become available. If you purchased this product directly from John Wiley & Sons, Inc., we have already recorded your subscription for this update service.

Exhibits

PART ONE

Qualifications of Tax-Exempt Organizations

CHAPTER ONE

Distinguishing Characteristics of Tax-Exempt Organizations

The world of tax-exempt (or simply *exempt*) organizations includes a broad range of nonprofit institutions: churches, schools, charities, business leagues, political parties, schools, country clubs, and united giving campaigns all conducting a wide variety of pursuits intended to serve the public, or common, good. All exempt organizations (EOs) share the common attribute of being organized for the advancement of a group of persons, rather than particular individuals or businesses. Most EOs are afforded special tax and legal status precisely because of the unselfish motivation behind their formation.

The common thread running through the various types of EOs is the lack of private ownership and profit motive. A broad definition of an EO is a nonprofit entity operated without self-interest to serve a societal or group mission that pays over none of the income or profit to private individuals—its members and governing officials.

Federal and state governments view nonprofits as relieving their burdens by performing certain functions of government. Thus, many nonprofits are exempted from the levies that finance government, including income, sales, and ad valorem and other local property taxes. This special status recognizes the work they perform essentially on behalf of the government. In addition, for charitable nonprofits, labor unions, business leagues, and other types of exempt organizations the tax deductibility of dues and donations paid to them further evidences the government's willingness to forgo money in their favor. At the same time, deductibility provides a major fund-raising tool. For complex reasons, some of which are not readily apparent, all nonprofits are not equal for tax deduction purposes, and not all "donations" are deductible, as discussed in Chapter 24.

On the federal level, Internal Revenue Code (IRC) §501 exempts some 30 specific types of nonprofit organizations, plus pension plans (§401), political organizations (§527), homeowner's associations (§528), and qualified state tuition programs (§529), from income tax. Although exempt organizations are often perceived as charitable, many other types of nonprofits are classified as tax-exempt under the federal income tax code. Labor unions, business leagues, community associations, cemeteries, employee benefit societies, social clubs, and many other types of organizations are listed in IRC §501. Exhibit 1-1 contains the Internal Revenue Service (IRS) master chart listing all categories of exempt organizations and illustrates the wide variety.

For purposes of federal tax exemption, each category has its own distinct set of criteria for qualification. Chapters 2 through 10 discuss the requirements for the most common types, compare the categories, explain the attributes that distinguish them from each other, and consider instances in which they overlap. Chapter 11 presents the rather complicated rules governing the preferred type of §501(c)(3) organization—public charities. Those §501(c)(3)s unable to be treated as public because of their narrow funding sources are called *private foundations* and are subject to special sanctions, found in Chapters 12 through 17. The always challenging task of applying for recognition of tax-exempt status is considered in Chapter 18. The information submitted must draw a picture of the prospective exempt organization both in words and in numbers to enable the IRS to perceive the fashion in which it will serve exempt purposes. Suggestions for answering those questions for which the import is not readily apparent can be found in this important chapter along with filled-in forms. Chapter 19 contains annual tax compliance checklists for both charitable and noncharitable organizations. These lists are designed to be used by nonprofit managers and advisors each year to verify ongoing qualification for exempt status and satisfaction of the various filing requirements. Chapters 20 through 26 cover special issues that face a tax-exempt organization during its life—transactions with insiders, unrelated business income, relationships with other organizations and businesses, lobbying and electioneering, payroll taxes, mergers, and bankruptcy. Finally, Chapters 27 and 28 focus on a tax-exempt organization's relationship to the IRS. Suggestions for completing the various Form 990s with line-by-line comments and filled-in

Exhibit 1.1

Organization Reference Chart

Section of 1986 Code	Description of organization	General nature of activities	Application Form No.	Annual return to be filed	Contributions allowable
501(c)(1)	Corporations Organized Under Act of Congress (including Federal Credit Unions)	Instrumentalities of the United States	No Form	None	Yes, if made for exclusively public purposes
501(c)(2)	Title Holding Corporation For Exempt Organization	Holding title to property of an exempt organization	1024	990[1] or 990EZ[8]	No[2]
501(c)(3)	Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations	Activities of nature implied by description of class of organization	1023	990[1] or 990EZ[8], or 990-PF	Yes, generally
501(c)(4)	Civic Leagues, Social Welfare Organizations, and Local Associations of Employees	Promotion of community welfare; charitable, educational, or recreational	1024	990[1] or 990EZ[8]	No, generally[2,3]
501(c)(5)	Labor, Agricultural, and Horticultural Organizations	Educational or instructive, the purpose being to improve conditions of work, and to improve products and efficiency	1024	990[1] or 990EZ[8]	No[2]
501(c)(6)	Business Leagues, Chambers of Commerce, Real Estate Boards, Etc.	Improvement of business conditions of one or more lines of business	1024	990[1] or 990EZ[8]	No[2]
501(c)(7)	Social and Recreation Clubs	Pleasure, recreation, social activities	1024	990[1] or 990EZ[8]	No[2]
501(c)(8)	Fraternal Beneficiary Societies and Associations	Lodge providing for payment of life, sickness, accident, or other benefits to members	1024	990[1] or 990EZ[8]	Yes, if for certain Sec. 501(c)(3) purposes

EXHIBIT 1.1 *(CONTINUED)*

Organization Reference Chart

Section of 1986 Code	Description of organization	General nature of activities	Application Form No.	Annual return to be filed	Contributions allowable
501(c)(9)	Voluntary Employees' Beneficiary Associations	Providing for payment of life, sickness, accident, or other benefits to members	1024	990[1] or 990EZ[8]	No[2]
501(c)(10)	Domestic Fraternal Societies and Associations	Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members	1024	990[1] or 990EZ[8]	Yes, if for certain Sec. 501(c)(3) purposes
501(c)(11)	Teachers' Retirement Fund Associations	Teachers' association for payment of retirement benefits	No Form[6]	990[1] or 990EZ[8]	No[2]
501(c)(12)	Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, Etc.	Activities of a mutually beneficial nature similar to those implied by the description of class of organization	1024	990[1] or 990EZ[8]	No[2]
501(c)(13)	Cemetery Companies	Burials and incidental activities	1024	990[1] or 990EZ[8]	Yes, generally
501(c)(14)	State Chartered Credit Unions, Mutual Reserve Funds	Loans to members	No Form[6]	990[1] or 990EZ[8]	No[2]
501(c)(15)	Mutual Insurance Companies or Associations	Providing insurance to members substantially at cost	1024	990[1] or 990EZ[8]	No[2]
501(c)(16)	Cooperative Organizations to Finance Crop Operations	Financing crop operations in conjunction with activities of a marketing or purchasing association	No Form[6]	990[1] or 990EZ[8]	No[2]
501(c)(17)	Supplemental Unemployment Benefit Trusts	Provides for payment of supplemental unemployment compensation benefits	1024	990[1] or 990EZ[8]	No[2]
501(c)(18)	Employee Funded Pension Trust (created before June 25, 1959)	Payment of benefits under a pension plan funded by employees	No Form[6]	990[1] or 990EZ[8]	No[2]
501(c)(19)	Post or Organization of Past or Present Members of the Armed Forces	Activities implied by nature of organization	1024	990[1] or 990EZ[8]	No, generally[7]

Exhibit 1.1 *(continued)*

Organization Reference Chart

501(c)(21)	Black Lung Benefit Trusts	Funded by coal mine operators to satisfy their liability for disability or death due to black lung diseases	No Form[6]	990-BL	No[4]
501(c)(22)	Withdrawal Liability Payment Fund	To provide funds to meet the liability of employers withdrawing from a multi-employer pension fund	No Form[6]	990 or 990EZ[8]	No[5]
501(c)(23)	Veterans Organization (created before 1880)	To provide insurance and other benefits to veterans	No Form[6]	990 or 990EZ[8]	No, generally[7]
501(c)(25)	Title Holding Corporations or Trusts with Multiple Parents	Holding title and paying over income from property to 35 or fewer parents or beneficiaries	1024	990 or 990EZ	No
501(c)(26)	State-Sponsored Organization Providing Health Coverage for High-Risk Individuals	Provides health care coverage to high-risk individuals	No Form[6]	990[1] or 990EZ[8]	No
501(c)(27)	State-Sponsored Workers' Compensation Reinsurance Organization	Reimburses members for losses under workers' compensation acts	No Form[6]	990[1] or 990EZ[8]	No
501(d)	Religious and Apostolic Associations	Regular business activities. Communal religious community	No Form	1065[9]	No[2]
501(e)	Cooperative Hospital Service Organizations	Performs cooperative services for hospitals	1023	990[1] or 990EZ[8]	Yes
501(f)	Cooperative Service Organizations of Operating Educational Organizations	Performs collective investment services for educational organizations	1023	990[1] or 990EZ[8]	Yes
501(k)	Child Care Organization	Provides care for children	1023	990 or 990EZ[8]	Yes
501(n)	Charitable Risk Pools	Pools certain insurance risks of 501(c)(3) organizations	1023	990[1] or 990EZ[8]	Yes

EXHIBIT 1.1 *(CONTINUED)*

Organization Reference Chart

Section of 1986 Code	Description of organization	General nature of activities	Application Form No.	Annual return to be filed	Contributions allowable
521(a)	Farmers' Cooperative Associations	Cooperative marketing and purchasing for agricultural producers	1028	990-C	No
527	Political organizations	A party, committee, fund, association, etc., that directly or indirectly accepts contributions or makes expenditures for political campaigns	8871	1120-POL[10] 990 or 990EZ[8]	No

[1]For exceptions to the filing requirement, see chapter 2 and the Form instructions.

[2]An organization exempt under a Subsection of Code Sec. 501 other than (c)(3) may establish a charitable fund, contributions to which are deductible. Such a fund must itself meet the requirements of section 501(c)(3) and the related notice requirements of section 508(a).

[3]Contributions to volunteer fire companies and similar organizations are deductible, but only if made for exclusively public purposes.

[4]Deductible as a business expense to the extent allowed by Code section 192.

[5]Deductible as a business expense to the extent allowed by Code section 194A.

[6]Application is by letter to the address shown on Form 8718. A copy of the organizing document should be attached and the letter should be signed by an officer.

[7]Contributions to these organizations are deductible only if 90% or more of the organization's members are war veterans.

[8]For limits on the use of Form 990EZ, see chapter 2 and the general instructions for Form 990EZ (or Form 990).

[9]Although the organization files a partnership return, all distributions are deemed dividends. The members are not entitled to "pass-through" treatment of the organization's income or expenses.

[10]Form 1120-POL is required only if the organization has taxable income as defined in IRC 527(c).

[11]Application procedures not yet determined.

forms are provided. Section 18.3 discusses reasons why an organization might need to communicate with the IRS and the alternatives in doing so.

This introductory chapter presents the issues to consider prior to establishing an exempt organization, along with checklists to serve as a guide. An enlightening and thorough legal treatise on exempt organizations, written by the senior editor of the John Wiley & Sons Nonprofit Law, Finance, and Management Series, is *The Law of Tax-Exempt Organizations* by Bruce R. Hopkins, now in its eighth edition. It is an extremely valuable resource for in-depth historical context and explanation.

Throughout the book, and particularly in the next few chapters, readers will note revenue rulings issued mostly in the 1960s and 1970s. These citations still reflect the precedential IRS view on the particular issue involved. Their age reflects an IRS policy, started in the late 1970s due to staffing limitations, to issue private letter rulings that eventually led to almost no published rulings during the 1980s and 1990s. Instead, throughout the text, in the interest of indicating IRS current opinions on the topics, the private ruling, announcements, and information letter citations are provided. As a part of its major reorganization,[1] the IRS did begin again in 2003 to publish the few new rulings that readers will find in this volume.

1.1 DIFFERENCES BETWEEN EXEMPT AND NONEXEMPT ORGANIZATIONS

An exempt organization is distinguished from a nonexempt organization by its ownership structure, the motivation or purpose for its operations, its activities, and the sources of revenue with which it finances its operations. Exempts are commonly called nonprofit or not-for-profit organizations under state law, which leads to a certain amount of confusion. The term *nonprofit* is a contradiction in one respect. To grow and be financially successful, an exempt can and often must generate profits. It is perfectly acceptable for an exempt to accumulate funds as working capital, a building fund, or an endowment. Many pay income tax on unrelated business income they are permitted to conduct, as a modest part of their activity, to raise funding. Exempts are fascinating because they are full of such paradoxes and surprises.

Businesses do not often give away food or house the poor, but they do operate schools, hospitals, theaters, galleries, and publishing companies and conduct other activities that are also carried on by exempt organizations. The nature of the activity or business is often the same for both. One goal of this book is to provide the tools for understanding the differences between exempt and nonexempt organizations.

The requirements for nonprofit status vary from state to state, and few generalizations apply. Exempt charitable institutions are called *public benefit* corporations in some states. Business leagues and social clubs are sometimes called *mutual benefit* corporations. Rather than being organized to generate profits for owners or investors, exempt organizations instead generate resources to accomplish the purposes of their broadly based public or membership constituents.

[1] Described in Section 18.1.

(a) Choosing a Category

Do not expect the distinctions among the categories to be clear or logical. The group of exempt organizations has expanded considerably since the Tariff Act of 1894 established a single category of exempt organizations, which included charitable, religious, educational, fraternal, and certain building and loan, savings, and insurance organizations. Since then, the number of categories has expanded to include at least 30 distinct types.

As with all federal tax matters, the Internal Revenue Code expresses general concepts subject to endless interpretation. Tax rules are often gray, rather than black and white, and require careful study to reach the desired result. For example, only scholars of legislative history can explain why agricultural organizations and labor unions are coupled together. Why are agricultural groups not considered business leagues? Why are agricultural auxiliaries classified as business leagues? Why was a separate category carved out for real estate title-holding companies with multiple parents, instead of placing them in the original §501(c)(2) for single-parent organizations?

The choice of category is driven by a number of different factors that are presented in Chapters 2 through 10 along with cited examples of those that do qualify for exemption compared to those that do not. Often the choice is influenced by the desire to receive tax-deductible revenues. To receive a charitable donation, a §501(c)(3) charitable or (c)(19) veterans' group classification is required. However, the freedom to lobby is constrained by the (c)(3) category, so that the §501(c)(4) structure might be chosen instead by a charitable project that can be accomplished only through the passage of legislation, as discussed in Chapters 6 and 23.

(b) Businesslike Behavior

Ironically, in order to be financially successful, a nonprofit can operate in a businesslike fashion—efficiently and often profitably. Most of the financial management tools applied by for-profit businesses—strategic planning, investment management, responsive organizational structure, budgeting, and others—are appropriately used by an exempt. A thorough consideration of this subject can be found in my book *Financial Planning for Nonprofit Organizations.*[2]

The distinguishing characteristic of an exempt organization in this regard is the motivation for undertaking an activity that generates revenue. The fact that a nonprofit charges for the services it performs is not determinative. A school, a hospital, or any other type of exempt organization may pay all of its costs with fees paid by students, patients, and others using its facilities and services. Whether a hospital is exempt, for example, depends on whether it was created and operated to provide health care for the purpose of promoting the general public's health (see Chapter 4), not upon a deficiency of patient revenues in comparison to its expenditures.

An exempt organization can generate revenues in excess of its expenses and accumulate a reasonable amount of working capital or fund balances. It can save money to purchase a building, to expand operations, to protect itself with a reserve

[2] John Wiley & Sons, 1996, 275 pages.

for lost or reduced funding, to ensure a flow of cash to pay for continuous operations, or for any other valid reason serving its underlying exempt purposes. Many private foundations are endowed with assets that are as much as 20 times their annual expenditures since they are required to spend only 5 percent of the value of their investment assets each year, as explained in Chapter 15. There is no specific tax limitation on the amount of assets other types of exempt organizations can accumulate so long as the amount does not evidence a lack of exempt purpose, as discussed in Section 2.2 of this book. Too high a level of assets in relation to expenditures, however, can hamper an organization's fund-raising efforts. Public charities, business leagues, clubs, and other membership organizations that depend upon annual support commonly have modest asset levels in relation to their annual spending. The level of accumulated assets may also be influenced by funders that are sometimes reluctant to make grants to an exempt with significant reserve funds.

An exempt organization can also seek to borrow money from private or public lenders to finance its activities—to establish a new office or acquire an asset, for example. Basically, an exempt can operate without a profit motive and still produce a profit! It can pay salaries and employee benefits comparable to those of a nonexempt business. So long as the overall compensation is reasonable, as discussed in Chapter 20, an exempt entity can offer incentive compensation to its employees. What it normally cannot do with its net profit is distribute it as a return on capital to the persons who control the organization or other private individuals.

The focus and purpose of an exempt organization's activity are outward and unselfish, and are directed at accomplishing a public purpose. One way to think of this characteristic is as a one-way street. Much of the money received by an exempt is one-way money—donations or dues paid out of pure generosity with nothing being received or expected in return. Nonprofits also operate on a two-way street regarding selling goods and services that accomplish their exempt purpose. Such revenue activity cannot be conducted strictly with the intention of producing a return on investment. In contrast, privately owned businesses operate totally on a two-way street. Their activity is directed at selling goods and services for the purpose of reaping return for their owners' investment.

On a limited basis, an exempt is allowed to compete directly with nonexempt businesses and operate a business that does not advance exempt purposes. The Internal Revenue Code places such an exempt on the same footing as competing businesses by imposing a regular income tax on profits from such activity. If the unrelated business activity becomes too substantial, the exempt can lose its exemption. Chapter 21 considers the question of when a business activity is unrelated, describes the level of business activity allowed, and presents the myriad of exceptions and modifications that allow much of this type of income to escape taxation.

1.2 NOMENCLATURE

The complexity of this subject is illustrated by the fact that the Internal Revenue Code does not contain the word *nonprofit*—it refers only to exempt organizations. The term *nonprofit,* or *not-for-profit,* describes the type of organization created in most states and is widely used to identify tax-exempt organizations. The terms are often used interchangeably, as they are in this book.

Another factor coloring the distinctions is the language of the code. Tax rules are gray and not necessarily made clear by IRS rulings and decisions. In many cases, the terms used do not necessarily possess their dictionary definitions. To obtain exempt status, an organization applies for a determination by the Exempt Organization branch of the IRS. Form 1023 or 1024 is submitted to allow the IRS to determine whether exempt status is appropriate. If the organization plans certain activities within an initial fiscal year of at least eight months, a definitive determination is granted. When the operation is prospective, a five-year advance ruling is granted, subject to a subsequent final determination, as discussed in Chapter 18.

An exempt organization qualified under §501(c)(3) must be organized exclusively for exempt purposes within the specific terms described in the code and must operate primarily for such purposes.[3] The primary test is applied by deciding whether substantially all of the activity is exempt. "Exclusively" does not mean 100 percent, and "primarily" can mean a little more than 50 percent. The facts and circumstances are examined in each case to ascertain qualification. The regulations provide a few specific numerical tests, which are indicated in the checklists when applicable. A numerical test is most often applied to gross revenues, but it can also be applied to net profits, direct costs, contributions, and the like. In each case, the IRS examines the exact facts to determine whether exemption is in order.

1.3 OWNERSHIP AND CONTROL

Directors or trustees, as a general rule, may control and govern an exempt organization, but may not beneficially own it. Upon dissolution, a charitable exempt may not return any of its funds to its individual contributors or to controlling parties. Instead, its funds can be paid only to other charitable organizations or beneficiaries. A business league, however, can rebate an accumulated surplus to its members upon dissolution, if the accumulation of such a reserve was not a primary purpose of the league. A mutual insurance company continually reduces premiums by the profits earned on investments.

The code of conduct for directors of exempt organizations is most often found in state law defining fiduciary responsibility and embodies the duties of care, loyalty, and obedience. Those who control an exempt are expected to manage the organization in the best interest of its exempt constituents, that is, its charitable class or membership, not to benefit themselves or their families. A common question concerning exempts is whether paid staff members can serve on the organization's board of directors. Such a dual position creates a conflict of interest. To evidence that the interests of the organization rather than the conflicted person are served, paid directors should not participate in votes approving their compensation or in other financial transactions that affect them. In Texas, a director or trustee may serve in a staff capacity for compensation so long as the pay is reasonable and not in violation of his or her fiduciary responsibility. However, other states limit the circumstances under which board members may serve as staff members.

[3] See Section 2.1.

Funders sometimes impose restraints of this type. This question should be investigated under the laws of the state in which the exempt conducts its activities.

The federal tax code does not, as a general rule, prohibit the payment of compensation to private individuals, including board members and other organizational officials. IRC §501(c) does, however, for most types of exempt organizations, require that none of the profits or assets of an exempt organization inure to the benefit of private individuals. The meaning of the word *inure* is somewhat elusive and is primarily dependent upon the reasonableness and necessity for payments to insiders. Private foundations are, as a general rule, prohibited from having any financial transactions with officials. The limited circumstances under which the rule is lifted for compensation for personal services and other payments to officials associated with the conduct of a foundation's programs are discussed in Chapter 14. In 1996 Congress subjected officials of public charities and civic welfare organizations to similar penalties on the receipt of excessive compensation or other benefits called *intermediate sanctions.* The special rules that must be followed to document the appropriateness of insider payments are discussed in Chapter 20.

1.4 ROLE OF THE INTERNAL REVENUE SERVICE

The IRS giveth and taketh away an organization's tax-exempt status. Only §501(c)(3) organizations technically need IRS consent, called a *determination,* of their qualification. A (c)(3) organization is not classified as exempt until it makes its request for such status by filing Form 1023. For all other kinds of exempts, being established and operated according to the characteristics described in the tax code should be sufficient. However, most all other categories of exempts have traditionally sought IRS determination to secure proof of their status for local authorities, members, and in some cases the IRS itself, and to ensure against penalties and interest due on their income if they do not qualify. Chapter 18 explains the process by which application is made and the fact that, since issuing a controversial information letter in 2000, the IRS will not allow the filing of Form 990 unless Form 1024 is filed.

To qualify for exemption from inception, a prospective §501(c)(3) organization must file a determination application within 27 months of its creation. Later filing will result in a determination only from the date of filing, unless the IRS grants retroactive relief, which is unlikely. Careful timing in the formative stage is critical.

The Tax Exempt Organizations Division of the IRS began to reorganize itself in October 1999. The *blueprint* for the changes reflected an intention to be proactive in disseminating useful information to its exempt *customers*. Organizations are encouraged to direct their questions to a toll-free Tax Exempt Customer Service Representative line.[4] Personnel are trained to not only answer the specific questions asked but to get additional information. They offer to send publications and information about workshops and seminars on filing requirements, return preparation, and other subjects they identify the organization could benefit from knowing.

[4] As of January, 2004, the Cincinnati Taxpayer Assistance line is 1-877-829-5500.

The IRS plan addressed the fact that "Exempt Organization customers represent a very diverse segment ranging from churches and small local clubs to large national organizations." While most nonprofits file for an IRS determination of their exempt status, about three-quarters of those qualified are not required to submit annual filings because they are churches or their revenues are less than $25,000 a year.

Due to reduced funding over the years, the IRS EO Division has significantly reduced its personnel and published guidance issued to construe the rules. Chapter 18 outlines matters that bring an organization into contact with the IRS, such as changes in purpose, public status, and fiscal year and offers suggestions for successful communication with the IRS. Annual information return (Form 990, 990-PF, or 990-T) filing requirements are also outlined. These returns contain detailed financial information, lists of directors and officers and their compensation, and descriptions of activities. The returns must be made available to anyone that asks for a copy; for charitable organizations, the returns are posted on www.guidestar.org. It is extremely important that they be prepared with care. The author's web-based book, 990 HANDBOOK, contains detailed line-by-line guidelines and filled-in forms to aid in completion of these forms.

1.5 SUITABILITY AS AN EXEMPT ORGANIZATION

Before embarking on the creation of an exempt organization, some basic questions that may influence the decision to go forward should be addressed. Although certain requirements are applied precisely according to published guidelines, the rules are often ambiguous and subject to varying interpretations. The IRS determination branch is highly skilled (except for new recruits) and thorough in its evaluation of applications for exemption, and its taxpayer assisters are helpful. Nevertheless, the determination process and annual tax compliance responsibilities for exempt organizations are at best very similar to those required of profit-motivated taxpayers. The highest scrutiny applied by the IRS to exempt organizations occurs when they review Forms 1023 or 1024. In the past, they allocated a sizeable portion of their limited financial resources to the determination branch. Though not expressed, the goal seemed (and will probably continue) to be to weed out questionable organizations at their inception, since the IRS's limited resources would enable them to be examined later. Until 2004, the form and its instructions did not reveal the import of the information requested. Applicants described their plans in some detail, with projected activities and associated financial budgets, and it was up to the reviewed to interpret the worthiness of the plans.

As this edition is being prepared, a major revision of the form is under way. The goal is to streamline the process with an online form[5] beginning a series of questions of the sort outlined in the following subchapter to allow the filer to understand whether the plans will qualify. Readers should be alert for changes in this evolving process. Professional assistance from accountants and lawyers familiar with nonprofit matters can be very useful in facilitating the process. If funds are limited, a qualified volunteer can be sought. In many states, pro bono

[5] The IRS hopes to initiate this process in 2004. Go to www.irs.gov.

assistance is available through technical support centers staffed by volunteers from certified public accountant (CPA), bar, and other professional associations.

Before a prospective project is formally established, four major questions should be asked to determine whether a proposed organization is suitable for qualification for tax-exempt status and ongoing operation as a nonprofit project.

(a) Question 1 Is a new organization really necessary?

Could the project be carried out under the auspices of an existing organization? Several factors can indicate that a new organization is not necessary. If the proposed project is a short-term or one-time objective with no prospect for ongoing funding, it may not be worth the trouble to set up an independent exempt to handle it. Maybe the project can operate as a branch of an existing exempt organization. If a local branch of an organization holding a group exemption is available through a national organization, the new exempt may be formed as a member of the group, thereby avoiding the need to seek separate qualification for tax exemption.[6] If there would be a costly duplication of administrative effort, or if the cost of obtaining and maintaining independent exemption would be excessive in relation to the total budget, it makes sense to opt for another route.

(b) Question 2 Which category of exemption is appropriate?

If the proposed organization passes the first test, the category of exemption best suited to the goals and purposes of the project must be chosen. Due to the rigidity and limitations of the §501(c)(3) exemption rules, certain activities may only be suitable for other categories of exemption. The (c)(3) rules include a complete prohibition against involvement in political campaigns and limitations on legislative and grassroots lobbying, as explained in Chapter 23. For such projects, a §501(c)(4) organization may be more suitable for the purposes of the founding group.

As explained in Chapters 6 through 9, some projects can conceivably qualify for more than one category. There are garden clubs classified as charities under §501(c)(3), civic welfare societies under §501(c)(4), and social clubs under §501(c)(7). An association of businesspersons, such as a professional association or the Lions Club, most often qualifies as a business league. If the activities of the group involve educational and/or charitable efforts, (c)(3) status, rather than (c)(6) status, might be sought, or two organizations—a (c)(3) and a (c)(6)—might be formed. A breakfast group composed of representatives of many different types of businesses may not qualify as a business league under §501(c)(6), but might instead easily qualify under §501(c)(7). The tax deductibility of member dues and taxability or limitation on types of income influence the desired choice of category, as discussed for each category of exemption in Chapters 2 through 10. The creation of a nonexempt nonprofit can also be considered. When profits are expected to be minimal, the projected federal, state, and local taxes due might be less than the cost of obtaining and maintaining tax exemption.

(c) Question 3 Do expected revenue sources indicate nonprofit character?

Next, the proposed sources of revenues expected to support the project must be examined. Exempt organizations are traditionally supported by donations, mem-

[6] See Section18.1(f).

ber dues, and fees for performing exempt functions, such as admission to a museum or fees for certification of professional standing. Certain sources of revenue are not suitable for exemption. Among those sources are sales of goods produced by members and income from services rendered in competition with nonexempt businesses (for example, insurance or legal services). Too high a level of revenue from unrelated businesses, as discussed in Chapter 21, can disqualify exemption. Self-dealing and certain other insider transactions may be prohibited[7], and certain sources of support could result in the exempt organization being designated a private foundation subject to stringent operating requirements.[8]

(d) Question 4 Are creators motivated by selfish goals?

A tax-exempt organization as a rule must be established to serve persons other than its creators (though creators can participate in its affairs). This question examines the reasons why persons seek to establish the nonprofit. Do the organization's creators desire economic benefits, other than savings resulting from tax deduction of donations, from the formation or ongoing operation of the organization? Will the organization be operated to serve the self-interested purposes of its creators? If so, it is likely the project cannot qualify for tax-exempt status. The one-way-street characteristic of nonprofits is crucial to ongoing qualification for tax exemption. If the founders desire incentive compensation based on funds raised, or wish to gain from profits generated, an exempt organization may not be the appropriate form of organization. Reasonable compensation for services actually and genuinely rendered can be paid, as discussed in Chapter 20, but no private benefit to insiders or significant participants can result from the exempt's activities.

For a variety of reasons, it is sometimes desirable to convert a for-profit business into a nonprofit one. In the health and human service field, for example, funding is often available from both for-profit and nonprofit sources. An organization's direction may change or funds may become available only for tax-exempt organizations, such as for health issue research programs. When an exempt is created to take over the assets and operations of a for-profit entity, the buyout terms will be carefully scrutinized. Too high a price, ongoing payments having the appearance of dividends, and assumptions of liability that take the creators off the hook are among the issues faced in this situation, as also discussed in Chapters 4 and 20.

When a tax-exempt organization ceases to exist, its assets to be distributed on dissolution must essentially be used for the same exempt purposes for which the organization was initially granted tax exemption. Charities exempt under §501(c)(3) can distribute funds only to another (c)(3) organization or in support of a charitable project, and their charters must contain a binding dissolution clause. Assets of a charitable tax-exempt organization must be permanently dedicated to charitable purposes. Again, the one-way-street concept exemplifies the character of a tax-exempt organization. The creators must understand and intend from inception that they will gain no personal economic benefit from the organization's operations and benefits. Exhibit 1-2 can be used to review the considerations in forming a new exempt organization.

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[7] See Chapters 14 and 20.
[8] See Chapters 11–17.

EXHIBIT 1.2

Suitability for Tax-Exempt Status Checklist

A predominance of "yes" answers to the following questions indicate the proposed organization is NOT a suitable candidate for tax-exempt status or that special rules may apply. Chapter sections can be studied for more discussion of each issue.

	Yes	No
1. Is a new organization necessary, or could the project be carried out as a branch of an existing organization?		
Life of the project is short.	☐	☐
It is a one-time project with no prospect for ongoing funding.	☐	☐
Project could operate under auspices of another EO.	☐	☐
Duplication of administrative effort is too costly.	☐	☐
Cost of obtaining and maintaining independent exemption is excessive in relation to total budget (Ch. 18).	☐	☐
Group exemption is available through a national EO (Sec. 18.2(f)).	☐	☐
2. Which §501(c) category of exemption is appropriate to the goals and purposes of the project?		
The organization participates in efforts to influence elections or otherwise participate in political campaigns (Ch. 23).	☐	☐
Purposes of the organization can only be accomplished through legislative and grassroots lobbying activity (Ch. 6 and 23).	☐	☐
Activities benefit a group of business persons or a social group? (Ch. 7, 8, and 9).	☐	☐
Persons benefited by the proposed activities represent a limited group rather than a charitable class? (Sec. 2.2(a)).	☐	☐
3. Are the sources of revenue suitable for an exempt organization?		
Organization plans to sell goods produced by members indicating a cooperative (Sec. 2.2(e)).	☐	☐
A significant amount of the revenues will come from services to be rendered in competition with nonexempt businesses, such as legal services or insurance? (Sec. 21.8).	☐	☐
Over half of revenues will be from unrelated businesses operated in competition with for-profit companies? (Sec. 21. 4(b)).	☐	☐
A majority of the funding will come from a particular individual, family, or limited group of people that may require classification as a private foundation (Ch. 11–17).	☐	☐
4. Do the creators desire economic benefits from the operation of the organization?		
Transactions with related parties are anticipated (Sec. 20.1).	☐	☐
Proposed financial arrangements with creators will pay portion of revenues to insiders as rent, royalty, or interest (Sec. 20.6).	☐	☐
Creators wish to be paid incentive compensation based upon funds raised or profitability of the organization (Sec. 2.1(c) and 20.2(c)).	☐	☐
Assets will be purchased and/or debts of creators assumed (Sec. 20.6).	☐	☐
Project will operate in partnership with for-profit investors (Ch. 22).	☐	☐
Services and activities will be available to a limited group of persons or members instead of a public class? (Sec. 2.2(a) and 8.2).	☐	☐
Upon dissolution of the organization, assets can be returned to creators and/or major donors (Sec. 2.1(b)).	☐	☐

1.6 START-UP TAX AND FINANCIAL CONSIDERATIONS

A project that meets the criteria in the previous section indicating that a new nonprofit organization is suitable under the federal tax rules also has significant financial issues to consider before the nonprofit is formed. One important issue that must be thoroughly considered is organizational structure—whether to form a corporation versus a trust, how the board will be chosen, and what bylaw provisions are suitable, among others. Financial issues should be considered and quantified—projections prepared, feasibility studies conducted, and seed money sources identified. A business plan of the sort prepared by a for-profit organization to seek investment capital can be useful in the planning stage of a new nonprofit. Much of the information that is gathered for that purpose is the same as that required for completion of Form 1023 or 1024 to seek recognition of tax-exempt status. Operational plans should commence—financial management, record-keeping requirements, staffing, and other issues outlined in Exhibit 1-3.

Exhibit 1.3

Basic Tax and Financial Considerations in Starting a New Nonprofit Organization

ORGANIZATIONAL ISSUES:

- ☐ Suitability for exempt organization status (See Exhibit 1.2.)
- ☐ Form of organization/corporation, trust, or association (Sec. 1.7)
- Organizational Documents:
  - ☐ Mission statement/purpose clause (Sec. 2.1)
  - ☐ Membership or not
  - ☐ Provisions of bylaws
  - ☐ Board composition and terms for advisors
- ☐ Choose name and check availability
- Federal tax considerations
  - ☐ Qualification for tax exemptions (Ch. 2–10)
  - ☐ Amount of business activity planned (Ch. 21)
  - ☐ Transactions with creators, directors, and officers (Ch. 14 and 20)
  - ☐ Private vs. public charity (Ch. 11)

FINANCIAL CONSIDERATIONS:

- Capitalization needs
  - ☐ Future need for capital and ability to raise funds
  - ☐ Reliability of funding sources
- Financial planning systems
  - ☐ Long- and short-range financial plans (budgets)
  - ☐ Maximizing cash flow and investment income
  - ☐ Billing, collection, and bill-paying policies
- ☐ Internal control systems

RECORDKEEPING SYSTEMS:

- ☐ Primary accounting records (banking records, original invoices, and customer/ patron/client billings)
- ☐ Secondary records (cash, general, payroll, and other ledgers)
- ☐ Cash vs. accrual method
- ☐ Cost accounting systems
- ☐ Fund accounting and donor/member database software

EXHIBIT 1.3 *(CONTINUED)*

Basic Tax and Financial Considerations in Starting a New Nonprofit Organization	
Filing systems	
Paid bills in alphabetical order	☐
Permanent assets (individual files by objects or type)	☐
Establish "throwaway" date system	☐
Exempt activity records (archives)	☐
Tax compliance systems (Ch. 19)	
Application for federal identification number and exemption	☐
Complete federal tax compliance checklist	☐
State and local registration, permits, and/or taxes	☐
Employees vs. independent contractors (Ch. 25)	
Tax aspects: proper classification, withholding, and reporting requirements	☐
Personnel policies: vacation, sick leave, written contracts, and job descriptions	☐
Fringe benefits	☐
Travel and expense documentation requirements	☐

(a) Preliminary Planning

An important start-up question concerns the type of entity to be created. Founders must decide the type of organization that should be formed—corporation, trust, or association. Each structure has its benefits and drawbacks, as addressed in Section 1.7.

Future sources of funds to operate the proposed nonprofit should next be projected in the planning stage for several reasons. First and foremost, creators should evaluate the financial feasibility of their ideas. It is laudable to want to feed the poor in one's county; the question to ask at this stage is whether the group forming the program can put together enough funds to efficiently do so. Second, many categories of exempt organization have special attributes and standards measured by their sources of funding for reasons explained in the chapter pertaining to that particular type of organization. If the exempt organization wishes to be classified as a charity, for example, it is time to see whether the organization will qualify as a public charity or a private foundation. Expected donation levels must be quantified to measure public support.[9] Social clubs are subject to strict numerical limits on the amount of nonmember revenues they may receive.[10] Business leagues and labor unions, like charities, cannot generate an amount of unrelated business income that indicates the business activity is its primary function. The specific plans for the proposed organization should be tested at this point from a financial standpoint, using the basic rules for qualifying as a tax-exempt organization.[11]

Whether the organization will operate as a membership group must be decided. The term *membership* is often misunderstood and misused. Some organiza-

[9] See Chapter 11.
[10] See Chapter 9.
[11] See Chapter 8.

tions use the term *member* to designate contributors who actually have no voting rights. Under some state governance standards, a membership organization is one whose members elect the persons on the governing board. The democracy afforded by such a form of organization may or may not be desirable. A self-perpetuating board retaining control in the hands of a few persons may be appropriate, indicating that a nonmembership organization should be formed.

The rules governing the organization's future decision-making procedures are outlined in the bylaws. The answers to the following questions, among many others, are found in the bylaws: How will officers be elected? When will meetings be held, and who can call them? Who will serve as advisors? Who signs checks? What credentials will be required of board members, and what length of term will they serve? A skilled attorney can be very helpful in designing appropriate bylaws. The IRS and some states are not particularly interested in parliamentary procedures. No sample bylaws are provided in IRS Publication 557, Tax-Exempt Status for Your Organization. On the other hand, this guide prescribes very particular provisions that must be contained in an organization's articles of organization for exemption to be granted. For groups affiliated with a state or national group, model articles and bylaws may be available.

This is a good time to think about what name to bestow on the organization. A name that accurately presents the organization's purpose should be chosen. The words *fund* or *foundation* might not be suitable in a name for a nonprofit that intends to do fund-raising for operating support because the words connote that it already has resources. Similarly, the word *center* connotes a place where people gather for a variety of reasons; *institute,* a place where people meet to talk and study. The name cannot repeat or conflict with names already in use. If there is already a Center for Genetic Research chartered in the state, a newly created Center for Genetic Study may not be permitted. The availability of the chosen name can be investigated through the local and state authorities. In Texas, the office of the secretary of state can be called to check availability and to reserve a name.

(b) Financial Management

In a nutshell, to be successful a nonprofit organization should be financially managed just like a business. To be financially viable, an exempt organization needs sufficient capitalization similar to a for-profit organization—but it cannot float a stock issue. The reliability of funding sources should be evaluated to ensure sustainable spending levels. Before the final decision to establish a new organization is made, the exempt's future needs for capital and its ability to raise money must be projected.

The initial projections can be a starting point for an ongoing planning process that can improve the financial well-being for an exempt organization. Short-range budgets and long-range financial plans should be maintained and continually updated. Operating and capital budgets are recommended. Plans for maximizing yield on cash and other investment assets should be formulated. As much of the exempt organization's money as possible should be kept in interest-bearing accounts, and professional investment managers can be sought once capital reserves exceed immediate needs.

An accounting system and procedure should be established to record, report, and internally control the financial resources in accordance with generally accepted accounting principles. This system should also maximize cash flow by billing customers and collecting from contributors as quickly as possible, while at the same time delaying payment of the organization's own bills for as long as is reasonable. Guidance on this vitally important aspect of the operation of a nonprofit organization can be found in my book *Financial Planning for Nonprofit Organizations.*[12]

1.7 CHOOSING THE BEST FORM OF ORGANIZATION

The three common structural forms for a nonprofit organization are nonprofit corporation, trust, or unincorporated association. The choice of organizational form is influenced by the laws of the states in which the nonprofit will operate. Certain categories of §501 organizations are limited in their choice of form. A title-holding company, for example, must be a corporation. Some §501 categories of exemption apply to clubs, associations, leagues, and posts, and may have unique organizational structures. An experienced attorney knowledgeable about nonprofit organizations can be extremely valuable in making this choice. If the project needs to seek volunteer or pro bono assistance due to limited funds, the local bar association or accountants' society may have such a program.

Whichever form of organization is chosen, the federal tax code and regulations often have differing requirements from those of the state in which the nonprofit is established. Particularly for those seeking classification as §501(c)(3) organizations, the standards for federal exemption are very specific and commonly more stringent than those of the state. A charter that allows a nonprofit to conduct those activities permitted under local law may not necessarily qualify for federal exemption. Caution must be used in drafting a charter, as more thoroughly discussed in Chapter 2.

(a) Corporation

Corporate status is said to be the most flexible form of organization for a nonprofit and is the form of choice in most states. Many nonprofit assistance programs established by local united giving organizations and volunteer lawyer and accountant associations have developed model organizational documents that an organization can use in designing its corporate charter.

Creating a corporation as a separate entity is said to establish a corporate veil that may shield the individuals governing and operating the nonprofit from liabilities incurred by the organization, unless they are negligent or somehow remiss in their duties. Some states have adopted immunity laws augmenting protection against liability for directors and officers of nonprofits. In Texas, the Charitable Immunity and Liability Act of 1987 applies to §501(c)(3) organizations. This statute shields a charity's officers, directors, and volunteers, regardless of the form of organization, thus obviating one of the advantages in establishing a corporation.

[12] John Wiley & Sons, 1996, 275 pages.

These rules are different for the particular state(s) in which the nonprofit operates and should be carefully studied.

Though historically many nonprofit organizations had members, an exempt corporation can be formed with or without members. Unless the charter provides otherwise, members are presumed in some states. The primary role of members in this context is to elect the board of directors, who in turn govern the organization. In a privately funded organization, the members may be family representatives whose job is to retain control. The founder of a charity can be named the only member. With most public benefit corporations, members broaden the base of financial support and involve the community in the organization's activities. In such cases, there may be hundreds or thousands of individual contributors who, as a group, control the organization because they elect the directors. Mutual benefit societies, unions, clubs, and the like are usually controlled by their dues-paying members.

The other choice is to allow the board of directors to govern the organization. Closer control can be maintained by a small, self-perpetuating board that chooses its own successors. The charter may also appoint representatives of specified organizations or institutions to occupy board positions. A city arts council board might automatically have a representative of the city museum, the college art department, and the symphony orchestra, as well as an individual artist, alongside those directors elected by members. A charity seeking classification as a supporting organization must very carefully design its governing structure to satisfy one of the tests found in IRC §509(a)(3).[13]

Bylaws are adopted by a nonprofit corporation to provide rules of governance, such as the number of directors, duration of director terms, and procedures for removing them. Bylaws typically also address the frequency of meetings, notice procedures, type and duties of officers, delegation of authority to committees, and the extent of member responsibility. The manner in which the bylaws can be amended should also be covered in the bylaws. Indemnity to directors may be provided.

An advantage of the corporate form, as compared to a trust, is that its organizational documents can often be easily amended. Usually, the currently serving board has authority to make changes to both the bylaws and the charter. Though such changes may require approval and must be submitted to both the state and the IRS, they are allowed and do not customarily impact tax-exempt status. For consideration of choices to be made in seeking IRS approval, see Section 18.3 in this book. A nonprofit corporation's articles can (and normally do) allow its directors and members to mold and change its provisions as the organization evolves throughout its existence.

(b) Trust

The trust form of organization is often chosen for an individually or family-funded charitable organization. A trust created while one is living is called an *inter vivos* ("among the living") trust. A trust created by a bequest in the cre-

[13] See Section 11.6.

ator(s)' will is called a *testamentary* trust. A trust is favored by some because, unlike a corporation, a trust can be totally inflexible absent a reformation approved by a court order. A trust can be created without provisions allowing for changes in its purpose or trustees. Thus, a donor with specific wishes may prefer this potentially unalterable form for a substantial testamentary bequest. Another advantage of a trust is that some states require no registration of a charitable trust. Finally, a wholly charitable trust described in §4947(a)(1) is not necessarily required to seek recognition of its tax-exempt status although many do so to aid in fundraising.

There is sometimes an argument that a charitable trust violates the rule against perpetuities. To get around this potential obstacle, a trust instrument might contain a provision allowing the trustee(s) to convert the trust into an exempt corporation with identical purposes and organizational restraints. Conversion to a nonprofit corporation might also be allowed if the trustees find that the trust form is disadvantageous. Exempt organization immunity statutes do not apply to trusts in some states, and more stringent fiduciary standards are often imposed upon trustees than on corporate directors. As a rule, trustees are said to be more exposed to potential liability for their actions than are corporate directors. The tax rates on unrelated business income of a trust are higher than the rate applied to corporations.

(c) Unincorporated Association

The unincorporated association form of nonprofit organization is the easiest to establish and, correspondingly, to reform. To qualify for exemption, an association must have organizing instruments outlining the same basic information found in a corporate charter or trust instrument. Rules of governance must be provided, and it must have regularly chosen officers. Particularly for §501(c)(3) status, the IRS requires specific provisions in the documents prohibiting certain activities.[14] IRS procedures require that the constitution or articles of association must be signed by at least two persons.[15] There are few established statutes or guidelines to follow. National and statewide organizations and nonprofits with branches or chapters can facilitate orderly governance for their subordinates by furnishing a uniform structure document.

An unincorporated group may face substantial pitfalls. The primary concern is lack of protection from legal liability for officers and directors. Banks and creditors may be reluctant to establish business relationships without personal guarantees by the officers or directors.

(d) Limited Liability Companies

A tax-exempt organization might form a single-member limited liability company (LLC) for purposes of isolating itself from the liability associated with conducting certain activities. The check-the-box rules allow the single member to disregard such an entity as separate from itself and treat the activities of the LLC

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[14] See Section 2.1

[15] Instructions for Form 1023 issues in 1996, page 3.

as part of the parent organization. The financial activities of the LLC can be reported on the parent's own Form 990(s) rather than on a separate return. An LLC electing to be treated as a separate organization is not mentioned, but presumably would file its own return. The unanswered question is what type of return it should file.

IRS guidance has not addressed the necessity of seeking formal recognition of exemption for the LLC, disregarded or not. Conduct of activities in an LLC that is a disregarded entity has been approved. It is problematic for a charitable LLC, however, that an entity is not "treated as organization described in section 501(c)(3) unless it gives notice to the Secretary . . . that it is applying for recogni-

EXHIBIT 1.4

Comparison of Requirements and Tax Attributes for IRC §501(c)(2), (3), (4), (5), (6), and (7)

	(c)(2)	(c)(3)	(c)(4)	(c)(5)	(c)(6)	(c)(7)
Exemption application required.	Y	Y	N	N	N	N
Time limit for filing IRS application for exemption (15 months)	N	Y	N	N	N	N
Form 1023 filed.	N	Y	N	N	N	N
Form 1024 filed.	Y	N	Y	Y	Y	Y
REGARDING CHARTER/INSTRUMENT:						
Purpose clause limiting.	Y	Y	N	N	N	N
Dissolution clause required.	N	Y	N	N	N	N
Activity limitations required.	Y	Y	N	N	N	N
REGARDING PAYMENTS TO EO:						
Receive tax deductible contributions.	N	Y	N	N	N	N
Receive tax deductible business dues.	N	N	N/Y	Y/N	Y/N	Y/N
REGARDING REVENUES:						
Annualsupporttestforprivatefoundationclass.	N	Y	N	N	N	N
Membership primary income source.	N	N/Y	Y/N	Y	Y	Y
Amount of nonmember income limited.	N	N	N	N	N	Y
REGARDING UBIT:*						
Investment income exempt from UBIT unless investment indebted.	Y	Y	Y	Y	Y	N
Volunteer and donated property exceptions available for UBIT.	Y	Y	Y	Y	Y	Y
Convenience exception.	N	Y	N	N	N	N
Amount of UBI† must be limited.	N	Y	Y	N	N	Y
REGARDING ACTIVITIES:						
Can engage in political campaigns.	N	N	N/Y	Y	Y	Y
Can engage in lobbying.	N	N/Y	Y	Y	Y	Y
Lobbying activity limited.	Y	Y	N	N	N	N
Broad purposes can be pursued.	N	Y	Y	N	N	N
Private inurement/benefit prohibited.	Y	Y	Y	Y	Y	Y
Operations must primarily be exempt.	Y	Y	Y	Y	Y	Y
Can carry out active projects.	N	Y	Y	Y	Y	Y

* Unrelated business income tax.
† Unrelated business income.

tion of such status." To achieve deductibility for payments to a disregarded LLC, Form 1023 must be filed.

In reviewing applications for LLCs, an IRS representative said, "Eventually we probably will be recognizing LLCs, but for now, we are reviewing the applications." The issue is whether LLC organizational documents comply with 501(c)(3) standards.

(e) Conclusion

Once a decision has been made that a tax-exempt entity is suitable, the form of organization is chosen, and the necessary organizational requirements satisfied, the specific category of exemption can be chosen. Exhibit 1-1 lists the more than 30 types of organizations included in the Internal Revenue Code. Chapters 2 through 10 discuss the particulars of the first seven types. Exhibit 1-4 compares the filing requirements and primary characteristics of categories (c)(2) through (c)(7). Chapters 11 through 17 consider the important distinction between public and private charities and thoroughly present the special rules applicable to private foundations. Chapters 18 and 19 contain guidance about IRS filing and tax compliance issues, including comprehensive annual checklists. Chapters 20 through 26 address compliance issues in depth—private inurement, unrelated business income, lobbying and political campaign activities, employment taxes, and transformations such as mergers and bankruptcies.

CHAPTER TWO

Qualifying Under IRC §501(c)(3)

Organizations that qualify for exemption under Internal Revenue Code (IRC) §501(c)(3) include "[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively" for one of eight specific charitable purposes and that meet the four specific and absolute criteria listed below:[1]

1. It operates for religious,[2] charitable,[3] scientific,[4] testing for public safety, literary, or educational purposes,[5] or to foster national or international amateur sports competition (but only if no part of its activities involves the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;
2. No part of its net earnings inures to the benefit of any private shareholder or individual;[6]

[1] Reg. §1.501(c)(3)-1(a).
[2] The subject of Chapter 3.
[3] The subject of Chapter 4.
[4] The subject of Section 5.3.
[5] The subject of Section 5.1.
[6] The subject of Chapter 20.

3. No substantial part of its activities is carrying on propaganda or otherwise attempting to influence legislation[7] (except as otherwise provided in subsection (h)); and
4. It does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[8]

IRC §501(c)(3) organizations as a group are commonly referred to as "charitable," partly because they qualify for the charitable deduction for income, estate, and gift tax purposes. The title of IRC §170 is "Charitable, etc., *Contributions and Gifts.*" Note, however, that "charitable" is only one of the eight named types of charitable purposes listed in §501(c)(3).

Our concept of charity in the United States is very broad, including far more than giving alms to the poor—the traditional European notion. Charity is an evolving concept that has changed over the years to meet societal needs and occasionally to advance public policy thought appropriate by those currently making the laws. Private schools, for example, are allowed exempt status only if they adopt a policy prohibiting discrimination against persons on the basis of their race. The tax laws evidence an intention to encourage private sector initiatives in social programs—health care, education, and research, among many other social concerns that typically are governmental responsibilities in the rest of the developed world. Interestingly, the U.S. philanthropic model has been used by Mexico and the former satellites of the Soviet Union as they developed their tax systems during the 1990s.

Chapters 2 through 5 detail the requirements for qualifying under §501(c)(3), along with criteria for the different categories of exemption thereunder. This classification contains both the most numerous categories and the most controversial. Each category is the subject of myriad rulings and case decisions. *The Law of Tax-Exempt Organizations*[9] contains more than 150 pages about charitable organizations and contains a wealth of information beyond the scope of this book.

Although this discussion provides guideposts for determining qualification under §501(c)(3), it offers few hard-and-fast rules because the rules are broad and often vague. By far the largest body of law and written material concerning exempt organizations deals with those classified as charities. The possibilities for qualification are endless, and success lies in a thorough review of the alternatives. In a deceptively simple fashion, there are two tests for qualification for §501(c)(3) status, called the *organizational* and *operational* tests.

2.1 ORGANIZATIONAL TEST

The organizational test dictates certain rules of governance of a qualifying charitable organization and restricts its purposes and goals primarily to those eight

[7] The subject of Chapter 23.
[8] Also the subject of Chapter 23.
[9] Bruce R. Hopkins, *The Law of Tax-Exempt Organizations, Eighth Edition* (Hoboken: Wiley, 2003).

specifically listed in the statute. Language in the governing instrument empowering the organization to conduct activities (except insubstantial ones) beyond the specified purposes is not permitted.[10] The organizational documents of a private foundation must literally, or by operation of state law, prohibit violations of the special sanctions to which it is subject.[11] Assets must be permanently dedicated to §501(c)(3) exempt purposes in the organizational rules pertaining to dissolution, inurement, purpose, and prohibited activities.

(a) Charter, Constitution, or Instrument

To receive IRS approval of exempt status, an organization must be created with properly executed documents filed and approved by appropriate state officials. A formless aggregation of individuals cannot be exempt, nor can a partnership.[12] The IRS determination procedures generally assume two types of organizational documents:

1. Articles of incorporation or association or a trust instrument
2. Rules of governance under which the exempt organization is operated, usually bylaws

Bylaws alone are not an organizing document for a nonprofit corporation, but merely the internal rules and regulations of the organization. For trusts and unincorporated associations, the charter or constitution and bylaws are combined into one document. The form of organization must be a "corporation, community chest, fund, or foundation." Individuals, partnerships, and formless groups of individuals cannot qualify.[13] The language required for creation of a nonprofit corporation in some states may not include the provisions required for federal tax exemption. IRS Publication 557, Tax-Exempt Status for Your Organization, contains sample documents with language that satisfies the tests and should be consulted to ensure that proper provisions are included.[14]

A charter that is defective because it does not contain the four required components cannot be cured by the organization's bylaws. The IRS routinely requires revision of deficient articles prior to issuing a positive determination of (c)(3) exempt status. Although they allow for amendment of deficient charters during the review process, sometimes qualification is issued effective from the date of such an amendment. When the charter is complete and appropriate, exemption is granted retroactively to the original incorporation date. A defective charter is also not overcome merely because the organization's activities are actually charitable; likewise, an acceptable charter cannot overcome nonexempt activity.[15]

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[10] Reg. §1.510(c)(3)-1(b).

[11] Discussed in Section 2.1(f) and Chapters 12–17.

[12] *Exempt Organizations Handbook* (IRM 7751), §321.1.

[13] IRS Instructions to Form 1023 (those issued in 1996), at page 2; see Section 1.7 for consideration of the different forms of organization.

[14] See also 2004 Exempt Organizations Continuing Professional Education Technical Instruction Program.

[15] *Exempt Organizations Handbook* (IRM 7751), §320(2); Rev. Proc. 84-47, 1984-1 C.B. 545.

IRS policy is to require the dissolution, inurement, purpose, and political action clauses of a proposed (c)(3) exempt organization to contain the literal term "501(c)(3)." Descriptive language limiting the activity solely to charitable purposes, without specifically mentioning (c)(3), may be acceptable, but other language may not be.[16] In response to a request that the IRS verify exempt status for a 10-year-old organization, an organization with which the author is familiar was required to reform its charter to meet the specific requirements even though their original charter had been approved by the IRS upon initial determination.

The Tax Court disagreed with this policy in *Colorado State Chiropractic Society*.[17] A charitable organization, in the court's opinion, need not satisfy the organizational test solely by language in its corporate articles. Other factual evidence in addition to the charter, such as the bylaws, can be considered in determining passage of the test. Nevertheless, in the author's experience, the IRS continues to require that the language specifically limit the purposes to charitable ones and preferably using the term "501(c)(3)."

The IRS does not ordinarily question the validity of the corporate status of an organization that has satisfied the formal requirements for such status under the law governing its creation.[18] However as noted above, the minimum requirement for establishing a nonprofit organization in some states, such as Texas, is deficient by federal standards. The range of activities permitted a nonprofit corporation is commonly broader, for example, and a charter granting all powers provided under a state's nonprofit corporation act may not qualify.[19] The charter must be approved or registered with the applicable state agency, usually the secretary of state, before submission to the IRS.

Since many nonprofit organizations have similar names, it is very useful to investigate name availability before the documents are submitted to the state. Unlike a business corporation, a nonprofit may not necessarily be required to use the words "corporation," "company," or "incorporated." A trust instrument need not necessarily be registered with the state in which the nonprofit is established, but must contain the four operating rules specified in the regulations and listed at the beginning of this chapter.

(b) Dissolution Clause

Specific language in the nonprofit's charter must describe the manner in which its assets will be distributed in the event of dissolution. Assets may not be returned to contributors, directors, or any non-501(c)(3) organization or purposes.[20] It is not sufficient to say that the assets will be dedicated to "nonprofit purposes," since nonprofit purposes include activities that are broader than the eight specific (c)(3) purposes. Remaining assets at the time of dissolution must be either expended for (c)(3) purposes or given to another (c)(3) organization. To

[16] Discussed in Section 2.1(e).
[17] *Colorado State Chiropractic Society v. Commissioner*, 93 T.C. 39 (1989).
[18] *Exempt Organizations Handbook* (IRM 7751), §321.2.
[19] Gen. Coun. Memo. 39,633.
[20] Reg. §1.501(c)(3)-1(b)(4); *Church of Nature of Man v. Commissioner*, 49 T.C.M. 1393 (1985).

avoid any questions from the determination group, the tax code section should be specifically mentioned by number.

Some state statutes make these provisions automatic unless otherwise stated in the corporate charter. The IRS has a list identifying states whose dissolution clauses qualify.[21] Even so, specific mention in the charter is advisable to avert IRS challenges to the charter when the application exemption is filed.

(c) Inurement Clause

The inurement clause required in the charter must forbid distribution of any part of the organization's net earnings to its directors, officers, or trustees, or to any private individual.[22] Although IRC §503 now applies only to §501(c)(17) and (18) organizations, it is instructive to study its list of the type of insider transactions that are still essentially prohibited for §501(c)(3) organizations.[23] The five prohibited transactions listed in §503 as causes for revocation of exemption are:

1. Lending any part of its income or corpus, without receipt of adequate security and reasonable rate of interest
2. Paying any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered
3. Making any part of its services available on a preferential basis
4. Selling any substantial part of its securities or other property for less than an adequate consideration in money or money's worth
5. Engaging in any other transaction that results in a substantial diversion of its income or corpus to the EO's creator, substantial contributors, family members, or controlled corporations of such persons

In other words, a (c)(3) organization cannot use its assets to benefit its insiders. Chapter 20 defines *insiders* and considers the vague difference between private inurement and private benefit and thoroughly outlines the criteria used to evaluate transactions to identify inurement. Chapter 22 discusses a variety of business transactions and associations between one exempt organization and another and between an exempt organization and private individuals or businesses and presents the standards under which such relationships might be deemed to represent impermissible inurement.

Despite the fact that no evidence was submitted to prove the person(s) forming the Fund for Anonymous Gifts did so to derive financial benefit, the court found its true purpose was to provide investment management services to the

[21] Rev. Proc. 82-2, 1982-1 C.B. 367.
[22] Reg. §1.501(c)(3)-1(c)(2).
[23] This code section was replaced for private foundations in 1969 by the self-dealing rules discussed in Chapter 14 and for public charities in 1996 by the intermediate sanction rules discussed in Section 20.9.

donors—or to privately benefit the donors.[24] Donors were explicitly allowed to retain full control over the investment of their assets and also retained a high degree of control over how to choose grantees. The IRS argued that the fund was designed to circumvent the restrictions on private foundations and limitations on charitable deductions and was therefore not organized and operated exclusively for an exempt purpose. Approval was finally received after reformation of the organizational documents. Control of a somewhat similar nature is retained by donors to community foundations[25] and charitable funds created by investment companies evidencing the care required in the formation of a tax-exempt charitable organization.

(d) Purpose Clause

Organizational documents must limit the purposes of the exempt organization to one or more of the eight specific 501(c)(3) purposes in the following list. To qualify under §501(c)(3), an exempt organization must also operate exclusively for one of these purposes. The only permitted purposes are:

1. Religious
2. Charitable
3. Scientific
4. Testing for public safety
5. Literary
6. Educational
7. Fostering national or international amateur sports competition
8. Preventing cruelty to children or animals

Ideally, the charter will describe one or more of the eight, such as charitable, charitable and scientific, or scientific and educational, along with the qualifier "as defined in (or within the meaning of) §501(c)(3) of the Internal Revenue Code." Words having similar meaning to those in the preceding list cannot be used unless they are so qualified. The term "eleemosynary" may mean charitable but is not acceptable. "Civic welfare," although listed as a charitable pursuit in the regulations, also does not, standing alone, qualify under (c)(3) —although such words are suitable under (c)(4). Also, combining permissible with impermissible purposes is not acceptable.[26] The IRS provides the following examples:

ACCEPTABLE: "XYZ Organization is created to receive contributions and pay them over to the organizations which are described in §501(c)(3) and exempt

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[24] *Fund for Anonymous Gifts v. IRS*, No. 95-1629 (D.D.C. 1997), No. 97-5142 (D.D.Cir. April 1999, D.D.C. No. 95CV1629 (remand). Though exemption was allowed after reformation of its organizational documents, it was ultimately classified as a private foundation. See Sections 11.2 and 11.3 for discussion of support tests.

[25] See Section 11.3(c).

[26] Rev. Rul. 69-279, 1969-1 C.B. 152; Rev. Rul 69-253, 1969-1 C.B. 151.

from income taxation under §501(a)."[27] It is also acceptable "to grant scholarships to deserving junior college students residing in Gotham City."[28]

NOT ACCEPTABLE: "MD, Inc., will operate a hospital (with no stipulation that the operation be charitable.)"[29] Nor is it acceptable to state that "ABC will conduct adult education classes," without also stating that the organization is formed exclusively for educational or charitable purposes.[30]

An organization that has a substantial nonexempt purpose cannot qualify for exemption under (c)(3). Reciting detailed descriptions of the organization's purpose in its charter is not necessarily advisable. Such explanations are more suitably placed in the bylaws or mission statement. An organization's activities tend to evolve over the years and it is best to avoid the need to make formal charter changes that require approval by the state. Bylaws can normally be altered by the organization's governing body. Any changes to the organizational documents must be submitted to the IRS, either in connection with filing the annual Form 990 or by submission to the Exempt Organization Group in Cincinnati.[31]

(e) Political Activities

A charity's organizational documents must absolutely prohibit political campaign involvement with the following language:

> The organization shall not participate in, or intervene in (including the publication or distribution of statements) on behalf of or in opposition to any candidate for public office.[32]

A campaign management school organized to train individuals for professional careers in managing political races, for example, was denied exemption because it was formed to be operated to benefit the Republican Party. Most of the school's graduates were associated with Republican candidates and committees supporting them. In its application for exemption, the American Campaign Academy revealed that it was an outgrowth of a National Republican Congressional Committee project and that its funding was provided solely by the National Republican Congressional Trust. The academy argued, nevertheless, that it met all the definitions of a school and did not discriminate on the basis of political preference, race, color, or national or ethnic origins in its admission policies. The Tax Court agreed with the IRS that the facts—actual curriculum and admission applications—showed narrow partisan interests. The court found that the size of the class and number of Republican Party members did not transform the benefited class into a charitable class.[33]

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[27] Reg. §1.501(c)(3)-1(b)(1)(ii).

[28] *Exempt Organizations Handbook* (IRM 7751), §322.2.

[29] Id. §322.2.

[30] Reg. §1.501(c)(3)-1(b)(1)(ii). This regulation essentially says that conducting classes is not necessarily educational unless the articles specify that term or the term *charitable*.

[31] See Section 18.3 for discussion of circumstances and the methods in which an organization seeks overt IRS approval of such changes.

[32] Reg. §1.501(c)(3)-1(b)(3)(ii); see also Chapter 23.

[33] *American Campaign Academy v. Commissioner*, 92 T.C. 66 (1989).

Nonpartisan voter registration drives do not constitute prohibited political activity if they are truly nonpartisan.[34] The fact that all candidates in the race are given a platform to discuss universal issues, rather than issues of concern to a particular political party, evidences an educational effort. When the facts indicate that an organization is formed to engage in nonpartisan analysis, study, and research and to conduct educational programs for voters, it may qualify for exemption.[35]

Legislative lobbying must be limited by the following language: "No substantial part of the activities of the organization shall be the carrying on of propaganda, or otherwise attempting to influence legislation."[36] Note the word "substantial." A limited amount of lobbying can be conducted by a charity (except a private foundation). The permissible limits apply to both grassroots and direct lobbying efforts.[37]

(f) Private Foundations

Enhanced requirements are placed on charities classified as private foundations. A private foundation's charter, or laws of the state in which it operates, must specifically prohibit actions that would cause the imposition of excise taxes. Laws have been passed to automatically incorporate the required language into a private foundation's charter in most states, and the IRS has issued a ruling approving the list.[38] To be cautious, some counselors recommend inclusion of the prohibition against incurring excise taxes for all foundations, but they may not be necessary. A private foundation generally is a nonprofit organization qualifying for tax exemption that receives its funding from investment income and/or donations of a limited number of people, usually a family or a particular individual.[39]

(g) Limited Liability Companies

A tax-exempt organization might form a single-member limited liability company (LLC) to isolate itself from the risks associated with conducting certain activities. The LLC can choose to seek its own independent recognition of tax exemption or the single member can treat the LLC as a disregarded entity under the "check-the-box" rules.[40] When this form of organization was initially considered, the IRS was uncertain whether the LLC itself could be recognized as a charitable organization, particularly in those states that require that an LLC be formed for a business purpose. The IRS, however, announced it was willing to recognize exemption based on the LLC's representation that its charitable status is permitted under state law and that enforceable provisions are present in the

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[34] Discussed in Sections 17.2 and 23.2.
[35] See Section 23.2; Priv. Ltr. Rul. 9117001.
[36] Reg. §1.501(c)(3)-1(d)(1)(ii).
[37] These limitations are discussed in Section 23.4.
[38] Rev. Rul. 75-38, 1975-1 C.B. 161.
[39] See Chapters 11 and 12.
[40] Reg. §301.7701-1.

organizational document.[41] The 12 specific provisions required for the LLC to be separately recognized as a §501(c)(3) entity follow:

1. A specific statement must limit the LLC's activities to one or more exempt purposes.
2. The LLC must be required to operate exclusively to further the charitable purposes of its members.
3. The LLC's members must be §501(c)(3) organizations, governmental units, or wholly owned instrumentalities of a state or political subdivision thereof.
4. Any direct or indirect transfer of any membership interest in the LLC to a transferee other than a §501(c)(3) organization, governmental unit, or instrumentality must be prohibited.
5. The LLC itself, interests in the LLC (other than a membership interest), or its assets may only be availed or transferred to (whether directly or indirectly) any nonmember other than a §501(c)(3) organization, governmental unit, or instrumentality in exchange for fair market value.
6. The organizational documents must guarantee that upon dissolution of the LLC, its assets will be devoted to the LLC's charitable purposes.
7. Any amendments to the LLC's articles of organization and operating agreement must be consistent with §501(c)(3).
8. The LLC must be prohibited from merging with, or converting into, a for-profit entity.
9. The LLC may not distribute any assets to members who cease to be organizations described in §501(c)(3), governmental units, or instrumentalities thereof.
10. An acceptable contingency plan in the event that one or more members cease to be qualifying members must be provided. (Forfeiture of the nonexempt member's interest or sale of the interest to a qualifying member is allowed.)
11. The LLC's exempt members must expeditiously and vigorously enforce all of their rights in the LLC and pursue all legal and equitable remedies to protect their interests in the LLC.
12. The LLC must represent that all of its organizing document provisions are consistent with state LLC laws and are enforceable at law and in equity.

Rather than seeking separate recognition, the LLC can be treated as a disregarded entity and its tax-exempt status attributed to its parent member. In that case, the LLC financial activity is reported on the member's Form 990.[42] Without

[41] Richard A. McCray and Ward L. Thomas, *IRS Exempt Organizations Technical Instructional Program for FY 2001*, Chapter B, "Limited Liability Companies as Exempt Organizations Update," 2001 IRS CPE Text, pp. 27–33; see also Priv. Ltr. Rul. 200124022.

[42] IRS Announcement 99-102, IRB 1000-43.

separate recognition, however, the LLC is not necessarily qualified to receive tax-deductible contributions itself, but may serve as agent for donations collected on behalf of another qualified organization.[43]

2.2 OPERATIONAL TEST

To qualify under §501(c)(3), an organization must also meet an operational test. A nonprofit exempt under (c)(3) must operate exclusively to accomplish one of the eight purposes listed at Section 2.1(d) and discussed in detail in Chapters 3, 4, and 5. The term "exclusively," for this purpose, does not mean 100 percent, so some amount of nonexempt activity is permitted for all (c)(3)s, except private foundations. The words used in the statute, "operated exclusively," mean "primarily." To satisfy this test, an organization must operate to accomplish one of the eight named charitable (and public) purposes, rather than a private purpose. A qualifying organization promotes the general welfare of society rather than the private interests of its founders, those who control it (directors, trustees, or key employees), or its supporters (members or major contributors). Evidence for the operational test is found not only in the nature of the nonprofit's activities, but also in its sources of financial support, the constituency for whom it operates, and the nature of its expenditures. The presence of a single nonexempt program, if substantial in nature, will destroy the exemption regardless of the number or importance of the truly exempt purposes.[44]

The benefit to an individual participating in an exempt organization's programs is acceptable when the activity itself is considered a charitable pursuit. Examples of such benefits are the advancement a student receives from attending college and the relief from suffering experienced by a sick person. As outlined in Chapters 3, 4, and 5, the standards of permissible individual benefit are different for certain of the eight categories of charitable purpose, and the distinctions are sometimes vague. For example, promoting amateur sports competition is listed as a permitted exempt purpose, but providing recreational athletic facilities was found not to be an exempt purpose because of the benefit to the individual members of a sports club.[45] A fitness center set up as part of a medical center qualified under the theory that it promoted health.[46] Visiting a museum or attending a play is recognized as educational,[47] but attending a semiprofessional baseball game is not.[48] The Greater Kansas City Community Foundation was allowed to operate the Kansas City Royals baseball team for whatever period was necessary to sell the team to a purchaser that would agree to keep the team in Kansas City to relieve the burdens of government.[49]

[43] Reg. §1.501(c)(3)-I(d)(1)(ii).
[44] *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279 (1945).
[45] I *Media Sports League Inc. v. Commissioner*, 52 T.C.M. 1093 (1986).
[46] See Section 4.6(f).
[47] See Section 5.1(g).
[48] *Hutchinson Baseball Enterprises, Inc. v. Commissioner*, 73 T.C. 144 (1979), *aff'd* 696 F.2d 757 (10th Cir. 1982).
[49] See Section 4.3.

(a) Charitable Class

To be exempt as a charitable organization under (c)(3), an organization must operate to benefit an indefinite class of persons, referred to as a "charitable class," rather than a particular individual or a limited group of individuals. It may not be "organized or operated for the benefit of private interests such as designated individuals, the creator's family, or shareholders of the organization or persons controlled, directly or indirectly, by such private interests."[50] A trust established to benefit an impoverished retired minister and his wife, for example, cannot qualify.[51] Likewise, a fund established to raise money to finance a medical operation, rebuild a house destroyed by fire, or provide food for a particular person does not benefit a charitable class. An organization formed by merchants to relocate homeless persons ("throw the bums out") from a downtown area was found to serve the merchant class and promote their interests rather than those of the homeless or the citizens.[52] In explaining the meaning of the word *charitable*, the regulations also deem federal, state, and local governments to be a charitable class by stipulating that relieving their burdens is a form of charitable activity qualifying for §501(c)(3) exemption.[53]

A comparatively small group of individuals can be benefited as long as the group is not limited to identifiable individuals. The class need not be indigent, poor, or distressed.[54] A scholarship fund for a college fraternity that provided school tuition for deserving members was ruled to be an exempt foundation.[55] On the other hand, a trust formed to aid destitute or disabled members of a particular college class was deemed to benefit a limited class. The "general law of charity recognizes that a narrowly defined class of beneficiaries will not cause a charitable trust to fail unless the trust's purposes are so personal, private or selfish as to lack the element of public usefulness."[56] Criteria for selection of eligible beneficiaries should be specified and evidence used to choose eligible individuals—case histories, grade reports, financial information, recommendations from specialists, and the like—should be maintained.

Victims of a disaster unquestionably represent members of a charitable class. The issue is, however, the type and extent of aid that can be given to individuals by a charitable organization. A "needy and distressed" test was provided by the

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[50] Reg. §1.501(c)(3)-1(d)(1)(ii). See Chapter 20 for a detailed discussion of these private inurement rules, including the intermediate sanctions that can be applied to penalize persons receiving excess benefits.

[51] *Carrie A. Maxwell Trust, Pasadena Methodist Foundation v. Commissioner*, 2 T.C.M. 905 (1943).

[52] *Westward Ho v. Commissioner*, T.C. Memo. 1992-192.

[53] Reg. §1.501(c)(3)-1)d(2); see Section 4.3 for discussion of standards for qualifying as "Lessening the Burdens of Government." See also "How the Concept of Charity Has Evolved," a presentation for the American Bar Association Exempt Organization Committee, reprinted in the *Exempt Organization Tax Review,* March 1997, vol. 16, no. 3, pp. 403–412.

[54] C*onsumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 78-2 USTC 9468 (D.C. 1979), but see *El Paso del Aquila Elderly*, T.C. Memo., 1992.441. Making burial insurance available at cost for the elderly is a charitable activity only if distress is relieved (by allowing indigents to participate) and the community as a whole benefits.

[55] Rev. Rul. 56-403, 1956-2 C.B. 307.

[56] Gen. Coun. Memo. 39876 (July 29, 1992).

IRS as guidance to those organizations handling the outpouring of support given in response to the September 11 disaster. The criteria applied by a relief organization to objectively make distributions to individuals, financially or otherwise distressed, must be written and records maintained to support the basis on which assistance is provided.[57]

The some 9,000 current and former employees, volunteers, and families of a health care provider were found to be a sufficiently large class of beneficiaries to qualify as a charitable class. Gifts to the assistance fund created by a hospital were deductible as charitable gifts because they were not earmarked for any specific person. The contributions were not made with the expectation of individual financial benefit, but instead were voluntary gifts to provide assistance to financially needy persons suffering economic hardship due to accident, loss, or disaster.[58] On the other hand, the IRS reversed its approval of a company foundation's disaster relief program in finding that the benefit to the company in promoting a stable and loyal group of employees outweighed the charitable benefit to the employees.[59]

A genealogical society tracing the migrations to and within the United States of persons with a common name was found to qualify as a social club, not a charity. Although there was educational merit in the historical information compiled, the private interest of the family group predominated.[60] If membership in the society is open to all and its focus is educational—presenting lectures, sponsoring exhibitions, publishing a geographic area's pioneer history—an organization may be classified as charitable.[61] In contrast, a society limiting its membership to one family and compiling research data for family members individually cannot qualify.[62]

A hospital providing medical care unquestionably performs a charitable service—the promotion of the health of its patients. When a for-profit company manages the hospital, however, the interests of private investors may be found to contravene tax-exempt status.[63] To be recognized as a charity, such a hospital must show that there is not more than an insubstantial private benefit given to the investors. The hospital cannot convey "a priority right of beneficial interaction to a select and identifiable person or group."[64] Similarly, the court decided that the American Campaign Academy program to train political volunteers for the Republican Party advanced the narrow partisan interests of the party rather than its many students and party members.[65]

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[57] See Section 17.3(c).

[58] Priv. Ltr. Rul. 9316051.

[59] Priv. Ltr. Rul. 199914040 revoking Priv. Ltr. Rul. 9516047; see Section 17.3(e) for discussion of company foundation plans.

[60] *The Callaway Family Association, Inc. v. Commissioner*, 71 T.C. 340 (1978); Rev. Rul. 67-8, 1967-1 C.B. 142.

[61] Rev. Rul 80-301, 1980-2 C.B. 180.

[62] Rev. Rul. 80-302, 1980-2 C.B. 182; see also exemption letter issued to Legal Assistance for Vietnamese Asylum Seekers.

[63] See Section 4.6.

[64] Darryll K. Jones, "Some Hard Thinking and Harder Realities Concerning Joint Ventures," *The Exempt Organization Tax Review,* May 2002; see also Priv. Ltr. Rul. 200206058.

[65] *Supra* §2.1(e).

A simple way to prove that an organization operates to benefit a charitable class is for the organization to regrant its moneys only to one or more other §501(c)(3) public charitable organizations. Congress imposed such a system on private foundations in 1969 to constrain their grant-making freedom.[66] Private foundations can grant moneys to individuals and nonpublic entities for a charitable purpose, but only if they enter into a formal contractual agreement with the grant recipient or obtain IRS approval in advance for individual grant programs. Although there are no such formal rules for public charities, a similar burden to prove that grant funds reach a charitable class exists. The Internal Revenue Service inserts the following language in the determination letters of grant-making public charities:

> This determination is based upon evidence that your funds are dedicated to the purposes listed in section 501(c)(3). To assure your continued exemption, you should maintain records to show that funds are expended only for such purposes. If you distribute funds to other organizations, your records should show whether they are exempt under section 501(c)(3). In cases where the recipient organization is not exempt under section 501(c)(3), there should be evidence that the funds will remain dedicated to the required purposes and that they will be used for those purposes by the recipient.

The exempt status of the National Defense Council, Inc., was revoked because it failed to prove that its individual refugee relief payments were made to members of a charitable class. The IRS agreed to reinstate the exemption only if all payments were made directly to §501(c)(3) organizations, governmental units, or organizations that would otherwise qualify as public charities (presumably foreign relief groups such as the World Health Organization or the United Nations Relief Agency).[67] Similarly, New Faith, Inc., lost its tax-exempt status for lack of evidence that it served a charitable class.[68] The organization operated canteen-style lunch trucks and argued the food was provided to needy persons on a donation or "love offering basis." The evidence found lacking by the court included:

- There was no record of the number of persons, if any, receiving food items for free or below cost nor of the number of customers that were impoverished or needy persons.
- No tally of sales below fair market value was maintained.
- Written statements of the organization did not show that food was offered to anybody free or below cost.

A subset of this issue concerns designated funds. A charity must take responsibility and maintain dominion and control over the use of its funds. It cannot act as a conduit for funds directed to be paid to particular individual scholarships, medical emergency grants, a foreign organization, religious "deputies," or other grant recipients for which a donor is not entitled to claim a contribution deduc-

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[66] See expenditure responsibility rules described in Section 17.6.

[67] Exemption letter dated March 24, 1993.

[68] *New Faith, Inc. v. Commissioner*, TCM 47,411(M); Dec. 48,572(M) (Tax Court, 1993).

tion if the payment is made directly to the ultimate recipient.[69] Another aspect of the issue is whether the organization accepting the conduit donations can qualify as a public charity or rather as a private foundation.

Serving both charity and an individual is also not permitted. A split-interest trust paying a fixed annual percentage of its income to its creator and the balance to a named charity is not exempt.[70] Nor is a trust paying a fixed annual sum for perpetual care of the creator's cemetery lot, with the balance paid to charities.[71]

(b) Amount of Charitable Expenditures

IRC §501(c)(3) does not require a specific amount of annual expenditures by a charitable organization, although the IRS may impose a commensurate test.[72] Presumably, it is left to the contributors and supporters of an organization to require that their money be spent for worthy causes and to monitor the manner in which funds are expended. Some states have rules governing spending by nonprofit organizations to monitor particularly the level of administrative and fund-raising costs in relation to program costs.

A private foundation, partly because it is not scrutinized by public contributors, is subject to a *minimum* distribution requirement. At least 5 percent of the average annual value of its investment assets must be expended annually in making grants, conducting programs, or purchasing assets used in charitable activities.[73] A subset of this issue is the inurement test.[74] A nonprofit cannot qualify as a §501(c)(3) organization if more than an insubstantial amount of its expenditures are devoted to activities that do not advance its exempt purposes.[75]

(c) Income Accumulations

There is no prohibition per se against a (c)(3) organization accumulating revenues in excess of its expenditures. Nonetheless, a criterion applied by the IRS to measure whether an organization operates exclusively for charitable purposes is the portion of its revenues actually expended on charitable projects. Where funds are accumulated, the organization has a burden of proving to the IRS and those from whom it is seeking financial support how its charitable purposes are better served by increasing its resources.

This issue arises particularly in connection with publicly funded charities—those organizations that annually raise funds to support their programs through donations or fees charged for services rendered (often both). When fund-raising

[69] Rev. Rul. 62-113, 1962-2 CB 10 9; Peace, 43 TC 1 (1964) (support of specific missionaries), and *Davi*s, 495 U.S. 472, 65 AFTR 2d 90-1052 (these citations all involving donations to missionary organizations earmarked for particular individuals).

[70] Rev. Rul. 69-279, 1969-1 C.B. 152.

[71] Rev. Rul. 69-256, 1969-1 C.B. 151.

[72] See Section 2.2(d).

[73] See Chapter 15.

[74] See Chapter 20.

[75] Reg. §1.501(c)(3)-1(c)(1); see Tech. Adv. Memo. 9711003, where the IRS opined that the amount of money spent was not determinative but rather the scope and extent of charitable activities.

efforts are unusually successful, operations are cost efficient, or for whatever reason an organization generates revenues in excess of expenses, these questions arise: Will the excess revenues jeopardize exempt status? Can the organization save the income? Must it spend it and, if so, how soon? Some profit—excess of revenues over expenditures—can be accumulated so long as the purpose for increasing fund balances is to better advance the charitable interests of the organization over a period of time. Acceptable reasons why funds might be accumulated include:

- To maintain sufficient working capital to ensure ongoing, continuous provision of charitable services. Working capital can be saved to protect against years when income declines due to loss of grants, lower donations, reduced investment income, and other uncontrollable outside forces. The standards concerning for-profit corporation earnings accumulations can be applied. Ask how investors would view the accumulated funds. Liquid assets equal to one year's operating budget are thought by some to be a minimally reasonable amount of working capital, though some agencies may consider such an asset level too high.
- To replace obsolete equipment, to acquire a new building, or to establish a new program dedicated to charitable purposes. Saving funds until the organization can self-finance new or improvement projects may be prudent because it allows the organization to avoid indebtedness. In other instances, a sinking fund might be established to ensure the organization meets its annual obligation to pay off the mortgage on a new building.
- To establish new programs or expand services for charitable constituents when the funds required exceed current available resources. Savings to self-finance expansion can be accumulated.

Another context in which to consider this issue is the standard applicable to foundations. A private foundation is required to distribute only 5 percent of the fair market value of its investment assets each year for charitable purposes.[76] The required charitable expenditure level is determined without regard to the actual annual return on investments; a foundation that is able to earn above 5 percent on its assets may accumulate the excess income.

(d) Commensurate Test

Another criterion applied by the IRS is the commensurate test that asks whether the organization's expenditures are commensurate in scope to its financial resources. The theory was espoused in 1964 in looking at what portion of an organization's assets could be invested in unrelated business activities.[77] In addition to operating exclusively for charitable purposes, a charity's primary purpose must also be charitable. The distinction between the two tests is blurry, and no exact mathematical test is provided. It is sufficient to say that both must be satisfied to ensure maintenance of exempt status. Beginning in 1990, revenue

[76] See Chapter 15.
[77] Rev. Rul. 64-182, 1964 (Part 1) C.B. 186.

agents examined fund-raising organizations with professional fund-raisers to see whether they receive an excessive portion of the funds they raise for charity. State charitable regulators continue to be concerned and may have specific limitations on such payments.

The commensurate test was used to revoke the exempt status of United Cancer Council, Inc. (UCC), a charity that solicited funds by mail. Out of over $7 million raised during 1986, UCC spent less than $300,000 on patient services and research and paid the balance to its fund-raising counsel, Watson & Hughey.[78] Needless to say, the commensurate test was failed. Bingo operations paying excessive operating costs and salaries, with little or no profits left for charity, also fail the test.[79] In the published determination letter of Temple City High School Bingo, the IRS applied a 15 percent of gross receipts guideline to evaluate whether a commensurate amount of the receipts actually was paid to the high school for which the organization was formed to raise funds.[80]

A nonprofit whose sole purpose is to raise money for other organizations must devote or pay a sufficient amount of the money it raises to charitable purposes to qualify for exemption under §501(c)(3). Other aspects of its operations and policies may also be indicative of its charitable nature. In a published exemption letter, the Sacramento Charities, Inc., an entity organized to conduct an annual golf tournament, agreed to the following IRS conditions to qualify for exemption.[81]

- All net income was payable to other §501(c)(3) organizations.
- Recipient organizations were local charities chosen on the basis of their community involvement, use of the funds, and fund-raising ability.
- Grants would not be related to the recipient's volunteer efforts toward the annual event.
- Charitable aspects of the tournament were emphasized in publicity materials about the event.
- The mission statement was printed in the tournament program.
- New board members who better reflect charitable interests and broadly represent the community would be added to the board.

In meeting the commensurate test, it is the way in which the organization's revenues are expended, rather than their source, that is determinative. A private foundation is recognized as exempt even though it expects to receive all of its income from passive investment sources.[82] The IRS says, "It is well established that organizations that do nothing but make contributions to other charitable organizations can qualify for exemption."[83]

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[78] *United Cancer Council, Inc. v. Commissioner*, 109 T.C. 326.

[79] Priv. Ltr. Rul. 9132005. For a good history of the commensurate issue, read Gen. Coun. Memo. 32689 published in 1963, Gen. Coun. Memo. 34682 in 1971, and Gen. Coun. Memo. 38742 in 1982.

[80] IRS Exemption Letter, July 6, 1992.

[81] Exemption letter dated June 2, 1993; see also Priv. Ltr. Rul. 9711003.

[82] Rev. Rul. 64-182, 1964-1 C.B. 18.

[83] Priv. Ltr. Rul. 9417003.

(e) Business Activity

The receipt of unrelated business income can jeopardize an organization's exempt status. An organization that conducts a trade or business as a substantial part of its activities can be exempt only if the operation of the business furthers its exempt purpose; that is, it is related. The primary purpose of an organization exempt under (c)(3) must not be to carry on an unrelated trade or business.[84] What is meant by "substantial" is not numerically expressed and is measured by taking all of the facts and circumstances of the organization's operations into account. The size and extent of the trade or business in relation to the organization's exempt activity is determinative. The customary measure of *primariness* is the portion of the organization's overall budget produced by the business and the time expended by its managers on business versus charitable activities.

The IRS has said it is "likely exempt status of an organization will be revoked where it regularly derives over one-half of its annual revenue from unrelated activities."[85] The regulations, however, provide no specific numerical percentage level. The Second Circuit Court of Appeals thought one-third was excessive.[86] Another court indicated that a safe level of unrelated income would be under 20 to 25 percent of the organization's overall revenues.[87] An organization working with mentally challenged children was allowed to retain its tax-exempt status despite the fact that more than 98 percent of its revenues and over 95 percent of the expenditures pertained to a bingo operation.[88] Similarly, an organization operated to help needy women retained its tax exemption despite the fact that it gained about 65 percent of its revenues from operation of an unrelated tearoom and gift shop operated alongside a shop in which it displayed and sold goods made by the women.[89] Though confusing and sometimes difficult to apply, the fact that a quantitative test does not exist for determining the amount of permitted unrelated business activity allows an organization to be relatively aggressive in pursuing revenue-producing activities.[90]

The operation of a trade or business that furthers, or is related to, an organization's exempt purposes is permitted. Proving that a business is related, rather than unrelated, may be necessary for an organization to achieve or maintain exempt status. In evaluating the relatedness of a business enterprise, the purpose toward which the activity is directed, rather than the nature of the activity itself, determines whether the activity serves an exempt purpose.[91] In other words, if a resale shop run with workers who have disabilities provides a livelihood for workers not otherwise able to support themselves, the fact that the shop is in business competing with commercial resale shops does not prevent relatedness. Consider

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[84] Reg. §1.501(c)(3)-1(e); Rev. Rul. 64-182, 1964 (Part I) C.B. 186.
[85] Gen. Coun. Memo. 39108.
[86] *Orange County Agricultural Society, Inc. v. Commissioner*, 893 F.2d 647 (2d Cir. 1990). *aff'g* 55 T.C.M. 1602 (1988).
[87] *Manning Association v. Commissioner*, 93 T.C.M. 596, 603-604 (1989).
[88] Priv. Ltr. Rul. 9711003, cited in Priv. Ltr. Rul. 199910007.
[89] Tech. Adv. Memo. 200021056.
[90] See Section 21.3.
[91] *Junaluska Assembly Housing, Inc. v. Commissioner*, 86 T.C.M. 1114, 1121 (1986).

Goodwill Industries: As a part of a job-training program, handicapped workers repair and refurbish furniture and other items for resale. The primary motivation is to provide training and livelihood for the disadvantaged workers (a charitable purpose), not to operate the stores. An unlimited amount of such related business is permitted.

The profit from business activity that is unrelated to the organization's exempt purpose is subject to income tax. Chapter 21 discusses the complex issue of permitted amounts of unrelated business activity, methods of calculating the tax, the many exceptions, and the commerciality test. Spinning excess business activity off into an independent subsidiary corporation saved the exemption application for the Ark Environmental Foundation U.S., Inc. Since a substantial part of its activity was the sale of environmentally friendly products, exempt status was initially denied in the key district. The national office, upon reconsideration, decided that if a truly separate subsidiary was created with a bona fide business purpose, exempt status would be available for the parent.[92]

(f) Importance of Sources of Support

The classic (c)(3) organization receives its financial support from voluntary contributions and from investment income produced from contributions it retains in an endowment or working capital fund. Its charitable nature is evidenced by its ability to attract such donations (one-way-street gifts) in support of its activities. The IRS applies support ratio tests in its determinations and examinations. Support coming from a limited group of donors may dictate or result in private foundation status. An absence of or a limited amount of donations may imply noncharitable status.

The level of public support normally differs according to the type of organization. For example, a grant-making United Fund would receive the bulk of its revenues from donations; a university would receive a sizeable part of its revenues from student tuition (exempt function income). Chapter 11 details the definition of various categories of public charities and requirements for obtaining public status.

(g) Action Organization

An organization whose purposes can be accomplished only through the passage of legislation changing local, state, or federal laws is called an *action organization* and cannot qualify for exemption as a charity under (c)(3).[93] When a substantial part of the organization's activity is attempting to influence legislation by propaganda or otherwise, it is considered an action organization. Attempting to influence legislation means:

- Contacting or urging the public to contact members of a legislative body (the Congress, any state legislature, local council, or similar governing

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[92] Exemption letter dated May 26, 1993.
[93] Reg. §1.501(c)(3)-1(b)(3).

body or the public in a referendum) for the purpose of proposing, supporting, or opposing legislation, or

- Advocating the adoption or rejection of legislation.

The test of whether an organization's legislative activity is substantial is applied subjectively with no specific mathematical test. One early case applied a 5 percent limitation.[94] In another case, the use of a percentage test was rejected and instead the balance of an organization's activities in relation to its objectives and circumstances was considered.[95] Due to the uncertainty, Congress added an elective test containing percentage limitations for measuring permissible lobbying—the expenditure test of IRC §501(h).

Another kind of action organization is one that participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. Chapters 6 and 23 discuss these rules in detail, including when to consider the formation of a (c)(4) organization.

(h) Feeders and the Integral Part Test

Each separately organized nonprofit organization must seek to qualify for exemption unless it is included in a group exemption.[96] For legal and/or management reasons, an existing nonprofit may create another organization to conduct high-risk activities, to hold investment assets, or for a variety of other reasons. The new nonprofit can qualify for exemption if it performs essential services directly to or for its parent or affiliate or to the class of direct beneficiaries of the exempt activities of its parent.[97] Such an entity is said to be an *integral part* of the parent. Services can be rendered to the natural constituency of its creator, such as the students and faculty of a university or the patients of a hospital. The affiliate can be exempt despite the fact that it makes a profit from its dealings with the parent organization. It cannot, however, be exempt if its activities would produce unrelated income in the hands of the parent.

The relationship between the related organizations is significant. Performing services for a group of similar, but unrelated, organizations is an unrelated activity.[98] The regulations say, "An exempt organization is not related to another merely because they both engage in the same type of exempt activities."[99] Being an integral part essentially means to operate as a subsidiary of, although the nature of the control relationship is not stipulated. In one situation, the IRS asked whether the services are essential to the exempt functioning of the group.[100] The word *feeder* is used to describe an organization that provides or conducts an unre-

94 *Seasongood v. Commissioner*, 227 F.2d 907 (10th Cir. 1955).

95 *Christian Echoes Ministries v. U.S.,* 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1974).

96 See Section 18.2(f).

97 Rev. Rul. 78-41, 1978-1 C.B. 148; *Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951).

98 See Section 21.8(b).

99 Reg. §1.502-1(b).

100 Priv. Ltr. Rul 9849027.

lated business (provides its services or sells products to unrelated parties) and pays all or feeds its profits to one or more other exempt organizations. Feeder entities are specifically prohibited from exempt status by IRC §502. A separately incorporated nonprofit entity selling pharmaceuticals to a hospital's patients would qualify for exemption only if the nonpatient sales were insubstantial. It would have to prove that its primary purpose was to sell drugs to patients to be classified as an integral part.

The IRS, in a private ruling, provided a good illustration of the type of relationship it expects to exist between organizations for the service provider to be considered an integral part. Provision of services by one member of a related group of organizations to others in the group is not treated as an unrelated activity if the services rendered are essential to the exempt functioning of the group so as to satisfy the integral part test. In the ruling, "College" provides a wide range of services, including campus security, telephone and mail service, steam plant, financial services, auditorium, faculty house used for meals and meetings, medical center, library, and interfaith fellowship center, to its related "small colleges arranged around a library."[101] Though each entity was legally separate, College's constitution and bylaws provide for a council made up of the presidents of each college in the group to provide policy guidelines on the administration and development of common programs and facilities. Thus, sufficient control and close supervision were exercised by the group in relation to College to satisfy the structural relatedness requirement to avoid classification of College as a feeder organization.

(i) International Activities

A tax-exempt organization is entitled to pursue its mission anywhere on earth; the tax code imposes no geographic limitations. It is the motivation for conducting an activity, not its situs, that determines its character for tax purposes. So long as the fashion in which the activities are conducted meets the requirements outlined in Chapters 3 through 9, the location in which they take place is unconstrained. The tax home of a nonprofit organization, however, influences the deductibility of payments it receives. For U.S. tax purposes, a qualifying charitable contribution is a "gift to or for the use of a State, a possession of the United States, or the United States or the District of Columbia" used exclusively for public purposes, or to a U.S.-based corporation, trust, or community chest, fund, or foundation[102] that satisfies the organizational and operational tests outlined in this chapter. A donation to a foreign charity is not deductible for U.S. tax purposes, but a donation to a U.S. charity that conducts foreign programs is deductible. The charity that solicits gifts earmarked for foreign programs must retain the ultimate control over disposition of the funds to avoid a situation in which the donors are deemed to have made a gift to a foreign charity.[103] Private foun-

[101] Priv. Ltr. Rul. 9849027.
[102] IRC §170(c).
[103] This control and discretion over funding is discussed in Section 24.1(b).

dations that support foreign organizations that have no recognition as qualifying public charities must take additional steps to document such grants.[104]

(j) The Internet and Tax-Exempt Organizations

Most exempt organizations use the Internet as a means of conveying and accomplishing their mission. Opportunities to provide links between an organization's Web site and other sites on the World Wide Web abound, making it increasingly important that tax-exempt organizations and advisors familiarize themselves with the impact of the use of electronic communication systems on their tax-exempt status. Application of existing tax rules and standards to activities conducted on the Internet, including e-mail and other forms of electronic transmission, is an evolving issue. In October 2000, the U.S. Treasury Department solicited public comments on the application of existing rules regarding use of the Internet, but to date have offered minimal guidance.[105] Readers must be alert for new developments.

Exempt Status Issues. To obtain recognition and to maintain tax-exempt status, a nonprofit organization must be dedicated to and devote its primary energies to conducting activities that accomplish a qualifying exempt purpose. The standards for qualification under the different categories of §501(c) are well defined and documented in the Treasury Regulations, in Internal Revenue manuals, in countless published and private IRS rulings, and in court decisions discussed in Chapters 3 through 9 of this book. The IRS agrees that the existing standards apply in making determinations about the character of electronic communication activities. Logically, the tax code and regulations should be applied consistently without regard to the medium in which activities are conducted.

Electronic communication is a relatively unexplored area of activity for tax-exempt organizations. In 1974, the IRS approved exemption for a regional computer network for a consortium of colleges and universities because it advanced education.[106] In 1981, a computer network to exchange bibliographic information between libraries was also ruled to be a 501(c)(3) organization, even though some of its members were not tax exempt.[107] Providing communication services of an ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes.[108] IRS technicians were told to peruse the ISP's home page to evaluate its exempt character as a source of public information and to see if placards, banners, and links to commercial sites constitute advertising that

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[104] This requirement and the deductibility problem are discussed further in Section 17.4(c); see also John R. Wylie and Stuart J. Lark, "Form Follows Function in Planning Activities with Foreign Organizations," *Journal of Taxation of Tax-Exempt Organizations,* May/June 1999.

[105] IRS Announcement 2000-84, 2000-2 IRB 385.

[106] Rev. Rul. 74-614, 1974-2 C.B. 164.

[107] Rev. Rul. 81-29, 1981-1 C.B. 328.

[108] Cheryl Chasin and Robert Harper, *Fiscal 1997 CPE Test for Exempt Organizations,* Chapter A, entitled "Computer-Related Organizations," pp. 9–12.

creates unrelated business income. In 1999 the IRS said, "Internet Service Providers (ISPs) have usually been denied exemption because they are viewed as carrying on a trade or business for profit, or conferring an unmixed private benefit, or both.[109]

The IRS challenged the tax exemption of an organization that provided Internet services to the public. Its application for exemption described it as a community-based public access information and communications nonprofit. A council of community representatives managed the program, and its services were provided primarily[110] by volunteers. Nonetheless, providing services of an ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes. What could qualify as charitable was operation of the ISP to serve only low-income individuals and other charitable organizations on a substantially below-cost basis. By transferring the unrelated (full pay to general public) ISP to a for-profit subsidiary, the organization was allowed to maintain its tax-exempt status.[111]

The IRS has approved exemption applications for Internet-related organizations, including a virtual educational organization that disseminates information and another that conducts fund-raising for other organizations totally via the Internet. Groups claiming exemption as Internet churches were granted tax-exempt status as religious or educational organizations but not allowed church status. The IRS has said a church cannot operate in cyberspace because an online group cannot, in their view, meet the 14-point test for church status. They apparently believe a regular congregation cannot exist electronically.[112] Again, the medium for accomplishing the charitable or other nonprofit mission should not, per se, deprive an organization of eligibility for exempt status. Is there a reason religious worship services cannot be provided to a virtual congregation solely on the Internet? Why not an e-marriage? Why must spiritual ceremonies take place in a physical space?

Providing Information. The publication of information pertaining to the organization's mission and program activities for free on its own Web site is certainly an exempt activity. A site containing basic information about the rate schedules, grant applications, deadlines, admission standards, locations, caregiver resumes, and any other information describing the services it provides simply replaces brochures and reports now available on paper. Any dissemination of information through the Internet to advance the accomplishment of exempt purposes is permitted. A site might also contain a bulletin board for constituent communication, such as a parent forum concerning child care issues. Linking the site to those of other tax-exempt organizations that contain reference materials, services, or

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[109] Donna Moore and Robert Harper, *Fiscal 1999 CPE Text for Exempt Organizations,* Chapter C, entitled "Internet Service Providers Exemption Issues," discussed in Section 5.1(i).

[110] Presumably the percentage of volunteer help was less than substantial, usually meaning 85 percent or more as described in Section 21.9(a).

[111] Priv. Ltr. Rul. 200203069.

[112] Robert C. Harper, Chief of IRS Technical Branch 3 of the Tax Exempt/Government Entities Division, in comments at the American Bar Association Exempt Organization Committee meeting, May 13, 2000.

resources pertaining to its exempt function is an exempt activity. For example, a child care provider can link its site to a mental health agency, to the school district, to the association of child psychiatrists, or to a child protective service agency. Links that might cause concern regarding exempt status or produce unrelated business income are discussed below. Publishing information pertaining to legislation and elections on an organization's Web site will have different consequences to the different types of exempt organizations, as outlined in Chapter 23. Because information on a Web site is available for all to see, the rules pertaining to communicating with an organization's members will not necessarily apply.

Providing Services. Selling services and information that advance the mission to an organization's exempt constituents is similarly an exempt activity. Again, the standards for identifying services that promote the mission are well documented. The business league that sells legal forms to industry members to provide common conveyance documents that avoid controversies should certainly be allowed to do so electronically.[113] An organization that provides counseling, resource information, and transportation assistance to disabled and elderly people can do so through its Web site.[114] A legal aid society can provide advice and documents electronically.[115] Providing bibliographic information to libraries has been found to be an exempt function; by reference, such an exempt service can be provided on the Internet.[116]

Fees for Internet Activities. When information, goods, or consulting services are sold on an organization's Web site, however, the activity may or may not be considered exempt. For all categories of tax-exempt organizations, the character of revenues generated through a Web site and delivery of services in connection with electronic communication will depend on the relationship between the activity generating the revenue and accomplishment of the organization's exempt purposes.[117] Any charges made by the organizations described in the preceding paragraph would represent exempt function revenues related to mission. In considering other situations, the standards for defining relatedness under IRC §513 and the labyrinth of exceptions and modifications applied in calculating taxable income under IRC §512 can provide answers. Undoubtedly, the irregular activity exception will not normally apply to items available for sale on a site. Also, without question, using a Web site in a commercial fashion or providing Internet services to the general public constitutes unrelated activity. What constitutes exploitation for different types of exempt organizations, however, is determined by existing rulings and court decisions discussed in Chapters 3 through 9 and Section 21.8(j).

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[113] *San Antonio Bar Association v. U.S.*, 80-2 USTC 9594 (W.D. Texas 1980*); Texas Apartment Association v. U.S.*, 869 F.2d 884 (5th Cir. 1989).

[114] Rev. Rul. 77-246, 1977-2 C.B. 190, discussed in §21.8(e).

[115] Rev. Ruls. 78-428, 1978-2 C.B. 177 and 76-22, 1976-1 C.B. 148.

[116] *The Council for Bibliographic and Information Technologies v. Comm.*, 63 TCM 3186 (1992); Rev. Rul. 70-79, 1970-1 C.B. 127.

[117] IRC §513(a) and Reg. §1.513-1.

Links. The one issue unique to the Internet may be the capability of linking an organization's Web site instantly and without any charge to another Web site. Links can be considered from the vantage point of several different tax consequences.

Links that serve an exempt purpose. The child care provider previously mentioned would be making related links when it connects its site to a mental health agency, to the school district, to the association of child psychiatrists, or to the child protective service agency.

Links to sites of sponsoring organizations that provide benefits to an agricultural association's members businesses, as a part of its listing information on its own web site, was found to serve an exempt purose.[118]

Links that create unrelated business income. Links to the sales pages of a business sponsor's site could create taxable advertising income, depending on the content of the linked site.[119] Sale of goods or services unrelated to the organization's objectives, including those fragmented from a group of related items, creates unrelated business income. Commissions or fees rebated to the organization from commercial business sites may produce related or unrelated income, depending on the type of items sold. An educational organization that sells its own publications through a link to Amazon.com receives related revenues for its share of the book sales. An organization dedicated to literacy that encourages reading might also be allowed to treat the Amazon revenues as related. The rebate it receives because it prompted a visitor to its site to link to Amazon's site, however, is a commission that may be considered unrelated income. Some say such a link need not be related to the organization's mission. That view says the rebates are royalties for the use of the organization's intangible property—the visitors to its Web site. They ask why a link is any different from a name on a mailing list, though to date the IRS has indicated that it expects such revenues should be treated as active business income.

Links that represent nonexempt activity. A link that promotes the private interests of the organization's disqualified persons constitutes a nonexempt activity.[120] An example of such inurement occurs for a cancer treatment research group that links only to the clinic site of its creator, an oncologist. Linking a site of any category of exempt organization to privately owned business(es), if the activity it represents is substantial in relation to other organizational functions, could threaten an organization's exempt status. Whether an organization's exempt status is endangered by such link activity is measured by the standard that requires it to operate primarily for tax-exempt purposes. Links to a particular political party's site would be impermissible for (c)(3) and possibly (c)(4) organizations.[121] Unbiased links to all parties might be considered voter education rather than intervention in a political campaign. There is no specific limitation on electioneering by a labor union or business league, for example, so that links to a particular political candidate or party may be acceptable from a tax

[118] Priv. Ltr. Rul. 200303062.
[119] See Section 21.8(e).
[120] See Chapter 20.
[121] See Chapter 23.

standpoint. The Federal Election Commission (FEC) sanctioned a site called DNet.org established by two 501(c)(3) organizations to provide nonpartisan information on candidates to encourage an online debate between candidates.[122]

Links that cause penalties. Certain nonexempt function links could subject the organization to penalties. For a private foundation, the self-dealing and taxable expenditure sanctions would impose a penalty for impermissible links. The cost associated with links that constitute political expenditures would be reportable as taxable income on Form 1120-POL and also subject to either the §4955 or §4945 penalty and reported on Form 4720.[123]

Other Internet Issues. There are a number of issues beyond the scope of this book that should be mentioned for the sake of completeness. Nonprofits conducting activities from a Web page should seek assistance in answering the following questions (among others the author is not qualified to suggest):

- Must any state sales tax be collected for sales of goods or products?
- Do the materials published on the organization's site, or sites to which it is linked, involve legal issues concerning intellectual property rights, invasion of privacy, or defamation of character issues, and so on?
- If contributions or memberships are solicited on the Web site, must the organization report its fund-raising activity in any states? Must special disclosures about the organization's financials be shown on the site?

Fund-Raising Issues. The solicitation disclosures that apply to charities,[124] civic welfare organizations,[125] labor unions, and business leagues apply to requests for donations, membership dues, and other forms of payments in support of (or to qualify for participation in) a tax-exempt organization's programs. To be able to claim a deduction for a donation of $250 or more to a §501(c)(3) organization, the donor must have a written receipt. Such "contemporaneous substantiation" must reflect the amount of the payment and a statement reporting whether any goods or services were provided in connection with the gift—and if so, the worth of those goods or services. The revised version of Publication 1771, issued in March 2002, says that the disclosure of the value of benefits provided in a quid pro quo solicitation can be conveyed in electronic form.

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[122] The Federal Election Commission rules, however, hold that a link from a corporate Web site to a candidate's site is a violation of FEC rules. Lacking IRS guidance for this type of Internet activity, organizations should look to Federal Election Commission rulings on character of political campaign activity. See Section 23.2 for distinctions between voter education and candidate promotion.

[123] See Section 23.2(d)

[124] See Section 24.2

[125] See Section 6.4 as it pertains to §501(c)(4), (5), and (6) organizations.

CHAPTER THREE

Religious Organizations

The first type of 501(c)(3) organization listed in the statute is *religious*. An organization whose primary purpose is to conduct religious activities qualifies for exemption. However, the regulations do not define religious purposes, presumably to maintain the separation of church and state, and the IRS says that the term cannot be defined precisely.[1]

3.1 TYPES OF RELIGIOUS ORGANIZATIONS

Religious organizations are basically those that concern themselves with people's relationship to divine or supernatural powers, either to worship them through ritual or to study human manifestations of their teachings. The major religions—Catholicism, various Protestant denominations, Judaism, Islam, and so on—clearly qualify as religious organizations and furthermore as churches. However, there are many nonchurches that qualify for exemption as religious organizations. Churches have a special set of qualifications partly because they are afforded special filing status.

[1] *Exempt Organizations Handbook* (IRM 7751) §344.2.

(a) Ideology or Dogma Not Essential

Religion is not confined to a particular sect or ritual. One court has noted that the symbols of one religion may be anathema to another.[2] Another court stated that judgments about the validity or truth of the organization's beliefs must be avoided by the courts: "It is not the province of government officials or courts to determine religious orthodoxy."[3] Religions that do not believe in a supreme being in the Judeo-Christian sense, such as Taoism, Buddhism, and secular humanism, are eligible for exemption.[4] It is unnecessary to inquire into the nature of the beliefs of an organization. A religion with thousands of adherents based upon supernatural revelations to its founder was found to operate for religious purposes, despite its total control by the founder and its lucrative publication sales.[5]

Although a formal written dogma, such as the Christian Bible or the Catholic catechism, may not be necessary, to be classified as religious an organization must adhere to or promote religious beliefs. In the *Seeger* case, the Supreme Court used a two-pronged test to identify a religious belief:

1. The beliefs must be deeply and sincerely held by its members, and
2. Those beliefs must involve a matter of ultimate concern to the person to which all else is subordinate (such as the Catholic notion of God as the supreme being).

A series of questions was asked by another court to evaluate the existence of religion[6]:

- Does the system of beliefs address the meaning of life and death, a person's role in the universe, and the proper moral code of right and wrong?
- Is the system of beliefs comprehensive? (More than one moral teaching is expected.)
- Are there any formal, external, or surface signs that may be analogized to accepted religions (such as services, ceremonial functions, the existence of clergy, structure and organization, efforts at propagation, observation of holidays, and other similar manifestations associated with traditional religions)?

(b) Examples of Qualifying Organizations

Although religious orders and churches unquestionably qualify as religious organizations, a vast array of organizations conducting related activities also qualify under the religious category. To illustrate the concepts, the following list

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[2] *Unity School of Christianity,* 4 B.T.A. 61 (1962), acq. VI-IC.B. 6 (1927).
[3] *Teterud v. Burns,* 522 F. 2d 357 (8th Cir. 1975).
[4] *U.S. v. Seeger,* 380 U.S. 163 (1965).
[5] *St. Germain Foundation,* 26 T.C. 648 (1956), acq., 1956-2 C.B. 8.
[6] *Malnak v. Yogi,* 592 F. 2d 197 (3d Cir. 1979).

compares qualifying organizations to other organizations with a similar focus that do not qualify for exemption.

- Weekend retreat centers, open to individuals of diverse Christian denominations, where organized religious programs are presented and recreational time is limited, can qualify.[7] In contrast, an organization sponsoring religious cruises including extensive social and recreational activities was not permitted exemption.[8] Nor was a retreat center that held unscheduled and nonrequired religious activity available for its visitors, to encourage individual meditation and prayer. (It looked too much like a spa or vacation place.)[9]

- Kosher food preparation and inspection of commercial products for compliance with religious belief advances religion and can be exempt.[10] However, a Seventh-Day Adventist Church affiliate was denied exemption for its vegetarian restaurant and food store that provided foodstuffs in accordance with church doctrines. Although not so stated, perhaps the fatal flaw was the fact that the stores were open to the general public, evidencing a commercial purpose beyond that of ministering to the spiritual needs of the church members.[11]

- A religious publishing house that disseminates literature to promote its own beliefs can qualify for exemption.[12] Also, publication of a nondenominational newsletter is an exempt activity.[13] If, instead, the publishing house sells a wide variety of religious publications and supplies in a profitable, commercial manner, it looks to the IRS and the courts like a business venture and cannot qualify for exemption.[14]

- Communal living groups that practice religious functions also provide food, shelter, and other basic human needs that give individual benefit to the commune members. New age communes were found not to qualify as exempt religious organizations in the late 1970s.[15] Later, the IRS recanted its seeming discrimination against alternative religions. When the living quarters and provisions are minimal and "do not exceed those strictly

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[7] Rev. Rul. 77-430, 1977-2 C.B. 1914.

[8] Rev. Rul. 77-366, 1977-2 C.B. 192.

[9] *The Schoger Foundation v. Commissioner,* 76 T.C. 380 (1981).

[10] Rev. Rul. 74-575, 1974-2 C.B. 161.

[11] *Living Faith, Inc. v. Commissioner,* T.C.M. Dec. ¶46,860, 60 T.C.M. 710, 1990-484.

[12] *Presbyterian and Reformed Publishing Co. v. Commissioner,* 743 F. 2d 148 (3rd Cir. 1984); *St. Germain Foundation,* supra note 5; *Unity School of Christianity,* supra note 2*; Pulpit Resource v. Commissioner,* 70 T.C. 594 (1978).

[13] Rev. Rul. 68-306, 1968-1 C.B. 257.

[14] *Scripture Press Foundation v. U.S.,* 285 F. 2d 800 (1961), cert. den. 368 U.S. 1985, *Fides Publishers Association v. U.S.,* 263 F. Supp. 924 (1967); *Incorporated Trustees of the Gospel Workers Society v. U.S.,* 520 F. Supp. 924 (D.D.C. 1981).

[15] *Martinsville Ministries, Inc. v. U.S.,* 80-2 USTC ¶9710 (D.C. 1980); *Canada v. Commissioner,* 82 T.C. 973 (1984); *Beth El Ministries, Inc. v. U.S.,* 79-2 USTC ¶9412 (D.C. 1979).

necessary," a few members work outside the community, and the group has a religious focus, the IRS may rule favorably.[16] Groups of monks, nuns, and other clerics traditionally have been allowed to qualify as religious organizations and are often exempt as an integrated auxiliary of a church.[17] Special rules apply to religious orders and apostolic associations.[18]

(c) Peripheral Religious Activity

Other types of organizations conducting activities associated with religious matters include the following:

- A religious burial service provided by an exempt organization, the purpose of which is to support and maintain basic tenets and beliefs of a religion regarding burial of its members, qualifies as exempt.[19]
- A coffeehouse for college students to meet with church leaders, educators, and business leaders for discussion and counseling on religion, current events, or social and vocational problems is exempt.[20]
- Radio and television broadcasts of religious materials and worship services are exempt religious activities, and an organization presenting such broadcasts can qualify even when the station holds a commercial license, as long as the amount of broadcasting devoted to advertisements is insignificant.[21]

(d) Secular Groups

Spirituality, rather than secular or worldly issues, should be the focus of a religious organization. An organization practicing a doctrine of ethical egoism by holding dinner meetings and publishing a newsletter was found not to be religious.[22] A nationwide broadcast ministry that engages in substantial legislative activity was also denied exemption.[23] In the absence of "any solid evidence of a belief in a supreme being, a religious discipline, a ritual, or tenets to guide one's daily existence," the Neo-American Church, whose beliefs focused on psychedelic substances, was denied exemption.[24]

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[16] Gen. Coun. Memo. 38827 (1981).
[17] Priv. Ltr. Rul. 7838028-7838036.
[18] See Sections 3.3 and 3.4.
[19] Rev. Rul. 79-359, 1979-2 C.B. 226.
[20] Rev. Rul. 68-72, 1968-1 C.B. 250.
[21] Rev. Rul. 68-563, 1968-2 C.B. 212, amplified by Rev. Rul. 78-385, 1978-2 C.B. 174, which added the comments about advertisements.
[22] *First Libertarian Church v. Commissioner,* 74 T.C. 396 (1980).
[23] *Christian Echoes National Ministry, Inc. v. U.S.,* 470 F. 2d 849 (10th Cir., 1972), cert. den., 414 U.S. 864 (1972).
[24] *U.S. v. Kuch,* 288 F. Supp. 439, 443-444 (D.C. 1968).

An organization teaching "Gay Imperative" was denied exemption because it was a secular group.[25] The organization was dedicated to "religious explorations and a secular lifestyle for men and women who won't worship a god who oppresses gays." Although the court accepted the sincerity of their beliefs, it found that the group's beliefs were not religious. The basis of the decision was threefold:

1. Religious beliefs must address fundamental and ultimate questions concerning the human condition—issues of right and wrong, life and death, good and evil. Focusing singularly on sexual preference and lifestyle was found not to be a religious question.
2. The beliefs must be comprehensive in nature and constitute an entire system of belief rather than merely an isolated teaching. The court found no outward characteristics analogous to those of other religions. There is no published literature explaining its tradition, no formal written documentation of beliefs, such as the Bible or Koran, nor an oral literature reflecting its beliefs or history.
3. The beliefs must be manifested in external form. This group held no regular ceremonies or services.

(e) Pseudoreligious Groups

Partly because of the lack of specific definitions, pseudoreligious groups formed to take advantage of favorable tax status afforded to ministers have proliferated over the years. The primary reason such groups are denied exemption is that they provide private benefits to their members, who are often their founders. The classic example is the mail-order, or personal, church. For a few hundred dollars, one buys a church—a charter, ordination papers, or other ministerial credentials—through the mail. In the typical scenario, the buyer takes a "vow of poverty" and gives all of his or her property to the church. Afterward, the church pays all of the person's living expenses in a purportedly nontaxable manner. It has been easy for the IRS and the courts to find that these organizations serve the private interests of their creators and cannot qualify for exemption.[26]

3.2 CHURCHES

Churches are an important subset of the religious exemption category, but there is no definition of *church* in the regulations under §501(c)(3). A brief definition of

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[25] *Church of the Chosen People (North American Panarchate) v. U.S.*, 1982-2 USTC ¶9646 (Minn. 1982).

[26] *Basic Bible Church v. Commissioner*, 74 T.C. 846 (1980); Rev. Rul. 81-94, 1981-1 C.B. 330; *Church of the Transfiguring Spirit, Inc. v. Commissioner*, 76 T.C. 1 (1981); *Bubbling Well Church of Universal Love, Inc. v. Commissioner*, 74 T.C. 531 (1980); *American Guidance Foundation, Inc. v. U.S.*, 80-1 USTC ¶9452 (D.C. 1980); *Unitary Mission Church of Long Island v. Commissioner*, 74 T.C. 36 (1980); *Tony and Susan Alamo Foundation v. Commissioner*, T.C. Memo. 199-155, Dec.48.078.

churches is found in the regulations on contributions and unrelated business income: the term *church* includes a religious order or organization if such entity (1) is an integral part of a church, and (2) is engaged in carrying out the functions of a church. What constitutes proper church conduct is to be determined by the tenets and practices of a particular religious body constituting a church. The functions of a church include only two activities according to the regulations[27]:

1. Ministration of sacerdotal functions (communion, marriages, and so on)
2. Conduct of religious worship

In July 2002, the IRS issued Publication 1828, Tax Guide for Churches and Religious Organizations, which is available on their Web site. This new 28-page publication surveys the applicable tax rules in an understandable, thorough, and helpful fashion. The publication first outlines the process of applying for exempt status and the 14-point test for qualifying as a church. Although it does not say so, the guide serves to remind churches that, despite the fact that they are not required to seek recognition of their tax-exempt status, churches are, in fact, taxpayers for many purposes and subject to the myriad of tax compliance rules applicable to all taxpayers. Issues that jeopardize exempt status are discussed—particularly, the requirement that a church not allow its assets to inure to the benefit of the minister and other persons who control it.[28] The limitations on lobbying and the prohibition against efforts to influence an election campaign are presented.[29] Churches are reminded they must pay tax if they receive unrelated income.[30] Donor disclosure rules are described. The payroll tax reporting issues unique to ministers are explained, with a reminder that most church workers are normal employees subject to withholding and other rules.[31] Finally, the publication talks about record-keeping requirements. This publication serves as a good reference guide for persons concerned with protecting the tax-exempt status of these organizations.

(a) Special Aspects of a Church

Apparently for reasons of respecting the separation of church and state, churches benefit from several special rules:

- A church and its integrated auxiliaries are automatically exempt from income tax and need not seek recognition of exemption.
- No annual filing of Form 990 is required, and a high degree of abuse must be present for the IRS to seek to examine a church.[32]
- Parsonage allowances are exempt from income tax, and ministers have special employment tax rules.[33]

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[27] Reg. §1.170-2(b)(2) and §1.511-2(a)(3)(ii).
[28] See Chapter 20.
[29] See Chapter 23.
[30] See Chapter 21.
[31] See Chapter 25.
[32] IRC §7611.
[33] See Chapter 25.

- A church qualifies under §509(a)(1) and §170(b)(1)(a)(i) as a public charity without regard to its sources of support.

(b) Definition of Church

The decision in an early case noted that Congress left the definition of church to the "common usage of the word."[34] A religious order organized under the auspices of the Roman Catholic Church to train members to teach in Catholic schools was found not to be a church. Similarly an organization formed by missionaries affiliated with different Christian churches was not a church.[35] The court declared that the Congress used *church* more in the sense of a denomination or sect than in a generic or universal sense, though to be considered a church, organizational hierarchy or buildings were not required. Judge Tannenwald, in the concurring opinion, stressed the importance of a congregational component. He said, "A man may, of course, pray alone, but in such a case, though his house may be a castle, it is not a church. Similarly, an organization engaged in an evangelical activity exclusively through the mails would not be a church."

The IRS in 1978 announced a very specific set of characteristics that a church must possess to gain such favorable tax status. The criteria are not exclusive; any other facts and circumstances that may bear on the organization's claim for church status may be considered.[36] The fourteen attributes are:[37]

1. Distinct legal existence
2. Recognized form of worship and creed
3. Definite and distinct ecclesiastical government
4. Distinct religious history
5. Formal code of doctrine and discipline
6. Membership not associated with any other church or denomination
7. Organization of ordained ministers
8. Ordained ministers selected after completing prescribed courses of study
9. Literature of its own
10. Places of worship
11. Regular congregations
12. Regular religious services
13. Sunday schools for religious instruction for youths
14. Schools for preparation of its ministers

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[34] *De La Salle Institute v. U.S.*, 195 F.Supp. 891 (N.D. Cal. 1961.
[35] *Chapman v. Commissioner*, 48 T.C. 358 (1967).
[36] 2003 Exempt Organization Technical Instruction Program, *Public Charity or Private Foundation Status*, by Virginia G. Richardson and John Francis Reilly.
[37] *Exempt Organizations Handbook* (IRM 7751) §321.3; Rev. Rul. 59-129, 19591 C.B. 58.

Determinations are not made simply on the basis of the number of characteristics the organization possesses. Given the variety of religious practices, a determination of what constitutes a church is inherently unquantifiable. The 1981 IRS CPE text cited items 5, 7, 11, 12, and 13 as the most significant attributes. "At a minimum, a church includes a body of believers or communicants that assembles regularly in order to worship. Unless the organization is reasonably available to the public in its conduct of worship, its educational instruction, and its promulgation of doctrine, it cannot fulfill this associational role." [38]

The first case to apply the 14-point test concluded at a minimum, an organization failed the test because it did not have a body of believers that assembled regularly in order to worship.[39] A religious publishing organization without membership also failed.[40] An organization founded to spread "God's love and hope throughout the world" also did not qualify as a church.[41] It conducted bimonthly programs with prayers and gospel music in an amphitheater. It built a small chapel for unsupervised meditational activities and individual prayer, but did not conduct religious services in the chapel. Although the society argued that the test discriminated against new, rural, and poor religious organizations, the court agreed that the IRS's standard for qualification as a church was appropriate. The failure to meet three particular criteria influenced the court:

- The society did not have a regular congregation and its attendees did not consider it their church.
- It did not ordain ministers but held services conducted by guest ministers.
- It did not conduct school for religious instruction of the young.

A television ministry known as the Foundation for Human Understanding had its status as a church challenged by the IRS because about one-half of its budget went to pay for the broadcasts to its 30,000 regular listeners. Its estimated total audience was two million persons. There was no question that television broadcasts alone do not qualify an organization as a church. This entity, however, conducted regular services at two locations for 50 to 350 persons under the guidance of an ordained minister. Religious instruction was provided and it had a "distinct, although short, religious history." Therefore the court felt it possessed most of the criteria to some degree, the critical factors were satisfied, and church classification was permitted.[42] The court also noted the diversity of religious beliefs and the First Amendment rights must be respected in identifying a church.

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[38] Exempt Organizations Continuing Education Technical Instruction Program for 1981, Training 3177-20 (1-18), TPDS 87196 at 44.

[39] *American Guidance Foundation, Inc. v. U.S.*, 490 F. Supp. 304 (D.D.C. 1980). Lack of membership, or a congregation, also caused failure of the test in several cases; see *Church of the Visible Intelligence That Governs the Universe v. U.S.*, 14 Ct. Cl. 55(1983), *Universal Bible Church, Inc. v. Commissioner*, T.C.M. 1986-170, *Church of Eternal Life and Liberty, Inc. v. Commissioner*, 86 T.C. 916(1986).

[40] *First Church of Theo v. Commissioner*, T.C.M. 1989-16.

[41] *Spiritual Outreach Society v. Commissioner*, 91-1 USTC ¶50,111 (8th Cir. 1991).

[42] *Foundation for Human Understanding v. Commissioner,* 88 T.C. 1341 (1987)

(c) Conventions and Auxiliaries

Conventions or associations of churches also qualify as churches.[43] Such organizations customarily undertake cooperative activities for churches of the same denomination, and for some groups, such as the United States Catholic Conference, represent a governing body. An interdenominational cooperative association of churches may also qualify as a church, as long as it otherwise qualifies as a religious organization.[44]

An integrated auxiliary of a church is afforded the same benefits as a church. Church schools, missionary groups, youth organizations, theological seminaries, and women's and men's fellowship associations are listed in the regulations as examples of qualifying auxiliary organizations. Hospitals, retirement homes, orphanages, and some schools do not perform religious functions and so may not necessarily qualify as auxiliaries. To qualify as an integrated auxiliary of a church before 1995, the organization needed to operate exclusively for religious purposes and be controlled by a church or an association of churches.[45]

The regulations defining a church's integrated auxiliary were revised, effective in December 1995, to encompass a financial support test and eliminate an exclusively religious test.[46] An auxiliary can now be independently controlled as long as it has a legal structure similar to a supporting organization.[47] Note that the definition of a religious order continues to require that the activities be exclusively religious. The amended regulations now provide that the auxiliary cannot finance itself with public donations and charges for services to the general public. Instead, its money must come from church constituents. Specifically, an integrated auxiliary of a church is defined as an organization that

- Is affiliated with a church or a convention or association of churches
- Receives its primary financial support (over 50 percent) from internal church sources rather than public or governmental sources, or is "internally supported"

From an organizational standpoint, an auxiliary is considered affiliated if it

- Is covered by a group exemption
- Is operated, supervised, or controlled by or in connection with a church (relationship of a type embodied in §509(a)(3))
- One of the following facts and circumstances shows that it is so affiliated:
    - The organization affirms in its charter, trust instrument, bylaws, articles of association, or other organizing documents that it shares common religious doctrines, principles, disciplines, or practices with the church.

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[43] IRC §170(b)(1)(a)(i).
[44] Rev. Rul. 74-224, 1974-1 C.B. 61.
[45] Reg. §1.6033-2(g) before its revision.
[46] Reg. §1.6033-2(h) essentially codifying Rev. Rul. 86-23, 1986-1 C.B. 564.
[47] Defined in Section 11.6.

- ○ The organization's name indicates an institutional relationship.
- ○ Reports of financial and general operations are made at least annually to the church.
- ○ The church affirms the organization's affiliation with it.
- ○ In the event of dissolution, the affiliate's assets are required to be distributed to the church.

The support requirement is written negatively to say that an organization is internally supported unless it both

- Offers admissions, goods, services, or facilities for sale, on other than an incidental basis, to the general public
- Normally receives more than 50 percent of its support from a combination of governmental sources, public solicitation of contributions, and exempt function receipts

Ministers employed by an integrated auxiliary of a church qualify for special employment tax treatment.[48] For that purpose, the IRS provided a list of criteria for defining what in 1972 it called an *integral agency*.[49] The following factors given in that ruling can be applied to ascertain when an auxiliary is controlled by the church:

- Whether the religious organization incorporated the institution
- Whether the corporate name of the institution indicates a church relationship
- Whether the religious organization continuously controls, manages, and maintains the institution
- Whether the trustees or directors of the institution are approved by or must be approved by the religious organization or church
- Whether trustees or directors may be removed by the religious organization or church
- Whether annual reports of finances and general operations are required to be made
- Whether the religious organization or church contributes to the support of the institution
- Whether, in the event of dissolution of the institution, its assets would be turned over to the religious organization or church

The ruling provides that the absence of one or more of these characteristics will not necessarily be determinative in a particular case. Church-affiliated organizations that are exclusively engaged in managing funds or maintaining retirement programs can also be treated as an integrated auxiliary of a church.[50]

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[48] Discussed in Section 25.2.
[49] IRC §3121(w); Rev. Rul. 72-606, 1972-2 C.B. 78.
[50] Rev. Proc. 96-10, 1996-1 C.B. 577.

(d) IRS Examination Protection

The IRS has limited information and power to review the tax-exempt status of a church. Churches are not required to file an application for recognition of exemption on Form 1023,[51] nor an annual information return on Form 990. The IRS must be able to prove an extraordinary abuse of the tax law to request to examine the records of a church. A church may be audited by the IRS only if the principal internal revenue officer for the IRS region in which the church is located or the secretary of the treasury reasonably believes on the basis of written facts and circumstances that the church is not exempted or may be carrying on an unrelated trade or business.[52]

The Church of Scientology and some of its branches have won significant court battles with the IRS about the application of these rules. The church won a limitation of the IRS's right to request information under the IRC §7611(b)(1)(A) summons provisions when the court found that the records were not necessary, rather than merely relevant, to determining the church's tax liability.[53] In similar battles in Florida and California, the government was more successful.[54] The church in Los Angeles sued the IRS under the Freedom of Information Act for details of a "tax shelter litigation project" designating the church and its parishioners.

After 30 years of battle, the Church of Scientology received favorable IRS determination letters recognizing the tax-exempt status of some 20 of its related organizations in October 1993. A Scientology booklet titled *Information on Taxes and Your Donation* said, "The Internal Revenue Service's action has two consequences of utmost interest to Scientologists. First, this action signifies that the IRS—and the United States Government as well—has formally recognized that the Church operates exclusively for religious purposes and that Scientology, as a bona fide religion, is beneficial to society as a whole. Second, the action means that the donations you make to the church—including donations for auditing and training—qualify as charitable contributions and can be claimed as deductions on your federal and state income tax return!" Payments for training sessions had been considered by the IRS and the Supreme Court[55] to represent nondeductible quid pro quo[56] donations. In a decision surprising to some observers,[57] the IRS

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[51] See Chapter 18.

[52] IRC §7611(a).

[53] *U.S. v. Church of Scientology of Boston, Inc.,* 90-2 USTC ¶50,349 (D.C. Mass). The report was subsequently released based upon a suit brought by tax analysts.

[54] In *U.S. v. Church of Scientology Flag Service Org., Inc.,* 90-1 USTC ¶50,019 (M.D. Fla. Dec. 1989), the church essentially lost when the case was referred to a magistrate to decide which requested items were necessary. Also, in *U.S. v. Church of Scientology Western United States* and *U.S. v. Church of Scientology International, et al.,* CV 90-2690-HLH (Central D. Cal. Feb. 11, 1991), the court ordered the organizations to produce documents that the court found necessary to the IRS determinations.

[55] *Hernandez v. Commissioner,* 109 S. Ct. 2137 (1989).

[56] See Chapter 24 for more information about deductibility of such payments.

[57] "Recap—What We Know About the Scientology Closing Agreement," by Paul Streckfus, 9 *Exempt Organization Tax Review* 247 (Feb. 1994) and "Church of Spiritual Technology's Explanation to the IRS," 8 at p. 983 (Dec. 1993).

Exempt Organization division, as a part of its settlement of Scientology, agreed effective January 1, 1993, not to follow the Supreme Court decision. The IRS agreed to drop all pending cases involving deductibility of payments to the church and discontinue any audits already under way.

3.3 RELIGIOUS ORDERS

The following characteristics are considered by the IRS to identify a qualifying religious order, but only the first factor must necessarily be present.[58]

- The order is an organization otherwise qualifying for exemption under IRC §501(e)(3).[59]
- The order is, directly or indirectly, under the control and supervision of a church or convention or association of churches.
- The members of the order vow to live under set rules of moral and spiritual self-sacrifice of their material well-being and to dedicate themselves to the goals of the organization.
- Members make a long-term commitment, normally more than two years, to the organization after successful completion of the training and probationary period.
- The organization's members ordinarily live together in a community and are held to a significantly stricter level of moral and religious discipline than that required of lay church members.
- Members work or serve full-time on behalf of the religious, educational, or charitable goals of the organization.
- Members regularly participate in public or private prayer, religious study, teaching, care of the aging, missionary work, or church reform or renewal.

Status as a religious order is significant for groups whose members wish to claim exemption from participation in the Social Security system under IRC §1402(c)(4).[60]

3.4 RELIGIOUS AND APOSTOLIC ASSOCIATIONS

Religious and apostolic organizations that cannot qualify for exemption under §501(c)(3) because they engage in business for the common good of their members may instead be classified as exempt from income tax under §501(d). Such organizations are not eligible to receive tax-deductible donations,[61] but need not pay income tax on annual profits, if any, that the organization itself generates. Earnings are reportable by members of such organizations, however, who do pay income tax.

58 Rev. Proc. 91-20, 1991-10 IRB 26.
59 Meets the organizational and operational tests discussed in Chapter 2.
60 See Form 4361.
61 Rev. Rul. 57-574, 1957-2 C.B. 161.

The spirit of this exemption is to prevent what Congress perceived in 1936 to be an unfair double tax on both the apostolic organizations and their members.[62] Since the rules of apostolic organizations, such as the House of David and the Shakers, prevent members from being holders of property in an individual capacity, the undistributed profits tax should not be imposed on their corporations. The organization must possess the following attributes:

- A common or community treasury must be maintained. Each member is not required to make a vow of poverty nor contribute private property to the organization.[63] It is the organization's property and earnings that are shared, placed in a common fund, and used for the maintenance and support of the members.
- Each member reports as dividends his or her pro rata share of income (distributed or undistributed) from business conducted for the common benefit of the members.[64]

The earnings of such organizations are reported annually on Form 1065, U.S. Partnership Return of Income. Each member is treated as a partner and is taxed on his or her proportionate share of the organization's profits.[65] The income is not subject to self-employment tax.[66] No form is provided for making application for exemption under this section. Instead, a letter describing the attributes of the association that cause it to qualify is submitted to the IRS.[67]

[62] 80 *Congressional Record* 9074 (1936).
[63] *Twin Oaks Community, Inc. v. Commissioner,* 87 T.C. 1233 (1986).
[64] Reg. §1.501(d)-(1)(a).
[65] Reg. §1.6033-1(a)(5); Reg. §1.501(d)(1)(b).
[66] Priv. Ltr. Rul. 7740009.
[67] Rev. Proc. 72-5, 1972-1 C.B. 709.

CHAPTER FOUR

Charitable Organizations

The second type of activity qualified for exemption under Internal Revenue Code (IRC) §501(c)(3) is *charitable*, which is expansively defined "in its generally accepted legal sense," meaning much more than relief of the poor.[1] Charity is an evolving concept, fashioned over the years by societal need and perceived abuses. The definition sometimes also depends upon the policies of the administration currently in the White House: A shelter to house Vietnamese refugees qualified for exemption in 1978; but in 1987, the application for exemption for a similar shelter for Central American refugees was denied because the activity was "against government policy."

Charity connotes broad public benefit that is accomplished either by giving direct financial support to individuals and organizations or by operating projects that benefit the community at large. The courts have reminded the Internal Revenue Service (IRS) that community benefit is not limited to housing the homeless or feeding the poor.[2] The education, culture, and health of the public are also charitable concerns. Although the IRS does not always agree, an organization that charges for its services and excludes those that cannot pay may qualify as a char-

[1] Reg. §1.501(c)(3)-1(d)(2).
[2] *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 78-2 9660 (D.C. 1978).

itable one. Particularly in the health-care arena, the requirement that the poor be served to achieve charitable classification has been for years the subject of a see-saw battle that continues. The two most important criteria for achieving and maintaining tax-exempt status are whether a broad enough charitable class benefits and whether the services convey a public benefit rather than an individual or private benefit.[3]

Application of the criteria is exemplified by comparing two entities. A performing arts center supported by the sale of $40 to $100 tickets per performance is considered charitable because it advances culture and educates the people in its community. Its public is considered broad enough despite the fact that it is essentially unavailable to many people who cannot afford to buy the tickets. A community center located in a subdivision in a poor neighborhood where the residents own their own homes may not be classified as charitable because it benefits them as individual owners. Such an entity would more likely be considered as a homeowner's association.[4] Under each category outlined in the following sections, the evolving character of charitable class, the consequence of charging for services, and the different standards applied for certain categories are discussed. The regulations contain the following list of charitable purposes[5]:

- Relief for the poor and distress of the underprivileged
- Advancement of religion
- Advancement of education or science
- Erection or maintenance of public buildings, monuments, or works
- Lessening of the burdens of government
- Promotion of social welfare by organizations designed to accomplish one of the previously listed purposes, or to lessen neighborhood tensions, eliminate prejudice and discrimination, defend human and civil rights secured by law, or combat community deterioration and juvenile delinquency

This regulation specifies that "the fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinions on controversial issues with the intention of molding public opinion or creating public sentiment or an acceptance of its views does not preclude such organization from qualifying as long as it is not an *action organization*."[6] It also provides that the receipt of voluntary contributions from the indigent persons whom the organization is operated to benefit will not necessarily prevent the organization from being exempt as charitable. This comment can be interpreted to permit an organization to charge for the services it renders—a policy followed by many tax-exempt organizations, including schools, hospitals, health centers, and other service-providing organizations.

[3] Rev. Rul. 75-74, 1975-1 C.B. 152.
[4] IRC §528; see Section 6.3.
[5] Reg. §1.501(c)(3)-1(d)(2).
[6] Reg. §1.501(c)(3)-1(c)(3); see Section 2.2(g).

4.1 RELIEF OF THE POOR

Relief of the poor and distressed can include a vast array of programs. Examples of the types of organizations that qualify are those that focus on

- Promotion of rights and welfare for public housing occupants[7]
- Vocational training[8]
- Low-cost housing[9]
- Legal aid[10]
- Transportation for the handicapped and elderly[11]
- Counseling for senior citizens[12]
- Money management advice[13]
- Assistance to widow(er)s and orphans of police officers[14]
- Prisoner rehabilitation[15]
- Disaster relief[16]
- Day care for needy parents[17]
- Marketing of products made by the blind in programs designed to provide employment (including distribution of modest profits to the individuals with the disability)[18]

An organization seeking qualification because it relieves the poor and distressed is not precluded from exemption because it charges a fee for the services it provides to its charitable constituents. When services are provided for a fee, the factor that evidences charitable status is the basis on which the fees are determined. The fee structure must be distinguishable from that used by a commercial business. Typically, a charity would charge on a sliding scale according to the recipients' ability to pay—reduced-price services for groups of persons identified to be poor or economically distressed. Another type of noncommercial pricing system might set the price to recoup the organization's cost with no profit added on top of cost or the charge might be only that amount not reimbursed by another funding agency.

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[7] Rev. Rul. 75-283, 1975-2 C.B. 201.
[8] Rev. Rul. 73-128, 1973-1 C.B. 222; Priv. Ltr. Rul. 9150052.
[9] Rev. Rul. 70-585, 1970-2 C.B. 115; see Section 4.2(a).
[10] Rev. Rul. 78-428, 1978-2 C.B. 177; Rev. Rul. 76-22, 1976-1 C.B. 148; see Section 4.2(c).
[11] Rev. Rul. 77-246, 1977-2 C.B. 190.
[12] Rev. Rul. 75-198, 1975-1 C.B. 157.
[13] Rev. Rul. 69-441, 1969-2 C.B. 115.
[14] Rev. Rul. 55-406, 1955-1 C.B. 73.
[15] Rev. Rul. 70-583, 1970-2 C.B. 114; Rev. Rul. 67-150, 1967-1 C.B. 133; Rev. Rul. 76-21, 1976-1 C.B. 147.
[16] Rev. Rul. 69-174, 1969-1 C.B. 149.
[17] Rev. Rul. 70-533, 1970-2 C.B. 112; see Section 4.2(h).
[18] *Industrial Aid for the Blind v. Commissioner,* 73 T.C. 96 (1979), acq. C.B. 1980-2, 1.

Without regard to the amount of fees charged, a charitable organization must always benefit a charitable class.[19] To clarify this distinction, consider two projects that the IRS ruled did not qualify as charitable. An employee benefit program for needy retired workers of a particular business[20] was not exempt apparently for the unexpressed reason that the organization relieved the burden in the company. Also, a discount pharmaceutical service for senior citizens[21] could not qualify because it made no provision for free or reduced-price drugs for the poor and was therefore indistinguishable from a commercial business.

How the IRS views charges for services varies for different types of exemption categories. The pricing method for different types of nonprofit organizations is interesting to ponder because the rules stem from historical custom and public policy, rather than economics. Although many hospitals serve the poor, the tax rules allow nonprofit health-care providers to charge full price for services they provide without any requirement under the federal tax rules that price reductions be provided for those unable to pay.[22] A small business incubator providing financial and management consulting services is not treated as tax exempt if it charges full price to anyone able to pay.[23] Many museums and libraries, on the other hand, are open for modest or no charge to all, with little if any governmental funding.

4.2 PROMOTION OF SOCIAL WELFARE

Promotion of social welfare is another mission considered appropriate for a charitable organization. One of the vaguest categories, social welfare purposes include working to

- Eliminate discrimination and prejudice in the workplace,[24] in neighborhoods,[25] in housing,[26] and against women[27]
- Defend human and civil rights,[28] including the right to work[29]

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[19] See Section 2.2(a).

[20] Rev. Rul. 56-138, 1956-1 C.B. 202; the IRS has a similar opinion regarding employee disaster relief plans, as discussed in Section 17.3(d).

[21] *Federation Pharmacy Service, Inc. v. U.S.*, 625 F.2d 804 (8th Cir. 1980), aff'g. 72 T.C. 687 (1979); tax-exenpt status was not permissible since the unrelated business was the primary activity—see Section 21.3.

[22] The history of the evolving standards applied to health-care organizations is discussed in Section 4.6. A significant portion of the charity care is provided by Medicare and Medicaid funding for elderly and indigent patients.

[23] Particularly if it lacks focus on a charitable class, such as a minority group or the unemployed; see Section 21.8(b).

[24] Rev. Rul. 68-70, 1968-1, C.B. 248; Rev. Rul. 75-285, 1975-2 C.B. 203.

[25] Rev. Rul. 68-655, 1968-2 C.B. 613.

[26] Rev. Rul. 68-438, 1968-2 C.B. 609; Rev. Rul. 67-250, 1967-2 C.B. 182.

[27] Rev. Rul. 72-228, 1972-1 C.B. 148.

[28] Rev. Rul. 73-285, 1973-2 C.B. 174.

[29] *National Right to Work Legal Defense and Education Foundation, Inc. v. U.S.,* 487 F. Supp. 801 (E.D. 1979).

- Combat community deterioration,[30] lessen neighborhood tensions, and combat juvenile delinquency[31]
- Improve the economic climate in a depressed area[32]
- Encourage building of low-cost housing[33] and monitor zoning regulations[34]
- Acquire, restore, and maintain historic properties[35]
- Preserve and protect the environment,[36] including instituting litigation as a party plaintiff to enforce environmental protection laws[37] and conducting legal research to settle international environmental disputes through mediation[38]
- Promote world peace, except through illegal protests[39]
- Maintain and set aside public parks and wildlife areas[40]

Organizations qualifying in this category operate to benefit the community, which may be a town, the state, or the world. Under the social welfare umbrella, a legislative initiative to adopt laws to achieve the change can be used to accomplish the organization's goals. If the social welfare can be promoted only through passage of legislation, however, the action organization rules may prevent charitable status.[41]

(a) Low-Income Housing

Low-income housing and economic development projects receive significant government funding. As a result, the policies affecting them are subject to change as the persons in charge of their local, state, and federal funding sources change and, correspondingly, the standards for tax exemption change. Most low-income housing units constructed before 1980 were privately owned. The significant income tax benefits and federal funding available made low-income housing a favored investment, typically in the limited partnership form. As government funding was cut and eliminated during the 1980s and the 1986 Tax Reform Act virtually killed the tax advantages of passive ownership, low-income housing lost its appeal. Renovations and owner attention waned, and many such properties were put up for sale or foreclosed. Congress and the Resolution Trust Company responded to the need to protect the tenants by adopting policies encouraging charities to acquire such units.

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[30] Rev. Rul. 76-147, 1976-1 C.B. 151.
[31] Rev. Rul. 68-15, 1968-1 C.B. 244.
[32] Rev. Rul. 76-419, 1976-2 C.B. 146; Rev. Rul. 77-111, 1977-1 C.B. 144.
[33] Rev. Rul. 67-138, 1967-1 C.B. 129.
[34] Rev. Rul. 68-15, supra note 26.
[35] Reg. §1.501(c)(3)-1(d)(2).
[36] Rev. Rul. 67-292, 1967-2 C.B. 184; Rev. Rul. 76-204, 1976-1 C.B. 152.
[37] Rev. Rul. 80-278, 1980-2 C.B. 175.
[38] Rev. Rul. 80-279, 1980-2 C.B. 176.
[39] Rev. Rul. 75-384, 1975-2 C.B. 204.
[40] Rev. Rul. 70-186, 1970-1 C.B. 128; Rev. Rul. 75-85, 1978-1 C.B. 150.
[41] An action organization may qualify under IRC §501(c)(4); see Chapter 6 and Section 23.4.

Acquisition and maintenance of low-income housing units has long been considered a charitable activity because it accomplishes several purposes: relieving the suffering of the poor, eliminating discrimination, relieving the burdens of government, combating community deterioration, and promoting social welfare.[42] The IRS adopted a baseline, or minimum level, of low-income residents of 75 percent in 1993 when factors indicating whether the housing project serves a charitable class were added to the Internal Revenue Manual.[43] The standards were effective, prospectively enabling existing units to continue to be tax exempt as operated. The standards were again revised in 1995, and in 1996 the safe harbor proposals were finalized in a revenue procedure.[44] The preamble to the guidelines says that they are intended to help charities involved in low-income housing and facilitate the exemption application process, and again they were applied prospectively. It behooves existing projects to conform, if possible, to the safe harbor rules, particularly when the more lenient facts and circumstances might apply.[45]

- At least 75 percent of the units are occupied by residents who qualify as low-income individuals.
- Either 20 percent of the residents renting units must qualify as very low income, or 40 percent of the units must be occupied by residents whose income does not exceed 120 percent of the area's very low income limit.
- Up to 25 percent of the units may be rented at market rates to persons whose income exceeds the low-income limit.

A project not meeting the safe harbor percentages can still seek to qualify for exemption by demonstrating qualification through facts and circumstances, such as combating community deterioration, lessening the burdens of government, and eliminating discrimination and prejudice. The facts and circumstances that can be considered include the following:

- A substantially greater percentage of residents than required by the safe harbor rules with incomes up to 120 percent of the area's very low income limit
- A limited degree of deviation from the safe harbor percentages
- Limitation of rents to ensure that they are affordable to low-income and very low income residents

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[42] Rev. Rul. 70-585, 1970-2 C.B. 115.

[43] Notice 93-1, 1993-1 I.R.B. 172, announcing addition of the guidelines in Internal Revenue Manual 7664.34; see also Priv. Ltr. Rul. 9311034 for application of the guidelines to a charity formed by a commercial real estate company for the purposes of buying low-income housing from the Resolution Trust Company.

[44] Rev. Proc. 96-32, 1996-20 I.R.B. 1.

[45] IRS Announcement 95-37, 1995-20 I.R.B. 18. See Lynn Kawecki and Marvin Friedlander, Topic B, "Recent Developments in Housing Regarding Qualification Standards and Partnership Issues," *IRS CPE Text,* 1996, and Mary Jo Salina and Robert Fonterose, "Housing Partnership Agreements," *IRS CPE Text,* 2003.

- Participation in a government housing program designed to provide affordable housing
- Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization's operations
- The provision of additional social services affordable to poor residents
- A relationship with an existing §501(c)(3) organization active in low-income housing for at least five years, if the existing organization demonstrates control
- Acceptance of residents who, when considered individually, have unusual burdens such as extremely high medical costs that cause them to be in a condition similar to persons within the qualifying income limits, in spite of their higher incomes
- Participation in a home ownership program designed to provide home ownership opportunities for families that cannot otherwise afford to purchase safe and decent housing
- Existence of affordability covenants or property restrictions

Financing for low-income housing projects is often provided partly or wholly by commercial investors, either as lenders or as owners, so the criteria listed here deserve careful consideration. A California nonprofit corporation established to serve as general partner and essentially lend its tax status to a low-income housing project was deemed to serve the private interests of its investors and did not qualify for exemption.[46] To obtain property tax reductions, local law required that a nonprofit serve as manager of housing projects. Housing Pioneers, Inc.'s only duty was to maintain sufficient records to retain the property exemption; it "served as managing partner in name only." Although it used its modest fee for services to finance job training, counseling, and rent subsidies for the low-income residents, these activities were insufficient to outweigh the significant tax benefits flowing to the individual investors who also controlled its board.[47] Instead, an organization established to provide credit enhancement services to developers of low-income housing meeting the standards previously listed was found to be exempt.[48]

(b) Economic Development

Society's welfare may be promoted by exempt organizations working in concert with for-profit businesses, rather than directly with members of a charitable class. Supporting business programs that provide job training and placement,

[46] *Housing Pioneers, Inc. v. Commissioner,* T.C. Memo. 1993-120, aff'd. (9th Cir. June 20, 1995); see Tech. Adv. Memos. 200218037 and 200151045.

[47] This decision does not mention and can be construed to conflict with the *Plumstead Theatre* decision, discussed in Section 22.3; see also Rev. Rul. 98-15, discussed in Section 4.6(b).

[48] Priv. Ltr. Rul. 199929049.

loans, and other services available in a commercial setting may be treated as a charitable activity. Although the private business owners may stand to gain from the activity, such a program that has significant public benefit may qualify for exemption. Evaluating relative benefits is difficult, and the line separating the private and public interests is often very thin. Again, the rules may be influenced by the current opinion of lawmakers in regard to using tax policy to support social programs.

Economic development corporations (EDCs) typify this sort of charity. EDCs relieve poverty, combat community deterioration, lessen neighborhood tension, and strive to reduce the economic effect of prejudice and discrimination against minorities. An EDC qualifying as a charitable organization must be established to benefit disadvantaged members of the public.[49] Examples of programs approved as charitable by the IRS include

- Making loans and purchasing equity interests in businesses unable to obtain conventional loans because of their location in an economically depressed urban area and/or ownership by members of a minority or other disadvantaged group[50]
- Establishing an industrial park in an economically blighted area to attract tenants willing to give employment and training opportunities to unemployed or underemployed residents in return for favorable lease terms[51]
- Having a small business investment company provide low-cost or long-term loans to businesses not able to obtain funds from conventional commercial sources, with preference given to businesses that provide training and employment opportunities for the unemployed or underemployed residents of economically depressed areas[52]

Conversely, an organization formed to increase business patronage for stores in economically depressed areas was noncharitable.[53] The balance of private/public interests tilted too far in favor of private. The IRS said the absentee, nonminority owners suffered no distress as a result of their operation in the depressed area. Instead, the project's efforts to increase sales served to promote the private business owners who had formed the organization. An economic development subsidiary of an accredited college of engineering and management was found to be charitable by the IRS based upon the following three factors distilled from the published rulings[54]:

1. Assistance is provided to help local businesses or to attract new local facilities of established businesses or to attract new local facilities of established outside businesses.

[49] Gen. Coun. Memo. 39883 (Oct. 10, 1992); see discussion of charitable class in Section 2.2(a).
[50] Rev. Rul. 74-587, 1974-2 C.B. 162.
[51] Rev. Rul. 76-419, 1976-2 C.B. 146.
[52] Rev. Rul. 81-284, 1981-2 C.B. 130.
[53] Rev. Rul. 77-111, 1977-1 C.B. 144.
[54] Priv. Ltr. Rul. 9240001.

2. The type of assistance provided has noncommercial terms and the potential to revitalize the disadvantaged area.
3. There is a nexus between the business entities assisted and relieving the problems of the disadvantaged area, or between the businesses and a disadvantaged group, such as a minority, in the area.

EDCs may qualify as exempt under §501(c)(3), (4), and/or (6), further indicating the complexity of the fine private/public line evidencing charitable status.

(c) Public Interest Law Firms

Organizations performing legal services must successfully answer a series of questions to prove that their law practice serves charitable purposes. One concern is whether their clients qualify as members of a charitable class, such as the poor, persons who are discriminated against, or persons whose freedom is jeopardized. Another concern is how their business policies are distinguishable from those of commercial law firms.

The expectation of a legal fee or award cannot be a motivating factor in selection of cases, and the organization cannot withdraw from a case if the client later becomes unable to pay. Also, charges may not exceed the actual cost of the litigation. In essence, charges based upon the client's ability to pay, rather than the amount of work involved, support designation as an exempt organization. Some portion of the organization's financial support must come from donations of cash and services.

Guidelines providing specific sanctions for public interest law firms (PILFs) were issued in 1992 (effective retroactively to taxable years beginning after December 31, 1987). To be exempt, the organization must possess the following characteristics:

- Litigation must not represent a private interest, but must instead be "said to be in representation of a broad public," such as class actions, suits seeking injunctions against actions harmful to the public, or test cases where the private interest is small.
- Litigants are not represented in actions between private persons when the financial interests at stake would warrant private legal representation, except that the PILF can serve as a friend of the court when an issue in litigation affects or will have an impact on a broad public interest.
- The nonprofit must achieve its objectives through legal and ethical means with no disruption of the judicial system, illegal activity, or violations of applicable canons of ethics.
- Litigated cases are described in detail annually on Form 990, including a rationale for the determination that they would benefit the public generally. Fees sought and recovered in each case must also be reported.
- Organizational authority, including approval of policies, programs, and compensation arrangements, rests with an independent board of trustees or a committee that is not controlled by employees or litigators.

- There must be no arrangement to accept donations from litigants to cover costs.
- The nonprofit may not be operated, through sharing of office space or otherwise, in a manner so as to create identification or confusion with a particular private law firm.
- Fees charged to clients may not exceed the cost of providing the legal services, and, once representation is started, the PILF cannot withdraw because the litigant is unable to pay the contemplated fee.
- Out-of-pocket cost reimbursements may be accepted from clients.
- Total attorney fees, both court-awarded and those received from clients, may not exceed 50 percent of the nonprofit's total costs of performing litigation services, calculated on a five-year rolling-average basis. If an exception to this limit "appears warranted," a ruling request may be submitted.
- Attorneys must be paid on a straight salary basis; compensation levels must be reasonable and not established by reference to any fees received in connection with the cases they have handled; and the fees must be paid to the organization, not to the individual attorneys.[55]

4.3 LESSENING THE BURDENS OF GOVERNMENT

Lessening the burdens of government overlaps social welfare and may include providing services usually rendered by a governmental agency, that is, those facilities and services ordinarily furnished at taxpayer expense. Proving that a nonprofit will lessen the burden of government requires also that there be agreement on what those burdens are and whether it is the responsibility of the government to relieve them, which sometimes becomes a political philosophy question. Privatization of governmental functions occurs through both for-profit and not-for-profit entities. Once the government is not shouldering its burden, it may be difficult to prove the organization qualifies for this category of exempt organization. Some disparate examples of projects qualifying as charitable under this category are

- Erecting or maintaining public buildings, monuments, or works[56]
- Combating drug traffic[57]
- Extending public transportation to an isolated community[58] or making grants to a city transit authority[59]

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[55] Proc. 92-59, 1992-29 I.R.B. 11. For historical background, see Rev. Ruls. 75-47, 75-75, and 75-76, 1975-1 C.B. 152.
[56] Reg. §1.501(c)(3)-1(d)(2).
[57] Rev. Rul. 85-1, 1985-1 C.B. 177.
[58] Rev. Rul. 78-68, 1978-1 C.B. 149.
[59] Rev. Rul. 71-29, 1971- C.B. 150.

- Maintaining a professional standards review committee to oversee Medicare or Medicaid programs[60] or conducting cash/risk management services for public school systems[61]
- Maintaining volunteer fire departments[62] and police performance award programs[63]
- Assisting police and fire departments during disasters[64]

To test a proposed organization for qualification, ask whether individual citizens normally provide the services for themselves. In some cities, for example, the municipality provides garbage pickup for individuals but not for businesses. Thus, an organization picking up commercial organizations' garbage would not lessen governmental burdens. It could, however, qualify under the promotion-of-health category, if proper disposal of garbage can be shown to promote public health.

Whether or not an organization lessens the burdens of government is a matter of what a government "objectively manifests" its burdens to be. A high degree of cooperation and involvement with the governmental body whose burdens are lessened is required.[65] Public statements of support, direct government funding, joint activities with the supervision by the government, appointment and approval of board members by the government, and local bond initiatives and tax exemptions all manifest the requisite connection. Without either written delegation of such responsibility or enabling legislation providing the framework, tax-exempt status is difficult to obtain. A two-part test is applied:

1. Are the activities the nonprofit engages in ones that a governmental unit considers to be its burden, and does the governmental unit recognize that the nonprofit is acting on its behalf?
2. Does the nonprofit's performance of the activities actually lessen the burden of government?

During the 1990s, applications for exemption for organizations seeking to relieve the burdens of government could be approved only by the Washington office, not by the key district offices. The strictness with which the IRS determination branch applies this test was illustrated by a prison-related organization that failed to receive tax-exempt status. Although it was created in response to federal and some state statutes that encourage productivity of prisoners and programs providing for their rehabilitation, the rules specifically prohibit sales to the public in competition with private enterprise—the program that Prison Industries, Inc., planned. Thus, exempt status was denied.[66] An organization established to develop

[60] Priv. Ltr. Rul. 9711002.
[61] Priv. Ltr. Rul. 9711002.
[62] Rev. Rul. 74-361, 1974-2 C.B. 159.
[63] Rev. Rul. 74-246, 1974-1 C.B. 130.
[64] Rev. Rul. 71-99, 1971-1 C.B. 151.
[65] Rev. Rul. 85-2, 1985-1 C.B. 178; Gen. Coun. Memos. 38693 (1981), 38347 and 38348 (1982), 39682 (1987), 39761 (1988), and 39864 (1991).
[66] *Prison Industries, Inc. v. Commissioner,* T.C.M. Dec. 47, 104(M), January 8, 1991.

standardized engineering code and specifications for use in the fabrication and construction of steel buildings and bridges was found not to qualify as a charitable organization.[67] Although its performance of "quality audits" aided public safety, there was no evidence that a governmental unit viewed the program as its responsibility. Instead, its work gave substantial benefit to the private companies engaging its auditing certification.

In an interesting application of these rules, the IRS permitted a community foundation (CF) to purchase and operate the Kansas City Royals baseball team. The purchase was financed with tax-deductible contributions to the CF.[68] The CF's ownership of the Royals was found to be a charitable activity because all levels of the Kansas City government considered it their burden to retain the club in their city. Additionally, the private foundation, created under the will of the Royals' now-deceased owner, could claim qualifying distributions for its grants to CF.[69] The private investment group participating in a small part of the financing was deemed not to reap private inurement from the arrangements. Because its grant to the CF was earmarked and restricted to purchase of the Royals, no self-dealing occurred.[70]

The "mere fact that the nonprofit's activities might improve the general economic well-being of the nation or a state or reduce any adverse impact from the failure of government to carry out such activities is not enough to prove that an organization is relieving the burden of government."[71] The fact that the government is not conducting the program may indicate that it is not the burden of government. Operating a state motor vehicle registration office for the government for a fee, for example, was found not to be relieving the burdens of government.[72]

Note that this category applies to organizations operating independently of government, not as a branch, division, or agency of a governmental body. Instrumentalities of states and cities are technically not exempt under §501(c)(3), but, rather, under a concept of governmental immunity. Interestingly, governmental organizations do qualify to receive charitable contributions.[73]

4.4 ADVANCEMENT OF RELIGION

Advancement of religion is included on the list of charitable purposes in the regulations, but there is no explanatory information. This category might include a religious publishing house or broadcast radio or TV station, a retreat center, a burial group, or other peripheral religious activity outside the realm of sacerdotal functions. These groups are discussed in Chapter 3.

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[67] *Quality Auditing Company, Inc. v. Commissioner,* 114 T.C. 31 (June 2000); see Priv. Ltr. Rul. 199922055 for approval of a certification program serving government agencies.

[68] Priv. Ltr. Ruls. 9530024, 9530025, and 9530026.

[69] See Chapter 15.

[70] See Chapter 14.

[71] *B.S.W. Group, Inc. v. Commissioner,* 70 T.C. 352, 359 (1978); 838 F.2d 465 (4th Cir. 1988), aff'g. 88 T.C. 1, 21 (1987).

[72] Tech. Adv. Memo. 9208002. Conceivably, such an organization established to promote public safety by removing unsafe cars from the road might qualify.

[73] IRC §170(b)(1)(A)(v); see Chapter 10 for the definition of a governmental unit.

4.5 ADVANCEMENT OF EDUCATION AND SCIENCE

Advancement of education and science reiterates two purposes specifically named in §501(c)(3). Perhaps the words are repeated to clarify that auxiliary activities carried on separately from established educational or scientific institutions are entitled to tax exemption. Organizations qualifying under this category include those sponsoring

- Scholarship programs,[74] even for members of a particular fraternity,[75] but not for contestants who had to participate in the Miss America Beauty Pageant to qualify[76]
- Low-interest college loans[77] and student food and housing programs[78]
- Vocational training for unemployed workers,[79] but not operation of a grocery store's training program[80]
- National honor societies[81]
- Foreign exchange programs[82]
- Film series and bookstores[83]
- Maintenance of library collections and bibliographic computer information networks[84]
- Research journals[85] and law reviews[86]
- Medical seminars to provide postgraduate education to physicians[87]

4.6 PROMOTION OF HEALTH

Promotion of health as a charitable pursuit is conspicuously absent from the tax code and regulations, which contain no guidance on the requirements to be classified as pursuing this very important charitable purpose. The criteria for exemption have been developed to distinguish charitable entities from privately owned businesses that provide identical health services. The fact that for-profit and nonprofit health-care providers operate in a sometimes indistinguishable fashion complicates this category of exemption. To identify a health-care organi-

[74] Rev. Rul. 69-257, 1969-1 C.B. 151; Rev. Rul. 66-103, 1866-1 C.B. 134.
[75] Rev. Rul. 56-403, 1956-2 C.B. 307; see Section 5.1(f).
[76] *Miss Georgia Scholarship Fund, Inc. v. Commissioner,* 72 T.C. 267 (1979).
[77] Rev. Rul. 63-220, 1963-2 C.B. 208; Rev. Rul. 61-87, 1961-1 C.B. 191.
[78] Rev. Rul. 67-217, 1967-2 C.B. 181.
[79] Rev. Rul. 73-128, 1973-1 C.B. 222.
[80] Rev. Rul. 73-129, 1973-1 C.B. 221.
[81] Rev. Rul. 71-97, 1971-1 C.B. 150.
[82] Rev. Rul. 80-286, 1980-2 C.B. 179.
[83] *Squire v. Students Book Corp.,* 191 F.2d 1018 (9th Cir. 1951).
[84] Rev. Rul. 81-29, 1981-1 C.B. 329.
[85] Rev. Rul. 67-4, 1967-1 C.B. 121.
[86] Rev. Rul. 63-235, 1963-2 C.B. 210.
[87] Rev. Rul. 65-298, 1965-2 C.B. 163.

zation that can qualify for exemption under §501(c)(3), it is important to first review the organizational and operational standards outlined in Chapter 2. The qualifying organization must be able to prove it will operate to benefit a charitable class rather than the health-care professional who created and operates it. The issues primarily involve private inurement: Who benefits from the health-care entity's operations, the sick or the private doctors and investors who are in control? The rules are constantly evolving; any organization seeking qualification under this category must carefully study the latest developments and might study, for reference, Schedule C of the 1996 version of Form 1023. The special considerations applicable to the various segments of the health-care industry must also be considered, as discussed in the following paragraphs.[88]

A hospital does not qualify as a charitable organization merely because it promotes health. Over the years, there have been controversies between the IRS, courts, health-care organizations, and the doctors who staff them, seeking to find a suitable definition for a health-care entity that qualifies as a charitable one. In 1974, a court had to remind the IRS that promotion of health is a charitable purpose listed under the law of charitable trusts.[89] This broad category encompasses hospitals, clinics, homes for the aged, hospices, medical research organizations, mental health facilities, blood banks, home health agencies, organ donor retrieval centers, health maintenance organizations (HMOs), medical centers, hospital holding companies, and many other entities that provide care to promote health.

After first arguing that a charity hospital had to provide care to the indigent, the IRS compromised with a community benefit standard. A health-care organization that can satisfy most of the seven factors listed below is allowed charity status. Nonetheless, the IRS has continued to encourage service to indigents.[90] "Operating a full-time emergency room open to all regardless of a person's ability to pay is strong evidence that a hospital is operating to benefit the community."[91] In *Geisinger Health Plan*, the court opined that to qualify as a tax-exempt charitable organization, a hospital must do more than design a subsidized fees program for the indigent. The facts indicated that a minuscule amount of services were provided to indigents.[92] Again, in the more recent *Redlands Surgical Services* case, the Tax Court thought one of the indicators of community benefit is whether the organization provides free care to indigents.[93] The objective of the community benefit standard is to ensure that adequate health-care services are actually delivered to those in the community who need them.

As the cost of medical care began to accelerate in the 1980s and the number of persons to whom such care was unavailable rose, pressure mounted on Con-

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[88] The IRS now publishes articles in its Continuing Professional Education Technical Instruction Program on their Internet site rather than in book form once a year. In recent years, there has annually been an extensive article on health-care exemption issues. The 2004 CPE series includes *Health Care Provider Reference Guide,* by Janet E. Gitterman and Marvin Friedlander.

[89] *Eastern Kentucky Welfare Rights Organization v. Simon,* 506 F.2d 1278, 1287 (D.C. Cir. 1974).

[90] Field Service Advice 200110030.

[91] Rev. Rul. 83-157, 1983-2 C.B. 94.

[92] *Geisinger Health Plan v. Commissioner,* 985 F.2d 1210, 1216 (3rd Cir. 1993).

[93] *Redlands Surgical Services v. Commissioner*, 113 T.C.N. 3, *aff'd*, 242 F. 3d 904 (9th Cir. 2003).

gress to change the rules. Ironically, as this edition is prepared in late 2003, the health-care industry has reformed itself, but costs have continued to accelerate as treatment modalities improve. Unfortunately, the number of uninsured persons without adequate care has not measurably improved and the pressure on nonprofit organizations to meet this societal need remains high. The following summary of the issues involving health-care organizations presents a brief overview of this complex subject. The Wiley Nonprofit Series includes a book entitled *The Law of Tax-Exempt Healthcare Organizations, 2nd Edition*, which contains comprehensive consideration of the issues.[94]

(a) Charity Care

A tax-exempt health-care provider must serve its charitable class—the sick—rather than those who manage it. The IRS's initial opinion on this subject was that a charity hospital "must be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay."[95] In 1969, the IRS eased this policy and recognized that the charitable purpose of promoting health is served, even if the cost is borne by patients and insurance companies.[96] Later, the IRS refined its position: "[T]o be exempt a hospital must promote the health of a class of persons broad enough to benefit the community and must be operated to serve a public rather than a private interest."[97] Management style and financial facts that distinguish an exempt hospital from a for-profit one provide the evidence of public purpose. Indicators of a hospital's charitable nature as originally set out by the IRS,[98] and still cited today, are called the *community benefit standards* and include the following:

- Control by a community-based board of directors with no financial interest in the hospital
- Open medical staff with privileges available to all qualified physicians
- Emergency room open to all (unless this duplicates services provided by another institution in the area)
- Provision of public health programs and extensive research and medical training
- No unreasonable accumulation of surplus funds
- Limited funds invested in for-profit subsidiaries
- A high level of receivables from uncollected billings

Each of the IRS continuing education texts in recent years contains an update on issues facing health-care providers. The texts must be carefully studied by

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[94] By Thomas K. Hyatt and Bruce R. Hopkins (Hoboken: Wiley, 2001).
[95] Rev. Rul. 56-185, 1956-1 C.B. 202.
[96] Rev. Rul. 69-545, 1969-2 C.B. 117.
[97] *Exempt Organizations Handbook* (IRM 7751) §343.5(2); Rev. Rul. 83-157, 1983-2 C.B. 94.
[98] Rev. Rul. 69-545, note 86.

those representing hospitals and other health-related entities.[99] The texts are available on the IRS Exempt Organizations Internet site www.irs.gov/charitableorgs.

(b) Private Inurement

To achieve and maintain tax exemption, a health-care organization cannot allow its earnings or properties to benefit its medical staff or other private individuals. The IRS closely scrutinizes contractual relationships with physicians and, until 1996, maintained a policy that no more than 20 percent of the board members could be physicians. Under a Community Board and Conflicts of Interest Policy,[100] the IRS eased this policy if less than 50 percent of the board is constituted of physicians and the organization in question has an adequate conflict-of-interest policy.[101] Other factors that the IRS has said evidence private inurement to physicians include

- Favorable rental rates and exclusive use of facilities by a limited group of doctors[102]
- Profitable services (e.g., a lab) operated by private owners[103]
- A newly established nonprofit paying a high price to purchase a proprietary hospital[104]
- Excessive compensation to medical staff[105] and joint ventures[106]

After many years of private rulings and guidelines, the IRS issued a formal revenue ruling on incentives that a tax-exempt hospital may offer to recruit private practice physicians to join its staff or work in its medical community.[107] The ruling stipulates that it only applies to hospitals that have the following characteristics[108]:

- The hospital is a §501(c)(3) organization that operates to promote health (its exempt purpose) by the standards for exemption set forth in Rev. Rul. 69-545.[109]

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99 See Lawrence M. Brauer and Roderick H. Darling, Chapter D, "Update on Health Care," *IRS CPE Text,* 2001, pp. 49–68; Lawrence M. Brauer, Mary Jo Salins, and Robert Fontenrose, Chapter D, "Update on Health Care," *IRS CPE Text,* 2002, pp. 155–174.

100 Lawrence M. Brauer and Charles F. Kaiser, Chapter C, "Tax-Exempt Health Care Organization Community Board and Conflicts of Interest Policy," *IRS CPE Text,* 1997.

101 The IRS granted exemption to the C.H. Wilkinson Physician Network, despite the fact that, in compliance with Texas law, all board members were physicians.

102 *Harding Hospital, Inc. v. U.S.,* 505 F.2d 1068 (6th Cir. 1974); *Sonora Community Hospital v. Commissioner,* 46-T.C. 519 (1966), aff'd., 397 F.2d 814 (9th Cir. 1968).

103 Rev. Rul. 69-383, 1969-2 C.B. 113.

104 *State v. Wilmar Hospital,* 2 N.W. 2d 564 (Sup. Ct. Minn. 1942).

105 Rev. Rul. 97-21, 1997-18 IRB 115; see also Chapter 20.

106 Rev. Rul. 98-15, 1998-12 IRB 6; see also Chapter 22.

107 Rev. Rul. 97-21 formalizing IRS Announcement 95-25, issued March 15, 1995.

108 This ruling is cited to evaluate reasonableness of compensation paid to university scientists in Chapter B, "Intellectual Property," *IRS CPE Text,* 1999.

109 Ibid. note 65.

- The hospital meets the operational test and engages, to a substantial extent, in activities that further its exempt purposes and are reasonably related to accomplishing that purpose in keeping with the standards described in Rev. Ruls. 80-278 and 80-279.[110]
- The physicians do not have a substantial influence over the affairs of the hospitals recruiting them so that they would be treated as disqualified persons under §4958,[111] nor do they have any personal or private interest in the hospital that could result in private inurement. The recruitment package must not be structured as a device to distribute net earnings of the hospital to the physician.
- The hospital must not engage in substantial unlawful activities inconsistent with charitable purposes.

The ruling states that the determination of whether the recruitment incentives cause the organization to violate the operational test is based upon all relevant facts and circumstances and contains five scenarios illustrating their position. The first four provide for acceptable recruitment incentives that do not result in private inurement to the physicians. In Situation 5, the hospital is found to operate for substantial nonexempt purposes and fails to qualify for exemption.

Situation 1. Hospital A is the only hospital within a 100-mile radius and designated by the U.S. Public Health Service as a Health Professional Shortage Area for primary medical care professionals. The hospital has a demonstrated need for ob-gyns in its service area. The hospital recruits a physician who has recently completed an obstetrics and gynecological residency to establish and maintain a full-time practice in its service area and become a member of its medical staff. A signing bonus is paid, a professional liability insurance premium is paid for a limited period of time, below-market office rent for a limited number of years (after which time the rent will be at fair value; again, number not given) is provided, the physician's residential mortgage is guaranteed, and start-up financial assistance bearing "reasonable terms" is provided. The written incentive package is negotiated in an arm's-length fashion in accordance with guidelines that are adopted, monitored, and reviewed regularly by the hospital's board of directors to ensure its exempt purposes are being served. A committee responsible for medical staff contracts approves the agreement. No benefits other than those stipulated in the agreement are provided.

Situation 2. Hospital B is located in an economically depressed inner-city area of City W and has conducted a community needs assessment indicating both a shortage of pediatricians in its service area and difficulties Medicaid patients are having obtaining pediatric services. Hospital B recruits a physician to relocate and establish a full-time pediatric practice in its service area, join its medical staff, and treat a reasonable number of Medicaid patients. Again in an arm's-length negotiation approved by its board, the physician is offered payment of moving expenses, professional liability "tail" coverage for the former practice,

[110] 1980-2 C.B. 175-176.
[111] See Section 20.9.

and a guaranteed level of private practice income for a limited number of years. The amount guaranteed falls within the range of compensation paid to physicians in similar positions according to regional or national surveys.

Situation 3. Hospital C, also located in an economically depressed inner-city area, conducts a community needs assessment and finds indigent patients are having difficulty getting access to care because of a shortage of obstetricians in its area willing to treat Medicaid and charity care patients. A member of its current medical staff is recruited to provide these services in return for payment of professional liability insurance during the year the services are provided. The agreement is written and approved in the same fashion as described in Situation 1. The ruling finds the amount paid to the physician is reasonable and that any private benefit to the physician is outweighed by the public purposes served by the agreement.

Situation 4. Hospital D is located in a medium- to large-size metropolitan area. It maintains a minimum of four diagnostic radiologists to ensure adequate coverage and a high quality of care for its radiology department. When two of its radiologists resign, it recruits a radiologist currently working for another hospital in the city. The hospital agrees in a properly approved and written document to supplement the physician's income to the extent the private practice does not generate a certain level of net income for the first few years.

Situation 5. Hospital F was criminally convicted of knowingly and willfully violating the Medicare and Medicaid anti-kickback statute in its physician recruitment practices. The activities resulting in the violations were substantial.

The examples in the ruling emphasize the board and duly authorized units operating under the aegis of the board analyzing the institution's ability to accomplish its exempt purpose. With that focus, a board can develop a methodology for meeting its charitable needs and take appropriate steps using reasonable standards for determining fair value and the terms of the arrangements deemed necessary to accomplish the exempt purposes. All exempt organizations, particularly hospitals, are expected to have "contemporaneous documentation of process" to evidence the tax-exempt nature of their financial decisions.[112]

Practitioners were pleased when the IRS issued Rev. Rul. 97-21 containing the examples of permissible physician recruitment plans. New circumstances were added when the IRS privately approved bonuses to sway currently practicing physicians to move across town.[113] The hospital's hiring decisions were based on community need assessments. Incentives were given only to physicians whose services were not currently available within its service area or to graduates of a physician-training program. Because the "determination of whether the recruitment incentives cause the organization to violate the operational test is based on all relevant facts and circumstances," the ruling request also stipulated that the plan further its

[112] Remarks of then-chief of IRS Exempt Organization Division, Marcus Owens, at a meeting of the American Bar Association Exempt Organizations Committee, May 9, 1997.

[113] Unpublished private letter ruling dated July 31, 1998, reprinted in *The Exempt Organization Tax Review,* vol. 25, no. 1, July 1999, pp. 117–122.

charitable objectives. The hospital required that the terms be reasonable in regard to each recruit, be set out in a written agreement, and not confer any prohibited private inurement or more than incidental private benefit to any physician. The assistance provided to an existing physician practice for recruiting a physician was limited to no more than 50 percent of the physician's total assistance.

(c) Hospital Joint Ventures

While the national and state legislatures, the administration officials in the White House, and the general populace debated the need to reform health-care delivery in the United States, no significant changes in the law were passed, but the health-care industry voluntarily reformed itself. Managed care became the normal method for dispensing health care; mergers, consolidations, and buyouts of nonprofit providers with and by for-profit entities frequently occurred. Combinations of health-care providers happened at such a pace that the IRS was often unable to keep up. Because of reduced staff levels, during the 1990s the Exempt Organization Group could not consider requests for private letter rulings within the time frame projects required. Significant transactions involving nonprofit hospitals that previously would have been undertaken only after approval by the IRS went without.[114] The significant issue in determining a hospital's qualification as a (c)(3) organization is whether it operates to provide public benefit or yields private inurement to those that manage and operate it.

To finance expansion and improve their health-care facilities, tax-exempt hospitals have opportunities to enter into associations with for-profit companies and investors. When the use and control of hospital assets is altered by entering into a joint venture or partnership, the hospital may maintain its tax-exempt status as long as the venture's activity is primarily charitable and the private interests of the for-profit partners are only incidentally served by the arrangement. Importantly, under concepts of partnership taxation, the activities and income of the venture are treated as those of the partners in the venture. The IRS illustrated the venture terms it considers to serve charitable interests as compared to those it deems serve private interests in Rev. Rul. 98-15. The 2003–04 IRS/Treasury Guidance Plan promising new guidance on this subject was not yet issued as this edition was written.

Charitable Venture. A (c)(3) hospital, in need of additional funding, forms a limited liability company (LLC) with investors. All of the hospital's assets are contributed to the venture in return for an ownership interest proportional to their value. The LLC board has three representatives of the hospital and two chosen by the investors (hospital controls). Governing documents require that the venture operate to further charitable purposes by promoting health for a broad cross section of its community and can only be amended by the hospital-controlled board. The board must also approve major decisions relating to the venture operations, such as capital and operating budgets, distribution of earnings, selection of key executives, contracts in excess of $X a year, changes in types of services the hospital offers, and renewal or termination of management agreements.

[114] An article on this complex and ever-changing subject, entitled "Virtual Mergers—Hospital Joint Operating Agreement Affiliations," in the *IRS CPE Text,* 1997, provided seven meager pages of guidance.

Commercial Venture. A tax-exempt hospital (the "exempt") in need of capital forms an LLC with a for-profit hospital. Similar to the charitable venture, each venturer receives ownership in proportion to the value of its respective assets contributed. Otherwise the venture agreement evidences to the IRS that ownership of the LLC will not serve the exempt's purposes. The purpose clause of the governing documents does not dedicate the LLC to charitable purposes. The governing body that is empowered to amend the documents and make major decisions consists of three individuals chosen by each venturer (the exempt is not in control). The LLC is to be operated by a management company owned by the for-profit hospital (major decisions delegated to the for-profit). As a part of the agreement, the exempt agrees to approve of two for-profit executives to serve as the LLC's chief executive and financial officers. The IRS found that the absence of a binding obligation on the LLC to serve a charitable purpose meant the venture could "deny care to segments of the community, such as indigents."

The first chapter in the 1999 *Exempt Organization Continuing Professional Education (EO CPE) Text* is entitled "Whole Hospital Joint Ventures" and states that the IRS, in issuing Rev. Rul. 98-15, "does not seek to curb" all such ventures. When an exempt enters into a venture, the IRS expects charitable purposes to supersede profit maximization purposes, that health-care services benefit the community as a whole, and that the venture does not result in greater than incidental private benefit to the taxable partner or other private parties. The *CPE Text* contains a list of 24 questions the exempt organization division used in its examinations of such ventures as part of its 1999 work plan. How ventures stray from the acceptable venture in the ruling remains to be seen. What if the charter constrains the operations to be charitable but the for-profit partners control, for example? Readers should be alert for new developments as a result of the examinations and the Tax Court litigation of Redlands Surgical Services pending as this edition is prepared.

The Tax Court agreed with the IRS that Redlands Surgical Services (RSS), through its joint ownership and operation of health-care facilities, served the private interests of its for-profit partners and could not qualify for tax exemption.[115] RSS owned only 46 percent of a general partnership that deprived it of control while allowing it to be exposed to liabilities. Management services were provided by a subsidiary of the for-profit 54 percent partner under terms that were "favorable to the for-profit" and lasted for 15 years, with renewals for 10 more years at the for-profit's option. The entire arrangement was in "direct conflict with achieving charitable goals," according to the IRS, and the agreements did not contain charitable objectives. Very few Medicaid patients were served, indicating a lack of community benefit necessary to evidence charitable purposes. In keeping with the conclusion in the second example—the "commercial venture" described in Rev. Rul. 98-15—the IRS insists that the charity must be in control for a joint venture to serve charitable purposes. The U.S. Court of Appeals adopted the Tax Court's decision to sustain the IRS's disapproval of exempt status for Redlands Surgical Services. In its brief comments, the court emphasized its objections to the

[115] *Redlands Surgical Services v. Commissioner* 113 T.C. 47, KTC 2001-102 (9th Circ. 2001) see new comments for Section 22.3.

ceding of effecting control over the operations of the health-care facility to the for-profit partners that, in its opinion, conferred impermissible private benefit.

St. David's Health Care System Inc. initially convinced a Texas District Court that, despite the fact that it owned a 45.9 percent interest in the joint venture it formed with a for-profit hospital company, HCA, Inc., there was "absolutely no question" that it was operated for charitable purposes and substantially engaged in charitable activity. The Fifth Circuit Court, however, agreed with the IRS and ruled St. David's less than 50 percent equity interest furthered the private, profit-seeking interests of its for-profit partner.[116] The IRS, in its examination, found charity care levels could not be measured by the hospital's bad debts. It also insisted the community board was required to control the joint venture to assure lack of private interests. The operating agreement's requirement that the hospital operate in accordance with the community benefit standard was insufficient despite the fact that St. David's has the unilateral right to dissolve the partnership if the activity fails to do so. Nor was it persuasive that St. David names the board chair and can remove the chief executive officer. This revocation of the hospital system's exempt status reinforces the IRS view that at least a 50-50, and preferably more than 50 percent control, by the exempt organization is necessary in such a joint venture to be considered a charitable activity.[117]

The 2002 *IRS CPE Text* contains a 24-factor checklist to use to analyze the impact of joint venture participation on a tax-exempt entity; it is the opinion of many that the IRS will appeal this case, so readers should stay tuned.[118] Guidance on this important subject is on the top of the list on the IRS/Treasury Work Plan for 2003-2004.

(d) Physician Clinics

A clinic providing private medical care to individuals is traditionally owned by the doctors, operated for their profit-making purposes, and not qualified for tax exemption, even though it operates for the purpose of promoting health. When a clinic has no private ownership, provides a reasonable level of free or reduced-charge care to members of a charitable class, and otherwise distinguishes itself as a charitable organization, exemption can be sought under the standards previously listed under "Charity Care."

Clinics operated in conjunction with charity hospitals and medical schools, so-called faculty practice plans, have traditionally been granted exemption, but there are few clear precedents in the area. In one case approving exemption for such a clinic, the physicians were staff members of a teaching hospital and full-

[116] *St. David's Health Care System Inc. v. United States,* No. A-01-CA-046 (D.C. W. Tex. 2002) revoked in KTC 2003-425 (5th Cir. 2003); see also Priv. Ltr. Ruls. 200151046, 200218037, and 200206058.

[117] See L. Brauer, M.J. Salins, & R. Fontenrose, Chapter D: Update on Health Care, *IRS CPE Text,* 2002.

[118] See G.M. Griffith, "Redefining Joint Venture Control Requirements: St.David's vs. Goliath?" *The Exempt Organization Tax Review,* August 2002, pp. 255-276; and M. Sanders, "How to Structure Joint Ventures Involving Charities inToday's Climate," *Taxation of Exempts,* July/August 2002.

time medical school faculty members.[119] About 25 percent of the patients were indigent or students, and medical research was conducted, evidencing a significant element of charitable purpose in addition to the promotion of health.

Leasing of computer systems to a nonexempt faculty practice partnership was deemed an exempt activity for a hospital support organization. Because the doctors were necessary for teaching and supervising residents and interns, the IRS found the leasing activity consistent with the purposes of the teaching hospital and, correspondingly, its support organization, making the revenues related to exempt purposes.[120]

(e) Integrated Health-Care Delivery Systems

Health-care organizations often combine all service providers—the doctor's clinic, the hospital, the HMO, the pharmacy, and so on—into a consolidated group, called an *integrated health delivery system,* or IDS. The doctors sell their practices to the IDS, become hospital employees, and provide medical services on behalf of one branch, usually the hospital. For management and legal liability reasons, the respective parts of the IDS may remain separately incorporated and individually maintain tax-exempt status. Such a related group of organizations can function as a unit of separate, but integrated, exempt organizations.[121] The IRS had some difficulty originally approving IDSs for charitable status.

A favorable ruling for this type of entity depends upon proof that the private doctors do not get favorable treatment in the deal or do not reap private inurement. To give an idea of the policies an organization must adopt to prove they benefit the community[122] rather than the individual doctors, the conditions under which one IDS was granted exemption are described here. Facey Medical Foundation, a newly created holding company that planned to control 12 tax-exempt hospitals and also create a taxable subsidiary to purchase a private medical practice, received a favorable determination that it qualified as a §501(c)(3) organization.[123] The nonexempt sub planned to buy a 48-physician practice, along with the tangible and intangible assets, including trade name, medical service contracts, noncompetition agreements, and patient files. Following IRS policy that the purchase of goodwill is inconsistent with exempt status, there was no compensation for goodwill. Facey leased back the assets and provided management services and nonphysician support for the medical practice. The selling doctors receive a set percentage of Facey's gross income for the first two years

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[119] *University of Maryland Physicians, P.A. v. Commissioner*, 41 T.C.M. 732 (1981); see also *University of Massachusetts Medical School Group Practice v. Commissioner*, 74 T.C. 1299 (1980).

[120] Priv. Ltr. Rul. 9847002.

[121] Discussed in Section 2.2(h).

[122] The community benefit standard was originally set out by the IRS in Rev. Rul. 69-545, 1969-2 C.B. 117.

[123] Exemption letter dated March 31, 1993; see also exemption letter of Friendly Hills Healthcare Network, issued on February 8, 1993. For comparison of the two letters, read special report of Michael W. Peregrine and Bernadette M. Broccolo, entitled "New 'IDS' Determination Letter Offers Promise, Sparks Controversy," and also "A Practical Examination of the IRS and OIG Rules for Integrated Delivery Systems," by Gerald R. Peters, *7 The Exempt Organization Tax Review* 757 (May 1993).

only, with their compensation subsequently to be worked out in arm's-length negotiations. The favorable determination was based upon the following significant factors that apparently proved to the IRS that there was sufficient community benefit[124] rather than private benefit to the doctors whose practices were being purchased:

- The organization's board of directors will be controlled by members of the community, with no more than 20 percent of the board members being doctors.
- A substantial number of the physicians will give emergency room care without regard to a patient's ability to pay.
- The hospitals will provide at least $400,000 worth, not counting bad debts, of charity care annually.
- Facey will participate in both the Medicare and MediCal Insurance program in a nondiscriminatory manner.
- Significant clinical research and public education programs will be conducted.
- Facey will comply with anti-kickback provisions of the Social Security Act.[125] Essentially, the terms of the buyout and compensation arrangements with physicians would not induce or reward referrals.

The published determination letters of other integrated delivery systems issued since that time can be studied to further clarify the IRS's thinking on this subject.[126]

A pair of professional service organizations, operated in conjunction with the State University of New York at Buffalo's medical and dental schools to assign residents to local teaching hospitals, was denied tax-exempt status. The court found that the organizations were "appendages rather than integral parts of the educational or hospital organizations they serve" (organizational documents themselves stated the service organizations were ancillary to the primary purpose of the school's graduate medical and dental education). Since they serve the university, as well as the hospitals, they also could not qualify as cooperative hospital service organizations under IRC §501(e)."[127]

(f) Health Maintenance Organizations

Health maintenance organizations (HMOs) providing prepaid medical care to members can be exempt if a large enough charitable class is benefited and the HMO provides the care itself.[128] HMOs providing commercial-type insurance as

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[124] The community benefit standard was originally set out by the IRS in Rev. Rul. 69-545, supra note 95.

[125] §1128(b) of the Social Security Act, 42 U.S.C. §1230a-7b(b)(1) and (2), prohibiting payment of fees for referrals of patients eligible for Medicare coverage.

[126] Friendly Hills Healthcare Network, Geisinger Health Plan, Presbyterian Multi-Specialty Group Practice Foundation (Philadelphia, PA), St. Luke's Medical Associates, Inc. (Kansas City, MO), and Tobey Medical Associates, Inc. (Wareham, MA).

[127] *University Medical Resident Services, P.C. v. Commissioner,* T.C. Memo. 1996251.

[128] *Sound Health Associates v. Commissioner,* 71 T.C. 158, acq. 1981-2 C.B.2.

a substantial part of their activities are not, however, tax exempt under §501(m), which was enacted as a part of the Tax Reform Act of 1986. Insubstantial insurance activity that does not prevent exemption is subject to unrelated business income tax.

Due to the significant controversies discussed here, the IRS on May 27, 2003, announced it was suspending revocation of HMO exemption for 18 months.[129] Examination guidelines will be revised.[130] Comments were solicited to aid them in proposing new regulations to define *commercial-type insurance.* Matters involving HMOs were to be referred to EO Technical (Washington office). Readers therefore should review the following discussion for historical reference but check for updated guidance on this subject.

In September 1990, the IRS issued a memo setting forth the criteria it would follow for issuing exemptions to HMOs.[131] The standards were designed to ensure that HMOs operate to benefit the community and were similar to those applied for exemption of hospitals. The criteria are as follows:

- Health-care services and facilities are provided.
- Emergency treatment is available without regard to ability to pay, and this fact is communicated to the public.
- Membership organizations must make efforts to expand the number of members to spread the cost among more persons, seek individual members, have no age or eligibility barriers, and charge individuals rates similar to those charged groups.
- Nonmembers are served on a fee-for-service basis.
- Medicare, Medicaid, and other publicly assisted patients are accepted, and care is provided at reduced rates for indigents.
- Health education and research programs are provided.
- Health-care providers are paid fixed compensation (no incentive pay).
- Operating surpluses are dedicated to improving facilities and health-care programs.
- The community is broadly represented on the governing body.

A court agreed with the IRS that an HMO that did not itself provide direct medical services and conducted no programs to satisfy the community benefit standards previously outlined could not qualify as charitable.[132] Although the HMO at issue, Geisinger Health Plan, could conceivably qualify as charitable if it were an integral part of a parent health-care system, its primary activity—the provision of insurance-like contract medical services for private patients—did not qualify for charitable status. Likewise, because its primary focus was serving private patients in addition to those of the hospitals, it could not qualify as an

[129] IRS Notice 2003-31.
[130] Internal Revenue Manual, Chapter 27, Health Maintenance Organizations Handbook: IRM 7.8.1.
[131] Gen. Coun. Memo. 39828.
[132] *Geisinger Health Plan v. Commissioner,* 985 F.2d 1210 (3d Cir. 1993), rev'g. 62 T.C.M. 1656 (1991).

exempt feeder under the integral part test. The decision should be read in detail by any proposed HMO not meeting most of the nine IRS criteria previously listed. The Third Circuit revisited the Geisinger Health Plan and again decided that it failed to qualify for exemption.[133] A two-pronged test was applied to determine whether the organization qualified under the integral part test:

1. It is not carrying on a trade or business that would be an unrelated trade or business if regularly carried on by the parent.
2. The relationship to its parent somehow enhances the subsidiary's own exempt character to the point that, when the boost provided by the parent is added to the contribution made by the subsidiary itself, the subsidiary would be entitled to (c)(3) status.

Nonprofit HMOs exclusively providing services to Medicaid recipients can also qualify for (c)(3) status if the standards described here are satisfied. Such organizations are formed to serve managed care systems established by states following the example of other health-care providers.[134]

IHC Health Plans and its two affiliated organizations were denied exemption under §501(c)(3) because they did not provide sufficient community benefits.[135] Despite the fact that the organizations provided Medicaid managed care services to nearly 50 percent of eligible persons in Utah and health-care coverage to about 20 percent of the state's total population, the court agreed with the IRS that the organizations essentially provided commercial-type insurance. IHC did not have its own facilities, emergency care, subsidized coverage to the needy, or a health education program. Also, the fact that plan enrollees received nearly 80 percent of their services from physicians with no direct link to IHC indicated it could not qualify as a health-care provider.

(g) Health/Fitness Centers

An increasingly important component of the health-care industry is alternative therapies and regimes that prevent illness. Most everyone in America today agrees that physical fitness and dietary prudence promote health. Nonprofit organizations as well as private industry address this concern. For both, the activity itself is essentially charitable: to promote health. What distinguishes a nonprofit fitness center is the absence of private ownership and operational practices that distinguish it from its commercial counterparts, following the standards outlined in Chapter 2.

The provision of a fitness facility to the healthy, however, may not always be considered a charitable activity. A community center that restricts its availability to less than an entire community, for example, cannot be classified as charita-

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[133] *Geisinger Health Plan v. Commissioner,* 100 T.C. 394 (1993), aff'd. 30 F.3d 494 (3rd Cir. 1994).

[134] Chapter D, "Exemption of Medicaid HMOs and Medicaid Service Organizations under IRC 501(c)(3)," *IRS CPE Text,* 1999, contains two examples of Medicaid HMOs that do not qualify compared to one that does.

[135] *IHC Health Plans Inc. v. Commissioner,* T.C. Memo. 2001-246, *IHC Group v. Commissioner,* T.C. Memo. 2001-247, and *IHC Care Inc. v. Commissioner,* T.C. Memo. 2001-242-8, aff'd. 325 F.3d 1188 (10th Cir. 2003).

ble.[136] On the other hand, the operation of a health and fitness center providing access to handicapped persons and offering reduced daily rates for persons of limited financial means serves a health-care organization's exempt purposes.[137] As a part of a new medical complex, a sports and physical medicine facility was designed to serve patients referred by the center's hospitals and physicians, as well as the general public. What primarily distinguished this center as a charitable facility is its provision of services to patients and employees of the medical center. It provided availability to the general public in a noncommercial manner and was found to contribute to the center's exempt purpose of providing health care to the community in which it is located.

A similar conclusion was reached regarding a wellness center created as a joint venture of an acute care hospital, its parent, and an orthopedic hospital. The facilities were designed to provide physical rehabilitation services to patients and to the general public. The membership fee structure would permit access to the general public, and the facility would serve the creators' exempt health-care purposes. The center was therefore found to be exempt.[138] A heart health center operating as an integral part of an acute care hospital was also deemed distinguishable from commercial health centers. Its fees were low enough to be within financial reach of a significant segment of its community, and scholarships were granted to those in need of cardiovascular rejuvenation but unable to pay.[139] An organization sponsoring general fitness programs for youths by operating a track, gymnasium, swimming pool, and courts for racquetball, handball, and squash, was also found to be accomplishing an exempt purpose.[140] Access to most of its facilities was available upon payment of a nominal annual fee. Its operation of a health club program providing use of a spa, exercise rooms, whirlpool, sauna, and such, was, however, considered an unrelated activity not contributing to its exempt purposes. Club members paid an advance annual fee that was comparable to that charged by a commercial health club and sufficiently high to restrict participation in the facility.

(h) Professional Standards Review Organizations

Under Social Security legislation in 1972, Congress authorized the creation of professional standards review organizations (PSROs). PSROs monitor and establish cost and quality controls for hospitals in their area with the intention of reducing overutilization of government-financed health programs. PSRO members must be licensed physicians. The exemption issue is again whether the PSRO serves the public or the individual doctor members and the medical pro-

[136] Rev. Rul. 67-325, 1967-2 C.B. 113.
[137] Priv. Ltr. Rul. 8935061.
[138] Priv. Ltr. Rul. 9226055; similar result in Priv. Ltr. Rul. 200203070.
[139] Priv. Ltr. Ruls. 9736047 and 200101036.
[140] Rev. Rul. 79-630, 1979-2 C.B. 236; see Priv. Ltr. Rul. 9736047 for IRS rationale for granting exemption to a heart health center operated in conjunction with an acute care hospital; see also Priv. Ltr. Ruls. 9329041, 9226055, and 9110042, which focus on whether fees were set at a level to make the facility available to the general public. Topic A of the *IRS CPE Text,* for fiscal year 2000, addresses factors that distinguish tax-exempt fitness centers from their commercial counterparts.

fession. A PSRO must possess the following attributes to qualify for exemption as a charity—otherwise, it may qualify as a business league[141]:

- It must operate to ensure quality and care utilization for Medicare and Medicaid patients.
- Membership is open to all physicians without charge.
- The governing body cannot be controlled by or tied to a medical society.
- The PSRO is authorized to act under the federal statutes.

An organization that reviewed the propriety of hospital treatment provided to Medicaid recipients was also found to be exempt because it relieved the burden of government and promoted the health of persons eligible for Medicare and Medicaid.[142]

(i) Homes for the Elderly

Until 1972, homes for senior citizens were required to provide free or low-cost services.[143] Today, a charitable home may charge full cost for its services so long as it provides for the primary needs of the elderly—housing, health care, and financial security. In seeking approval for exemption, a home must furnish detailed information about its proposed or actual operation on Schedule F of Form 1023.[144] The questions address the following specific policies that a home must maintain to qualify as charitable[145]:

- Have a commitment to maintain in the residence any person who becomes unable to pay his or her regular charges, or do all that is possible to make other suitable arrangements for their care
- Provide its services at the lowest feasible cost, taking the facts and circumstances of the home into account (for example, cost of facility or wages in the area)
- Charge fees affordable by a significant segment of the elderly population so as to evidence benefit to the community in which it is located
- Adopt policies to protect itself financially and enable it to meet its obligation not to expel elderly residents who become unable to pay

A home may require its applicants to make a deposit upon admission of an amount of assets calculated to secure their care.[146] A home might also permit residents to establish trusts, the income of which is payable to the home during the resident's life. Income from trusts is exempt function income to the home because

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[141] Rev. Rul. 81-276, 1981-2 C.B. 128.
[142] *Professional Standards Review Organization of Queens County, Inc. v. Commissioner,* 74 T.C. 240(1980).
[143] Rev. Rul. 72-124, 1972-1 C.B. 145.
[144] Reproduced in Appendix 18-1.
[145] Rev. Rul. 79-18, 1979-1 C.B. 152.
[146] Priv. Ltr. Rul. 9225041.

it is paying the fees.[147] Charitable status can be allowed for a senior citizen home that allows full-paying elderly to keep their assets, subject to a requirement that such assets could be used, if necessary, to supplement income to meet the monthly charges.[148]

A pharmacy organized to furnish discount drugs to senior citizens was denied exemption because it operated for commercial purposes and had no charitable attributes such as low-cost or free drugs to the indigent.[149]

4.7 COOPERATIVE HOSPITAL SERVICE ORGANIZATIONS

IRC §501(e) provides that a cooperative hospital service organization is a charitable organization. Two or more hospitals, either one of which meets the qualifications of IRC §170(b)(1)(A)(iii) or is operated by a governmental unit, may organize and operate under the following rules:

- It must perform, on a centralized basis, the following functions: data processing, purchasing (including insurance), warehousing, billing and collections, food service, clinical care, industrial engineering, laboratory services, printing, communications, record center, and personnel (including selection, testing, training, and education).
- The cooperative cannot accumulate profits, but must distribute all net earnings to its patrons on the basis of services performed for them.
- Any stock issued by the cooperative must be owned by its patrons.

Note that the list does not include laundry; Congress deliberately omitted laundry services. The courts have agreed that only the specified services listed in the code may be performed on a cooperative basis. A group providing laundry service may be treated as a cooperative under IRC §1388.

[147] Rev. Rul. 81-61, 1981-1 C.B. 355.

[148] Priv. Ltr. Rul. 9307027.

[149] *Federation Pharmacy Service, Inc. v. U.S.*, note 21. Likewise, an organization formed to help senior citizens with funeral expenses could not be exempt unless it allowed indigents to participate. *El Paso del Aquila Elderly,* T.C. Memo, 1992, 441.

CHAPTER FIVE

Educational, Scientific, and Literary Purposes and Prevention of Cruelty to Children and Animals

5.1 EDUCATIONAL PURPOSES

Educational purposes include "instruction or training of individuals to improve or develop their capabilities; or instruction of the public on subjects useful to the individual and beneficial to the community."[1] This definition of *educational* encompasses professional or occupational training regarding business capabilities.[2] The regulation gives the following four examples of educational organizations:

[1] Reg. §1.501(c)(3)-1(d)(3).
[2] Subject to standards discussed in Section 5.1(e).

1. Primary or secondary schools, colleges, or professional or trade schools
2. Public discussion groups, forums, panels, lectures, or similar programs
3. Organizations that present courses of instruction by means of correspondence or through the utilization of television or radio
4. Museums, zoos, planetariums, symphony orchestras, and other similar organizations

In clearing the hurdles to obtain exemption, a potentially tax-exempt nonprofit must first decide whether to claim exemption as a charitable or as an educational organization. A stricter standard, with more fully developed criteria, exists for educational organizations. The Internal Revenue Service (IRS) regulation defining *charitable* organizations says:

> The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under IRC §501(c)(3) so long as it is not an "action" organization.[3]

The same regulation, in defining *educational* organizations, instead says:

> An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.[4]

This regulation was held to be unconstitutionally vague in the Big Mama Rag, Inc., case in 1980.[5] The IRS had argued that the newspaper, in celebrating the cause of lesbians, failed to present a "full and fair exposition of the facts" as required by the regulations. The court noted that the regulations do not make clear what groups are advocacy groups that must meet this test, nor do they provide any objective standard for distinguishing facts from opinions.

Without answering the questions posed by the D.C. Circuit, the IRS, in November 1986, issued a ruling outlining a methodology test for identifying impermissible advocacy.[6] The presence of any of the following factors indicates that the method used by the organization to advocate its viewpoints or positions is not educational:

- The presentation of viewpoints or positions unsupported by facts is a significant portion of the organization's communications.
- The facts that purport to support the viewpoints or positions are distorted.

[3] Reg. §1.501(c)(3)-1(d)(2); see Sections 2.2(g) and 23.6.
[4] Reg. §1.501(c)(3)-1(d)(3); discussed in Section 3.1(j).
[5] *Big Mama Rag, Inc. v. U.S.*, 631 F.2d 1030 (D.C. Cir. 1980*), rev'g.* 79-1 USTC ¶9362 (D.C. 1979).
[6] Rev. Rul. 86-43, 1986-2 C.B. 729.

- The organization's presentations make substantial use of inflammatory and disparaging terms, and express conclusions more on the basis of strong emotional feelings than of objective evaluations.
- The approach used in the organization's presentations is not aimed at developing an understanding on the part of the intended audience or readership because it does not consider their background or training in the subject matter.

The methodology test was designed to "eliminate or minimize the potential for any public official to impose his or her preconceptions or beliefs in determining whether the particular viewpoint or position is educational." It is the method used by the organization to communicate its viewpoint or position to others, not the viewpoint itself, that will be tested. The IRS continues to apply this methodology test that was condoned by the Tax Court in confirming denial of exemption for The Nationalist Movement, a pro-white Mississippi organization advocating social, economic, and political change.[7]

An organization that espouses a particular viewpoint concerning issues that may be the subject of legislation or political debate, such as welfare, abortion, or guns, must first test its methodology for making a sufficient presentation of facts. A parallel, but different, issue is whether it is an action organization whose purposes can be accomplished only through the passage of legislation.[8] If legislative advocacy is the organization's primary mission, it may not qualify for tax-exempt status. Electioneering is strictly prohibited for a (3) organization. Ask also whether its purposes can be accomplished only through the passage of legislation by persons it plans to help to get elected. The House Ethics Committee investigation of Representative Newt Gingrich's work with the Abraham Lincoln Opportunity Foundation and the Progress and Freedom Foundations during 1997 focused on these issues. Were the contents of the foundation programs biased? Were the foundations created to advance the private interests of Gingrich and the Republican Party? The information gathered by the committee was turned over to the IRS for examination. Some were surprised that exempt status was not eventually revoked.[9]

(a) Schools

Schools, like churches and hospitals, occupy a privileged category of §501(c)(3) organizations that are classified as public charities because of the activity they conduct rather than the sources of their revenue. Consequently, the definition of an educational organization that qualifies for classification as a school is very

[7] *The Nationalist Movement v. Commissioner,* 102 T.C.No. 22 (1994), *aff'd.* 37 F.3d 216,74 (5th Cir. 1994).

[8] See Section 2.2(g).

[9] After a 3-1/2 year audit, the IRS determined that the college course sponsored by the Progress and Freedom Foundation (PFF) did not yield private benefit to Newt Gingrich nor constitute campaign intervention. The 74-page unreleased Tech. Adv. Memo. was printed in the March 1999 issue of *The Exempt Organization Tax Review;* for discussion of the political intervention prohibitions, see Section 2.1(e) and Chapter 23.

specific and encompasses what can be thought of as the three "regulars." A school is a formally organized entity that possesses the following attributes[10]:

- Regular faculty of qualified teachers
- Regularly scheduled curriculum
- Regularly enrolled body of students in attendance at the location where the educational activities take place

The following educational organizations have also been ruled to be schools:

- Early childhood education centers[11]
- Boards of education that employ all the teachers in a school system and that supervise all the schools in a district[12]

The presentation of formal instruction must be a primary function of a school. The term includes primary, secondary, preparatory, and high schools, and colleges and universities. Schools publicly supported by federal, state, and local governments qualify for this category by definition, and in most cases also qualify as governmental units.[13] A school possessing this duality might seek recognition of (c)(3) qualification to facilitate fund-raising. When the state school has tax-exempt status, however, it is subject to the organizational and operations tests.[14] Advisors for a school can test its qualification for this category by studying the IRS examination guidelines for colleges and universities developed for use by its specialists.[15] Factors considered by the IRS to determine that a school can continue to qualify can also be used as a reference for organizations seeking recognition as a school. The IRS addressed the special issues involved in the qualification of charter schools in its year 2000 training materials.[16]

What the regulations call "noneducational" activities must be incidental. A recognized university can operate a museum or sponsor concerts and remain a school. A museum's art school, however, does not make the museum a school.[17]

All four elements must be present to achieve recognition as a school: regular faculty, students, curriculum, and facility. A home-tutoring entity providing private tutoring was held not to be an educational organization for this purpose.[18] Likewise, a correspondence school was not approved under this section because it lacked a physical site where classes were conducted.[19]

The word *curriculum* was loosely construed in a ruling that permitted an elementary school to qualify despite the fact that it had no formal course program

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[10] Id., note 1.
[11] *Michigan Early Childhood Center, Inc. v. Commissioner,* 37 T.C.M. 808 (1978); *San Francisco Infant School, Inc. v. Commissioner,* 69 T.C. 957 (1978); Rev. Rul. 70-533, 1970-2 C.B. 112.
[12] *Estate of Ethel P. Green v. Commissioner,* 82 T.C. 843 (1984).
[13] Reg. §1.170A-9(b); see discussion in Section 10.2.
[14] See Chapter 2.
[15] Exempt Organizations Examination Guidelines Handbook 7(10)69.
[16] Chapter J, *IRS CPE Text,* 2000.
[17] Rev. Rul. 76-167, 1976-1 C.B. 329.
[18] Rev. Rul. 76-384, 1976-2 C.B. 57.
[19] Rev. Rul. 75-492, 1975-2 C.B. 80.

and espoused an open learning concept.[20] However, leisure learning classes, in the eyes of the IRS, do not present a sufficiently formal course of instruction to qualify as a school. Lectures and short courses on a variety of general subjects not leading to a degree or accreditation do not constitute a curriculum.[21] Also, invited authorities and personalities recognized in the field are not considered to be members of a regular faculty.[22]

The duration of the courses has not been considered a barrier by the IRS. An outdoor survival school whose classes lasted only 26 days, but were conducted with regular teachers, students, and course study, was classified as a school, despite the fact that part of the facilities it used were wide open spaces.[23]

IRC §529, entitled Qualified State Tuition Programs, exempts organizations established for prepaid tuition plans and exempts their investment income, except to the extent to which it may be subject to the unrelated business income tax.[24] To qualify, the program must be established or maintained by a state or instrumentality of a state to allow persons to purchase tuition credits and to contribute to an account established to pay the qualified higher education expense of a designated beneficiary. Such expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible education institution.[25]

(b) Race Discrimination

Schools must adopt and practice, in good faith, policies prohibiting racial discrimination. A statement that it has a racially nondiscriminatory policy must be included in its charter, bylaws, or other governing instrument or be effective by resolution of its governing body. School brochures, catalogs, and other printed matter used to inform prospective students of the school's programs must contain a policy statement as it relates to admission applications, scholarships, and program participation. Statistical records of the racial composition of the student body must be maintained to evidence the existence of the nondiscrimination policy. Schools must complete a special page of Form 990, Schedule A, to inform the IRS that it has met these requirements.[26] The nondiscrimination policy must be made known, or publicized, to all segments of the general community served by the school. A school that, in fact, has currently enrolled students of racial minority groups in meaningful numbers is excused from the media publicity requirement. Form 5578 is due to be filed by schools that are not required to file Form 990, primarily including church schools that qualify as an integrated auxiliary of a church.[27] Some denominations file this form on behalf of their schools.

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[20] Rev. Rul. 72-430, 1972-2 C.B. 105.
[21] Rev. Rul. 62-23, 1962-1 C.B. 200.
[22] Rev. Rul. 78-82, 1978-1 C.B. 70.
[23] Rev. Rul. 73-434, 1973-2 C.B. 71.
[24] Small Business Job Protection Act of 1996, §1806.
[25] See Section 10.2 for history of this code section.
[26] Reproduced and explained line by line in Jody Blazek, *IRS Form 990 Tax Preparation Guide for Nonprofits* (Hoboken; Wiley, 2004) and companion website at www.wiley.com
[27] See Section 3.2 and Blazek; *IRS Form 990 Tax Preparation Guide.*

A private school that adopted a nondiscrimination policy in connection with seeking application for recognition of its exemption as an educational organization was denied exemption when the subsequent information revealed that it, in fact, did discriminate—it failed the good faith test. The Tax Court denied tax exemption for Calhoun Academy because the "clear and convincing evidence" indicated that the school operated in a discriminatory fashion.[28] The school was established concurrently with court-ordered desegregation plans. Although the community in which it was located was 50 percent black, no black student had ever been admitted. The school argued, unsuccessfully, that none had applied. Although the school had been in existence for 15 years, the nondiscrimination policy was implemented only in connection with the exemption application. The court noted that a school could qualify for tax-exempt status without establishing that it took the specific affirmative acts set forth in the IRS procedures, if, in fact, it operates in a racially nondiscriminatory manner.

In 1980, a district court issued an injunction presuming any private school formed in Mississippi at the time of court-ordered public school integration was created with a racially discriminatory purpose and could not qualify for tax exemption. A published exemption letter indicates how a Mississippi school that lost its exemption under the injunction regained exempt status subject to the following conditions[29]:

- The school adopts a nondiscriminatory admission policy.
- It takes positive steps to recruit black students.
- It provides the IRS, for a period of three years, information concerning the racial composition of its student body, faculty, and students receiving financial aid.[30]

The Bob Jones University Museum was determined to be qualified for exemption despite the fact that it was affiliated with the non-tax-exempt Bob Jones University.[31]

The IRS has been accused of discriminating against gay and lesbian groups seeking recognition of exemption. The Lambda Legal Defense and Education Fund representatives wrote to the commissioner of Internal Revenue at the time, Charles O. Rossotti, to complain about discriminatory treatment by "front-line agents" who initially deal with applications when gay- and lesbian-oriented groups apply for tax-exempt status. Marcus S. Owens, the director of the Exempt Organizations Division at the time, responded by scheduling visits by himself and other IRS officials to field offices to brief agents on the importance of professionalism, impartiality, and fairness in dealing with all organizations.[32]

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[28] *Calhoun Academy v. Commissioner*, 94 T.C. 17 (1990).

[29] Exemption letter dated April 7, 1993, to Rebul Academy, Inc., citing *Green v. Connelly*, 330 F. Supp. 1150 (D.D.C. 1971), aff'd. sub nom. *Coit v. Green*, 404 U.S. 997 (1971).

[30] These factors are also outlined in Rev. Proc. 75-50, 1975-2 C.B. 587.

[31] See more information in Section 5.1(g).

[32] Letters reprinted in *The Exempt Organization Tax Review*, vol. 21, no. 3 (September 1998).

(c) Day Care Centers

IRC §501(k) states that "providing care of children away from their homes" is an educational and, therefore, exempt purpose if

- Substantially all of the care (at least 85 percent) is provided to enable individuals to be gainfully employed (including employees, self-employed, enrolled students or vocational trainees, and individuals who are actively seeking employment).[33]
- The day care is available to the general public. Limitations based upon a geographic or political boundary are permissible. Restricting enrollment to children of employees of a particular employer, however, is not permissible.[34]

Whether such an organization created by a consortium of employers could qualify for exemption is an unanswered question in the author's experience. Providing day care referrals and assistance information to the general public, however, has been treated by the IRS as a service that is ordinarily a commercial activity. Counseling parents and caregivers about day care was found not to be, per se, an educational or charitable activity. In an entity where 98 percent of its revenues came from charges for its services, the IRS refused to grant tax-exempt status as an educational institution.[35]

(d) Cooperative Educational Service Organizations

IRC §501(f) was added to the Code to sanction pooled investing by educational institutions. To qualify, the organization must be

- Organized and operated to hold, commingle, and collectively invest and reinvest in stocks and securities the moneys contributed by its members and to collect the income therefrom, and pay over the entire amount, less expenses, to the members
- Organized and controlled by its members
- Composed solely of organizations qualifying as schools under IRC §170(b)(1)(A)(ii) or IRC §115(a) (schools operated by an instrumentality of a government—a municipality or state)

(e) Informal Education

Organizations that present instructional materials or training on a less formal basis than a school can qualify as tax-exempt educational organizations if they operate to benefit the general public rather than a particular business. Discussion groups, retreat centers, apprentice training programs, and the many other types of educational programs in the following list are exempt if they can prove they provide the requisite instruction for the benefit of individuals:

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[33] *Exempt Organization Handbook* (IRM 7751), §345(11)2.
[34] Gen. Coun. Memos. 39613 and 39347.
[35] Gen. Coun. Memo. 39872, modifying Gen. Coun. Memo. 39622.

- Training programs for bankers,[36] physicians,[37] artists,[38] credit union managers,[39] and dancers[40]
- Travel study tours that provide genuine cultural and educational programs, with no or limited recreational aspects and that are led by professionals[41]
- Interscholastic high school athletic associations[42] and youth sports organizations[43]
- On-the-job training of unemployed and underemployed workers, even if the toys they manufacture are sold[44]
- Trade skill training for American Indians[45]
- Counseling and educational instruction through publications concerning homosexuals[46] and voluntary sterilization methods[47]
- Student and cultural exchange programs[48]
- Studying and publishing reports on Civil War battles[49] or career planning and vocational counseling[50]

Computer users' groups are not exempt if their membership is limited to persons using a particular type of computer,[51] but they may qualify as business leagues.[52]

An educational organization affiliated with or focused on a particular line of business or product must carefully adhere to the private inurement standards.[53] The list of qualifying organizations found in the regulations defining educational organizations does not include instruction and training to improve and develop professional or business skills. Business groups conducting classes and sharing information are eligible for exempt status as educational organizations as long as two significant characteristics are present:

1. The organization provides no private benefit to a particular manufacturer, product, software company, accounting firm, or similar private company (certainly should not be controlled, financed, or otherwise too closely connected to a commercial company).

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[36] Rev. Rul. 68-504, 1968-2 C.B. 211.
[37] Rev. Rul. 65-298, 1965-2 C.B. 163.
[38] Rev. Rul. 67-392, 1967-2 C.B. 191.
[39] Rev. Rul. 74-16, 1974-1 C.B. 126.
[40] Rev. Rul. 65-270, 1965-2 C.B. 160.
[41] Rev. Rul. 70-534, 1970-2 C.B. 113.
[42] Rev. Rul. 55-587, 1955-2 C.B. 261.
[43] Rev. Rul. 80-215, 1980-2 C.B. 174.
[44] Rev. Rul. 73-128, 1973-1 C.B. 222.
[45] Rev. Rul. 77-272, 1977-2 C.B. 191.
[46] Rev. Rul. 78-305, 1978-2 C.B. 172.
[47] Rev. Rul. 74-595, 1974-2 C.B. 164.
[48] Rev. Rul. 80-286, 1980-2 C.B. 179; Rev. Rul. 68-165, 1968-1 C.B. 253.
[49] Rev. Rul. 67-148, 1967-1 C.B. 132.
[50] Rev. Rul. 79-71, 1968-1 C.B. 249.
[51] Rev. Rul. 74-116, 1974-1 C.B. 127.
[52] See Chapter 8.
[53] Discussed in Section 2.1(c).

2. The group's primary function is education, not selling products or consulting services.

Interesting and unique exemption issues arise when the training and information are transmitted by way of electronic bulletin boards and across the Internet. For what it calls "computer related organizations," the IRS in 1996 compiled a list of rulings concerning computer users' groups and to update guidance on the issue. Advisors to formulators of such groups will want to carefully study this reference prior to seeking recognition of exemption or adopting new programs for existing organizations.[54] You can visit the IRS Web site at www.irs.gov at Charities and Nonprofits, for the *CPE Text* and other IRS publications.[55]

(f) Fraternity/Sorority Educational Foundations

Foundations established to support the educational programs of social fraternities and sororities[56] may be treated as qualifying educational organizations so long as they do not provide impermissible private benefit to the club members. Support granted for scholarships, tutoring, and other specific academic concerns unquestionably promotes an educational purpose. Traditionally, the club members have been considered as a sufficiently broad charitable class. The troublesome issue is whether the foundation can grant funds to improve the club's facilities. An early ruling found that structural improvements to a fraternity house granted private inurement to the club.[57] Where the improvement primarily served an educational purpose, such as the construction or renovation of a library or study room, the IRS later opined that the educational benefit could outweigh the private benefit.[58] The 1999 IRS training text commented that this issue was still unsettled and provided no criteria for measuring the relative benefit.[59]

The exemption applications of two foundations affiliated with a fraternity issued favorably in late 2001 were based on a "similar benefit" standard.[60] The foundation may "provide grants for facilities, services, or goods for the benefit of the members" of the fraternity house if "the benefit is similar to those provided" at the affiliated universities. In other words, if the school normally provides funding to fraternities to provide computers, study rooms, and the like, the foundation can also. Though not stated, this criterion implies that such grants benefit the school rather than the club. This distinction implies that a foundation benefiting a fraternity located on a campus that does not provide such support would not qualify for exemption.

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54 Cheryl Chasin and Robert Harper, Chapter A, "Computer Related Organizations," *IRS CPE Text,* 1996.

55 See discussion of Internet issues in Section 2.2(j).

56 Qualify for exemption under §501(c)(7); see Chapter 9.

57 Rev. Rul. 64-118, 1964-1 C.B. 182.

58 Gen. Coun. Memo. 39612.

59 Chapter Q, "Fraternity Foundations," *IRS CPE Text,* 1999.

60 Exemption letter issued to Charlotte Peck Lienemann/Alpha Xi Delta Rho Foundation and Gamma Nu Educational Foundation Inc.

(g) Performing Arts

Performing arts organizations presenting music, drama, poetry, film, and dance are classified as cultural and, thus, as educational organizations. Symphony orchestras, theaters, public television and radio, and other performing groups easily gain exempt status if they meet the basic organizational and operational tests. Although most charge admission for performances, such arts organizations are characteristically charitable because they receive a significant portion of their revenues from voluntary contributions. The few rulings on the subject follow:

- Repertory theater established to develop the public's interest in dramatic arts, and a foundation funding local community theaters[61]
- Jazz music appreciation society presenting festivals and concerts[62]
- Weekly workshops, public concerts, and booking agency for young musicians[63]
- Sponsor of annual film festival and symposium promoting unknown independent filmmakers[64]
- Producer of cultural, educational, and public interest films that distributes them through public educational channels[65] or makes equipment available to the public to produce programs[66]

Coproduction of performances or recordings with commercial businesses must be carefully planned by a tax-exempt arts organization. As with all organizations qualifying under §501(c)(3), a performing arts organization must not operate to yield benefit to private individuals. In forming an association with a commercial entity, the terms must be designed to better promote performing arts with only incidental benefit, if any, to the coproducers. An exempt television production company, for example, was found to be advancing its own exempt purposes in entering into a joint venture to develop children's programming for a commercial network.[67] Permissible joint venture activities are explored in Chapter 22, including the famous Plumstead Theatre case.

(h) Museums, Libraries, and Zoos

Organizations that collect and exhibit objects of a literary, artistic, historic, biological, or other educational nature for the general public qualify as exempt educational organizations. Again, this type of cultural nonprofit is a prototypical charity because admission charges commonly cover a small portion of a museum's budget, with contributions and endowment income providing the lion's share. There

[61] Rev. Rul. 64-175, 1964-1 (Part 1) C.B. 185; Rev. Rul. 64-174, 1964-1 (Part 1) C.B. 183.
[62] Rev. Rul. 65-271, 1965-2 C.B. 161.
[63] Rev. Rul. 67-392, 1967-2 C.B. 191.
[64] Rev. Rul. 75-471, 1975-2 C.B. 207.
[65] Rev. Rul. 76-4, 1976-1 C.B. 145.
[66] Rev. Rul. 76-443, 1976-2 C.B. 149.
[67] Priv. Ltr. Rul. 9350044.

are only a few rulings on this type of educational organization, but the IRS has ruled that the following activities qualify:

- Acquiring, restoring, preserving, and opening to the public homes, churches, and public buildings having historic significance[68]
- Operating a wild bird and animal sanctuary[69]
- Operating a sports museum[70]
- Operating the library of a bar association[71]
- Organizing an international exposition[72]
- Promoting unknown but promising artists through exhibitions of their work,[73] but cooperative art sales galleries are not exempt[74]

Bob Jones University's federal tax exemption was revoked in 1983 by the Supreme Court because the university was racially discriminatory.[75] The school art gallery, operated since 1951, was separately incorporated in 1992 to lease the museum facility from the school (at below-market price) and operate the facility with the same staff and artwork previously on display, now on loan from the school. The museum was to be open to the public free of charge; approximately 80 percent of the museum's 20,000 annual visitors had no connection with the school. The museum's major support comes from contributions.[76] The court found the museum itself qualified for tax exemption and overruled the IRS on all of its following arguments:

- Excessive control: Bob Jones and his son were only two out of five directors; therefore, the school officials did not literally control the museum.
- Payment of rent and salaries: The court stated that an organization is entitled to pay ordinary and necessary operating expenses. The rent was at below-market value and, in the court's opinion, did not confer an impermissible private benefit on the school. The employees of the museum provided no services to the school, so payment of their salaries by the new museum was also found not to benefit the school.
- Reputation and location: Any enhancement of the school's reputation from the location of the museum was minimal and incidental in the eyes of the court.

[68] Rev. Rul. 75-470, 1975-2 C.B. 207.
[69] Rev. Rul. 67-292, 1967-2 C.B. 184.
[70] Rev. Rul. 68-372, 1968-2 C.B. 205.
[71] Rev. Rul. 75-196, 1975-1 C.B. 155.
[72] Rev. Rul. 71-545, 1971-2 C.B. 235.
[73] Rev. Rul. 66-178, 1966-1 C.B. 138.
[74] Rev. Rul. 71-395, 1971-2 C.B. 228.
[75] *Bob Jones University v. United States,* 461 U.S. 574 (1983); nondiscrimination standards discussed in Section 5.1(b).
[76] *Bob Jones University Museum & Gallery, Inc. v. Commissioner,* T.C.M. 1996-247.

(i) Sale of Art Objects

An art museum or gallery that sells the works of art it exhibits must overcome a presumption that it is operating a business, rather than serving a purely educational purpose that would entitle it to exemption. The question is whether the sale of an object off the exhibition walls or in the museum gift shop enhances the visitor's educational experience and thereby contributes to the accomplishment of its educational purposes. The answer varies depending upon whether the object is an original work of handicraft or work of fine art, or, rather, a reproduction or replica of an object displayed in a museum exhibition or contained in the organization's collection of art. The latter items are considered to advance the educational mission (to continue the learning by taking a representation of a museum object home). The former, instead, are deemed to simply allow the organization to raise money, an unrelated objective. An organization may not continue to qualify for tax-exempt status if its unrelated business activity is more than insubstantial (commonly thought to equal about 10 to 15 percent). Those many museums and art centers that have gift shops should study the special section of Chapter 21 that focuses on museum sales and the need to distinguish the items sold between those that advance the mission and those that the IRS deems do not.

(j) Publishing: Print and Electronic

Publishing projects have been a subject of controversy with the IRS. The two issues most debated have been controversial subject matter and commercial activity. It is not sufficient that the subject matter of the published work be religious, cultural, scientific, or educational. An exempt publishing company must also distinguish itself from a commercial one so as to evidence that it is not operating an unrelated business. The factors that identify an educational publication program follow[77]:

- The content of the publication must be educational.
- Preparation of the materials follows methods generally accepted as educational.[78]
- Distribution of the materials is necessary or valuable in achieving the organization's educational and scientific purposes.
- The manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices.

Organizations distributing educational materials free[79] or at a nominal price[80] indisputably operate in a noncommercial manner. However, publishing a foreign language magazine on a subscription basis at a price and through channels

[77] Exempt Organizations Handbook (IRM 7751), §345.(10)2; Rev. Rul. 67-4, 1967-1 C.B. 121.
[78] Discussed at the beginning of this chapter.
[79] Rev. Rul. 66-147, 1966-1 C.B. 137.
[80] Rev. Rul. 68-307, 1968-1 C.B. 258.

used by commercial publishers is not an exempt activity.[81] A section on the unrelated business aspects of publishing is provided in Chapter 21.

Electronic publishing is a relatively unexplored area of activity for tax-exempt organizations. In its 1998 training materials, the IRS said, "In the past, Internet Service Providers (ISP) have usually been denied exemption because they are viewed as carrying on a trade or business for profit, or conferring an unmixed private benefit, or both."[82] "Providing communication services of an ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes."[83] Both of the IRS training course articles from which the previous quotes are taken should be carefully studied for an ISP seeking tax-exempt status. The articles conclude that exemption may be possible if the ISP is an adjunct or integral part of a university, public school, library system, or a local government. Accountability and control, dependence on government grants rather than user fees, and free use to students, library patrons, and the general public are said to be characteristics that evidence a charitable ISP. Such an ISP might also qualify as relieving the burdens of government.[84] The training manual suggests the IRS technician "peruse to the ISP's home page to evaluate its exempt character as a source of public information and to see if 'placards,' 'banners,' and links to commercial sites constitute advertising that create unrelated business income."[85]

Establishment of a tax-exempt organization's Web site for the purpose of disseminating information and linking to other sites presents a range of tax issues discussed in Sections 2.2(j) and 21.8(j).

(k) Controversial Materials

As early as 1919, the Bureau of Revenue said educational organizations may include one whose sole purpose is the instruction of the public, "but an association formed to disseminate controversial or partisan propaganda is not educational." The American Birth Control League was found not to be educational in 1930. Judge Learned Hand opined that a purpose to change the law as an end in itself was not itself exempt regardless of the problem of uncontrolled procreation. He thought "political agitation as such is outside the statute, however innocent the aim."[86]

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[81] Rev. Rul. 77-4, 1977-1 C.B. 141.

[82] Donna Moore and Robert Harper, Chapter C, "Internet Service Providers Exemption Issues," *IRS CPE Text,* 1999.

[83] Cheryl Chasin and Robert Harper, Chapter A, "Computer-Related Organizations," *IRS CPE Text,* 1997, pp. 9–12; IPS approved as charitable because it offered below-cost Internet access to all members of the public with reduced fees for low-income individuals, schools, and libraries—the IPS was deemed to serve a charitable class under standards described in Section 2.2(a).

[84] See Section 4.3.

[85] See Section 21.8(d); Form 1023 requests the applicant's Web site address on page 1.

[86] *Slee v. Commissioner,* 42 F.2d 184 (2d Cir. 1930).

The more recent "service view is that an organization's mere dissemination of words or a viewpoint to the public does not necessarily benefit the public sufficiently to warrant the organization's tax exemption under §501(c)(3)."[87] The methodology test discussed at the beginning of this chapter applies to determine the educational nature of a program. To be educational, information must be useful to the individual and beneficial to the community. The materials presented must contain a sufficiently full and fair exposition of the pertinent facts about a subject, rather than an unsupported opinion.

The Tax Court denied exemption for The Nationalist Movement (TNM), a pro-white Mississippi organization advocating social, economic, and political change in the United States.[88] Denial was based not upon excessive lobbying or political activity, but instead on a finding that the organizational activities were neither educational nor charitable. The court found that the organization did not operate exclusively for an exempt purpose. The opinion quotes extensively from the organization's literature—newsletters, convention programs, and writings of the founder, Richard Barrett. The following two quotations are from a fund-raising letter and epitomize the philosophy of the organization. The second quotation, from a TNM newsletter, served, in the court's opinion, to exemplify viewpoints unsupported by facts and therefore not educational.

1. "We'll do for the majority in the 1980s what others did for the minorities in the 1960s. Parading, speaking, rallying, petitioning. Only we won't riot, loot or burn. We'll wave flags, win lawsuits, sing songs, and gain power."
2. "What is Black History anyhow? No such thing. Nary a wheel, building or useful tool ever emanated from non-white Africa. Africanization aims to set up a tyranny of minorities over Americans."

The IRS unsuccessfully argued that the organization served the private interests of Barrett by "supplying a forum to express and promote his personal agenda." The court found that "substantial domination of an organization by its founder does not necessarily disqualify the organization from exemption." The court also noted no evidence that Barrett used the organization to further his political career. TNM argued that it operated social service programs that qualified as charitable (feeding the poor and pursuing public interest litigation). The records about these activities were "inconsistent" in the eyes of the court and did not enable TNM to prove that it operated "exclusively for charitable purposes."

Most important, the court found that the messages presented through TNM's radio program and written materials failed the methodology test[89] and

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[87] Ward L. Thomas and Robert Fonterose, Chapter H, "Education, Propoganda, and The Methodology Test," *IRS CPE Text,* 1997, p. 83.

[88] *The Nationalist Movement v. Commissioner,* 102 T.C. No. 22 (1994), *aff'd.,* 37 F.3d 216,74 (5th Cir. 1994).

[89] Rev. Proc. 86-43 discussed at the beginning of this section; see also *National Alliance v. U.S.*, 710 F.2d 868 (D.C. Cir. 1983).

were not educational. Because they were TNM's primary activity, the organization did not qualify for exemption. The court also found that the methodology test "is not unconstitutionally vague or overbroad on its face" and reduces the vagueness of the regulation.[90] The criteria "tend toward ensuring that the educational exemption be restricted to material which substantially helps a reader or listener in a learning process." The court essentially condoned the regulation it had earlier found unconstitutional by finding that viewpoints unsupported by facts were not educational. Since a significant portion of the organization's communications contained such materials, the organization was not educational, even if such presentations were not its principal function.[91]

5.2 LITERARY PURPOSES

The regulations are silent and contain no definition or criteria for qualification of a literary organization. Since literature is both educational and cultural, a literary organization can be exempt under one or both of those categories. Most often at issue for a literary project is its relationship with those that create the literature. Do the programs advance the private interests of the writers? An organization established to encourage emerging writers by publishing their works in the small-press market must prove that it does not primarily benefit the individual writers, but instead promotes literature or culture in a global sense. The IRS customarily requires that the nonprofit own the rights to the intellectual property, although it allows writers to be compensated for the value of their work.

Examples of literary pursuits are publishing of literature, including poetry, essays, fiction, nonfiction, and all other forms of written compositions. Other examples include a sponsor of poetry readings, a literary workshop to teach writing skills, a critical journal of reviews, a committee to award a prize for excellence in literature (such as the Pulitzer Prize), and a preservation society for rare books.[92]

5.3 SCIENTIFIC PURPOSES

The IRS admitted in 1966 that the term *scientific* is not definable with precision.[93] The regulations say only that *scientific* includes the carrying on of scientific research in the public interest. Further, they say, "Research when taken alone is a word with many meanings; it is not synonymous with scientific and the nature of particular research depends upon the purpose which it serves." The determination as to whether research is scientific does not depend on whether such

[90] Note contrary opinion in the case of Big Mama Rag, Inc., discussed at the beginning of this chapter.

[91] The Nationalist Movement lastly argued unsuccessfully that the test allowed "excessive administrative discretion" and violated its free speech rights under the Constitution. The court pointed out that the Supreme Court has found that denial of a tax exemption for engaging in speech consisting of "dangerous ideas" can be a discriminatory limitation of free speech (*Speiser v. Randall,* 357 U.S. 513, 519 (1958)). It chose to follow, however, the Supreme Court's opinion that nondiscriminatory denial of a tax benefit, not aimed at suppressing speech content, does not infringe First Amendment rights *(Cammarano v. U.S.*, 358 U.S. 498, 512-513 (1959)). This case considered the issue of nondeductibility of lobbying expenses.

[92] See the discussion of publishing in Sections 5.1(i) and 21.14.

[93] Rev. Rul. 66-147, 1966-1 C.B. 137.

research is classified as fundamental, or basic, as contrasted with applied, or practical.[94]

(a) Research in the Public Interest

The ambiguity in the meaning of research noted in the preceding section is addressed by very exact and specific standards for judging whether scientific research is conducted in the public interest, qualifying as a tax-exempt activity. To be considered as conducted in the public interest, research—both fundamental and applied—must have the following characteristics:

- Results of the research, including patents, copyrights, processes, or formulas, must be made available to the public on a nondiscriminatory basis.
- Research is performed for a federal, state, or local government.
- Work is directed toward benefiting the public for the following reasons:
- To aid in scientific education of college students
- To obtain information toward a treatise, thesis, or trade publication, or in any form available to the general public
- To discover a cure for disease
- To aid a community or geographic area in attracting development of new industries

Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products, or the designing or construction of equipment, buildings, and the like.[95]

Retaining ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulas resulting from an organization's research and not making them available to the public may disqualify it from exempt status.[96] If granting an exclusive right is the only practical manner in which the patent can be utilized to benefit the public, such as in the case of research conducted for the government or for the purposes listed under the preceding standards, the information can be withheld.[97] An exempt organization that performs research only for its non-§501(c)(3) creators cannot be classified as a §501(c)(3) organization.[98]

One court has suggested that this regulation can be understood in the context of distinguishing a commercial testing laboratory from a scientific research institute.[99] The definition of scientific research would exclude the repetitive or

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94 Reg. §1.501(c)(3)-1(d)(5).
95 Rev. Rul. 65-1, 1965-1 C.B. 226; Rev. Rul. 68-373, 1968-2 C.B. 206.
96 Rev. Rul. 76-296, 1976-2 C.B. 141 discusses the timing of the release of public information under two different scenarios. Publication, as a general rule, can be withheld until the patent is issued, but may not be delayed to protect the sponsor's business interests.
97 Reg. §1.501(c)(3)-1(d)(5)(iv)(b).
98 Rev. Rul. 69-526, 1969-2 C.B. 115.
99 *Midwest Research Institute v. U.S.,* 554 F. Supp. 1379 (W.D. Mo. 1983), also discussed in Gen. Coun. Memo. 39883 (October 16, 1992).

relatively unsophisticated work done by commercial laboratories to determine whether items tested meet certain specifications, rather than the more sophisticated testing done to validate a scientific hypothesis. Scientific research was said to have three components:

1. There must be project supervision and design by professionals.
2. Researchers design the project to solve a problem through a search for demonstrable truth, also called "scientific method." A researcher forms a hypothesis, designs and conducts tests to gather data, and analyzes data for its effect on the verity or falsity of the hypothesis.
3. The research goal must be the discovery of a demonstrable truth. Information on the novelty and importance of the knowledge to be discovered is also important to determine whether a particular activity furthers a scientific purpose.

The IRS has suggested that in differentiating between research and testing, it may be useful to refer to "research and development expenses" qualifying for tax credit under §174.[100] In that situation, all costs are incident to the development of an experimental or pilot model, a product, a formula, an invention, or similar property, and the improvement of already existing property of these categories. The term does not include expenditures such as those for the ordinary testing or inspection of materials for products for quality control purposes or for efficiency surveys, management studies, consumer surveys, advertising, or promotion.

A combined educational and scientific purpose may also qualify an organization for exemption, as the following examples illustrate:

- Surveying scientific and medical literature and abstracting and publishing it free of charge is an exempt activity.[101]
- Developing treatment for human diseases and disseminating the results through physicians' seminars is also an exempt activity.[102]
- Manufacturing cast reproductions of anthropological specimens for sale to scholars and educational institutions was found to support a charitable research purpose.[103]
- Conducting seed technology research, approving certification of crop seeds within a state, and providing instruction in cooperation with a university are scientific activities, and are therefore exempt.[104]

Design and development of a patentable medical device, under a contract with a medical equipment company, was found not to qualify as scientific research, because the science was incidental to the commercial exploitation aspects of the activity. The organization obligated itself to license any patents for the device exclusively to the company in exchange for a royalty.[105]

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[100] Gen. Coun. Memo. 39196 (August 31, 1983).
[101] Rev. Rul. 66-147, supra note 73.
[102] Rev. Rul. 65-298, 1965-2 C.B. 163.
[103] Rev. Rul. 70-129, 1970-1 C.B. 128.
[104] *Indiana Crop Improvement Association, Inc. v. Commissioner,* 76 T.C. 394 400 (1981).
[105] Tech. Adv. Memo. 8028004.

(b) Commercialization of Research Results

Scientific research often results in valuable intellectual property capable of producing revenues. Two very different issues are involved when research results are sold or exploited for commercial dissemination:

1. Does the commercial sale indicate that the research is not actually conducted in the public interest and, if so, does the scope of the activity evidence a significant nonexempt purpose?
2. Is the revenue subject to the unrelated business income tax?

A research project commissioned by commercial interests can only incidentally benefit its private sponsors. To evaluate this benefit, the proverbial facts and circumstances of a project are examined to determine the motivation for conducting the research. Importantly, the exploited research activity cannot constitute a substantial nonexempt activity without jeopardy to the organization's tax-exempt status. To reduce this possibility, organizations conducting commercial research should consider creating a separate nonexempt organization to conduct the business of selling the results.[106]

Private rulings requested by research organizations reflect interesting facts that can be studied to understand the IRS view of exploitation of the results of scientific research. An organization was created to engage in research about the design of urban land and to educate the public on the need for improvement in the use and design of public urban open spaces. The facts provided a good forum for the IRS to find examples of excessive private interest.[107] Eight specific urban design projects were reviewed and a myriad of models analyzed. Private interest was found to exist in three projects studying the public's use of private property. One project studied pedestrian flow through a building's government-mandated public space and ways to enhance the underutilized plaza. Even though the projects serving private property owners produced some 15 percent of its revenue and were subject to tax, the organization was found to qualify for exemption.

In another instance, an organization was originally created to conduct basic research in biotechnology to broaden the industrial base and foster job creation through the development of innovations. To become financially independent of state funding, the organization planned to focus on applied research to produce marketable technology it could commercially license and exploit. Under the plan, its discovery research would be transferred to a university. The ruling also considered the sharing of intellectual property rights. The IRS said it preferred for the nonprofit to retain 100 percent of intellectual property rights based on the theory that any allocation of rights to individuals results in private inurement. However, the organization's federal research agreements required it to share royalties from patents with the inventors. One-third of revenues from licensing or other transfers of patents were allocated to the inventor employees. Further consulting fees were shared half and half or equally with the employees for services rendered during regular working hours. Individual scientists were allowed to

[106] See Section 22.4.
[107] Priv. Ltr. Rul. 9414003.

retain all fees for consulting performed on their own time. An additional bonus system rewarded managers and senior scientists. Because the compensation arrangements were a result of arm's-length bargaining and the overall compensation was reasonable, the IRS determined that the royalty, fee sharing, and bonus system did not result in private inurement. The IRS determined that it could retain its tax-exempt status.[108]

Another organization received approval for a reorganization in which it spun off inventions and products into wholly owned taxable for-profit subsidiaries. The plan had several goals: (1) to commercialize technologies developed by the exempt's scientists and engineers, (2) to improve the transfer of technology from the exempt's labs into the public domain, (3) to stimulate economic development, (4) to provide entrepreneurial opportunities for the scientists, and (5) to separate the commercial activities from the basic research function.[109]

Special UBI Exclusions. When research results are commercially sold, the form of revenue payments received by the exempt organization is important. The unrelated business income tax rules modify, or exclude, income that is essentially derived from research programs conducted in the public interest. Using slightly different language from that found in the §501(c)(3) regulations defining exempt scientific work, the tax code specifically excludes the following[110]:

- All income derived from research from the United States, any of its agencies or instrumentalities, or any state or political subdivision thereof
- In the case of a college, university, or hospital, all income derived from research performed for any person
- In the case of an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the general public

Instead, profits from research carried on for the following purposes would be treated as unrelated income, the receipt of which could jeopardize tax-exempt status.[111]

- Scientific research performed for a private sponsor that is not carried on in the public interest
- Work for a governmental body or others of a type ordinarily carried on as incident to commercial or industrial operations (such as testing for quality)

Royalty Exclusion. Revenues from research of a type not specifically excluded from the unrelated business income tax under the preceding rule may also be mod-

[108] Priv. Ltr. Rul. 9316052; see Chapter 20 and "Intellectual Property," *IRS CPE Text,* 1999.

[109] See William T. Hutton and Cynthia R. Rowland, "The Inurement Rule and Ownership of Copyrights," 9 *Exempt Organization Tax Review 813* (April 1994). The authors propose a revenue procedure containing eight situations exemplifying lack or presence of inurement when an individual retains or receives copyrights for a project financed by an exempt organization.

[110] IRC §§512((b)(7), (8), and (9).

[111] See Chapter 21.

ified, or excluded, from unrelated business income tax. When the revenue is paid in the form of royalties in return for licensing intellectual property, the income is not subject to income tax.[112] This exclusion recognizes the fact that the exempt organization entering into such a licensing agreement does not itself conduct the business in which the license is applied.

5.4 TESTING FOR PUBLIC SAFETY

The regulations give only one example of an organization qualifying because it tests for public safety. Such an organization tests consumer products, such as electrical products, to determine whether they are safe for use by the general public.[113] Other exempt programs might include testing for structural building strength against violent weather, such as hurricanes and tornadoes, or earthquakes. Testing boat equipment and establishing standards for pleasure craft were also ruled to be exempt activities.[114]

Similar to the scientific research constraints, testing must be performed to serve a public benefit, rather than the interests of private owners, such as drug manufacturers. This distinction is not always clear. In a published ruling, the IRS found that testing, research, and other work toward developing methods and safety certifications for shipping containers benefited the shipping industry and advanced international commerce and, therefore, was not exempt, despite the fact that the stevedores working with shipping containers constitute a charitable class whose safety is significant and worthy of testing.[115] Similarly, a drug company's testing program prior to approval by the Food and Drug Administration was ruled to serve the manufacturer's private interest.[116] A structural steel certification program operated by Quality Auditing Company failed to convince the IRS or the Tax Court that it qualified as charitable.[117] There was no overt evidence that the government considers the testing to be its burden or responsibility. The quality inspection program was established by American Institute of Steel Construction, a business league, rather than by an express governmental program. There was no finding that the certification program actually promoted increased structural integrity and safety in steel buildings. Finally it was determined that the program furthered the private interests of the industry members. League literature stated the program is "intened to make the task of selecting qualified bidders more reliable." The characteristics of scientific research as contrasted with testing activity was discussed in Section 5.3.

Perhaps because their funds are raised through the provision of services, these testing organizations do not qualify as charitable organizations eligible to receive deductible contributions under IRC §170(c), even though they do qualify

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[112] See Section 21.10(d).
[113] Reg. §1.501(c)(3)-1(d)(4).
[114] Rev. Rul. 65-61, 1965-1 C.B. 234.
[115] Rev. Rul. 78-426, 1978-2 C.B. 175.
[116] Rev. Rul. 68-373, 1968-2 C.B. 206.
[117] *Quality Auditing Company v. Comm.*, 114 T.C. 398 (2000), also citing *Indiana Crop Improvement Association v. Comm.*, 76 T.C. 394 (1981) and *Professional Standards Review Org. v. Comm*, T.C. 240(1980).

as exempt under §501(c)(3). They are excepted from private foundation classification under §509 presumably because they are not funded with private donations.

5.5 FOSTERING NATIONAL OR INTERNATIONAL AMATEUR SPORTS COMPETITION (BUT ONLY IF NO PART OF ITS ACTIVITIES INVOLVES THE PROVISION OF ATHLETIC FACILITIES OR EQUIPMENT)

The parenthetical qualification to this exemption category was added in 1976 to prevent athletic or social clubs from qualifying under §501(c)(3), while allowing charitable status to the Olympic and Pan-American Games. In a seemingly redundant provision, Congress in 1982 stipulated in §501(j) that certain qualified organizations are not subject to the restriction in the parentheses. Curiously, the definition of those organizations that qualify is identical to the words used in §501(c)(3). The regulations concerning the 1976 changes were withdrawn in 1984.

The most often cited case in this area involved the International E22 Class Association.[118] The organization was established to formulate and enforce measurements of a particular type of racing sailboat used in international competition. In addition to setting the standard, the association sold tools to measure compliance during construction of the boats and during races. The IRS argued that such devices were athletic equipment and refused to grant the organization an exemption. The Tax Court disagreed, saying that the measurement tools were not facilities, as clubhouses, swimming pools, and gymnasiums are. Equipment means property used directly in athletic endeavors. The court was not aware of any athletic exercise, game, competition, or other endeavor in which the tools could be used.

Local amateur athletic groups, like the Little League, need not necessarily qualify under this category. Such a group can instead qualify under the charitable category because it prevents juvenile delinquency and advances education.[119] The IRS decided that a national high school athletic association created in 1942 could continue to be classified as a charitable and educational entity rather than be reclassified under §501(j). The organization coordinated the efforts of state high school associations by sponsoring meetings and conferences, setting activity rules, publishing educational materials, and serving as the national governing body.[120] Promoting recreational sports for a limited membership, however, may not be an activity benefiting the requisite charitable class.[121]

Wayne Baseball, Inc., failed to convince the IRS or the Tax Court that its amateur baseball team qualified as a (c)(3) organization.[122] The typical player on the team was over age 21, and the team included a few players with professional experience. Because the team offered no formal instructional training and did not sponsor coaching or other programs for youths, the IRS determined that the team operated to promote the social and recreational interests of its members,

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[118] *International E22 Class Association v. Commissioner,* 78 T.C. 93 (1982).

[119] Rev. Rul. 80-215, 1980-2 C.B. 174.

[120] Tech. Adv. Memo. 9211004.

[121] See Section 2.2.

[122] *Wayne Baseball, Inc. v. Commissioner,* U.S. Tax Court, September 15, 1999.

not the general public. An organization that functions to advance amateur baseball in its community as a whole can so qualify.[123]

5.6 PREVENTION OF CRUELTY TO CHILDREN OR ANIMALS

This is another exemption category without explanation in the IRS regulations. Thankfully, a few published rulings provide guidelines, as the following examples of exempt activities indicate:

- Animal protection accomplished by accreditation of animal care facilities that supply, keep, and care for animals used by medical and scientific researchers[124]
- Preventing the birth of unwanted animals by providing low-cost spaying and neutering operations[125]
- Monitoring of hazardous occupations for violations of state laws and unfavorable work conditions, in order to protect child workers[126]

A troublesome case might be the provision of veterinary services to individual pet owners. While it could be argued that such services prevent cruelty, there is an additional burden to prove the public usefulness of the effort. Certain treatments probably deserve and could gain charitable status, such as rabies control, but the absence of individual benefit ultimately has to be proved in order to obtain exemption.

[123] *Hutchison Baseball Enterprises, Inc. v. Commissioner,* 73 T.C. 144, 151 (1979), *aff'd.,* 696 F.2d 757 (10th Cir. 1982); for a contrary decision, see *Media Sports League, Inc. v.Commissioner,* T.C. Memo. 1986-568.

[124] Rev. Rul. 66-359, 1966-2 C.B. 219.

[125] Rev. Rul. 74-194, 1974-1 C.B. 129.

[126] Rev. Rul. 67-151, 1967-1 C.B. 134.

CHAPTER SIX

Civic Leagues and Local Associations of Employees: §501(c)(4)

It is well-established that an organization may be created to carry out its purposes through the development and implementation of programs designed to have an impact on community, state, or national policymaking.[1] Environmental protection, housing, civil rights, aid to the poor, world peace, or other public issues may be involved. The pursuit of such subjects is the focus of both §§501(c)(3) and (c)(4) organizations. The term *social welfare* appears in the regulations defining *charitable* for (c)(3) purposes. This chapter focuses on the factors that distinguish a (c)(3) from a (c)(4) organization and the category of exemption most appropriate for organizations that pursue matters of public policies.

[1] B. Hopkins, *The Law of Tax-Exempt Organizations, Eighth Ed.* (Hoboken: Wiley, 2003), Section 12.1.

The regulations for Internal Revenue Code (IRC) §501(c)(4) were adopted in 1959 and cover only half a page. They list two basic types of organization that fall into this category.

Type 1. The first type of 501(c)(4) is a civic league or organization that is organized for nonprofit purposes and operated exclusively for promotion of social welfare. "To promote social welfare means to promote in some way the common good and general welfare of the people of the community."[2] This concept includes bringing about civic betterment and social improvements. A civic league may focus on environmental protection, civil rights, aid to the poor, world peace, and other issues of public concern. The regulations state that a social welfare organization may qualify for exemption as a charitable organization unless it is an action organization.[3]

Since this type of (c)(4) is often created to be active, meaning to change the laws, it cannot qualify under (c)(3). As a (c)(4), however, lobbying can be its primary function, as long as the legislative activity promotes in some way the common good and general welfare of the people of a community. Election campaign involvement is also permitted but cannot be a significant activity.[4] The phrase "exclusively operated for civic welfare" does not prohibit an organization from earning some unrelated business income.

Type 2. The second type of 501(c)(4) is a local association of employees whose membership is limited to the employees of a designated person or persons in a particular municipality and whose net earnings are devoted exclusively to charitable, educational, or recreational purposes.[5]

In 1996, §501(c)(4) was amended to prohibit a qualifying association from engaging in activities that allow net earnings to inure to the benefit of any private shareholder or individual.[6] Prior to that time, the private inurement prohibition applied by statute only to §501(c)(3) entities.[7] Intermediate sanctions can be applied to penalize associations that provide excess compensation or other monetary benefits to those that control the organization.[8]

6.1 COMPARISON OF (c)(3) AND (c)(4) ORGANIZATIONS

The term *social welfare* appears in the regulations defining *charitable* for (c)(3) purposes. Since social welfare can be the focus of both §§501(c)(3) and (c)(4) organizations, it is important to carefully choose which category is most appropriate for any particular organization.

[2] Reg. §1501(c)(4)-1(a)(1)(2)(i).
[3] See Section 2.2(g).
[4] Rev. Rul. 67-368, 1967-2 CB 194.
[5] Reg. §1.501(c)(4)-1(b).
[6] Taxpayer Bill of Rights 2, §1311(b).
[7] The regulations applicable to several other categories of tax exemption do contain this standard, including agricultural organization, business leagues, and veterans organizations.
[8] See Chapter 20.

IRC §501(c)(4) organizations have several elements in common with §501(c)(3) groups. They conduct similar social welfare activities—lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights secured by law, and combating community deterioration and juvenile delinquency. Other parallels include the following:

- Neither type of organization may be organized or operated for profit.
- Both must benefit the "community," defined as a charitable class (for example, a poor group, a minority group, or the population of an entire city, country, or the world).
- Membership in both types of organizations must be open and cannot be restricted to a limited or select group of individuals or businesses.
- No private inurement or benefit to a select group of insiders is permitted.

The following characteristics of a §501(c)(4) organization are very different and serve to distinguish it from a §501(c)(3) organization:

- A §501(c)(4) organization can engage in extensive *action* or lobbying efforts to influence legislation on subject matter related to its mission by propaganda and other means.
- A §501(c)(4) organization is not required to have a specific dissolution clause in its charter; its only organizational test is that it not be operated for profit-making purposes.
- Participation in political campaigns cannot be the primary purpose of a §501(c)(4) organization, but there is no absolute prohibition. Participation in political campaigns is not considered to be the promotion of social welfare, and §527 imposes an income tax on part of the organization's income to the extent of its political expenditures.[9]
- Donations to §501(c)(4) organizations are not deductible as charitable gifts under §170 and §2511, and such gifts are not deductible as business expenses if payments represent dues paid for lobbying and political expenditures.[10]

(a) Choosing to Apply under (c)(4) versus (c)(3)

It is possible for some organizations to qualify for exemption under both §§501(c)(3) and (c)(4), so an important choice must be made when a project promoting the social welfare applies for its exempt status. Those that plan action and expect to engage in extensive lobbying beyond the limits permitted under (c)(3) must seek (c)(4) status. There are very few circumstances when (c)(4) would be chosen in preference to (c)(3), particularly when tax-deductible contributions can be sought.

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[9] Rev. Rul. 81-95, 1981-1 C.B. 332; see Section 23.2 for discussion of factors that distinguish voter education from candidate promotion.

[10] Rev. Rul. 82-21; the imposition of gift tax on gifts to 501(c)(4) organizations is not effectively enforced by the IRS. This fact can be a significant detriment to such an organization's fund-raising efforts.

Proper timing is important for an existing (c)(3) organization since conversion is not allowed after an organization loses its exempt status due to excessive lobbying. An existing (c)(3) organization that expects its future lobbying efforts will cause it to lose its charitable status should apply to convert its category of exemption before the excessive lobbying activity occurs.

The right choice is critical. A (c)(3) organization that loses its exemption because it engages in excessive lobbying cannot then convert to the (c)(4) class, but instead loses its exempt status and becomes a taxable entity.[11] Intentional avoidance of this rule was anticipated by Congress. A transfer of assets by a (c)(3) to create a separate (c)(4) organization may result in loss of its exempt status. The excessive activity is attributed to a (c)(3) spinning off assets to carry on the lobbying in the following circumstances[12]:

- Over 30 percent of the net fair market value of the (c)(3)'s assets (other than those of a church) or 50 percent of the recipient organization's assets are transferred to a controlled non-(c)(3) entity, which then conducts excessive lobbying.
- The transfer is within two years of the discovery of excessive lobbying.
- Upon transfer or at any time within 10 years following such a transfer, the transferee is controlled by the same persons who control the transferor. Control for this purpose means that the persons in authority can, by using their voting power, require or prevent the transferee's spending of funds.[13]

The Christian Coalition's application for qualification as a §501(c)(4) civic welfare organization failed to receive IRS approval after 10 years of discussions. The coalition says it withdrew Form 1024 and chose to operate as a business corporation with freedom to endorse political candidates and make financial contributions to support candidates of its choice. Although the facts are not known, it is presumed that the coalition's voter guides and other election-related activities represented too high a portion of its overall activities.[14] Some commentators question why the organization had sought (c)(4) status in the first place rather than classification as a political organization.[15]

(b) Affiliated (c)(3) and (c)(4) Organizations

It is common for (c)(4) organizations to operate in affiliation with charitable organizations. Social welfare programs often encompass issues that are the subject of legislative proposals and also entail research, public education, and other activities that qualify as charitable. When it is anticipated that the advocacy efforts will make charitable status difficult to obtain or maintain, two organizations can be formed from the inception: (1) a (c)(4) to carry out lobbying activities and (2) a (c)(3) for strictly charitable activities.

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[11] IRC §504.
[12] Reg. §§1.504-2(e) and (f).
[13] Reg. §53.4942(a)-3(a)(3).
[14] C. Wright, "Christian Coalition Fails to Obtain Tax-Exempt Status," *The Exempt Organization Tax Review,* vol. 25, no. 1, July 1999, p. 9.
[15] See Section 23.3 for definitions and requirements under IRC §527.

Affiliated (c)(3) and (c)(4) organizations can operate side by side; can share resources, such as office space, equipment, and personnel; and often have similar names—the Sierra Club and the Sierra Club Legal Defense Fund, for example. The financial affairs of each organization, however, must be kept separate.[16] Documentation evidencing the fashion in which common costs are shared must be maintained. Form 990, Schedule A, requires that very detailed information be reported about such sharing.[17]

While overlapping board members are permissible, common control can suggest a lack of independence. The safest relationship is for each organization to have independent control. Staff overlap must be carefully documented with time records and evidence of staff activity. Shared facilities, memberships, funding campaigns, publications, and other overt products of activity deserve careful expense allocations based upon time spent, space occupied, or another suitable indicator of respective use.[18] For another version of the criteria for such affiliated organizations, read B. Holly Schadler's guidelines to "ensuring accurate and legally permissible resource allocations between a related (c)(3) and (c)(4)."[19]

A grant from the (c)(3) to the (c)(4) can be made if the grant is restricted to charitable purposes, such as research disassociated with particular legislative proposals. If allocated to lobbying, the grant should not be for a sum that would violate the (c)(3)'s limitations. Clearly, the (c)(3) organization should not raise general support funds to be transmitted to the (c)(4), but the reverse would be allowable.

(c) Conversion to (c)(3) Status

Circumstances of an organization qualified under (c)(4) may change. If legislative activity declines or for other reasons, such as those outlined in the following, an organization may consider converting its tax-exempt status to (c)(3). To explore the issues involved in such a conversion, consider two examples.

Example 1. Representing the population of a planned community of 100,000 residents qualifies for §501(c)(4) status, not (c)(3), in the opinion of the Tax Court.[20] Columbia Park and Recreation Association (CPRA) was a nonprofit organization formed to build and operate "facilities and services for the common good and social welfare of the people" of Columbia, Maryland; to represent property owners and residents with respect to owner assessment and collection of fees for such services; and to enforce property covenants.

The CPRA built the public utility and transportation systems, parks, pools, neighborhood and community centers, and recreational facilities such as tennis courts, golf courses, a zoo, an ice rink, boat docks, and athletic clubs for the com-

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[16] See Section 22.2.

[17] See online version of Blazek, *990 Handbook* (New York: John Wiley & Sons).

[18] Cost accounting concepts and documentation methods are discussed in Chapter 27.

[19] "Establishing a Sec. 501(c)(4) Organization," *The Exempt Organization Tax Review*, vol. 23, no. 3 (March 1999), excerpted from *The Connections: Strategies for Creating and Operating 501(c)(3)s, 501(c)(4)s, and PACs* (Alliance for Justice, 1998).

[20] *Columbia Park and Recreation Association, Inc. v. Commissioner,* 88 T.C. 1 (1987).

munity. CPRA essentially functions like a municipality but is not a political subdivision of the county in which it is located. CPRA was formed by the private developers of Columbia. Columbia has "villages" that have formed separate civic associations.

For the first 12 years of CPRA's existence, it was classified as a §501(c)(4) organization. To qualify for tax-favored bond financing, CPRA sought reclassification as a §501(c)(3) organization in 1982. The IRS denied the (c)(3) exemption based upon failure of both the operational and the organizational test, as follows:

- *Private benefit and control.* Regardless of the size of the group benefited (there was no argument that Columbia resembles a city that would qualify), CRPA is owned and controlled by the homeowners and residents, and serves their private interests. Every property owner possesses an ownership right in CPRA's facilities and services. The facilities open to the public represented less than 2 percent of the total, and out of 110,000 families, only 190 received reduced fees.
- *Funding source.* Another factor distinguishing CPRA from a §501(c)(3) organization was its source of funds: no voluntary contributions were solicited from the public, and the sole source of financing was property owner fees, which are nondeductible for §170 purposes.
- *No charitable purpose.* The CPRA did not lessen the burdens of government. There was no proof that the State of Maryland or Howard County accepted such responsibilities, and based upon documents regarding the public transportation system, Columbia was expected to bear the cost.
- *Dissolution clause.* The CPRA's charter names three possible recipients of its assets upon dissolution: Howard County, an agency or instrumentality of the county, or one of the village associations. The first two qualify as §501(c)(3) recipients, but the last does not because village associations are (c)(4) organizations. Thus, the assets are not dedicated permanently to §501(c)(3) purposes.

Example 2. A civic welfare organization operated to meet the financial and emotional needs of individuals employed in an industry worldwide was allowed to merge itself into its subsidiary §501(c)(3) organization, since it possessed the requisite charitable characteristics, as follows[21]:

- *Contributions.* More than one-third of the organization's support is received from contributions from the general public (i.e., nonindustry members).
- *Charitable services.* Gerontology, social services (legal and emotional counseling), job placement for the unemployed, and scholarships were considered charitable services.
- *Charitable class.* Because of its size (over 10,000 members), its dedication to members of a particular industry was ruled not to negate its charitable purposes.

[21] Priv. Ltr. Rul. 9019046.

In both examples, note that the organizational activities benefit a limited class of individuals. What distinguishes the two is (1) the character of the activities and (2) the sources of support. Relieving suffering in distress situations is generally considered charitable, as is promotion of health and education. Recreation, preservation of property values, and commuting to work are not generally classified as charitable activities.[22]

The IRS approved a merger of a §501(c)(4) entity and its §509(a)(3) supporting organization into a §501(c)(3) organization.[23] The organizational documents of both organizations dedicated the assets to charitable purposes so that, as a practical matter, either organization could have survived. For tax purposes, however, the assets of the (c)(3) organization could not have been transferred to the (c)(4).

6.2 QUALIFYING AND NONQUALIFYING CIVIC ORGANIZATIONS

The primary characteristic of a qualifying civic league is that it operates to benefit the members of a community as a whole, be it the world or a small town, as opposed to operating a social club for the benefit, pleasure, or recreation of particular individuals. Social events sponsored by civic leagues are permitted, if they are incidental to the group's primary function.[24] One court stated that "the organization must be a community movement designed to accomplish community ends."[25] Another said, "In short, social welfare is the well-being of persons as a community."[26] The following projects have been determined to be qualifying activities for civic leagues:

- Tenants' legal rights defense groups[27]
- Unemployment relief efforts organized to provide loans to purchase and develop land and facilities to create jobs,[28] and a credit counseling service to prevent bankruptcy in the community[29]
- Amateur baseball league[30] and a sports organization promoting the interest of youths by giving them free tickets to sporting events, thereby providing wholesome entertainment for the welfare of the community's youths (might also qualify under (c)(3))[31]
- Bus line providing transportation from a suburb to major employment centers in a metropolitan area.[32] A bus operation for the convenience of employees of a particular corporation would not qualify.[33]

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[22] See Section 22.2 on relationships between §501(c)(3) and §501(c)(4) organizations.
[23] Priv. Ltr. Rul. 200128059.
[24] Rev. Rul. 74-361, 1974-2 C.B. 159; Rev. Rul. 66-179, 1966-1 C.B. 139.
[25] *Erie Endowment v. U.S.*, 361 F.2d 151 (3rd Cir. 1963).
[26] *Commissioner v. Lake Forest, Inc*., 305 F.2d 814 (4th Cir. 1962).
[27] Rev. Rul. 80-206, 1980-2 C.B. 185.
[28] Rev. Rul. 64-187, 1964-1 C.B. (Part 1) 354; Rev. Rul. 67-294, 1967-2 C.B. 193.
[29] Rev. Rul. 65-299, 1965-2 C.B. 165.
[30] Rev. Rul. 69-384, 1969-2 C.B. 112.
[31] Rev. Rul. 68-118, 1968-1 C.B. 261.
[32] Rev. Rul. 78-69, 1978-1 C.B. 156.
[33] Rev. Rul. 55-311, 1955-1 C.B. 72.

- Junior chambers of commerce customarily qualify.[34]
- Antiabortion league formed to educate the public, promote the rights of the unborn, and lobby for legislation to restrict women's access to abortions[35]
- Society presenting an annual festival to preserve ethnic culture[36]
- Parks or gardens for beautification of a city, including a group formed to maintain the public areas of a particular block[37]
- Veterans organization that conducted social welfare programs. Less than 75 percent of its members were veterans, and therefore it could not qualify under IRC §501(c)(19).[38]
- Garden club to bring civic betterment and social improvement (note that a garden club can conceivably qualify under 501(c)(3), (4), (5), or (7))[39]
- Bridge club providing recreational activity for a nominal fee to a community[40]

A civic organization that benefits private individuals or operates for profit cannot qualify as a (c)(4) organization. The following groups have failed to receive exemption:

- A tenants' association for a particular apartment complex, and condominium management[41] or residential real estate management associations (see IRC §528) do not qualify.
- An individual practice association of local doctors benefited the member physicians, not a community.[42]
- A pirate ship replica operation and staging of an annual mock invasion and parade was for the benefit of its members.[43]
- An ethnic group, whose members live in an area and receive sickness and death benefits, operates for its members.[44]
- A television antenna group organized on a cooperative basis to improve reception for a remote area on a fee basis to members does not qualify,[45]

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[34] Rev. Rul. 65-195, 1965-2 C.B. 164.

[35] Rev. Rul. 76-81, 1976-1 C.B. 156.

[36] Rev. Rul. 68-224, 1968-1 C.B. 222. A kennel club focused on presenting an annual show that draws over 25,000 visitors and is broadcast on television to millions of people was allowed to qualify as a civic association since its social functions were incidental according to Priv. Ltr. Rul. 9805001.

[37] Rev. Rul. 68-14, 1968-1 C.B. 243, as distinguished by Rev. Rul. 75-286, 1975-2 C.B. 210.

[38] Priv. Ltr. Rul. 200011050; unfortunately for the organization, it also failed to qualify to receive deductible charitable contributions.

[39] Rev. Rul. 66-179, 1966-1 C.B. 139; see also IRS Priv. Ltr. Rul. 9805001.

[40] Tech. Adv. Memo. 9220010.

[41] Rev. Rul. 74-17, 1974-1 C.B. 130.

[42] Rev. Rul. 86-98, 1986-2 C.B. 74.

[43] *Ye Krewe of Gasparilla,* 80 T.C. 755, Dec. 40,052.

[44] Rev. Rul. 75-159, 1975-1 C.B. 48.

[45] Rev. Rul. 54-394, 1954-2 C.B. 131.

but a group with the same purpose supported by voluntary contributions and available to all that live in the area can qualify.[46]

- An educational camp society formed to provide a rural retreat for a school's faculty and students does not benefit the community.[47] Nor does a vacation home established and controlled by a corporation for its female employees, despite the facts that it was open for public use and the general public used it 20 percent of the time.[48]
- An antiwar protest group that encourages people to commit illegal acts during demonstrations operates against public policy and is not exempt.[49]
- A lake association formed to provide recreational services to its members as residents of a particular community cannot qualify under (c)(4) but instead is allowed to qualify as a social club under (c)(7).[50]

6.3 LOCAL ASSOCIATIONS OF EMPLOYEES

An association of employees of a particular company working in a local area to serve charitable, educational, or recreational purposes without allowing its assets to benefit the employees as individuals can qualify for tax exemption under §501(c)(4).

(a) Membership Requirements

The statute describes a local association as one limited to employees of a designated person or persons in a particular municipality. The word *local* means the organization has a purely local character confined to a particular community, place, or district, irrespective of political subdivisions.[51] A limit circumscribed by the borders of a state is too broad. An association limited to specified counties in two states, however, did qualify.[52] Employees of a business with locations in different cities and states would need to form separate associations in the various locations.[53]

The words *person or persons* allow an association to be comprised of employees of more than one employer in a local area.[54] Retired employees can be members[55] even if they were not members while they were actively employed.[56] The association may limit its membership to certain classes of employees. In one

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[46] Rev. Rul. 62-167, 1962-2 C.B. 142.

[47] *The People's Educational Camp Society, Inc. v. Commissioner,* 331 F.2d 923 (2d Cir. 1964), *aff'g.* 39 T.C. 756 (1963), cert. den., 379 U.S. 839 (1964).

[48] Rev. Rul. 80-205, 1980-1 C.B. 184, issued by the IRS to say that it will not follow *Eden Hall Farm v. U.S.,* 389 F. Supp. 858 (W.D. Penn. 1975), which held that a farm did qualify because the group of working women it served represented a community.

[49] Rev. Rul. 75-384, 1975-2 C.B. 204.

[50] April 1994 Determination Letter published by IRS National Office EO Technical Division.

[51] Reg. §1.510(c)(4)-1(b) by reference to Reg. §1.501(c)(12)-1.

[52] Priv. Ltr. Rul. 8738075.

[53] Tech. Adv. Memo 8306002.

[54] Tech. Adv. Memo. 8652006.

[55] Rev. Rul. 74-281, 1979-1 CB 133.

[56] Priv. Ltr. Rul. 8018073.

example, the IRS thought it was acceptable for an employee health club to admit only salaried employees and exclude hourly workers.[57] The 200 employees were deemed not to represent an "excessively exclusive" arrangement, but an association limited to employees paid over $100,000 annually might not qualify.

(b) Permissible Activities

Associations must conduct activities of a charitable, educational,[58] or recreational nature. The association might sponsor the company softball team or conduct safety programs or continuing education classes. An association that promotes cultural activities for employees by securing blocks of tickets for symphony or ballet performances could qualify.

The association that exists primarily to provide insurance, pension, or other retirement benefits to its members is not considered charitable and cannot qualify.[59] It was unsuccessfully argued that such an association formed by government employees should qualify as charitable because it relieves the burdens of government.[60] The IRS holds the same opinion.[61] Similarly, an association formed to provide employee bus[62] or cooperative buying services[63] cannot qualify.

6.4 NEIGHBORHOOD AND HOMEOWNER'S ASSOCIATIONS

To qualify under §501(c)(4), an organization must serve a constituency that constitutes a community rather than a limited group of individuals. The homeowner's association exemplifies the type of group not qualified for (c)(4) tax-exempt status, but the distinction between those that qualify and those that do not is often vague. One IRS definition of *community* says, "The term has traditionally been construed as having reference to a geographic unit bearing a reasonably recognizable relationship to an area ordinarily identified as a governmental subdivision or a unit or district thereof."[64] A community is sometimes hard to define, and the facts and circumstances of each case are determinative.[65] Taken as a whole, the rulings indicate that to prove that an organization operates for the benefit of the community as opposed to individual residents, the following factors must be present[66]:

- The association does not maintain private residences, either exterior or interior. Such services are evidence that an organization is operated for private benefit.[67]

[57] Gen. Coun. Memo. 39357 (May 3, 1985).
[58] See Chapters 4 and 5.
[59] Rev. Rul. 66-59, 1966-1 CB 142.
[60] *Police Benevolent Ass'n. of Richmond Va. v. U*.S., 661 F. Supp. 765 (ED Va. 1987, *aff'd,* 836 F.2d 547 (4th Cir. 1987).
[61] Tech. Adv. Memo. 8051004, 8120001, and 8135010.
[62] Rev. Rul. 55-31, 1955-1 CB 72; Priv. Ltr. Rul. 8027934.
[63] Rev. Rul. 79-128, 1979-1 197; see also section 5.4.
[64] Rev. Rul. 74-99, 1974-1 C.B. 131.
[65] Rev. Rul. 80-63, 1980-1 C.B. 116.
[66] Rev. Rul. 67-6, 1967-1 C.B. 135; Rev. Rul. 72-102, 1972-1 C.B. 149, mod. by Rev. Rul. 76-147, 1976-1 C.B. 151.
[67] Rev. Rul. 74-99, supra note 39.

- Common areas, including streets, sidewalks, and parks, are open to the general public for their use and enjoyment without controlled access restricted to members. Subdivisions often form a separate social club to operate a swimming pool or other recreational facility from which they want to exclude the public.
- Association is not limited to a particular commercial development unless it conducts only those activities customarily reserved to a municipality. This question is sometimes difficult, as the *Columbia Park* case discussed previously indicates.[68]
- The organization must not have as its sole purpose the provision of basic services to residents (such as garbage pickup and security patrol).
- Enforcing covenants for architectural appearance and limitations on commercial or multitenant occupancy with the intention of preserving the community provides a public benefit, despite the fact that it may serve also to maintain property values of the individual owners.[69]
- Revenue for a civic league comes from a variety of usage fees, governmental grants, and voluntary donations, as distinguished from a homeowner's association, which normally finances all of its costs from member assessments.

(a) Characteristics of Homeowner's Associations

Although it may have some activities that benefit the community, the typical homeowner's association will not qualify for §501(c)(4) exemption if its primary focus is to benefit individual owners—the first four items in the previous list. To stop some of the controversy, clarify the rules, and allow tax relief for such associations, Congress enacted §528 in 1976, which provides a special exemption section for homeowner's associations. Two types of associations qualify: condominium management associations and residential real estate management associations.[70] The basic requirements for qualifying include the following:

- An annual election to be so taxed pursuant to the section is made and filed by the due date of the return, including extensions.[71]
- The nonprofit must be organized and operated to acquire, construct, manage, maintain, and care for association property, whether held in common for the owners, held privately by the owners, or held by a governmental unit for use by the owners.[72]

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[68] *Columbia Park and Recreation Association, Inc. v. Commissioner,* supra note 20.

[69] Rev. Rul. 72-102, supra note 66.

[70] Reg. §1.528-2.

[71] IRS Instructions to Form 1120-H at 2. This election cannot be revoked retroactively to take advantage of a net operating loss. However, revocation was granted by the IRS to an association that relied on inadequate tax advice provided by a professional tax advisor. Rev. Rul. 83-74, 1983-1 C.B. 112.

[72] Reg. §1.528-3.

- Sixty percent or more of its gross income must be "exempt function income," that is, membership dues, fees, or assessments from member owners of residential units. A settlement for past underassessments of dues paid by a real estate developer is exempt function income.[73]
- Ninety percent or more of its expenditures in a tax year must be for "exempt function purposes." These purposes include capital expenditures for property improvements or replacement costs, salaries of managers, clerical, maintenance, and security personnel, gardening, paving, street signs, property taxes, repairs to association property, and all other disbursements to acquire, construct, manage, and maintain the property.
- Eighty-five percent or more of the condominium, subdivision, development, or similar area related to the association must be used by individuals as residences. Vacant units are included if they were residences before they became unoccupied.[74]
- No part of its net earnings can inure to the benefit of any private shareholder or individual.

(b) Calculating the Tax

The tax relief is only partial. While all of a qualifying civic league's income is exempt from income tax, a homeowner's association pays tax. It can elect to pay either a flat 30 percent tax on its nonexempt function income (basically, its investment in common-area facilities, passive investment income, and any unrelated business income less deductions) or the normal corporate tax payable on all of its income. Exempt function revenues are those received from the member property owners as dues or assessments unless such fees or assessments represent payments for services rendered to the members. Taxable revenues[75] for §528 purposes include the following:

- Interest earned on deposits and investments held in a sinking fund for improvements or repairs, including tax-exempt interest
- Member assessments for mortgage principal, interest, and real estate taxes on association property
- Amounts received for work performed on privately owned property
- Assessments for maintenance, trash collection, or snow removal
- Nonmember usage fees, as well as member fees for special services

Deductions from the listed taxable income items include expenses directly connected with producing the nonexempt function income. There is a $100 exemption. No deduction for net operating loss or dividends received is allowed.

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[73] Rev. Rul. 88-56, 1988-2 C.B. 126.
[74] Reg. §1.528-4.
[75] Reg. §1.528-9.

(c) Annual Election

A homeowner's association has an annual choice of electing to pay income tax as a normal corporation rather than to pay the flat 30 percent tax on its investment income. For taxable income of up to $50,000 the normal corporate tax rate for 2004 was 15 percent, and 25 percent for the next $25,000. For an association with modest income taxable, the election to pay the 30 percent tax may not be suitable. The decision turns on factors that should be quantified in each case to make the correct choice. The tax rate is one factor and is influenced by both the amount of the income and by the kind of income that is taxable. The part of an association's net income that is considered exempt function income is not taxed if the election is made, but it is taxed if the association elects to be taxed as a normal corporation.

A nonelecting homeowner's association is subject to a deduction limitation rule,[76] which allows deduction of expenses attributable to owner activities only to the extent of owner income. It is extremely important, therefore, to understand the interplay of the deduction limit in §277 and the flat tax of §528, which contains the exclusions from income. In other words, even though the association's financial statements show no net profit, it may have taxable income.

Once the election is made or not made, the association may seek permission from the IRS to revoke or elect pursuant to the relief provision of §9001. When the wrong decision was made based upon the recommendation of a professional advisor, revocation has been allowed.[77] Form 1120H filers need not pay quarterly estimated tax. The balance of tax is due by the fifteenth day of the third month following the end of the taxable year. For further details, see IRS Publication 588, Tax Information for Homeowners Associations.

6.5 DISCLOSURES OF NONDEDUCTIBILITY

Many non-(c)(3) organizations are required to make two different disclosures of the deductibility of payments they solicit. Organizations can be penalized for failure to properly make the disclosures.

(a) Notice of Noncharity Status

Social welfare organizations, agricultural organizations, business leagues, and many other tax-exempt organizations that are not eligible to receive gifts deductible as charitable contributions must say so on fund-raising solicitations.[78] Exempt organizations subject to the disclosure requirement include the following:

- Organizations not described in §170(c) that are exempt from tax under §501(c) or §501(d) and political organizations defined in §527(e), including political campaign committees and political action committees
- Organizations listed above whose gross annual receipts exceed $100,000 (multiple organizations created to circumvent this limit can be combined by the IRS)

[76] IRC §227.
[77] Priv. Ltr. Rul. 9233025; Rev. Rul. 83-74, 1983-1 C.B. 112.
[78] IRC §6113.

An express statement that payments (whether called dues, gifts, contributions, or something else) are not tax deductible must be printed on written requests for payments and announced in solicitations made by phone, radio, television, and the Internet (although not mentioned in the 1988 legislation). Certain types of exempt function payment requests are excluded, such as a fee for a newsletter ad, registration for an educational conference, premiums for an insurance program, community association fees for police and fire protection, and other payments for specific services rendered by the nonprofit.

The disclosure must be "conspicuous and easily recognizable." The statement of nondeductibility must be clearly legible in type of the same size as the primary message of the written piece. It cannot be obscured by placement, color, shape, or other means and cannot be buried in some part of the solicitation materials that ordinarily would not be noticed and read by the recipient. The script of telephone, radio, television, and Internet solicitations must contain a statement that the payments are not tax deductible.[79] In 2002 the IRS announced that the disclosures are not "difficult to adapt to computer-based communications" and found "no reason to treat e-mail solicitation any differently from direct mail solicitations.[80] Web-based fund raising is similar to print media, since unlike telephone, television, and radio, the viewer generally controls what he or she looks at and for how long."

The following four conditions should exist for the Web site solicitation to meet the disclosure requirements:

1. The solicitation includes an express statement that payments are not tax deductible as charitable contributions.
2. The statement is at least the same type size as the primary message and is readily visible against the background of the page.
3. The statement appears on the same [Web] page as, and in close proximity to, the actual request for funds.
4. The statement is either the first sentence in a paragraph or itself constitutes a paragraph.

The penalty for failure to disclose is $1,000 a day, up to $10,000 each year. The IRS imposed the maximum penalty for nondisclosure on a §527 political organization in the first ruling issued on the subject. No notice was included in its telemarketing script. It argued that it had relied upon the "inadequate compliance information supplied to it by its national umbrella organization" so that the penalty should be excused for "reasonable causes." The IRS found that the organization was "not run by inexperienced individuals ignorant of the tax laws, but by experienced, knowledgeable individuals with paid staff having access to information concerning the rules."[81]

[79] IRS Notice 88-120, 1988-2 C.B. 454.

[80] Cheryl Chasin, Susan Ruth, and Robert Harper, Chapter I, "Tax Exempt Organizations and World Wide Web Fundraising and Advertising on the Internet," *IRS CPE Text,* 2000; Rev. Proc. 2001-59, IRB 2001-52, 627.

[81] Priv. Ltr. Rul. 9315001.

(b) Dues Not Deductible as Business Expense

Congress listened to President Bill Clinton's suggestion that almost all lobbying expenses be made nondeductible for income tax purposes. Before 1994, a business expense deduction was not allowed for political campaign activity and grassroots lobbying attempts to influence the public at large, but expenses of direct efforts to influence lawmakers were deductible. IRC §162(e) was revised[82] to add two new types of nondeductible lobbying and political activity—for both for-profit and nonprofit entities—bringing the total to four, as follows:

1. Influencing legislation
2. Contacts with certain senior executive branch officials in attempts to influence official actions or positions of such officials
3. Political campaign activities
4. Grassroots lobbying

(c) Definition of Legislation

Influencing legislation is defined by §162(e)(4) to mean "any attempt to influence any legislation through communicating (oral or written) with any member or employee of a legislative body or with any government official or employee who may participate in the formulation of legislation." Influencing legislation is additionally defined by the regulations to include "[a]ll activities, such as research, preparation, planning, and coordination, including deciding whether to make a lobbying communication, engaged in for a purpose of making or supporting a lobbying communication, even if not yet made."[83]

Guidance has not yet been offered on the definition of "grassroots lobbying" or "communications with executive branch officials." The term *legislation* includes actions with respect to acts, bills, resolutions, or similar items by Congress; any state legislature, local council, or similar governing body; or the public in a referendum, initiative, constitutional amendment, or similar procedure.[84]

Action is limited to the introduction, amendment, enactment, defeat, or repeal of acts, bills, resolutions, or similar items. The IRS has deemed confirmation of a judicial nominee to be "similar to" legislation.[85] Actions of federal or state administrative or special-purpose bodies, such as auditing or issuing rulings, are not included.[86] Attempting to influence regulations proposed by the Treasury Department would not be considered legislative activity. These rules contain no exceptions for nonpartisan research and study of issues germane to legislative actions, as found in §4911 applicable to (c)(3) organizations. Some guidance as to when an issue becomes a legislative proposal is provided in the regulations under a "look-back rule."[87] The congressional conferees did say that any "communication com-

[82] The Omnibus Budget Reconciliation Act of 1993.
[83] Reg. §1.162-29(b)(1).
[84] Defined by referring to the language of §4911(e)(2) applicable to lobbying by charities.
[85] Gen. Coun. Memo. 39694 (January 22, 1988).
[86] H.R. Rep. 103-213 (Conference Report) at 605, note 57.
[87] See Section 6.4(h).

pelled by subpoena, or otherwise compelled by federal or state law, does not constitute an attempt to influence legislation or an official's actions, and therefore is not subject to the general disallowance rules."[88]

Local Councils. A special exception was carved out to permit the deduction of expenses of attempting to influence legislation of "any local council or similar governing body."[89] Any legislative body of a political subdivision of a state, such as a county or city council, comes within the exception for local lobbying.[90] State-level lobbying expenses associated with legislative actions of a state legislature are treated on a par with federal lobbying. Note, however, that communications with state officials are not subject to the disallowance provisions for federal officials.

Communications with Executive Branch. A brand-new category of lobbying was created. Expenses paid to make a direct communication with high officials in the executive branch of the federal government in an attempt to influence their official actions are not deductible. The disallowance applies when the communiqué concerns administrative action as well as pending or proposed legislation. The covered executive branch officials include the following:

- The president and the vice president
- Cabinet members, others having cabinet-level status, and their immediate deputies
- The two most senior officers of each agency within the Executive Office of the President, such as the National Security Agency
- An employee of the Executive Office of the President

A communication regarding proposed Treasury Department regulations may or may not be a direct communication. Comments about regulations submitted through normal channels to lower-level employees are not generally regarded as a communication with a cabinet member. Direct contact with the Secretary of the Treasury and his or her deputy, however, would be. The cost of research and analysis conducted to gather information intended to be communicated to a covered official is also nondeductible.

A communiqué addressed to a noncovered official can be treated as a direct communication if the covered official is the intended recipient.[91] The fact that a cabinet-level official must ultimately approve or sign off on a regulation does not make the lower-level contact a nondeductible activity.[92] It is important to distinguish regulation and procedural communications from those involving legislation. Communication with a member of the executive branch on any level concerning legislation being formulated will be treated as an attempt to influence legislation. Concerning the charitable lobbying rules, the IRS has stated that a

[88] Conf. Rep. at 607.
[89] IRC §162(e)(2).
[90] Conf. Rep. at 605.
[91] Id.
[92] Conf. Rep. at 607.

treaty required to be submitted by the president to the Senate is considered "legislation" from the moment a U.S. representative begins negotiations with the other country's delegates.[93]

(d) Nondeductible Membership Dues

Dues paid to membership organizations, including a civic league, labor union, or business league, are not deductible to the extent the money is spent on nondeductible lobbying or political expenses.[94] The disallowance applies to dues paid to organizations that spend more than $2,000 annually on "in-house" expenses, or what the code calls a de minimis amount.[95] An allocation of overhead costs, third-party payments, dues to other organizations, grassroots lobbying, political campaign intervention, and foreign lobbying are not considered in-house expenses. Also, certain organizations whose members ordinarily do not deduct their dues are excluded from this nondeductibility provision.[96]

Exempt organizations, other than (c)(3)s, that spend money for lobbying expenses associated with legislative and executive-branch communications have a choice under these rules. The first choice Congress gives an organization that lobbies is to disclose the nondeductible amount to its members. Under this choice, members are informed of the portion of nondeductible lobbying expenses paid with or allocable to the dues payments. With the proper notice to members, the organization can essentially pass through its nondeductible lobbying. Choice 2 allows the organization itself to instead pay unrelated business income tax on its lobbying expenditures, called a *proxy tax.*

Documents seeking payment of dues from members of organizations making the first choice must contain the estimated amount of the portion of dues that are nondeductible. If such notice is not given, the organization pays the proxy tax on its lobbying expenditures.[97] Form 990 requires the organization to report the total amount of dues allocable to lobbying.[98] The calculation of the nondeductible dues portion is made on a first-in, first-out basis. Disallowed expenses are considered as paid out of member dues rather than other funds or revenues of the organization. If the portion of member dues actually collected totals less than the amount of nondeductible lobbying in any one year, the excess expense is carried over to the succeeding year. This rule prevents an organization from using savings or other resources every other year or so to reduce bad member relations that might result from nondeductibility of dues.

(e) Proxy Tax

The league or union that chooses not to, or fails to, notify its members of the nondeductible amount pays a proxy tax. The tax is payable at the highest corporate tax rate, currently 35 percent.[99] The choice can be made (or imposed because

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[93] Reg. §56.4911-2(d)(1)(i).
[94] IRC §162(e)(4)(B), as amended by the Revenue Reconciliation Act of 1993.
[95] IRC §162(e)(B)(ii).
[96] See Section 6.4(f).
[97] IRC §6033(e)(1)(A)(ii).
[98] See www.wiley.com/go/blazek_990 (Hoboken: John Wiley & Sons).
[99] IRC §6033(e)(1)(A).

of a mistake) annually. The tax is due on the portion of member dues allocable to expenditures for nondeductible lobbying activities, but cannot exceed the amount of dues received during a year.[100]

(f) Excepted Organizations

Organizations that establish to the satisfaction of the secretary that substantially all of the dues or other similar amounts paid by persons to such organizations are not deductible without regard to §162(e) are excluded from this disclosure and disallowance provisions. The IRS explains the application of this exception by category of organization.[101]

Automatically Excluded. The notification and/or proxy tax provisions do not apply to organizations recognized by the IRS as exempt from taxation under §501(a) other than those exempt under §501(c)(4), (5), or (6).

- (c)(4) organizations are excluded if either of the following apply:
  - The largest amount of annual dues (or similar amounts) paid by any member is $50 indexed; for 2004 the amount is $86 or less and not more than 10 percent of the total amount of annual dues or similar amounts to come from members paying more than $75 annually
  - More than 90 percent of all annual dues are received from organizations described in §501(c)(3), state or local governments, or entities whose income is exempt under §115.
- (c)(5) organizations follow the same rule as (c)(4)s.
- (c)(6) organizations are excluded only if more than 90 percent of all annual dues are received from organizations described in §501(c)(3), state or local governments, or entities whose income is exempt under §115.

Excluded by Nondeductibility. An exempt organization that cannot satisfy the automatic exclusions may still be excluded if it

- Maintains records establishing that 90 percent or more of the annual dues (or similar amounts) paid to it are not deductible without regard to §162(e)
- Notifies the IRS that it is excluded by §6033(e)(3) when it files its annual Form 990

The procedure defines the significant terms as follows:

- Annual dues are the amount an organization requires a person, family, or entity to pay to be recognized by the organization as a member for an annual period.
- Similar amounts include, but are not limited to, voluntary payments made by persons, families, or entities; assessments made by the organiza-

[100] Conf. Rep. at 608.
[101] Rev. Proc. 95-35, 1995-32 I.R.B. 1; updated by Rev. Proc. 2003-85, 2003-49 IRB 49.

tion to cover basic operating costs; and special assessments imposed by the organization to conduct lobbying activities.

- *Member* is used in its broadest sense and is not limited to persons with voting rights in the organization.

The definition of *annual dues* is straightforward and clear. However, the meanings of *similar amounts* and *member* are extremely vague and broad. Assume that a group of individuals creates an organization to lobby the state legislature for more school funding. A self-perpetuating board creates a nonmembership not-for-profit corporation and seeks (c)(4) status. Using a direct mail campaign, the organization seeks support from citizens statewide. There is no mention of membership or dues nor of assessment. Such voluntary payments under a strict reading of the IRS definition could be construed as similar amounts. A cautious organization in this situation might notify supporters of the nondeductibility of their payments.

The vague definition of the term *member* for this purpose is quite contrary to the definition suggested by the IRS in trying to tax associate member dues of labor unions and business leagues. For that purpose, the IRS says a member is a person who has a formal relationship and specific rights and obligations in relation to the organization.[102]

(g) Cost of Lobbying

To tally up its lobbying costs, an organization includes the following:

- Third-party costs, or amounts spent specifically on lobbying—daily fees paid to professional lobbyists, expenses of travel to Washington, or cost of an opinion poll
- An allocable portion of the organization's overall operating expenses
- Expenses of preparing, planning, or coordinating lobbying activities
- Research and monitoring costs which, upon "looking back," are shown to lead up to lobbying

The preamble to the regulations says that costs properly allocable to lobbying activities are to be calculated using any reasonable method consistently applied.[103] The method must, however, follow specific rules for the exclusion or inclusion of labor. The labor hours (and presumably the cost of the labor, dependent upon the method used) of persons spending less than 5 percent of their time on lobbying may be ignored as de minimis, unless the time is spent in direct-contact lobbying.

Two distinct categories of cost are allocable: labor costs and general and administrative (G&A) costs. G&A is said to include depreciation, rent, utilities, insurance, maintenance costs, security costs, and other administrative department costs (for example, payroll, personnel, and accounting). The regulations suggest, but do not limit the organization to, use of one of the three following allocation methods.

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[102] See Section 8.6.
[103] Reg. §1.162-28, effective July 21, 1995.

Type 1: Ratio Method. A percentage of the organization's overall operating costs, not including third-party lobbying expense, is allocated to lobbying. The ratio compares the total number of hours the organization's personnel spend directly engaged in lobbying to the total number of hours personnel work. Any reasonable method may be used to determine labor hours. The opening explanation suggests, as examples of records to be maintained, daily time reports or daily logs. Absent exact records, it may be assumed that full-time personnel spend 1,800 hours a year on the "taxpayer's trade or business." Support personnel labor—"persons engaged in secretarial, maintenance, and similar activities"—may be excluded from both the numerator and the denominator of the ratio calculation.

Type 2: Gross-Up Method. Under this method, the total lobbying cost is

Third-party costs + (basic labor costs * 175%)

"Basic labor costs" means salary or other payment for services plus payroll taxes. Pension, profit sharing, employee benefits, and supplemental unemployment benefit plan costs, as well as other similar costs, are not included. The lobbying activities of many nonprofits are conducted by volunteers. This method cannot be used by organizations that do not incur reasonable labor costs for persons engaged in lobbying (efforts conducted by volunteers).[104]

Type 3: §263A Cost System. The cost system provided for manufacturing businesses can be used. Lobbying activity is treated as a service department or function to which costs are allocated, using a step methodology. The regulations contain a detailed example that can be studied to consider the viability of this choice. Under normal tax accounting ruling, the choice of method is binding and altered only with IRS permission.[105]

(h) Look-Back Rule

Internal Revenue Code §162(e)(5)(c) broadens the definition of what constitutes moneys spent to influence legislation to include "any amount paid or incurred for research, or preparation, planning, or coordination of any such activity." Merely monitoring legislative activity is not an attempt to influence it. An organization, however, must look back and reclassify monitoring expenses as nondeductible[106] in cases where it monitors legislation and subsequently attempts to influence the formulation or enactment of the same (or similar) legislation. The costs of the monitoring activities generally will be treated as incurred *in connection with* nondeductible lobbying activity. Likewise, if the organization conducts research and prepares presentations, meetings, and communications with underlings of a covered executive branch official "with a view toward directly communicating with the top official," all of the costs are nondeductible.[107]

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[104] Reg. §1.162-28(b)(2).
[105] See Section 28.2.
[106] Conf. Rep. at 606.
[107] Id. at 607.

The regulations recognize that an organization might be involved in matters of legislative import for multiple reasons and suggest that all of the facts and circumstances surrounding an activity be considered to identify the "purpose of an expenditure." The organization may treat an activity partially as related to a legislative initiative and partially for a nonlobbying purpose. The IRS suggests that the following facts would determine the purpose of engaging in such an activity[108]:

- Whether the activity and the lobbying communication are proximate in time
- Whether the activity and the lobbying communication relate to similar subject matter
- Whether the activity is performed at the request of, under the direction of, or on behalf of a person making the lobbying communication
- Whether the results of the activity are also used for a nonlobbying purpose
- Whether, at the time the taxpayer engages in the activity, there is specific legislation to which the activity is related

The final regulations helpfully list the activities that will be treated as having no purpose to influence legislation:

- Determining the existence or procedural status of specific legislation, or the time, place, and subject of any hearing to be held by a legislative body with respect to specific legislation
- Preparing routine, brief summaries of the provisions of specific legislation
- Performing an activity to comply with any law, such as satisfying state or federal securities law filings
- Reading any publications available to the general public or viewing or listening to other mass-media communications
- Merely attending a widely attended speech

Six detailed examples in the regulations can be studied by an organization wishing to distinguish between activities that have lobbying import and those that have no purpose to influence legislation.

[108] Reg. §1.162-29(c).

CHAPTER SEVEN

Labor, Agricultural, and Horticultural Organizations: §501(c)(5)

Internal Revenue Code (IRC) §501(c)(5) encompasses three specific kinds of organizations: labor unions, agricultural groups, and horticultural groups. These groups are distinguishable from those classified as business leagues partly because their members may represent a range of pursuits rather than a narrow "line of business" as required under (c)(6). An organization qualifying under this category may have no net earnings inuring to the private benefit of any member, although a labor union can provide some individual benefits.[1] Note that this phrase includes all of the members—a broad group of persons. Comparatively, the inurement provision applied to (c)(3) and (c)(4) organizations applies to those that are in a position to control the organization.[2] On a positive note, the Intermediate Sanction penalties are not imposed on members of a (c)(5) organization that receive impermissible benefits.[3] These worker-oriented groups may only serve the three purposes provided in regulations that have not been revised since 1958:

[1] Discussed in Section 7.2(b).

[2] See Chapter 20.

[3] Exempt status, however, could be challenged if the private benefits are extensive.

1. Betterment of conditions of those engaged in such pursuit.
2. Improvement of the grade of their products.
3. Development of a high degree of efficiency in their respective occupations.[4]

7.1 LABOR UNIONS

The Internal Revenue Service (IRS) defines a labor organization as an "association of workers who have combined to protect or promote the interests of the members by bargaining collectively with their employers to secure better working conditions, wages, and similar benefits." The term includes labor unions, councils, and committees.[5] It is not mandatory that the membership be exclusively employees, though the character of revenue received from nonmembers might be treated differently.[6] The purpose for which the nonprofit is formed determines exempt status.

(a) Organizational Structure and Documents

The Internal Revenue Code and Regulations impose no requirements regarding organizational structure. Form 1024,[7] however, imposes a very clear organization test: "If the organization does not have an organizing instrument, it will not qualify for exempt status. The bylaws of an organization alone are not an organizing instrument. They are merely the internal rules and regulations of the organization." IRS Publication 557, Tax Exempt Status for your Organization,[8] makes the following suggestion to enable a proposed union to achieve recognition of its exempt status:

> To show that your organization has the purpose of a labor organization, you should include in the articles of organization or accompanying statement (submitted with your exemption application) information establishing that the organization is organized to carry out the betterment of the conditions of workers, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

(b) Scope of Activities

Promoting and protecting the interests of workers can be accomplished in a variety of ways. Labor unions whose activities are limited to representing employee members can readily be granted exemption. Some peripheral activities may also allow a workers' organization to qualify under the labor organization classification. Examples of permissible activities include the following:

- Improvement of professional abilities of members through seminars, courses, and participation in conventions; securing better salaries and working conditions for workers through collective bargaining and processing grievance procedures[9]

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[4] Reg. §1.501(c)(5)-1(a).
[5] *Exempt Organizations Handbook* (IRM 7751) §521.
[6] See Section 7.1(e).
[7] Reproduced in Appendix 18-2.
[8] July 2001Version.
[9] Rev. Rul. 76-31, 1976-1 C.B. 157.

- Worker dispatch systems to provide equitable allocation of available work and to adjudicate and settle grievances[10]
- Provision of strike benefits[11] and mutual death, sickness, accident, and similar benefits for union members only (from member-contributed funds),[12] but not accounting and tax services[13]
- Apprenticeship committees with union and employer representatives to establish standards of employment and qualification in skilled crafts, and to arbitrate in apprentice-employer disputes[14]
- A nurses' association established to bargain collectively with health institutions[15]
- Seminars and training programs, newspapers,[16] conventions, and legal defense and litigation activities[17] by individual unions or associations of labor organizations and unions
- Labor "temples" or centers containing offices, meeting and recreation halls, and a barbershop, and otherwise providing a home to 162 unions, and which are owned by the unions[18]

(c) Non-(c)(5) Activities

Activities outside the historical role of unions may not be conducted as a primary purpose of a (c)(5) organization. A qualifying labor union cannot, as its primary activity, receive, hold, invest, distribute, or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans.[19] Whether the union itself, a directly affiliated organization, or a totally separate group undertakes the activity can be determinative. The IRS has generally allowed unions to have concerns other than wages, working hours, and working conditions, but only when they are mutually beneficial to union members. Among the activities that have resulted in denial of union status are

- Savings plans for individual members established under a collective bargaining agreement to collect money and disburse it annually to members, and unrelated to strikes or wage levels[20]

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10 Rev. Rul. 75-473, 1975-2 C.B. 213.
11 Rev. Rul. 67-7, 1967-1 C.B. 137.
12 Rev. Rul. 62-17, 1962-1 C.B. 87.
13 Rev. Rul. 62-191, 1962-2 C.B. 146.
14 Rev. Rul. 59-6, 1959-1 C.B. 121.
15 Rev. Rul. 77-154, 1977-1 C.B. 148.
16 Rev. Rul. 68-534, 1968-2 C.B. 217.
17 Rev. Rul. 74-596, 1974-2 C.B. 167; Rev. Rul. 75-288, 1975-2 C.B. 212.
18 *Portland Co-operative Labor Temple Ass'n. v. Commissioner,* 39 B.T.A. 450(1939), acq. 1939-1 C.B. 29.
19 Reg. §1.501(c)(5)-1(b).
20 Rev. Rul. 77-46, 1977-1 C.B. 147.

- Businesses formed to provide employment for members.[21] The fact that the profits from such a business go to a union does not help.
- An association formed to collect and pay over federal and state employment taxes on behalf of a group of manufacturers[22]
- An organization formed by individuals (not by a union) to pay weekly income to workers in the event of a strike called by the members' union, but not to represent the workers in employment matters, does not qualify.[23] But a labor union's provision of financial assistance to its members during a strike is an exempt activity.[24]
- Unions of individual business owners[25]

A labor organization that primarily conducts exempt functions may also have a limited amount of unrelated business activity without necessarily losing its exempt status.[26]

(d) Political Activities

There is no specific guideline limiting the extent of lobbying and other attempts to influence legislation permitted for a (c)(5) organization. The IRS says some germane lobbying activities relating to labor union concerns is acceptable, but should not become the organization's primary activity.[27] An organization that spends more than half the annual budget on lobbying might find its exempt status challenged.

Campaigning on behalf of candidates for public office is not specifically prohibited, as it is for organizations exempt under §501(c)(3).[28] However, campaigning[29] cannot be a primary purpose.[30] Funds expended in efforts to influence elections, to the extent of the organization's investment income, are taxable under IRC §527. A segregated fund could be created to clearly delineate the activity and its income from the union's other sources of funds. Importantly, there are also limitations on political activity imposed by federal and state election laws.

(e) Membership

Membership in a labor organization traditionally includes employees, employers, and others whose participation in the union is to advance a focused field of work, including autoworkers, pipefitters, or teachers, for example. To qualify for tax exemption, a union must be an association of workers formed to seek better

[21] Rev. Rul. 69-386, 1969-2 C.B. 123.
[22] Rev. Rul. 66-354, 1966-2 C.B. 207.
[23] Rev. Rul. 76-420, 1976-2 C.B. 153.
[24] Rev. Rul. 67-7, supra note 5.
[25] Rev. Rul. 78-288, 1978-2 C.B. 179.
[26] See Chapter 21.
[27] *Exempt Organizations Handbook* (IRM 7751) §544.
[28] *Marker v. Schultz*, 485 F.2d 1003 (D.C. Cir. 1973).
[29] See Chapter 23.
[30] Ibid. note IRM 7751 §544.

working conditions, wages, and similar benefits.[31] When the union has membership classes for persons not directly involved in its type of work, two related, but different, questions arise. The first issue is qualification for tax exemption—the union must show it operates to benefit workers. A nurses' association[32] and a plumbers' group[33] composed mostly of employees were allowed to qualify even though a limited number of their members were independent contractors working in the field. If, instead, most of the members are independent contractors, exemption must be sought under IRC §501(c)(6) as a business league.[34]

A union with associate membership classes also faces a question of character for the revenues paid by its members. The IRS once insisted that membership denotes a formal relationship in which a person, whether specifically described as a member or not, has specific rights and obligations. Dues revenues paid by nonvoting associate members represented unrelated business income in the IRS's eyes. Unions and the IRS fought about this question for some years, as described here for historical context.

To clarify the issue, the IRS issued formal guidance in 1995.[35] A primary purpose test was provided, which asks, "Is the associate member category created and used to further the organization's exempt purposes or simply to produce unrelated income?" Further, in applying this principle "the Service looks to the purposes and activities of the organization rather than of its members." The IRS noted in the guidance that (c)(5) organizations often receive dues payments not only from members who are accorded full privileges in voting but also from associate members who are given less than full, or no, voting privileges. The IRS said it would not treat associate member dues as unrelated business income unless the facts indicate the membership category was created to produce unrelated income.

Membership categories for students studying in the field and retired persons should not be questionable in this regard, nor should layers of membership according to years of service or amount of compensation. Note that Congress chose not to give unions the special exception[36] given to agricultural groups that automatically exempts a portion of the dues from classification as unrelated business income. Labor unions must be alert to documenting the purpose of creating various membership classes.

Two cases involving insurance plans administered by the Office of Personnel Management through the Federal Employee Health Benefits Act (FEHBA) provide some insight into this issue. The first case involved the American Postal Workers Union (APWU).[37] The IRS took the position that a portion of the associate (nonpostal worker) member dues was attributable to the group health insurance plan and thereby produced unrelated business income, essentially saying

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[31] See footnote 8.

[32] Rev. Rul. 77-154, supra note 10.

[33] Rev. Rul. 74-167, 1974-1 C.B. 134.

[34] Rev. Rul. 78-288, supra note 19.

[35] Rev. Proc. 95-21, 1995-15 IRB 1; see also Priv. Ltr. Rul. 9847001 in which the modest level of associate dues indicated a lack of desire to general unrelated revenues.

[36] See Section 7.2.

[37] *American Postal Workers Union, AFL-CIO v. U.S.*, 925 F.2d 480 (D.C. Cir. 1991), rev'g 90-1 USTC ¶50,013 (D.C. 1989).

that associate member concerns were unrelated to the basic purpose of serving postal worker members. Thus, the IRS assessed unrelated business income tax on the profits from the associate member group insurance.

After reviewing the charter and bylaws of the union, the district court found that the APWU was organized to serve not only postal workers but any classified federal employee. Its membership was not limited to those employed by the U.S. Postal Service. This broad scope of coverage for all federal employees is permissible under the §501(c)(5) regulations pertaining to labor unions, which state that "a labor union is a voluntary association of workers that is organized to pursue common economic and social interests." Any union is free to define its constituents. Furthermore, the court found that there were "no requirements in the Internal Revenue Code that a union member receive any particular quantum of benefit in order to be considered a bona fide member." Likewise, the court found that the IRS's position that members had to have the right to vote was wholly without authority.

The court decided that the APWU's sponsorship of a group insurance plan served an exempt purpose as a mutual benefit organization. The court also found that the insurance program was not undertaken to make a profit, and that "providing economic benefits to members in return for dues is not a trade or business," citing the 1921 Congressional Record.

The appeals court, however, disagreed and found that the provision of insurance to nonpostal workers was not related to the union's stated focus on the interests of postal employees. The judge admitted that the case was difficult because nothing in the regulations or any other authoritative source defined the exempt purposes of a labor union. However, based upon a review of the organization's constitution, the court found that privileges of membership were granted only to active members, and that provision of insurance benefits to nonmembers could not be substantially related to the union's exempt purpose. The court was also swayed by the substantial profit generated by nonmember fees.

In a somewhat similar case, the Court of Claims decided that the National Association of Postal Supervisors (NAPS) was taxable on its health insurance activity, because this was an unrelated trade or business operated to produce a profit and was in competition with taxable insurance providers.[38] The NAPS case facts were distinguishable from APWU in one important respect: The NAPS court decided that the associate members were not members. The nonpostal employee members were called "limited members." Their dues were calculated to produce a profit, they did not participate in other union programs, and their memberships were dropped if they failed to continue coverage in the health plan. Although it was not stated, perhaps the deciding factor in the NAPS case was the fact that within five years of starting the insurance program, the limited benefit members made up 71 percent of the total number of members in the plan. Thus, the facts supported the IRS's position that the insurance program's purpose was primarily to produce profit, not to serve members. Yet another postal union was made to pay tax on its insurance program because the court found "providing insurance to

[38] *National Association of Postal Supervisors v. U.S.*, 90-2 USTC ¶50,445 (Ct. Cl. 1990).

persons who are not members in any other sense" cannot be substantially related to the union's exempt purpose.[39]

7.2 AGRICULTURAL GROUPS

Agricultural associations are subject to the same basic requirements and constraints outlined previously for labor groups. Again, the code, regulations, and IRS Handbook are silent about the form of organization. In practice and for purposes of filing Form 1024, organizational documents must be adopted to establish governance rules and prohibit private inurement. The purpose must reflect that the organization is devoted to techniques of production, betterment of conditions to those engaged in agriculture or horticulture, development of efficiency, or improvement of the grade of products. Members of a qualifying agricultural group need not necessarily all be farmers.[40]

(a) Types of Crops

The IRS *Exempt Organizations Handbook* separately defines agriculture on the land and on the sea because, until 1976, aquaculture was excluded. The handbook first defines *agriculture* to include "the art and science of cultivating the ground, especially in fields or large quantities, including the preparation of the soil, planting of seeds, raising and harvesting of crops, and rearing, feeding, and management of livestock, that is tillage, husbandry, and farming."[41]

Next, it explains that IRC §501(g), added in 1976, includes the "harvesting of aquatic resources" and says that Congress now intends agriculture to include fishing and related pursuits such as the taking of lobsters and shrimp. Both freshwater and saltwater occupations are to qualify, along with the cultivation of underwater vegetation, such as edible sea plants. Finally, the handbook says that agriculture includes the "cultivation of any edible organism." In addition to cattle, crops, and fish, fur-bearing animals and their pelts[42] have also been ruled to be agricultural products. An association formed to guard the purity of the Welsh pony breed qualified.[43] Agricultural products and pursuits do not include the following:

- Mineral resources, such as limestone. (But what about minerals used in vitamin supplements for human consumption?)
- Dogs not used as farm animals[44]
- Horse racing, despite the fact that the horses are raised on a farm (unless the racing is a part of an agricultural fair and stock show)[45]

A broad range of activities associated with and supportive of agriculture may qualify under this category. The organization itself need not be directly involved

[39] *National League of Postmasters v. Commissioner,* T.C. Memo 1995-205.
[40] Rev. Rul. 60-80, 1960-1 C.B. 198.
[41] *Exempt Organizations Handbook* (IRM 7751) §531.
[42] Rev. Rul. 56-245, 1956-1 C.B. 204; there is no guidance on whether alligators raised for their skin qualify.
[43] Rev. Rul. 55-230, 1955-1 C.B. 71.
[44] Rev. Rul. 73-520, 1973-2 C.B. 180.
[45] *Forest City Livestock and Fair Co. v. Commissioner,* B.T.A. Memo, 32, 215 (1932).

in cultivation. Examples of agricultural groups that the IRS views as exempt include the following:

- State and county farm bureaus[46]
- Promoters of artificial insemination of cattle[47]
- A group to study aquatic harvesting of seaweed or organic gardening
- A crop seed certification, seed technology research group[48]
- A rodeo sponsor[49]
- An association of farmers' wives[50]
- A producers' association formed to negotiate crop prices (but not to market the crops as a sales agent)[51]

(b) Services to Members

A qualifying agricultural organization must not allow its net assets to benefit its individual members. Providing a direct business service for the economic benefit of members cannot be the primary purpose of an agricultural group. The rules generally place more constraints on agricultural groups than on unions. Activities that the IRS has deemed to convey such benefits, rather than advancing the "betterment of conditions of those engaged in agriculture," and which are therefore not appropriate activities for an exempt agricultural association, include the following:

- Management, grazing, and sale of members' cattle[52]
- A housing and labor pool for transient workers[53]
- Cooperative marketing of products (as opposed to monitoring or controlling pricing)[54]
- Leasing a facility to weigh, sort, grade, and ship livestock[55]
- A butter and cheese manufacturers' institute (because butter is an agricultural by-product—milk is the agricultural product)[56]
- Provision of welfare aid and financial assistance to members[57]
- Acting as sales agent for members rather than representing members in negotiating prices with processors.[58]

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[46] *Exempt Organizations Handbook* (IRM 7751) §532.1(1)(a).
[47] *East Tennessee Artificial Breeders Ass'n. v. U.S.*, 63-2 USTC ¶9748 (E.D. Tenn. 1963).
[48] *Indiana Crop Investment Association, Inc. v. Commissioner*, 76 T.C. 394 (1981).
[49] *Campbell v. Big Spring Cowboy Reunion*, 54-1 USTC ¶9232 (5th Cir. 1954).
[50] Rev. Rul. 74-118, 1974-1 C.B. 134.
[51] Rev. Rul. 76-399, 1976-2 C.B. 147.
[52] Rev. Rul. 74-195, 1974-1 C.B. 135.
[53] Rev. Rul. 72-391, 1972-2 C.B. 249.
[54] Rev. Rul. 66-105, 1966-1 C.B. 145.
[55] Rev. Rul. 77-153, 1977-1 C.B. 147.
[56] Rev. Rul. 67-252, 1967-2 C.B. 195.
[57] Rev. Rul. 67-251, 1967-2 C.B. 196.
[58] Rev. Rul. 76-399, supra note 51.

The rental of an agricultural association's fairground facilities for that portion of the year the spaces are not used for its own annual fair was a mini-storage business in the eyes of the IRS.[59]

To better illustrate the distinction between service to members and advancement of the industry, compare a producers' group formed to process production data for its members' use in improving their herds' milk production[60] with a nationwide organization that gathers milk production statistics for the U.S. Department of Agriculture.[61] The former group was not granted exemption because it relieved the individual farmers of work they would have had to perform themselves and did not necessarily improve the conditions of the milk industry.

Educational programs to promote farm cooperatives, information regarding economic and social conditions for farmers, information about farm products, youth camp sponsorships, newsletter publication, and other services were found by the Tax Court to be conducted by a statewide federation of local county farm bureaus for exempt purposes.[62] The fact that the services provided to the member cooperatives were "not directly proportional to the amount of the fees paid" also indicated that individual economic benefits were not directly tied to the payments.

(c) Special Exception

Agricultural or horticultural organizations gained a special exception from allocation of portions of their members' dues as unrelated business income.[63] The IRS has been aggressive and successful in treating the associate member dues collected by unions from nonunion members as unrelated business income.[64] Effective retroactively for taxable years beginning after December 31, 1986, agricultural groups were afforded special protection from such a position for required annual member dues of up to $100 (indexed annually $120). This special provision in §512(d) says:

> If an agricultural or horticultural organization described in section 501(c)(5) requires annual dues to be paid in order to be a member of such organization, and the amount of such required annual dues does not exceed $100 (indexed),[65] in no event shall any portion of such dues be treated as derived by such organization from an unrelated trade or business by reason of any benefits or privileges to which members of such organization are entitled.

7.3 HORTICULTURAL GROUPS

Horticulture is the cultivation of a garden or orchard and the science or art of growing fruits, vegetables, and flowers or ornamental plants. Under the IRS

[59] Tech. Adv. Memo. 9853001.
[60] Rev. Rul. 70-372, 1970-2 C.B. 118.
[61] Rev. Rul. 74-518, 1974-2 C.B. 166.
[62] *Ohio Farm Bureau Federation, Inc. v. Commissioner,* 106 T.C. 222 (1996).
[63] Small Business Job Protection Act of 1996, §1115, adding new IRC §512(d).
[64] See Section 7.1(e).
[65] Rev. Proc. 2003-85, 2003-49 IRB 49.

guidelines, horticulture is a division of agriculture and is subject to the same rules. No specific guidance or rules are provided, however, exclusively for horticulture. To ponder the interesting dilemma, consider a group of rose growers that is conceivably eligible to qualify under both (c)(5) and (c)(6). A garden club might qualify under (c)(3), (c)(4), or (c)(7) depending on the focus of its activities.[66] Certainly a garden club, the mission of which is to educate persons about horticulture, can qualify as a (c)(3) organization. A group of amateur gardeners not engaged in the business of growing plants for sale cannot qualify under (c)(5).

7.4 DISCLOSURES OF NONDEDUCTIBILITY

Dues attributable to political campaign participation and lobbying (other than on a local level) are not deductible for income tax purposes. In soliciting dues and other payments from its members, labor, agricultural, and horticultural organizations must make two different types of disclosures to their members in connection with soliciting payments, as follows:

1. *Nondeductibility as charitable contribution.* A nonprofit organization exempt under (c)(5) that has gross revenue of $100,000 must print an express statement that payments to it, whether called dues, gifts, contributions, or something else, are not deductible as charitable contributions.
2. *Nondeductible dues attributable to lobbying.* Members must be informed of that portion of their annual dues that is to be expended on lobbying and therefore is not tax deductible at all.[67]

An organization that fails to make the required disclosures is subject to penalties. Agricultural and horticultural organizations (but not labor unions) may qualify for an exclusion from the lobbying expense disclosure rule.[68] If the organization is able to show that 90 percent or more of its members who each pay $75[69] or less do not benefit from the deduction of their annual dues or similar amounts due, no disclosure is required. Dues are generally not deductible for an employee when two individual income tax circumstances exist: (1) The member claims the minimum standard deduction or (2) the member's employee business expenses are less than 2 percent of his or her adjusted gross income. A second type of safe harbor excludes an agricultural or horticultural organization that receives more than 90 percent of its annual dues from state or local government, §115 governmental instrumentalities, and §501(c) organizations not subject to this disclosure rule.

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66 Rev. Rul. 66-179, 1966-1 C.B. 139; also see Section 8.9 for comparison of (c)(5) and (c)(6) organizations.
67 IRC §6033(e); see Section 6.5 for detailed explanation of these rules.
68 Rev. Proc. 98-19, 1998-1 C.B. 547.
69 Indexed for inflation; for 2004 this amount is Rev. Proc. 2004-1.

CHAPTER EIGHT

Business Leagues: §501(c)(6)

Internal Revenue Code (IRC) §501(c)(6) provides exemption for business and professional associations not organized for profit and no part of the earnings of which inure to the benefit of private individuals or shareholders, and it specifically names

- Business leagues
- Chambers of commerce
- Real estate boards
- Boards of trade
- Professional football leagues

8.1 BASIC CHARACTERISTICS

To qualify under §501(c)(6), a business league must have the following attributes[1]:

- It is an association of persons having some common business interest.
- Its organizational purpose is to promote such common interest and to improve conditions of one or more "lines of business."
- It does not engage in a regular business of a kind ordinarily carried on for profit.
- It does not perform services for individuals or organizations as a primary activity.
- It is not organized for profit, and no private inurement accrues to individuals.

8.2 MEANING OF "COMMON BUSINESS INTEREST"

To qualify as a business league, the members of the association must have a "common business interest." This essentially means that they form the league to advance a mutual goal of improving an industry or profession, not their individual interests. Their purpose in joining together is to improve the overall economic condition of their field. Legislative lobbying germane to the interest of the league can be its sole purpose.[2] Each member of the league typically conducts a profitable business operation in competition with the other members, some of whom can be involved in a variety of functions operating in the profession or line of business. Examples include the following:

- *Doctors, Lawyers, and Accountants*. Professional groups, such as the American Medical Association, the American Bar Association, and the American Institute of Certified Public Accountants, are classic examples of groups formed to advance a particular profession. The activities of such organizations unquestionably advance the interests of the members as a profession. Programs considered to advance the profession include (1) establishing standards that control and monitor admission into the profession, (2) conducting educational programs to maintain the technical performance of the members and to advance the body of knowledge about the field, and (3) sponsoring numerous other programs designed to promote the reputation and quality of work performed by the members.
- *Business Leagues*. Business leagues may also conduct educational and charitable activities, such as presenting public lectures, conducting research, maintaining libraries, and disseminating useful information.[3] An association that conducts professional certification programs protects and benefits the general public, as well as the particular profession and its

[1] Reg. §1.501(c)(6)-1.
[2] Rev. Rul. 61-177, 1961-2 C.B. 117.
[3] Rev. Rul. 71-504, 1971-2 C.Bm. 231, 232.

members, and arguably could qualify as both a (c)(3) and a (c)(6) organization. However, the Internal Revenue Service (IRS) says certification programs are "directed in whole or in part to the support and promotion of the economic interests" of the members, not the public, and therefore could not qualify the organization for (c)(3) status.[4]

- *American Automobile Association.* The AAA illustrated a lack of common business interest when it failed both IRS and judicial scrutiny in its attempt to be classified as a business league. The interest of its members was found not to be common since it is open to individual motorists for their personal needs without regard to their trade or business association.[5]
- *Women's Leagues.* An organization formed to promote the acceptance and advancement of women in business and professions can qualify due to the shared business interest of its members.[6]
- *Dogs and Horses*. The American Kennel Club lost its fight to qualify as a business league because its member clubs had a common sporting, rather than a business, interest.[7] On the other hand, the Jockey Club's members, breeders and owners of thoroughbred horses, were considered to have "some common business interest."[8]
- *Investors and Stock Exchanges*. The IRS regulations specifically state that an association engaged in furnishing information to prospective investors to enable them to make sound investments does not serve a common business interest, nor does a stock or commodity exchange.[9]
- *Future Business Interests.* A group of students pursuing a single profession formed a qualifying business league even though the students were not yet engaged in the profession. The organization promoted their common business purpose as future members of the profession.[10]
- *Professional Sports Leagues.* The regulations refer specifically to football leagues and fail to mention baseball, basketball, hockey, or other types of sports. In explaining its view of this omission, the IRS says, "Since other professional sports leagues are indistinguishable in any meaningful way from football leagues, we think it is fair to conclude that by formally blessing the exemption it knew football leagues had historically enjoyed, Congress implicitly recognized a unique historical category of exemption under section 501(c)(6). The specific enumeration of football leagues can be

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[4] Gen. Coun. Memo. 39721; see Section 8.11 for discussion concerning formation of a separate charitable organization.

[5] *American Automobile Association,* 19 T.C. 1146 (1953).

[6] Rev. Rul. 76-401, 1976-2 C.B. 175.

[7] *American Kennel Club v. Hoey,* 148 F.2d 290 (2d Cir. 1945); see Priv. Ltr. Rul. 9805001 for a kennel club qualifying as a (c)(4).

[8] *The Jockey Club v. United States,* 137 F.Supp. 419 (Ct.Cl. 1956), cert. denied, 352 U.S. 834 (1957).

[9] Reg. §1.501(c)(6)-1.

[10] Rev. Rul. 77-112, 1977-1 C.B. 149.

viewed as merely exemplary of the category thus recognized…[A]ccordingly it is appropriate to continue the Service's 50-year practice of ruling [all] professional sports leagues exempt."[11] The IRS emphasized that its extension of the statutory language to other professional sports leagues had no implication for extending exemption under §501(c)(6) to other organizations that were not professional sports leagues.

8.3 LINE OF BUSINESS

Understanding what constitutes a "line of business" is the key to identifying groups that qualify as business leagues because they share a common business interest. A "line of business" is a trade or occupation, entry into which is not restricted by a patent, trademark, or similar device that would allow private parties to restrict the right to engage in the business.[12] The term *business* is construed broadly to include almost any enterprise or activity conducted for remuneration. The term encompasses professions as well as mercantile and trading businesses.[13] To qualify, a league's line of business must be broad; it must encompass the common business interest of an entire industry or one of its components, or an industry within a particular geographic area.

(a) User Groups

The computer industry provides good examples both of organizations deemed to serve a common business interest and of nonexempt private groups. In 1974, the IRS decided that an organization qualified as a business league because it was formed to stimulate the development of a free exchange of information about computer systems and programming. The membership was diverse, including businesses that owned, rented, or leased computers from a variety of manufacturers. It sponsored semiannual conferences, open to the public, to discuss technical and operational issues. Conversely, organizations formed for the same purposes by users of particular manufacturers' computers are denied business league status.[14] Such user groups are deemed to promote the particular computer vendors, rather than to benefit the entire industry or all components of an industry within an area. The Guide International Corporation, limited in membership to IBM mainframe computer users, was denied exemption because it benefited IBM, a large but nonetheless particular segment of the computer business, not the computer business in general.

Unlike Prime and Guide, the Corporation for Open Systems International found another way to achieve exempt status for its newly created Open Systems Research and Educational Corporation.[15] The entity was organized to conduct and disseminate the results of its research. It sought and achieved recognition as

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[11] Gen. Coun. Memo. 38179.

[12] IRS *Exempt Organizations Handbook* (IRM 7751) §652(1).

[13] Rev. Rul. 70-641, 1970-2 C.B. 119.

[14] Rev. Rul. 83-164, 1983-2 C.B. 95; *National Prime Users Group Inc. v. United States*, 667 F. Supp. 250 (D. Md. 1987); *Guide International Corporation v. United States,* 90-1 USTC ¶50,304 (N.D. Ill. 1990).

[15] Determination letter released by the IRS National Office's Exempt Organizations Technical Division.

a charitable (c)(3) organization, not a business league. The Form 1023 stated that its research would benefit the general public and "the users of products or services of more than one industry or segment of an industry." The application was initially denied exemption, presumably because the IRS thought there would be excessive private benefit from the research to the computer manufacturer. Upon appeal, the IRS National Office approved charitable status for the following reasons:

- The proposed entity would follow the IRS guidelines for research organizations.[16]
- Results of its work would be made available to the public through the Internet and printed documents.
- Any research performed for Open Systems would be intended to benefit all users of computers, software, and/or telecommunications products or services, and only incidentally to provide benefit to Open Systems.

(b) Dealer Associations

Associations of dealers and manufacturers of particular brands have been determined not to qualify for exemption as business leagues, because they failed to represent a "line of business." An association of Midas Muffler dealers formed to represent the dealers in negotiations with the manufacturer failed to convince the Supreme Court that it constituted a "line of business." It was deemed unfair to allow exemption to a group, the purpose of which is to compete with another group within an industry.[17] Earlier the Pepsi-Cola Bottlers' Association was allowed an exemption, a decision that the IRS promptly announced it would not follow.[18]

An association of licensed dealers of a patented product (held by the association) was deemed to engage in furthering the business interest of its member-dealers and not benefiting competing manufacturers of products of the same type covered by the patent.[19] Similarly, a shopping center merchants' association was found to benefit specific merchants. Its sole activity was to place advertisements to attract customers to the center and its membership was restricted to merchants in the one-owner shopping center.[20] If, instead, membership is open to all merchants within the neighborhood and if the association is not concerned with landlord-tenant matters relating to the shopping center, exemption is allowed.[21]

Dealers selling a particular type of car do not promote the automobile industry.[22] Franchisees of a particular chain, such as McDonald's restaurants, would

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16 See Section 5.3.

17 *Pepsi-Cola Bottlers' Association v. United States*, 369 F.2d 250 (7th Cir. 1966). The IRS announced its disagreement with this case in Rev. Rul. 68-182, 1968-1 C.B. 263.

18 *National Muffler Dealers Association v. United States,* 440 U.S. 472, 477-479 (1979).

19 Rev. Rul. 58-294, 1958-1 C.B. 244.

20 Rev. Rul. 73-411, 1973-2 C.B. 180.

21 Rev. Rul. 78-225, 1978-1 C.B. 159.

22 Rev. Rul. 67-77, 1967-1 C.B. 138.

similarly be precluded from forming an exempt group, but a league of franchise holders open to all types of merchants or food establishments would qualify.

(c) Hobby or Recreational Groups

Hobby groups do not qualify as business leagues because a hobby is not a business.[23] To be characterized as a business, the activity must be entered into with the intention of producing a profit. For income tax purposes, an activity is presumed to be a hobby if it loses money for more than two years in a five-year period.[24]

Gardeners, pet owners, cardplayers, and collectors of antiques, baseball cards, fine art, and so on, form groups for purposes somewhat similar to those of typical business leagues. However, unless the members are pursuing their hobby interests for personal profit, and therefore for individual business purposes, exemption is not available for the group under §501(c)(6). Such a group may, however, qualify in other categories of exemption, such as social club, civic welfare organization, or (rarely) charitable, depending upon its purposes.

8.4 RENDERING SERVICES FOR MEMBERS

A qualifying business league must devote its efforts primarily to promoting the industry. A (c)(6) association may not, as a significant activity, engage in a regular business of a kind ordinarily carried on for profit.[25] Services rendered for members aimed at improving the industry or maintaining its standards are treated as related to the exempt purposes. Activities that benefit members as individuals are unrelated. Excessive unrelated activity can preclude exemption[26] and are subject to the unrelated business income tax (UBIT).[27] Examples of the types of services that have been held to be "related" or to serve the industry as a whole, rather than the individual members, follow.

(a) Services Benefiting the Industry

- Industry-wide advertising to encourage use of products[28]
- Testing for quality control[29]
- Examination and certification of professionals, peer review, and ethics audits[30]
- Mediation service to settle disputes within the industry[31]

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[23] Rev. Rul. 66-179, 1966-1 C.B. 139.
[24] IRC §183.
[25] Supra note 1.
[26] Rev. Rul. 68-264, 1968-1 C.B. 264.
[27] See Chapter 21.
[28] *Washington State Apples, Inc. v. Commissioner*, 46 B.T.A. 64 (1942).
[29] Rev. Rul. 81-127, 1981-1 C.B. 357; Rev. Rul. 70-187 1970-1 C.B. 131.
[30] Rev. Rul. 73-567, 1973-2 C.B. 178; Rev. Rul. 74-553, 1974-2 C.B. 168.
[31] *American Fisherman's Tuna Boat Association v. Rogan*, 51 F.Supp. 933 (S.D. Cal. 1943).

- Research and publication of technical information,[32] but only if the information is available to the industry as a whole, rather than being available only to paying members[33]
- Referral services available to the general public, if there is evidence of benefit to the public rather than to individual service providers[34]
- A bid registry established and operated to encourage fair bidding practices with the industry[35]
- Insurance associations that serve their industry without charge and essentially do not sell insurance. See Section 8.4(b) for discussion of nonqualifying insurance groups.
- Lobbying groups presenting information, trade statistics, and group opinions to government agencies and bureaus[36]
- Contract negotiation services that include scheduling and investigating grievances and holding arbitration hearings further the common business purpose of the league members. Such administrative services solve industry problems and do not represent services to individual members that they could purchase elsewhere. [37]
- Maintenance of member names in an Internet domain was found to allow the public to recognize member organizations as a unified, strong, and distinct sector of the economy and thereby advance the mission of a business league.[38]

(b) Disqualifying Services to Individual Members

Services giving benefit to the members as individuals rather than to the industry as a whole may disqualify a business league as an exempt league if such services constitute a substantial and major activity of the organization. Individual benefit services are also subject to the unrelated business income tax.[39]

The distinction is often vague, but several factors evidence the difference. Of primary importance is the manner in which persons are charged for receiving the services, and whether the services are available to the general public. When the services are rendered in return for a specific charge or the services are available only to members, individual benefit is generally found. Activities for which individual members are not expected to pay are evidence of intangible industry-

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[32] Rev. Rul. 70-187, 1970-1 C.B. 131.
[33] Rev. Rul. 69-106, 1969-1 C.B. 153 and *Glass Container Industry Research Corp.,* 70-1 USTC ¶9214.
[34] Rev. Rul. 80-287, 1980-2 C.B. 185. See also *Kentucky Bar Foundation, Inc. v. Commissioner,* 49 T.C. 921, 930 (1982).
[35] Rev. Rul. 66-223, 1966-2 C.B. 224.
[36] Rev. Rul. 61-177, 1961-2 C.B. 117.
[37] Priv. Ltr. Rul. 9848002 citing Rev. Rul. 65-164, 1965-1 C.B. 238, and Rev. Rul. 71-504, 1971-2 C.B. 231.
[38] Priv. Ltr. Rul. 2002230671.
[39] See Section 21.8(b).

wide benefit. Making services available to all also reflects cooperative effort. By contrast, when members buy and the association sells services for member convenience or cost savings, individual benefit results. Examples of services that have been considered as providing individual benefit follow:

- Publication of catalogs containing advertisements for products manufactured by members[40] or a tourism promotion yearbook made up of advertisements from the association's members.[41] Compare these to ads promoting the entire industry.
- Group insurance plans provided for members[42]
- Real estate multiple listing services[43]
- Employment placement services[44]
- Credit rating or information services[45]
- Collective bargaining agreement records
- A luncheon or social meeting hall for members without a program for professional improvement did not qualify;[46] contrast this with a luncheon group devoted to discussion, review, and consideration of problems in a particular industry directed to the improvement of business conditions, which can qualify.[47]
- Trade shows organized primarily to allow members to sell merchandise individually, rather than to educate the audience, do not constitute qualifying business league activity.[48] Shows organized instead to attract persons to an industry by educating the public represent exempt activity.[49] The profits from qualifying convention and trade shows are excluded from the unrelated business income tax.[50]
- Sale of standardized forms for use by the profession and the public is a debatable type of service. The IRS thinks such activity is an unrelated trade or business.[51] The courts, however, felt that the San Antonio Bar Association improved relations between the bar, the bench, and the public

[40] Rev. Rul. 56-84, 1956-1 C.B. 201.

[41] Rev. Rul. 65-14, 1965-1 C.B. 236.

[42] *Oklahoma Cattlemen's Association v. U.S.*, 310 F.Supp. 320 (W.D. Okla. 1969); Rev. Rul. 70-95, 1970-1 C.B. 137; Rev. Rul. 67-176, 1967-1 C.B. 140.

[43] Rev. Rul. 59-234, 1959-2 C.B. 149 and *Evanston-North Shore Board of Realtors,* 63-2 USTC ¶9604, 320 F.2d 375 (Ct. Cl. 1963), cert. denied, 376 US 931 (1964).

[44] Rev. Rul. 61-170, 1961-2 C.B. 112.

[45] Rev. Rul. 68-265, 1968-1 C.B. 265 and Rev. Rul. 70-591, 1970-2 C.B. 118 and *Oklahoma City Retailers Ass'n.,* 64-1 USTC ¶9467, 331 F.2d 328 (10th Cir. 1964).

[46] *The Engineers Club of San Francisco v. United States,* 609 F.Supp. 519 (N.D. Cal. 1985).

[47] Rev. Rul. 67-295, 1967-2 C.B. 197.

[48] Rev. Rul. 58-224, 1958-1 C.B. 242; *Men's and Boys' Apparel Club of Florida,* 64-2 USTC ¶9840; *Indiana Hardware Ass'n., Inc*., 66-2 USTC ¶9691, 366 F.2d 998 (Ct.Cla. 1966).

[49] *American Woodworking Machinery and Equipment Show, Inc.,* 66-1 USTC ¶9219, 249 F.Supp. 393 (D.C. N.C. 1966).

[50] IRC §513(d)(3), discussed in Section 21.9(c).

[51] Rev. Rul. 78-51, 1978-1 C.B. 165.

with its forms. Similarly, the Texas Apartment Association's lease forms and landlord manuals prevented controversy and maintained fairness in the industry.[52] In a private ruling, the IRS said a national association operated a "commercial" trade or business selling its standard forms partly because more than half of the forms were sold to the general public.[53]

- Insurance company associations present a gray area. When the association provides its services or information to insurance companies without charge and is not selling the insurance itself, the requisite industry benefit is present. An association created to carry out state-mandated rules concerning uninsured parties[54] and an association of casualty companies settling claims against insolvent companies[55] were ruled exempt. In both cases, all companies within a state were required to be members, and the expenses of the association were paid from member dues. On the other hand, an association of insurance companies that maintained a data bank and exchange for confidential life insurance underwriting information, made available for a fee to its members (who wrote 98 percent of the legal reserve life insurance in force in the United States), was determined to serve the individual interests of the members and not to qualify for exemption.[56] Likewise, an association furnishing medical malpractice insurance to health-care providers was not exempt.[57] A thorough reading of the rulings and cases is warranted prior to forming such an association.[58]

The details of a few cases and rulings help to identify the types of facts and circumstances applied to determine the character of a program as accomplishing an exempt function. The American Academy of Family Physicians' information clearinghouse for physician placement fostered the "appropriate distribution of physicians to provide health care for the nation." The court found that this stated objective advanced the organization's exempt purposes so that the fees charged to access the information were related income. Additionally, the court found that payments to the business league by an insurance company did not stem from profit-motivated business activity, but instead represented passive interest income not taxable as unrelated business income.[59] Member insurance services were handled by an independent company that was required by the association to maintain reserves to pay claims and pay a fixed percentage of the reserves annually to the league without regard to the profitability of the insurance program. The court noted that the association's involvement did not pos-

[52] *San Antonio Bar Association v. United States*, 80-2 USTC ¶9594 (W.D. Texas 1980*); Texas Apartment Association v. United States*, 869 F.2d 884 (5th Cir. 1989).
[53] Priv. Ltr. Rul. 9527001; see also Tech. Adv. Memo. 200020056.
[54] Rev. Rul. 76-410, 1976-2 C.B. 155.
[55] Rev. Rul. 73-452, 1973-2 C.B. 183.
[56] *MIB, Inc.,* 84-1 USTC ¶9476, 734 F.2d 71 (1st. Cir. 1984).
[57] Rev. Rul. 81-175, 1981-1 C.B. 337, distinguishing Rev. Rul. 71-155, 1971-1 C.B. 152.
[58] *North Carolina Association of Insurance Agents, Inc.,* 84-2 USTC ¶9668, 739 F.2d 949 (4th. Cir. 1984); Priv. Ltr. Rul. 8841003, June 24, 1988.
[59] See Section 21.10.

sess the general characteristics of a trade or business—it furnished a list of its members, allowed the use of its name, and monitored the insurance products to ensure that the needs of its members were met. The league did not underwrite or administer the policies or have any other activities the court could equate to operating a business.[60]

Another physician recruitment program, called Medical Opportunities in Michigan, was found not to jeopardize the tax-exempt status of the Michigan Health Council, a (c)(3) organization.[61] The program was established to bring physicians, physician assistants, nurse practitioners, nurse midwives, and certified registered nurse anesthetists to the underserved and growing communities in Michigan. A priority-neutral computerized database of available positions, with no advertisements or logos of health-care entities, was made available free of charge to prospective medical workers. The facts indicated about 72 percent of Michigan's counties had primary care physician shortages and that 62 percent of the physicians trained in Michigan left the state to begin their medical practices. These facts, plus a finding that the registry was "clearly distinguishable from commercial placement services," allowed the IRS to find that the database promoted health and consequently served a charitable purpose. The IRS also found that no private benefit existed, because there was a broad cross section of potential subscribers and most of the job postings were for nonprofit hospitals, clinics, and community health centers. The IRS noted that the Tax Court had found that organizations that further exempt purposes through sponsoring legal or medical referral services do not confer private benefits so long as the service was open to a broad representation of professionals and no select group of professionals was the primary beneficiary of the service.[62]

The Service concluded that a business league operated its recycling facility as a trade or business unrelated to its exempt activities.[63] After the municipal dump in their area was closed, the league became a state-certified site in order to serve its members. However, other for-profit facilities operated in the area and performed a similar service, and several league members, including one of the larger manufacturers, use other facilities for waste disposal. Because the facility was not unique to the industry, the facility was treated as an unrelated business. Although the league argued that it was irregularly operated, the facility accepts material for recycling for seven months out of the year and pumps surface water 12 months of the year. Those factors indicated the league operated the facility on a fairly continuous basis and met the requirement that the business be regularly carried on.

A league operating to provide a telephone answering service to distribute calls for towing service on a rotational basis to its tow truck operating members did not qualify for exemption.[64] The activity provided members with an econom-

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[60] *American Academy of Family Physicians v. U.S.,* No. 95-2791 WM (8th Cir. 1996), aff'g. 95-1 USTC ¶50,240 (W.D. Mo. 1995).

[61] Priv. Ltr. Rul. 9617040.

[62] *Kentucky Bar Foundation v. Commissioner,* 78 T.C. 921 (Tax Ct. 1982); *Fraternal Medical Specialist Services, Inc. v. Commissioner*, T.C. Memo. 1984-644.

[63] Priv. Ltr. Rul. 9848002.

[64] Rev. Rul. 74-308, 1974-2 C.B. 168.

ical and convenient way to conduct their individual businesses and represented particular services for its members as distinguished from the improvement of business conditions of its industry.

Administrative services to maintain vacation pay and guaranteed annual income accounts required by a collective bargaining agreement, as opposed to negotiating the contract, also provided individual service to members. The organization's role as a record keeper and collection and disbursement agent was an unrelated business activity.[65]

(c) Avoiding the Exploitation Rule

A business league that partly finances its activities by earning unrelated business income faces limitations on deductions that can offset such income. In calculating the tax on unrelated business income, the *exploitation rule* disallows the deduction of expenses attributable to the league's member or exempt function activities.[66] Losses incurred in membership activities cannot be deducted against business income. Despite the economic fact that the league has a loss overall, it may have to pay tax.[67]

To avoid this situation, a league might consider abandoning its exempt status and filing as a normal corporation showing no profit. IRC §277 is designed to prevent this tactic. Membership expenses are deductible only to the extent of membership income and cannot be deducted against business income for a nonexempt taxpayer.

8.5 SOURCES OF REVENUE

The portion of total support received from members is a factor in determining qualification. The IRS expects "meaningful membership support," although the code and regulations contain no specific numerical support requirement. Revenue received in rendering services to individuals that do not benefit the industry as a whole cannot provide a major portion of the league's budget. As is true for other categories of exempt organizations, there is no prohibition against a league earning such income as long as the amounts are insubstantial, but there is no exact numerical test.[68] When a league's income from providing such services is excessive, its exempt status is jeopardized and the income is taxable. A safe rule of thumb is more than 50 percent of the league's support should come from member dues and exempt function charges. Decisions that illustrate the IRS's view on revenue sources follow:

- City contract revenue received by a tourism promotion organization was deemed to be related income and therefore member income. The ruling noted a high degree of member involvement, and opined that the organi-

[65] *Steamship Trade Association of Baltimore, Inc.*, 81 T.C. 303 (1983).
[66] Reg. §1.512(a)-1(d)(1).
[67] See Section 21.11.
[68] See Section 21.3.

zation should not lose its exemption "merely because a significant portion of its income was derived from other than traditional member sources."[69]

- "Incidental" television advertising activity and provision of laboratories for testing quality control on a fee basis were not enough to cause revocation of a league's exemption.[70]

8.6 MEMBERSHIP CATEGORIES

An exempt business league may have different classes of members, as long as the purpose is to advance the interests of the profession and all members share the same common business interest. Junior, senior, retired, associate, student, supporters, and other types of categories are common, in recognition of age, stature, or active versus peripheral involvement in the business. Varying levels of dues can also be charged to different types of members, presumably based upon their ability to pay or their involvement in league activities. Those members required to have continuing education might pay more than inactive or student members who are not required to participate in classes, for example. Member dues and assessments are deductible as business expenses for members who are actively engaged in a trade or business, except for the amount of the dues allocable to political activity or grassroots lobbying.[71]

The charging of substantially greater dues to associate members has been said to evidence private inurement benefiting the active members, although higher associate dues were permissible when the revenues benefited the entire industry by allowing more extensive programs.[72] Dues paid by associate or other subclass members who joined to market their products or obtain association benefits, such as group insurance, may be taxable as unrelated business income.[73] In one instance, industry suppliers could promote their products in the association publications and obtain the mailing list by becoming associate (nonvoting) members. Since the motivation of association members was to sell products to members rather than to advance the industry, their dues represented advertising revenue.[74]

Prior to 1997, the IRS asserted that membership assumes some right to participate in the organization's direction as well as an obligation to help support the organization through regular financial contributions. "Most importantly, members have voting rights and have a voice in the administration and direction of the organization." Labor unions and the IRS battled about the character of associate members for some years. The IRS eventually eased its stance and issued formal guidance on the character of member dues, originally only for labor unions[75] and later extended to (c)(6) organizations.[76] A primary-purpose

[69] Priv. Ltr. Rul. 9032005.
[70] *American Plywood Ass'n.*, 67-2 USTC ¶9568, 267 F.Supp. 830 (1967).
[71] See Section 8.12.
[72] Priv. Ltr. Rul. 9128002.
[73] See Section 7.1(e).
[74] Priv. Ltr. Rul. 9345004; this position also espoused in Priv Ltr. Rul. 8834006.
[75] Rev. Proc. 95-21, 1995-15 IRB 1.
[76] Rev. Proc. 97-12, 1997-4 IRB 1.

test is used to ask, "Was the associate member category created and used to further the organization's exempt purposes or simply to produce unrelated income?" Where members serve only to buy unrelated goods and services (insurance or advertising, for example), their dues will be treated as unrelated income. The procedure gives no specific criteria for applying the test except to say the IRS will look to the purposes and activities of the organization rather than its members. Subsequently, the IRS was asked to consider the status of "allied members" of a professional association. Although their rights were not as extensive as those accorded regular members, the associates could vote and serve as officers at a chapter level, and their dues were similar to those of regular members. The IRS thought, therefore, that the dichotomy between regular and allied members did not evidence an organization purpose to generate unrelated income.[77]

Tax-exempt organizations may also be members of a qualifying league, despite the fact that the regulations define a business league as an association of persons. A labor union and a business league have been permitted to form a qualifying league.[78]

8.7 MEMBER INUREMENT

The league may not allow its assets to inure to the benefit of individual members or otherwise operate primarily to benefit its members. The league may not, as its primary activity, provide direct services of benefit to individual members, but it can provide a whole host of services designed to benefit their common interests. The IRS *Exempt Organization Handbook*[79] and the courts have provided some additional guidance as to when inurement results, as follows:

- A charter provision that permits distributions of remaining assets to members upon dissolution of the league will not in and of itself preclude exemption.[80] However, regular distributions of income or accumulated surplus would constitute inurement.[81]
- A league cannot be organized as a stockholding company with members holding the shares.[82]
- Newsletters and member "informational materials" do not provide impermissible benefit.
- Preferential pricing for members results in private inurement unless it is shown that the league supports the activity from member dues and the pricing reflects that revenue.[83]

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[77] Tech. Adv. Memo. 9742001.
[78] Rev. Rul. 70-31, 1970-1 C.B. 130. See also Rev. Rul. 82-138, 1982-2 C.B. 106.
[79] *Exempt Organizations Handbook,* §640.
[80] *Crooks v. Kansas City Hay Dealers Association,* 37 F.2d 83 (1929).
[81] *Exempt Organizations Handbook,* §630.
[82] *Northwest Jobbers Credit Bureau v. Commissioner,* 37 F.2d 880 (1930) Ct. D. 206, C.B. IX-2, 228.
[83] Exempt Organizations Annual Technical Review Institutes for 1979, p. 354.

- Refunds of dues paid proportionately to all classes of members is permitted.[84]
- A partial rebate of trade show advance deposits to exhibitors is permitted if all participants receive a share.[85] Rebates paid to members only out of income-producing activity represents inurement.[86]
- Financial aid and welfare services provided to members represents benefit to the individual members, in the eyes of the IRS.[87]
- Payment of malpractice defense costs and paying judgments rendered in such suits creates individual inurement.[88]
- Payment of excessive compensation or purchase price for property or services to a member, particularly to persons controlling the league, results in inurement of earnings. See Chapter 20 for standards applied to measure reasonable values.

8.8 CHAMBERS OF COMMERCE AND BOARDS OF TRADE

A chamber of commerce or board of trade is distinguishable from a business league because it serves the general economic welfare of a community. Membership is typically open to all lines of business within a geographic area. Its activities must be directed at the promotion of the area's business and usually include the promotion of tourism, publishing directories of resources available in the area, developing programs to promote the business climate, conducting studies, and similar projects. The following activities have been ruled to be suitable for a chamber of commerce:

- Development of an industrial park to attract new businesses to an area, including the offering of below-cost rents and other subsidies[89]
- Encouraging national organizations to hold their conventions in a city[90]
- A "neighborhood community association" whose membership is open to all and whose purpose is to improve the business conditions of a neighborhood, as opposed to a particular subdivision or shopping area, can qualify.[91]

8.9 COMPARISON TO §501(c)(5)

The basic difference between §501(c)(5) and §501(c)(6) is sometimes gray, due both to industry type and to congressional logic. While (c)(5) is narrow and

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[84] Rev. Rul. 81-60, 1981-1 C.B. 335.
[85] Rev. Rul. 77-206, 1977-1 C.B. 149.
[86] *Michigan Mobile Home and Recreational Vehicle Institute v. Commissioner,* 66 T.C. 770 (1976).
[87] Rev. Rul. 67-251, 1967-2 C.B. 196.
[88] *National Chiropractor Association v. Birmingham,* 96 F.Supp. 824 (D.C. Iowa 1951).
[89] Rev. Rul. 70-81, 1970-1 C.B. 131; Rev. Rul. 81-138, 1981-1 C.B. 358.
[90] Rev. Rul. 76-207, 1976-1 C.B. 1578.
[91] Rev. Rul. 78-225, 1978-1 C.B. 159.

applies only to agricultural groups and labor unions, (c)(6) is broad and includes almost any business enterprise or activity.[92]

To contrast the two categories of §501(c) classification, consider a rose growers' association. Except for the roses, such an association would qualify as a business league under §501(c)(6). Nevertheless, the organization will be classified under §501(c)(5) as horticultural if its members are all directly involved in the cultivation of roses with the purpose of bettering the conditions of persons growing roses, improving the grade of roses, and developing growing systems. However, if group membership includes nongrowers such as shippers, pesticide suppliers, and florists, it will not qualify under §501(c)(5) and will instead have to meet the tests for §501(c)(6).

In many ways, the two categories are identical. For both, unrelated business income is taxed and must not be a substantial revenue source or activity. For both categories, economic benefits and services cannot generally be rendered to individual members. However, labor unions can provide mutually funded benefits for life, health, and accident insurance.

Neither political activity nor lobbying is prohibited under either §501(c)(5) or §501(c)(6). Advocacy of legislation beneficial to the common business interest can conceivably be the group's primary purpose, if the activity is undertaken to improve working conditions, production, or efficiencies.[93] Whether an activity is "primary" is generally measured by dollars expended on that function in relation to the league's total budget. For both, the portion of member dues spent on lobbying efforts is nondeductible and specific disclosures must be made to members.[94]

8.10 RECOGNITION OF EXEMPT STATUS

(a) Federal Recognition

Form 1024 is filed to achieve recognition of exemption. Statutorily, a league essentially qualifies if it meets the §501(c)(6) definitions and need not seek IRS approval to qualify. As a practical matter, however, the IRS requires filing of Form 1024 to avoid subjecting the league's income to tax. Suggestions for completion of Form 1024 can be found in Chapter 18. The information return, Form 990 or 990EZ, that is filed annually to report activity and allow the IRS to review continued qualification is illustrated in Chapter 27.

The non-(c)(3) categories of tax-exempt organizations are not subject to a specific organizational requirement, as discussed in Section 7.1(a) concerning labor unions. The instructions to Form 1024, however, say that exemption will not be approved unless organizing documents are attached. They go on to say that bylaws are internal rules and are not, by themselves, organizational documents.

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[92] Rev. Rul. 70-641, 1970-2 C.B. 119.
[93] Rev. Rul. 61-177, 1961-2 C.B. 117.
[94] See Section 8.12.

(b) State Exemptions

A business league may be qualified for state and local tax exemptions. In Texas, for example, an automatic exemption from the corporate franchise tax is granted for organizations furnishing their IRS determination letter evidencing their qualification as a §501(c)(6) organization. The sales tax exemption is only granted to "a chamber of commerce or a convention and tourist promotional agency representing a Texas city or county," and then only if the entity is not organized for profit and no part of its earnings inure to a private shareholder or other individual. Most Texas business leagues are subject to the sales tax on items they buy, lease, or consume. The rules of the particular state(s) in which a league operates must be investigated.

8.11 FORMATION OF A RELATED CHARITABLE ORGANIZATION

Business, trade, and professional associations described in §501(c)(6) can create a separate organization to pursue their educational, cultural, scientific, or other charitable interests. The motivation is usually financial—to form an entity able to seek funding from those who desire a charitable deduction for their support or those (such as another foundation) whose grants can only be paid for charitable purposes. Say, for example, an association wishes to create a library of educational materials. Rather than increasing overall dues, members capable of paying more can be asked to voluntarily contribute to the library. Gifts to the league itself for its use in establishing the library would not be deductible as contributions (could be a business expense), but a gift to the league's separate charity for the purpose of maintaining a library would be, so long as it is open to the general public.[95] Grants from foundations, corporations, and testamentary bequests from members can also be sought. See discussion of sponsorships in Section 21.8(e) for circumstances under which such payments may be treated as advertising taxable as unrelated business income to the league.

A charitable organization established by a business league must meet the same standards for qualification as a §501(c)(3) organization that require it to operate exclusively to benefit the general public, rather than to benefit the league and its members. In the IRS view, "the foundation cannot serve to improve the reputation and business interest of the association's members and the profession of which they form a part." For this reason, an organization that administers a national certification exam, presents seminars, and seeks to serve the public interest by maintaining high standards in the accounting profession cannot qualify as an educational organization.[96] A foundation can present educational programs, such as classes leading to certification in a particular line of business or continuing education. A foundation should not be responsible for certification, enforcement of a code of ethics for those who are certified, or other activities germane to an association of persons having a common business inter-

[95] Rev. Rul. 58-293, 1958-1 C.B. 146 and Rev. Rul. 66-79, 1966-1 C.B. 48.

[96] Gen. Coun. Memo. 39721.

est (definition of (c)(6) organization).[97] The foundation can conduct research on subjects pertaining to the business of the association members, but the results of the research must be available to the general public and conducted under the standards for charitable research organizations.[98] An engineering society conducting research that is made available to universities on a cost basis was allowed to convert to a (c)(3) because it did not police its profession or undertake a public relations program (so that it did not qualify as a business league).[99] The foundation can make scholarship grants to persons aspiring to enter the business, but should not sponsor an essay contest designed to increase public interest in its members and the line of business they represent.[100]

A business league and the foundation it creates can share common or overlapping board members or trustees; the league can, and for management reasons often does, absolutely control its affiliated foundation. Facilities, personnel, and other costs can be shared. When such a sharing arrangement exists, documentation must be maintained to evidence that the foundation's funds are not used for association purposes.[101] Furnishing of administrative services to the foundation for free is a charitable activity on the league's part that should not jeopardize its (c)(6) status if it is inconsequential to the league's overall operations.[102]

A controlled charitable subsidiary of a business league (or a (c)(4) or (c)(5) organization) may qualify as a public charity for one of three reasons. If its annual support is received from a broad range of contributors, it may qualify under 509(a)(1). If its primary source of support comes from sales of educational programs and materials, it may qualify under 509(a)(2). Lastly, it may be entirely funded and controlled by its affiliated (c)(6) organization and eligible under 509(a)(3). The charity's charter and organizational rules must be carefully drawn to meet the specific requirements for the last category, referred to as a supporting organization.[103] The third type may be desirable for a foundation that is receiving funding from a variety of sources because it avoids the need to maintain detailed public support information to prove that the affiliate is not a private foundation.

Rather than forming a new, separate charitable organization, it is conceivable that an organization classified as a (c)(6) might be able to requalify itself as a (c)(3) if its resources are devoted primarily to educational activities. The determinative factors are whether the organization promotes and protects the profession or business of its members and/or engages in extensive legislative activity.[104] Sponsoring semiannual law institutes and moot court proceedings and providing legal assistance to indigents were agreed to be charitable and

[97] A professional (standards) review organization created to oversee Medicare treatment is afforded (c)(3) status, as discussed in Section 4.6.
[98] Discussed in Section 5.3.
[99] Rev. Rul. 71-506, 1971-2 C.B. 233.
[100] Gen. Coun. Memo. 37579.
[101] See Section 27.3.
[102] Tech. Adv. Memo. 8418003.
[103] Chapter 11 presents the various categories of public charities in detail.
[104] Rev. Rul. 71-504, 1971-2 C.B. 231, in which a medical society sought unsuccessfully to be reclassified from (c)(6) to (c)(3).

educational activities for a city bar association. Establishing minimum fee schedules, enforcing standards of conduct, and studying ways to make the practice of law more profitable instead promote the common business purpose of the bar's members. Thus, a bar association conducting both educational and professional standard-type activities was not allowed to be reclassified as a (c)(3).[105]

8.12 DISCLOSURES FOR LOBBYING AND NONDEDUCTIBILITY

The Revenue Act of 1993 revised §162(e) and added direct lobbying expenses to the list of expenses that are nondeductible for income tax purposes. Leagues that finance their lobbying efforts with member dues payments must allocate their resources between those spent on lobbying and those spent on other programs. "Conspicuous and easily recognizable" notice of the nondeductible amount must be provided to members on dues notices soliciting payment providing a reasonable estimate of the lobbying expenses to be paid out of the dues.[106] A report of compliance with the rules, including the amount of lobbying expenses and dues allocable thereto must be provided on Form 990, filed annually.

A league that is able to show that 90 percent or more of its members do not benefit from the deduction of their dues, because of the 2 percent threshhold on employee business expenses, is excluded from these rules. Additionally, a league substantially all of whose members are §501(3) organizations is also excluded from the notice requirement. A league can choose to pay a proxy tax (at highest corporate rate) on its lobbying expenditures itself, rather than disclosing the nondeductible amount to its members. The limitation on deductibility of dues attributable to an organization's lobbying activity and associated reported requirements is outlined in Section 6.5.

Amounts expended in connection with political campaigns are also not deductible, and federal election laws generally prevent a business league from itself expending funds for electioneering. The association that wants to afford its members the opportunity to influence elections must, therefore, create a separate fund generally known as a political action committee (PAC). Chapter 23 outlines the definitions and limitations on activities of PACs and tax imposed on political expenditures if paid with organizational funds.

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[105] Rev. Rul. 71-505, 1971-2. C.B. 232; see also Rev. Rul. 73-567, 1973-2 C.B. 178 (medical board to certify specialists), Rev. Rul. 74-553, 1974-2 C.B. 168, Rev. Rul. 80-287, 1980-2 C.B. 185, and Gen. Coun. Memos. 35861 and 37853.

[106] IRC §6033(e)(1)(A)(ii).

CHAPTER NINE

Social Clubs: §501(c)(7)

Social clubs are defined in Internal Revenue Code (IRC) §501(c)(7) as "clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activity of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder." The tax exemption is based on the logic of allowing individuals to pool their funds for recreational purposes and is fundamentally very different from other types of exemptions. A club is not exempt because it provides public benefit, but rather because it serves to benefit private individuals. It is designed to allow individuals to join together on a mutual basis for personal reasons without tax consequences.[1] Few limits are placed on the type of activity a social club can conduct. The type of organizations that typically qualify as social clubs include

[1] *Exempt Organizations Handbook* (IRM 7751) §710; Reg. §1.501(c)(7)-1.

- Country clubs
- Amateur hunting, fishing, tennis, swimming, and other sport clubs
- Variety clubs
- Local women's and men's clubs
- Hobby clubs
- College sororities and fraternities operating chapter houses for students

The most significant tax attributes of a social club are that

- Members are bound together with a common social goal.
- No part of the club's assets inure to the benefit of any private shareholder.
- The primary source of support is membership fees, dues, and assessments.[2]
- The club has specific criteria or standards for membership.
- Passive income from dividends, interest, and other investments is taxed.
- Limited revenues come from nonmembers and other business activities, subject to specific numerical tests.[3]

9.1 ORGANIZATIONAL REQUIREMENTS AND CHARACTERISTICS

(a) Purpose Clause and Activities

The charter and bylaws of a social club should provide that the club is organized for pleasure, recreation, or other nonprofitable purposes. The document must also state that the club does not provide for discrimination on the basis of race, color, or religion.[4] A club operating under a defective charter will qualify for exemption from the date it commenced operation, but only if it has not conducted any of the proscribed activities permitted by the charter.[5] If impermissible activities have been conducted, exemption is only allowed beginning with the year of the revision.

Substantially all of the club's activities must be in pursuit of its recreational and social purposes. The charter should not expressly authorize the club to conduct activities beyond this (c)(7) scope, except that there can be provision for charitable, educational, and other (c)(3) purposes. A charitable deduction can offset the club's unrelated business income.[6]

The activities of a social club must encourage and permit members to join together; that is, the opportunity for social mingling and fellowship on a mutual basis must be present in club functions. Commingling by members must play a

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[2] See numerical tests applied to measure qualification, in Section 9.4.
[3] See Section 9.4.
[4] Reg. §1.501(c)(7); see Section 9.3(a).
[5] *Exempt Organizations Handbook* (IRM 7751) §722(4).
[6] Discussed in Section 9.5(g).

material part in the life of the organization.[7] Lack of personal contact may be an indication that the basic purpose of the organization is only to provide personal goods and services in a manner similar to commercial counterparts.[8]

(b) Examples of Qualifying and Nonqualifying Clubs

A wide variety of groups of persons with common interests have formed qualifying social clubs.

- A pet club,[9] a dog club,[10] a bowling tournament club,[11] a family historical society,[12] a garden club,[13] and a mineralogical and lapidary club[14] have been ruled to be exempt social clubs.
- Owning a building and operating the social facilities in it for a tax-exempt lodge,[15] for a fraternity chapter house,[16] and for a veterans organization[17] also is considered to be a qualifying activity for a social club. However, an organization whose primary activity was leasing building lots to members with peripheral recreational activity is not exempt.[18] The organization must itself be social or recreational in nature. If social activity predominates, rental activities restricted to members will usually be compatible with exemption as a social club. A fraternity can rent rooms to its members for their private use, for example.[19]
- Gambling, even though illegal under local law, was ruled to be a permissible social club focus when it was conducted only for members and their guests.[20] Similarly, a Calcutta wagering pool conducted by a club in connection with its annual golf tournament was deemed exempt.[21]

Two different flying clubs illustrate the rule. A hobby flying group that held informal meetings for members and owned an airplane that the members maintained, repaired, and flew together in small groups qualified as a social club.[22] In contrast, a group that only provided "economical" facilities for members' plane storage, but held no meetings or other commingling activity for them, did not qualify as a social group.[23] Lack of a physical facility for regular gatherings

[7] Rev. Rul. 58-589, 1958-2 C.B. 266.
[8] Rev. Rul. 69-635, 1969-2 C.B. 126 concerning a nonprofit automobile club.
[9] Rev. Rul. 73-520, 1973-2 C.B. 180.
[10] Rev. Rul. 71-421, 1971-2, C.B. 229; Rev. Rul. 73-520, 1973-2 C.B. 180.
[11] Rev. Rul. 74-148, 1974-1 C.B. 138.
[12] Rev. Rul. 67-8, 1967-1 C.B. 142.
[13] Rev. Rul. 66-179, 1966-1 C.B. 139.
[14] Rev. Rul. 67-139, 1967-1 C.B. 129.
[15] Rev. Rul. 56-305, 1956-2 C.B. 307.
[16] Rev. Rul. 64-118, 1964-1 (Part I) C.B. 182.
[17] Rev. Rul. 66-150, 1966-1 C.B. 147.
[18] Rev. Rul. 68-168, 1968-1 C.B. 269.
[19] *Exempt Organizations Handbook* (IRM 7751) §742.
[20] Rev. Rul. 69-68, 1969-1 C.B. 153.
[21] Rev. Rul. 74-425, 1974-2 C.B. 373.
[22] Rev. Rul. 74-30, 1974-1 C.B. 137.
[23] Rev. Rul. 70-32, 1970-1 C.B. 140.

implies lack of social purpose. Examples of nonqualifying groups include the following:

- A breakfast club established to assist its members working in business through study and discussion of problems at weekly meetings is not classified as a social club, but may qualify as a business league.[24]
- A television antenna service group formed to share the costs, but with no member mingling activities, is not a social group.[25]
- A community association operating a swimming pool that serves a social function for residents cannot qualify if it also maintains the streets, collects the trash, and pays the police and fire departments.[26] Separating the functions could result in a (c)(7) pool facility and a (c)(4) community service provider.
- A club with mixed purposes—both a social club and a provider of benevolent life insurance to members—cannot qualify (although, again, two independent organizations separately conducting such activities can independently qualify).[27]
- An automobile club providing lower-cost services to its members, but no social activities in which its members mingle, cannot qualify.[28]
- A club owning a multistory urban building in which it conducted a number of "nontraditional business activities" is not a qualifying club in the Internal Revenue Service's eyes. Operation of a parking garage, gas station, barbershop, flower shop, and liquor store, despite the fact that they are open only to members and their guests, does not serve a social purpose, but instead is the rendering of commercial services. Long-term rental of at least 10 percent of the rooms for members' principal residences is also a nonexempt activity.[29]
- Sale of take-out food for members' consumption off club premises is not a social function[30] nor is a veterans group operation of bar with gambling, golf course, swimming pool, and restaurant, all open to the public.[31]
- A Florida club sold a portion of its property to participate in a land price boom and distributed the proceeds to the members. The sale was found to be a "violent departure" from the club's normal behavior and not merely incidental to the regular functions of the club. Because financial gain was the aim, the club's exemption was revoked.[32]

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[24] Rev. Rul. 69-527, 1969-2 C.B. 125.

[25] Rev. Rul. 83-170, 1983-2 C.B. 97; Gen. Coun. Memo. 39063.

[26] Rev. Rul. 75-494, 1975-2 C.B. 214.

[27] *Allgemeiner Arbeit Verein v. Commissioner,* 24 T.C. 371 (1955), aff'd., 237 F.2d 604 (1956) 3rd Cir.; Rev. Rul. 63-190, 1963-2 C.B. 212.

[28] *Keystone Auto Club v. Commissioner,* 181 F.2d 420 (3rd Cir. 1950), aff'g. 12 T.C. 1038 (1949); Rev. Rul. 69-635, 1969-2 C.B. 126.

[29] Gen. Coun. Memo. 39115 (January 12, 1984).

[30] Tech. Adv. Memo. 9212002.

[31] Priv. Ltr. Rul. 9815061.

[32] *Juniper Hunting Club v. Commissioner*, 28 B.T.A. 525 (1933). The 35/15 test would now be applied to measure continued qualification for exemption, as discussed in Section 9.4.

- An educational program supported by social club members may qualify for recognition of its exemption under §501(c)(3) if it is a distinct and separate entity that meets the (c)(3) organizational and operations tests.[33]

9.2 MEMBER INUREMENT PROHIBITED

The charter or organizational document establishing the club should provide that no private benefit can inure to any individual member of the club.[34] Under two different circumstances, the governing rules can provide distributions to members that do not result in private benefit to the individual members:

- Upon dissolution or termination of the club, payment of distributions to club members (apportioning of the club assets among members) is acceptable.[35]
- Upon an individual member's withdrawal from the club, the member's shares can be redeemed at their book value. A payment equal to the member's proportionate share of the underlying value of the club's assets is also permitted.

Essentially, members can be reimbursed their original membership cost, plus their share of increases in the value of club property and accumulated surpluses.[36] Dissolution payments can differ by membership category if they parallel and are attributable to differing levels of initiation fees or types of members. Lower dues rates for a voting class of membership at the expense of higher-paying nonvoting members is viewed as providing inurement to the voting members.[37] Such a dues structure may reflect inurement, as does the lowering or reduction of member charges or dues with profits earned from nonmember activities. When there is some other reason for the difference, such as enhanced privileges, impermissible benefits may not flow to nor inure to the benefit of members.[38]

(a) Inurement from Nonmember Revenues

Reductions in member dues, facilities fees, and enhancement of club facilities, when financed by nonmember revenues, constitute member inurement.[39] Distribution of proceeds from sale of club land or property to members may be viewed as providing impermissible private inurement, if the sale is profit motivated. When club land is sold to take advantage of a land price boom with the profits distributed to the members, private benefit is found and the club's exemption revoked.[40] If, however, the club property is taken by a condemnation

[33] See Chapter 2; standards for educational organizations are discussed in Chapter 5.

[34] *West Side Tennis Club v. Commissioner,* 111 F.2d 6 (2d Circ 1940); Chapter 20 defines and explores inurement concepts in depth.

[35] Rev. Rul. 58-501, 1958-2 C.B. 262; *Mill Lane Club, Inc.* 23 TC 433, Dec. 20,683 (acq.).

[36] Rev. Rul. 68-639, 1968-2 C.B. 220.

[37] Rev. Rul. 70-48, 1970-1 C.B. 133.

[38] *Pittsburgh Press Club v. U.S.,* 536 F.2d 572 (3rd Cir. 1976).

[39] Rev. Rul. 58-589, 1958-2 C.B. 266.

[40] *Juniper Hunting Club v. Commissioner,* 28 B.T.A. 525 (1933).

proceeding[41] or is sold by a club because of encroaching urbanization and trespasses,[42] distribution of the proceeds to the members (with or without dissolution) has not been deemed to produce disallowed member benefit.

(b) Direct Inurement to Members

Direct services rendered to members beyond the social purposes of the club may result in inurement. Examples of services that have been found to provide direct inurement, rather than to serve the social purposes of the club, include the following:

- Sale of packaged liquor to members for off-premises consumption[43]
- Sickness and death benefit payments to members[44]
- Leasing building lots to members on a long-term basis[45]

9.3 MEMBERSHIP REQUIREMENTS

A social club must allow for social interaction among its members. Without commingling of members for social and recreational purposes, the club cannot qualify. A shared setting in which persons in significant numbers come together to share their social and recreational interests is required[46] Members are expected to share goals and active interests.[47]

(a) Discrimination

Discrimination against individuals for reason of their race, color, or religion by social clubs is strictly prohibited.[48] The charter, bylaws, or other governing instrument or written policy statement may contain no provision for discrimination against any person based upon race or color. Note that the code does not contain the word *sex*. A written policy against discrimination is not absolutely necessary as long as the club obeys the spirit of the prohibition. It is actual discrimination that will cause revocation of exemption. Two specific types of religious organizations are permitted to discriminate based upon religion and are relieved from this sweeping requirement:

1. A fraternal beneficiary society, order, or association limiting its members to a particular religious group
2. A club that in good faith limits it membership to the members of a particular religion in order to further the teachings or principles of that religion and not to exclude individuals of a particular race or color.[49]

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[41] Rev. Rul. 65-64, 1965-1 C.B. 241.
[42] Rev. Rul. 58-501, 1958-2 C.B. 262.
[43] Rev. Rul. 68-535, 1968-2 C.B. 219.
[44] Rev. Rul. 63-190, supra note 26.
[45] Rev. Rul. 68-168, 1968-1 C.B. 269.
[46] Rev. Rul. 58-589, 1958-2 C.B. 266.
[47] *Exempt Organizations Handbook* (IRM) 7.2.1(2).
[48] IRC §501(i), added to the Code in 1976.
[49] IRC §§501(i)(1) and (2).

IRS policy does not permit exemption for religious groups falling outside those specified in the preceding list nor for ethnic groups.[50]

Sexual discrimination is not prohibited by the tax code so that exemption is permitted for clubs that discriminate in favor of a particular sex. Such clubs may be challenged under the broader civil rights legislation. Princeton's last two "male only" social clubs were ordered to admit women by the Supreme Court of New Jersey in July 1990. However, the Massachusetts Commission Against Discrimination refused, in March 1990, to require the Harvard Fly Club to admit women.

(b) Classes of Membership

The shared interest of social club members is evidenced by the limitations and prerequisites of its membership structure.[51] Membership requirements cannot be broad or vague, but should serve to limit membership to a clearly defined constituency. Different classes of members, however, are permitted. Membership distinctions that are based on amount of dues paid, age, residency, and facilities used do not, in and of themselves, indicate lack of social purpose. Different voting rights and different dissolution rights for different classes of membership are also permissible. A health club with 25 active members and 25,000 nonvoting associate members, however, "clearly was not of an exempt character."[52] For geographically broad-based social clubs, mingling of members within each local chapter will suffice to meet IRS requirements.[53]

(c) Company Memberships

A social club must be a nonprofit membership organization of individuals. If corporate memberships are offered, individual representatives of the corporation must be subject to approval by the membership committee and must be granted the same privileges as other individual members.[54] The company can pay the bill as long as the charges are for member use.[55] If, instead, the club allows member corporations to designate their representatives, the club cannot qualify for exemption.[56]

(d) Subterfuge Clubs

Clubs actually doing business with the public under the guise of a social club cannot qualify for exemption. Clubs created to "circumvent liquor laws, zoning ordinances, or laws enforcing civil rights" are among those considered as subterfuges by the IRS. The following factors evidence nonqualifying clubs[57]:

[50] Priv. Ltr. Rul. 8317004.
[51] *Arner v. Rogan*, 40-2 USTC ¶9567 (D.C. 1940).
[52] Rev. Rul. 58-588, 1958-2 C.B. 265.
[53] Rev. Rul. 67-248, 1967-2 C.B. 204.
[54] Rev. Rul. 74-168, 1974-1 C.B. 139.
[55] Rev. Rul. 71-17, 1971-1 C.B. 683.
[56] Rev. Rul. 74-489, 1974-2 C.B. 169.
[57] *Exempt Organizations Handbook* (IRM 7751) §727.

- The membership requirements are broad or vaguely stated.
- Initiation charges or dues are so low that one-time transient use of the facilities by the general public is encouraged.
- Management conducts vigorous public solicitations to expand club membership.
- The club is closely associated with a for-profit hotel, restaurant, or health facility that also provides the management, the food services, and so on.

9.4 REVENUE TESTS

IRC §501(c)(7) was revised in 1976 to require that "substantially all" of a social club's activities involve the pleasure, recreation, and other nonprofit purposes of its members. Congress expressed an intention that no more than 35 percent of a qualifying social club's gross revenues come from investment and nonmember income, with nonmember income equaling no more than 15 percent of its gross revenue.[58] This gross receipts test is referred to as the *35/15 test* and establishes a specific numerical test that is used to measure a club's ongoing qualification for exemption under (c)(7). Prior to 1976, clubs had to operate "exclusively" for nonprofit purposes, and the regulations[59] provided that a club that engaged in business activity was not exempt, but no precise numerical test existed. Note that this regulation, originally proposed in 1956 and adopted in 1958, has not been revised since.

(a) 35/15 Test

The revenue test is two-pronged. First, an overall test requires that nonmember receipts, including investment income, cannot equal more than 35 percent of the club's "traditional, normal and usual activity." Extraordinary and nonrecurring income, such as gain on the clubhouse sale or member initiation and capital assessment fees, are excluded from the denominator and numerator for this test. Irregularly held events (but not annual events) are not counted. The revenue from a golf tournament held every 20 years was not counted in the test, although it was subject to the tax on unrelated business income.[60] Capital gains from investment activity and unrelated business income (including that set aside for charity) are also included in gross receipts.[61] The second prong of the test regards nonmember revenue only. The IRS provides the following guidelines for measuring nonmember usage and revenue[62]:

- Gross receipts from the general public (nonmember) facility and service charges may not exceed 15 percent of total receipts.

[58] P.L. 94-568, 94th Cong. 2d Sess. (1976).
[59] Reg. §1.501(c)(7)-1(b).
[60] Priv. Ltr. Rul. 7838018.
[61] Senate Report 94-1318, 2nd Session, 1976-2 C.B. 597, 599.
[62] Rev. Proc. 71-17, 1971-1 C.B. 683.

- The revenue generated from guest charges can be attributed to members if the guests are bona fide and the member pays for the guest charges.
- Reciprocal membership arrangements do not turn a visitor into a member of a visited club.[63]

For auditing purposes, the IRS guidelines say a group of eight or fewer persons that includes one member is counted as a member receipt. For larger parties, guests may be treated as members if 75 percent or more of the particular group using club facilities are members of that group. Typical business luncheon clubs hosting the Rotary Club, tax study forums, and similar groups have a hard time meeting this test.

(b) Failing the Test

Failure of the 35/15 test in one year does not necessarily cause immediate revocation of exemption. The facts and circumstances of each case can be considered individually when the club makes its case for continued exemption. The IRS is more likely to be sympathetic if an organization fails the test because of an unusual or occasional special event, as opposed to receiving regular, perhaps daily, funds from nonmembers.[64] If the club experiences a one-year failure out of a number of years, as opposed to small and recurring annual failures, continued qualification is more likely. The purpose for which facilities are made available to nonmembers will also be considered.

Accounting records are essential to document nonmember use and proper categories of gross receipts. The IRS procedures[65] contain detailed criteria that clubs serving nonmembers must study carefully to distinguish between member and nonmember income. The total income of a club failing to keep a record of the required details may become subject to the unrelated business income tax. The type of records a club should maintain regularly include the following:

- Date and description of club usage
- Number in each party, indicating members and nonmembers
- Total charges attributable to members and nonmembers
- Charges paid by nonmembers (based upon signed statements regarding reimbursements, including those of employers)

9.5 UNRELATED BUSINESS INCOME TAX

Social clubs are significantly different from other tax-exempt entities in one important respect: the definition of their revenues that are subject to the unrelated business income (UBI) tax. IRC §512(a)(3)(A) provides a special definition for social clubs, as well as voluntary employee benefit associations (VEBAs),

[63] Gen. Coun. Memo. 39343; Rev. Proc. 71-17.
[64] *Exempt Organizations Handbook* (IRM 7751) §733(1).
[65] Rev. Proc. 71-17, supra note 51.

group legal services plans, and supplemental unemployment funds. Taxable income for such groups is defined expansively to include all gross income other than exempt function income. Many of the exceptions and modifications that exclude investment and passive income from tax for other types of tax-exempt organizations, including the corporate dividend deduction, are not available to shelter a club's unrelated income.[66]

Exempt function income of a social club is "gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guest goods, facilities, or services constituting the basis for exemption." All other social club income is subject to regular income tax, including nonmember revenues, special events, open golf tournaments, royalties, rents, dividends, interest, and other unrelated business income. Losses attributable to nonmember club usage are not necessarily deductible against other types of taxable income.

In view of the limited tax exemption permitted to social clubs, some clubs choose not to seek exemption and instead remain normal taxpayers to pay lower taxes. This situation occurs due to interaction of the limitation on deduction of nonmember losses and the taxability of investment income on surplus funds. Such groups must carefully consider the advisability of seeking or maintaining tax-exempt status.

A previously taxable social club must also carefully project the potential tax savings, if any, from conversion to exempt status. To compound the problem, appreciation inherent in a club's assets may be reportable upon the conversion as taxable gain.[67] Switching from a normal taxpaying club to a tax-exempt club can, however, have a price. Such a conversion is a "Change of Status," treated as a taxable liquidation. The taxable club is treated as if it transferred all of its assets to one or more tax-exempt entities. It must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market value.[68] The regulations contain relief provisions for certain club conversions.[69] This issue is of importance to clubs formed by real estate developers to provide golf, swimming, and other recreational facilities to residents in a country club setting. The entity that will operate the club is formed during the development phase and may not become operational for some years. Because it cannot meet the revenue tests[70] until it has memberships, it cannot initially qualify for exempt status. Careful attention to the seven-year rule may be particularly important if the club's assets appreciate in value during its formative years.[71]

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[66] See Chapter 21 for discussion of these rules.

[67] Pursuant to regulations under §337(d); see discussion in Section 21.10(e).

[68] Reg. §1.337(d)-4(a)(1) applicable to all transfers of assets after January 28, 1999, unless grandfather provisions apply.

[69] Reg.§1.337(d)-4(a)(3)(i)(D).

[70] See Section 9.4(a).

[71] The February 1999 issue of *The Exempt Organization Tax Review,* p. 259, has a comprehensive article by Mitchell L. Stump, a CPA focused on social clubs, entitled "Final 337 Regulations Bad News for Clubs Wanting to Be 501(c)(7)s."

(a) Rationale for Different UBI Treatment

In extending the unrelated business income tax to social clubs in 1969, Congress reiterated its intention to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis without tax consequences. However, it made clear that tax exemption is properly applied only to sources of income generated from membership activity. When the club receives income from sources outside the membership, such as interest income on its savings or charges to outsiders for use of its facilities, it is taxed. Exempting such income from tax would allow club members to use tax-free dollars to pay for recreational and pleasure pursuits.

(b) Limitations on Deductions

Unrelated business taxable income generally means the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the "ordinary and necessary" expenses that are directly connected with the carrying on of such business.[72] Concepts used to identify a direct connection of an expense to a particular type of revenue are fairly vague and sometimes difficult to apply. Calculating permissible expense deductions is difficult where exempt functions (member-related) are carried on in connection with nonexempt (nonmember and investment) activities. This responsibility to differentiate expenses between functions makes it particularly important for a social club to maintain adequate accounting records to make the distinction.

A social club with workers who receive tips may be entitled to an income tax credit for employee Social Security and Medicare taxes paid on tip wages. The IRC §45B credit essentially allows the employer to pay employment taxes on the minimum wage without regard to the amount the worker is actually paid. In what seems like an incorrect conclusion, the IRS decided a country club was entitled to an income tax credit against its unrelated income tax for the entire amount of wages it paid.[73] Keep in mind the club was paying tax on that portion of its clubhouse revenues attributable to private parties, not to member usage. The service did not require allocation of the credit between the related and unrelated food service revenues. Items of expense deductible against unrelated business income must include only those directly attributable to the unrelated revenue producing activity.[74] This ruling could also be applied to other types of tax-exempt organizations employing persons who receive tips in an unrelated business.

(c) Nonmember Losses

Unless club facilities and services are made available to nonmembers with the intention of producing a profit—as opposed to simply recouping costs—losses from serving nonmembers are not deductible against club income (interest and dividend on reserves) subject to the unrelated business income tax. During the

[72] IRC §512(a)(1).
[73] Priv. Ltr. Rul. 199931041.
[74] IRC §512(a)(3) discussed in Section 27.14(e).

1980s, the IRS and social clubs fought in the courts about offsetting losses from nonmember activities against investment income. The battle was fought on two different fronts: (1) how to calculate the loss, that is, what portion of the club's fixed, or indirect, expenses are deductible, and (2) the deductibility of the loss itself. Permissible deductions are those expenses that are directly connected with the production of gross income otherwise allowed by the code, that is, ordinary and necessary business expenses allowed to for-profit businesses under §162. Beginning in 1981, the IRS took the position that a profit motive must be present for the expenses associated with income-producing activity to qualify as allowable trade or business expenses so that activities without profit motive could not be aggregated with those with profit motive.[75]

In a 1985 memorandum decision, the Tax Court adopted a narrower position in deciding that expenses attributable to nonmember activity were not "connected with the production of" income at all. In 1986, the Second Circuit Court of Appeals overruled the decision and held that all ordinary and necessary expenses of producing nonmember income, including investment income, were deductions only so long as they were incurred for the purpose of producing a profit.[76] North Ridge Country Club[77] lost its battle on this front in 1989 after the Cleveland Athletic Club[78] convinced the Sixth Circuit to allow such losses. In June 1990 the Supreme Court unanimously decided that the Portland Golf Club's nonmember activity losses were not deductible against investment income because the activity was neither profitable nor profit motivated. To calculate the loss for both purposes, direct and indirect costs had to be taken into account.[79] The Supreme Court agreed with the IRS's long-standing position that fixed and indirect expenses, which the club incurs whether or not it serves nonmembers, are not deductible to the extent they exceed nonmember income. Essentially, a social club cannot deduct an allocable portion of its basic member fixed expenses against its investment income, unless the nonmember activity is profit motivated. The Court looked to the hobby loss standards of IRC §183 to test the profit motivation, particularly because the Portland Golf Club incurred losses in every year from 1975 through 1984.

(d) Direct and Indirect Costs

The issue of deductible expenses is even more complicated, because two types of expenses are involved in calculating the profit or loss from any activity of the club:

1. Fixed or indirect expenses, such as club facility costs, insurance, mortgage interest, depreciation, utilities, managers, and other overhead, which the

[75] Rev. Rul. 81-69, 1981-1 C.B. 351.

[76] *The Brook, Inc. v. Commissioner,* 86-2 U.S.T.C. §9646 (2nd Cir. 1989), rev'g. 50 T.C.M. 959, 51 TCM 133 (1985).

[77] *North Ridge Country Club v. Commissioner,* 89-1 U.S.T.C. §9363 (9th Cir. 1989), rev'g. 89 T.C. 563 (1987).

[78] *Cleveland Athletic Club, Inc. v. U.S.*, 86-1 U.S.T.C. §9116 (6th Cir. 1986).

[79] *Portland Golf Club v. Commissioner,* 90-1 U.S.T.C. §50,332 (110 S. Ct. 2780, 1990).

club incurs to serve its basic membership and sustains whether or not nonmembers are served ("but for expenses")

2. Variable or direct expenses, such as food, waiters, golf caddies, and other expenses incurred in direct relationship to number of persons served, including members and nonmembers

The difficulty starts with the fact that the terms normally used in cost accounting texts—fixed and variable, direct and indirect—are absent in the tax code. The regulations only add a stipulation that the expenses must have a proximate and primary relationship to the income and provide for allocation of expenses attributable to both related and unrelated income. Adopting an allocation method designed to allot expenses based on a reasonable and consistent method is appropriate.[80]

(e) How to Measure Profit Motive

A secondary, but important, aspect of the *Portland Golf Club* case was an argument about how to measure profit motive. Are both direct and indirect costs taken into account in calculating profit or loss? Or is the fact that the nonmember direct income covers nonmember direct expenses (without any reduction for allocable indirect expense) sufficient evidence of profit motive? The *Portland Golf Club* case argued that since its nonmember income exceeded its nonmember direct expenses, it had a profit motive. The Court disagreed, and unless Congress acts to change the tax laws, profit motive for this purpose is calculated by deducting both direct and indirect costs associated with nonmember income.

Another issue to consider is whether one cost allocation method can be used to measure profit motive while another method is used to calculate taxable income. This issue was not settled in *Portland Golf Club,* although most justices thought that only one method should be used for both purposes. The question then becomes which method to use. Any method reasonably calculated to arrive at a fair allocation, and consistently applied, can be used. The regulations under IRC §512 provide that allocations must be made on a reasonable basis. The two basic methods used in the social club field are

1. *Gross-to-gross method.* Actual gross revenues from members and nonmembers are used to allocate the costs.

2. *Actual use method.* Square footage occupied and hours of actual use are tabulated to calculate fixed cost allocations. Here, the numerator of the equation is important. In a case involving a football stadium, the IRS and taxpayers have argued whether the proper divisor is the total number of hours in the year or the total number of hours the stadium was used. See Section 27.14 for further discussion of cost allocations.

[80] See Section 21.11.

(f) Aggregating Nonmember Activities

Another issue is whether all nonmember activities can be aggregated to evaluate profit motive and allocable costs. The Tax Court sided with the Atlanta Athletic Club to allow aggregation. Losses from nonmember food and beverage sales and facility fees (e.g., golf greens, tennis, pool) were deductible against profits from two professional golf tournaments. The club argued that there was a common business purpose for promoting its nonmember undertakings. The IRS argued that each activity had to be considered separately and any profitable activities taxed. The club's victory was only partial. The overall loss from nonmember activity was not deductible against other investment income because the court found the requisite profit motive lacking, following the *Portland* rationale.[81]

(g) Charitable Set-Asides

A special provision contained in IRC §512(a)(3)(B)(i) excludes income otherwise taxable as unrelated business income from tax to the extent the funds are set aside for charitable purposes. Essentially, an unlimited charitable deduction is allowed to a social club for income paid directly for charitable purposes described in IRC §170(c) and for funds accumulated or earmarked for such purposes in the future. This deduction is claimed in a specially designed portion of Form 990-T.[82]

Setting aside means something more than simply showing that a club expended a portion of its overall funds annually on charitable projects. Specific board action or stated policy—isolation or designation of the funds or other overt actions—is necessary to prove that funds are earmarked or set aside exclusively for (c)(3) purposes. In the case of a cooking club, the club's records did not show or prove that investment income. Instead, subscriptions and membership fees had been used to pay to publish an educational magazine.[83] Lacking proof that some other funds, rather than investment income, had paid, no set-aside deduction was permitted. Similarly, a court ruled that the Phi Delta Theta fraternity magazine was not educational, but rather served the recreational purposes of the members. Endowment income used to support the publication did not qualify for the charitable set-aside donation.[84]

(h) Sales of Real Estate

A gain from sale of real estate used in regular club activity to perform its exempt function may also be classed as unrelated business income to the extent that the proceeds are not reinvested one year before or three years after the date of its sale.[85] The phrase "used in regular club activities" does not necessarily include

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[81] *Atlanta Athletic Club v. Commissioner,* T.C. Memo. 1991-83 (1991).

[82] Schedule G of Form 1024. 1996 version.

[83] *Confrerie de la Chaine des Rotisseurs v. Commissioner,* T.C. Memo. 1993-637.

[84] *Phi Delta Theta Fraternity v. Commissioner,* 887 F.2d 1302 (6th Cir. 1989), aff'g. 90 T.C.B. 1033 (1988).

[85] IRC §512(a)(3)(D).

property contiguous to the club held for possible future expansion or simply to protect the club from the suburbs.[86] Only that property in actual, direct, continuous, and regular use for social and recreational purposes qualifies. For example, a steep buffer tract heavily wooded with thick undergrowth was found not to be used directly in exempt functions. Even though it served to isolate the club from the surrounding developed area and roads, its physical condition indicated that it was not devoted to exempt activity. Proceeds from granting a permanent easement for passage and use of the buffer produced taxable gain.[87] Where the proceeds of sale of a scenic easement to view the club's golf course were reinvested in improving the course, the proceeds were not taxable.[88] Compare those facts to the case of a club that owned a tract of land contiguous to a golf course. The tract was not actually part of the course and, therefore, was found to be mostly property unrelated to the country club's exempt purposes. The IRS permitted bifurcation of the tract and ruled that tax was due on the gain on sale of the land with the exception of the portion the club was able to show that golfers walked on to retrieve stray golf balls.[89]

Because social clubs, particularly country clubs, often own highly appreciated real estate, the reinvestment rule requires particular attention. A sale of such property can have two negative consequences: (1) a significant tax liability if the proceeds are not used to purchase other property to be used by the club and (2) loss of exempt status due to failure of the 35/15 test[90] when the proceeds from the property sale are treated as nonmember revenue. The cutting of timber from a wildlife preserve necessary to maintain its usefulness was not, in the IRS's opinion, a business activity because the club's exempt purposes were furthered. Nonetheless, the sale generated unrelated business income because the activity was not a direct exempt function.[91] Additional developments concerning the treatment of gains on sales of club real estate as taxable unrelated business income are presented in Section 21.8(g).

9.6 FILING AND DISCLOSURE REQUIREMENTS

Social clubs file Form 1024[92] for recognition of tax exemption under IRC §501(c)(7) and file Form 990 or 990EZ annually to report financial activity to the IRS. Form 990T is filed to report income subject to UBI tax.[93] A nonexempt membership club (or one whose exemption has been revoked) files Form 1120 as a regular corporation. A taxable club is subject to the special limitations of IRC §277. Essentially, expenses attributable to membership activities are allowed as a deduction only to the extent of membership income.

[86] *Cleveland Athletic Club v. Commissioner,* T.C. Memo. 1991-83 (1991*); Framingham Country Club v. U.S.*, 659 F. Supp. 650 (D. Mass. 1987).
[87] Tech. Adv. Memo. 9225001.
[88] Priv. Ltr. Rul. 9824045.
[89] Priv. Ltr. Rul. 199929044.
[90] Described in Section 9.4.
[91] Gen. Coun. Memo. 39688 (December 18, 1987).
[92] Process explained in Chapter 18.
[93] See online version of Blazek, *990 Handbook*, at Wiley.com.

Tax-exempt social clubs must disclose the fact that payments to the organization are not deductible as charitable contributions. The nondeductibility disclosure must be printed on all invoices issued to members in soliciting dues and other payments, as described in detail in Section 6.4.

Social club dues are generally not deductible as a business expense. Effective January 1, 1994, the code disallows a deduction for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.[94] The limitation applies to clubs whose principal purpose is to conduct entertainment activities for its members or their guests or to provide access to entertainment facilities. Examples given are country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussion. Dues paid to professional, civic, or public service organizations, such as the Rotary Club or Lions Club, are deductible if paid for business reasons and the principal purpose of the group is not to conduct entertainment activities.[95] Before 1994, dues or fees paid to social clubs were deductible when it could be shown that business discussions occurred.

[94] §274(a)(3).
[95] Reg. §1.274-2(a)(iii).

CHAPTER TEN

Instrumentalities of Government and Title-Holding Corporations

10.1 §501(c)(1) INSTRUMENTALITIES OF THE UNITED STATES

The Internal Revenue Code (IRC) §501(c)(1) exempts "instrumentalities" of the United States organized specifically under an act of Congress. Among these instrumentalities are the following:

- Federal Deposit Insurance Corporation (FDIC)
- Federal Home Loan Banks
- Federal Land Banks
- Federal Intermediate Credit Banks
- Federal National Mortgage Association (FNMA)
- Federal Reserve Bank
- Federal Crop Insurance Corporation
- United States Housing Authority
- Pennsylvania Avenue Development Corporation
- Federal Credit Unions
- Pension Benefit Guaranty Corporation

These creations of Congress are considered exempt because they are wholly owned by the United States government. They are not required to file annual information returns nor to apply for exemption from income tax.

10.2 GOVERNMENTAL UNITS

States, their municipalities, and other divisions thereof, interestingly, are not exempted by any part of §501(c), though they, by definition, could qualify under IRC §501(c)(3) because they relieve the burdens of government.[1] Although a governmental unit is separately organized, it is not entitled to exemption because of its sovereign powers to tax and to exercise eminent domain and police powers.[2] IRC §170(b)(1)(A)(v) provides for a charitable contribution deduction for a *governmental unit,* defined as follows:

> A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

The regulations under IRC §170 do not define what is meant by a political subdivision. One must look to the rules of IRC §103, Interest on State and Local Bonds, to find out what the term denotes:

> Any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any State or local governmental unit may or may not include special assessment districts so created, such as road, water, sewer, and similar districts.

The term most simply means a jurisdictional or geographical component of a state, such as a county or city. A 1944 court complicated the meaning by saying it must be broad and comprehensive and denotes any division of the state made by the proper authorities thereof, acting within their constitutional powers, for the purpose of carrying out a portion of these functions of the state that by long usage and the inherent necessities of government have always been regarded as public.[3]

To clarify their federal filing requirements, the IRS in 1995 added two more classes of organizations to the IRC §6033 list of those not required to file Form 990: governmental units and affiliates of governmental units. An organization is treated as a governmental unit for this purpose if at least one of the following conditions applies[4]

- It is a state or local governmental unit as defined in Reg. §1.103-1(b).

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[1] See discussion in Section 4.3.

[2] Rev. Rul. 60-384, 1960-2 C.B. 172; see also Joseph O'Malley, Elizabeth Mayer, and Marvin Friedlander, Chapter F, "State Institutions—Instrumentalities," *IRS CPE Text,* 1996 and 1997.

[3] *Commissioner v. Estate of Alexander J. Shamburg,* 3 T.C. 131, aff'd., 144 F.2d 998 (2d Cir.), cert. denied, 323 U.S. 792 (1944).

[4] Rev. Proc. 95-48, 1995-47 I.R.B. 13.

- It is entitled to receive deductible charitable contributions as an organization described in IRC §170(c)(1) of the Code.
- It is an Indian tribal government, or a political subdivision thereof, under IRC §§7701(a)(40) and 7871.

An organization is treated as an affiliate of a governmental unit if it meets one of two sets of criteria, as follows:

1. It has a ruling or determination from the IRS that
   - Its income, derived from activities constituting the basis for its exemption under IRC §501(c), is excluded from gross income under IRC §115.
   - It is entitled to receive deductible charitable contributions under IRC §170(c)(1) on the basis that contributions to it are "for the use of" governmental units.
   - It is a wholly owned instrumentality of a state or a political subdivision thereof, for employment tax purposes.
2. It does not have an IRS determination, but at least one of the following applies:
   - It is either "operated, supervised, or controlled by" governmental units, or by organizations that are affiliates of governmental units, or the members of the organization's governing body are elected by the public at large, pursuant to local statute or ordinance.
   - It possesses two or more of the affiliation factors in the following list.
   - Its filing of Form 990 is not otherwise necessary to the efficient administration of internal revenue laws.

Affiliation factors that are considered for this purpose include the following:

- The organization was created by one or more governmental units or a government affiliate, or by public officials acting in their official capacity.
- The organization's support is received principally from taxes, tolls, fines, government appropriations, or fees collected pursuant to statutory authority. Amounts received as government grants or other contract payments are not qualifying support for this purpose.
- The organization is financially accountable to one or more government units or affiliates thereof.
- One or more governmental units or affiliates exercises control over, or oversees, some or all of the organization's expenditures.
- Upon dissolution, its assets will be distributed to one or more governmental units or affiliates thereof.

Before issuance of the 1995 procedure, the definition of a governmental unit was found in IRS rulings issued in the 1970s. These rulings required that organizations qualified as governmental units have three important powers—to tax, to enforce laws, and to exercise eminent domain—a requirement that is not contained in the procedure outlined above. Here are some examples of entities qualifying as governmental units in rulings compared to those that do not:

- A rapid transit authority created by a state legislative act was empowered to issue bonds, exercise police powers, set rates, enforce its rules with a security force, and realize indirect benefit from taxes imposed and eminent domain exercised by participating local governmental bodies. The authority had sufficient sovereign powers of the state to constitute a governmental unit.[5]
- A community development authority similarly created under state laws to collect service and user fees for the construction, operation, and maintenance of community facilities was not classed as a governmental unit. It lacked the power to tax, power of eminent domain, and control over zoning, policy, and fire protection.[6]
- A state university without the three powers may not qualify as a political subdivision.[7]
- An unincorporated intergovernmental cooperative organization established by an act of the Texas legislature on behalf of a consortium of eleven Texas public school districts was found to be a private foundation, not a governmental unit, for two reasons[8]:
    - Its source of support was a particular private foundation that granted it the money to undertake its curriculum research and development.
    - It was not a governmental unit. Although the cooperative arguably was an instrumentality of the state because it had the required sovereign powers of eminent domain, it did not have the power to assess and collect taxes nor did it have police powers. The fact that it was an integral part of a group of governmental units—the public schools by which it was established—did not make it a governmental unit.

The Michigan Education Trust fought an interesting battle to qualify for tax exemption. It was created as a state agency to collect and receive advanced state college tuition, its board members were appointed by the governor, and its investments were managed by employees of the state treasury. Its assets, however, were not available to state creditors and were returnable to the "investors" upon dissolution. The IRS and a district court agreed that the trust was neither an instrumentality of the state nor a governmental unit and instead benefited the individual students who were to earn tax-free interest on their college savings. The Sixth Circuit Court disagreed and found the trust to be an integral part, or political subdivision, of the State of Michigan.[9]

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[5] Rev. Rul. 73-563, 1973-2 C.B. 24.
[6] Rev. Rul. 77-164, 1977-1 C.B. 20.
[7] Rev. Rul. 77-165, 1977-1 C.B. 21.
[8] *Texas Learning Technology Group v. Commissioner,* 96 T.C. 28 (April 30, 1991).
[9] *Michigan v. United States,* 40 F.3d 817 (6th Cir. 1994), rev'g. 92-2 USTC ¶50,424 (W.D. Mich. 1992); Priv. Ltr. Rul. 8825027.

Congress responded to the pressure about the Michigan decision and the 11 other states that, by July 1996, had tuition prepayment plans in place (Alabama, Alaska, Florida, Kentucky, Louisiana, Massachusetts, Michigan, Ohio, Pennsylvania, Texas, and Wyoming) by creating a new category of exempt organization. IRC §529, entitled Qualified State Tuition Programs, exempts such plans and their investment income, except to the extent to which they may be subject to the unrelated business income tax.[10] A qualified program is defined as one established or maintained by a state or instrumentality of a state under which a person may purchase tuition credits or may contribute to an account established to pay the qualified higher education expense of a designated beneficiary. Such expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible education institution.

Readers should be alert for the issuance of final regulations under §529. In reviewing requests for approval of the tax-exempt status of such plans, the IRS states the validity of each ruling could be affected by issuance of the regulations.[11]

10.3 §501(c)(2) TITLE-HOLDING CORPORATIONS

According to IRC §501(c)(2), "Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization that itself is exempt" under IRC §501 are title-holding companies (THCs). After some years of confusion and hesitation, IRC §501(c)(25) was added in 1986 to permit THCs with multiple parents.

Essentially, a title-holding corporation is a passive entity whose tax exemption stems from its subservient relationship to another exempt organization. The full range of organizations qualifying under §501 and pension plans are permissible beneficiaries. If the organization on whose behalf the property is held loses its tax exemption, the THC also does.[12] The THC also ceases to be an exempt organization when it no longer holds qualifying property. The sale of THC property, however, is considered to have occurred the day before it sells its property, so that the sale will not necessarily result in taxable income.[13]

A THC is traditionally formed to shelter the property transferred to it and assets it purchases from exposure to liability for claims asserted against its creator(s), although the reverse can occur if the property has inherent risk. A separate property-owning arm may also be created for administrative or management reasons, or to permit joint ownership under §501(c)(25). A (c)(2) title-holding company may also have a (c)(2) subsidiary if it meets the same qualifications of making distributions to its title-holding parent.[14]

[10] Small Business Job Protection Act of 1996, §1806.
[11] Priv. Ltr. Rul. 200214032.
[12] Rev. Rul. 68-371, 1968-2 C.B. 204.
[13] Priv. Ltr. Rul. 9551021.
[14] Rev. Rul. 76-335, 1965-2 C.B. 141.

(a) Organizational and Operational Requirements

As its names implies, a qualifying IRC §501(c)(2) title-holding corporation cannot be a trust, joint venture, or other unincorporated form of organization. It must be a corporation or an association classified as a corporation.[15] The *exclusive purpose* clause of the statute is strictly applied. The THC's purpose is reflected by its charter, its activities, and the facts and circumstances under which it was created. All of these factors are taken into account by the IRS in evaluating evidence that a THC's purposes are strictly limited to those provided in the statute. A THC will not be granted exemption if it engages in any business other than that of holding title to property and collecting income therefrom.[16] The income can be generated by investment sources, such as interest income on bonds held or rental income to commercial tenants.[17] A charter containing language that empowers the organization to engage in broader activities is not acceptable.[18] When the charter language contains the appropriate constraints, but the organization's proposed or actual activity goes beyond the limits, exemption may be denied. The (c)(25) THC must also comply with the specific requirements regarding beneficiary organizations and activities.

Connection to Beneficiary Organization. The amount of control and the relationship that must exist between the title-holding corporation and the exempt organization it benefits are not specified in the statute or in the regulation (which is only two paragraphs long). However, the IRS *Exempt Organizations Handbook* provides some guidelines.

A parent-subsidiary relationship is the most common form for a THC. As a rule, the THC must be controlled by and be responsive to the exempt organization for which it holds property, despite the lack of specific requirements in the statute or regulations. In the IRS's view, the elements of control necessary include owning the voting stock of the THC, possessing the power to select nominees to hold the voting stock, or having the ability to appoint the directors.[19] A group of philanthropists was not allowed to establish a THC that would have essentially circumvented the private foundation rules.

A single controlling beneficiary organization is ostensibly required for §501(c)(2) entities. The long-standing policy of the IRS was to consider multiple parents as evidence of asset pooling, not mere holding of title.[20] However, for some years the IRS debated the possibility that "conceivably a title-holding company might hold title for more than one kind of exempt."[21] Fortunately, in 1986 Congress created §501(c)(25), allowing pooled ownership in real estate by a group of tax-exempt organizations.

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[15] IRC §7701(a)(3).
[16] Reg. §1501(c)(2)-1; Senate Report No. 2375, 81st Congress, 2d Session (1950), 1950-2 C.B. 483, 504.
[17] Rev. Ruls. 69-381, 1969-2 C.B. 113 and 81-108, 1981-1 C.B. 327.
[18] Rev. Rul. 58-455, 1958-2 C.B. 261.
[19] Rev. Rul. 71-544, 1971-2 C.B. 227.
[20] Gen. Coun. Memo. 39341 and 37551.
[21] IRS *Exempt Organizations Handbook* (IRM 7751) §281.

The method of a title-holding company's formation may be influenced by state or local rules. In one example, a title-holding company was approved despite its being controlled by a broad individual base of members (a college fraternity), when the stock conferred no rights to dividends or distributions to members. All of the income from the property was payable to the §501(c)(7) organization.[22] A THC controlled by and created to benefit a private foundation is subject to the additional constraints explained in Chapters 12 through 17.

Restrictions on Activity. The operating powers of a THC must be limited to those required to hold title to its property—to conserve and maintain the property and to remit income to the beneficiary organization. The property held by a (c)(2) THC can include real and personal property, investments, and exempt function assets.[23] A (c)(25) THC, however, can only hold real estate. The THC can lease the property to commercial tenants unrelated to its exempt parent.[24] The THC cannot, however, operate a commercial manufacturing, service, or sales enterprise.[25] The property held by a THC can also be a leasehold interest that it sublets. Traditionally, the THC holds assets that need protection from exposure to operational liability, but it can also hold property that would expose the benefited organization to unacceptable risks.

There is no express reason why operational or exempt function assets, real or personal, cannot be kept in a (c)(2) holding company. Actively operating exempt functions by the THC, however, is not permissible because it goes beyond "title-holding." A subsidiary of a veterans organization that held title to a building and operated the social facilities located in the building was not permitted THC status.[26] Any activity that is actively conducted, whether it is considered to be related or unrelated to exempt purposes, is generally not appropriate to be carried on by a THC.

In some situations, the income earned from the THC property is treated as unrelated business income (UBI). For the purposes of identifying UBI, the THC is treated as being organized for the same exempt purposes for which its parent is organized.[27] The UBI rules treat two types of real estate activity as unrelated despite the fact that the activity is essentially passive. The most common type is rental income earned from a property that is acquired, refurbished, and/or maintained with borrowed funds. What is referred to as debt-financed income is treated as UBI and is permissible for a THC.[28] The exempt-use exception for indebted property applies to exclude rental from UBI if the parent organization plans to use the property within the requisite time period.[29] Similarly, leasing of personal property in connection with rental of the real estate that the THC owns is permissible, although it may result in UBI. Both (c)(2) and (c)(25) title-holding

[22] Rev. Rul. 68-222, 1968-1 C.B. 243.
[23] Rev. Rul. 76-335, 1976-2 C.B. 141.
[24] Rev. Rul. 81-108, 1980-1 C.B. 327.
[25] *Roche's Beach v. Comm.*, 96 F.2d, 776 (2nd Cir. 1938).
[26] Rev. Rul. 66-150, 1966-1 C.B. 147.
[27] IRC §511(c).
[28] Reg. §1.501(c)(2)-1(a); Rev. Rul. 66-295, 1966-2 C.B. 207.
[29] Discussed in §21.12.

companies are permitted to receive a de minimus amount of up to 10 percent of their gross income as unrelated income so long as the income is incidentally derived from ownership of real estate, such as parking lot fees. Such income is still subject to the unrelated business income tax, but will not cause the title-holding company to lose its exempt status.[30] Investment income earned by a title-holding entity that benefits a social club or voluntary employee benefits association (VEBA) is also taxable.[31]

Passive investments, other than real estate, that are also suitable as (c)(2) THC holdings include stocks and bonds and oil and gas royalties or production payments. Operating a merchandise store, managing a hotel, providing investment management services,[32] holding a working interest in an oil well, and other active business pursuits are not permitted.[33] When business activity is anticipated, the property should instead be spun off or transferred to a taxable "feeder" subsidiary.[34]

The calculation of taxable income from unrelated activity is based on the tax rules applicable to for-profit businesses and investors. Choice of depreciation methods, the definition of ordinary and necessary expenses that are deductible, tax rates, and other income tax rules apply. The calculation of taxable income from debt-financed property is based on a formula that equates the tax basis of the property in relation to the indebtedness.[35] When the THC receives unrelated business income, it is entitled to file a consolidated return with its parent organization under the rules applicable to normal for-profit corporations.[36] If separate returns are filed, the surtax exemptions must be shared, essentially reaching the same effective tax rate as if a common return was filed.

(b) Turning Over the Income

Accumulation of surplus income by a title-holding corporation generally is contrary to the statutory theme of turning over the income. As a rule, all net income must be paid over to the beneficiary organization. Deductions for depreciation[37] and reserves or sinking funds to make current or future mortgage payments[38] are allowed to be withheld from income required to be turned over. A reasonable provision for maintenance or restoration of the property can also be deducted from distributable income. Rents can also be used to repay an interest-free construction loan through an organization also controlled by the THC's parent.[39] Regarding the timing for distribution of funds, there is no specific requirement,

[30] Effective January 1, 1994.
[31] Reg. §1.501(c)(2)-1(a); see Section 9.5 and Chapter 21 for more detailed information about UBI.
[32] Rev. Rul. 69-528, 1969-2 C.B. 127.
[33] Rev. Rul. 66-295, 1966-2 C.B. 207.
[34] As defined in IRC §502.
[35] IRC §514.
[36] If both organizations qualify as includible organizations for purposes of IRC §1504; see Form 990-T instructions.
[37] Rev. Rul. 66-102, 1966-1 C.B. 133.
[38] Rev. Rul. 77-429, 1977-2 C.B. 189.
[39] Priv. Ltr. Rul. 9213027.

but a delay with no justification, as evidenced by a substantial surplus, might be expected to bring IRS scrutiny.

Payment to the beneficiary is customarily made in the form of cash dividends, or grants in the case of a nonstock corporation. When the THC owns the building occupied by the parent and no rent is paid, there may be no income generated and available to be paid. In such cases, the rent-free use of the building fulfills the statutory scheme.

(c) Why Form a Title-Holding Corporation?

A number of factors must be considered before deciding to form a title-holding corporation. Among the advantages of a THC are the opportunity it provides to shelter some assets from operating fund liabilities and the possibility of increasing the beneficiary organization's borrowing power. Setting up a THC can also facilitate separate management and administration of a corporation's physical plant. A THC might also be created to serve as a nonmember form of property ownership for a member-controlled organization.

There is, of course, a downside to the formation of a title-holding corporation. First, it increases paperwork burdens: Form 1024 must be filed to seek IRS recognition of its exemption and a separate Form 990 must be filed annually if gross receipts normally exceed $25,000. Some relief of the compliance burden may be gained by filing a consolidated tax return, which is permitted by IRC §1504(e).

On the other hand, there are situations in which the formation of a THC is ill-advised. The tax exemption of the THC is dependent upon the continued qualification of its beneficiary. If the parent company loses its exemption, the THC automatically loses its §501(c)(2) status.[40] Also, the THC cannot be used as a fund-raising vehicle, because donations to a THC generally do not qualify as charitable contributions under IRC §170. In a private ruling, the IRS has held that gifts to the parent dedicated expressly to a charitable project conducted by a THC, however, were deductible.[41]

10.4 §501(c)(25) TITLE-HOLDING CORPORATIONS

An IRC §501(c)(25) title-holding corporation serves a very narrow but significant purpose: to facilitate pooled purchasing and holding of real estate by a group of nonprofit organizations. It can hold no other type of asset and is available only to four specified types of tax-exempt organizations. Multiple unrelated exempt organizations may form a THC so long as it possesses the following characteristics:

- It must be a corporation or a trust.
- It must have no more than 35 shareholders or beneficiaries.
- It must have only one class of stock or beneficial interest.
- It must be organized for the exclusive purposes of acquiring real property, holding title to and collecting the income from such property, and remit-

[40] Rev. Rul. 68-371, 1968-2 C.B. 204.
[41] Priv. Ltr. Rul. 8705041.

ting the income (net of expenses) to one or more qualifying shareholders or beneficiaries.

- Its shareholders must be one of the following types of organizations:
  - §501(c)(3) organization
  - §401(a) qualified employee plan
  - §414(d) government plan
  - Federal, state, or local government agency or instrumentality

Since this type of exempt organization was created in 1986, the IRS has issued two notices providing detailed guidance for their establishment, which must be carefully studied by anyone contemplating the creation of a (c)(25) THC. The expanded criteria for qualification as fleshed out by the IRS include the following[42]:

- The articles of incorporation, bylaws, or trust document must contain language that clearly demonstrates that the entity satisfies the five statutory requirements previously listed.
- Removal of the investment advisor must be permitted by a majority vote of the beneficial owners.
- Termination of a beneficiary's interest must be allowed in one of only two ways: (1) by selling or exchanging its stock or interest to another qualifying (c)(25) organization (provided that the total number of shareholders remains below 35), or (2) upon 90 days notice, by having its shares or beneficial interest redeemed.

[42] IRS Notice 87-18, 1987-1 C.B. 455; IRS Notice 88-121, 1988-2 C.B. 457. There are no regulations nor published or private rulings on this code section as this chapter is being updated in 2003, although there have been a number of private letter rulings.

CHAPTER ELEVEN

Public Charities

The significance of "public charity" status for organizations tax exempt under Internal Revenue Code (IRC) §501(c)(3) is multifaceted and is of utmost importance to both private and public exempt organizations. Knowing the meaning of the four parts of IRC §509 is the key to understanding public charities. All §501(c)(3) organizations, other than those listed in §509(a)(1), (2), (3), and (4) are private foundations and are subject to the operational constraints outlined in

Chapters 12 through 17. The specific requirements of each of the §509 categories are described in this chapter. Briefly, the four categories of public charities are

1. §509(a)(1) organizations engaging in inherently public activity and those that receive revenues from the general public
2. §509(a)(2) organizations whose revenue stems primarily from charges for exempt function services
3. §509(a)(3) organizations that support another public charity
4. §509(a)(4) organizations that test for public safety

11.1 DISTINCTIONS BETWEEN PUBLIC AND PRIVATE CHARITIES

Private foundations (PFs) must comply with a variety of special rules and sanctions. The allowable contribution deductions for gifts to PFs are less than those afforded for public charities. It is useful for a charitable organization, when possible, to obtain and maintain public status. The important attributes of PFs, compared to public charities, are summarized in Exhibit 11.1. The comparison is described as follows, with the differences applicable to public charities presented in parentheses:

- The deduction for contributions by individuals to PFs is limited to 30 percent of the donor's adjusted gross income (AGI) for cash gifts and 20 percent for appreciated property gifts.[1] (Up to 50 percent of a donor's AGI can be deducted for cash gifts to public charity, and 30 percent for gifts of appreciated property.) To illustrate, assume that a generous taxpayer with an income of $1 million wants to annually give $500,000 in cash for charitable pursuits. Only $300,000 of the annual gift would be deductible if it is given to a private foundation. The full $500,000 is deductible if it is given to a public charity.
- The value of appreciated property, such as land, closely-held company stock, art works, or a partnership interest, is not deductible when the property is donated to a private, nonoperating, foundation. Only the basis of such property may be deductible.[2] The full fair market value of stocks for which market quotations are readily available on an established securities market is deductible. The maximum amount of the deduction, however, is limited to 20 percent of the donor's adjusted gross income.[3] (A full 30 to 50 percent of income can potentially be sheltered with gifts of most types of property to a public charity and private operating foundation.)
- An excise tax of 1 or 2 percent must be paid on a PF's investment income.[4] (There is no tax on investment income for a public charity.)

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[1] IRC §170(b)(1)(B).

[2] IRC §170(e)(1)(B) and (e)(5); unless the property is redistributed by the foundation in a timely fashion; see Section 15.4(a).

[3] IRC §170(e)(5)(D); this on-again-off-again provision was made permanent by the Omnibus Consolidated and Emergency Supplemental. See Section 15.5 for more details.

[4] Outlined in Chapter 13. CARE Bill, if approved, might reduce tax rate to a flat 1%.

EXHIBIT 11.1

Differences between Public and Private Charitable Organizations

	Charitable Deduction	Excise Tax	Activities	Minimum Distribution Requirements	Annual Filings
Private Foundations	Limited to 30% of AGI* for cash and qualified appreciated stock gifts Other property is limited to 20% and donor's tax basis	2% of investment income 5-15% of amount of disqualified transactions UBI taxed	Grants to other organizations Limits on grants to other PFs Self-initiated projects No lobbying	5% of fair market value of investment assets	All must file Form 990-PF
Private Operating Foundations	Limited to 30% for appreciated property, 50% for cash gifts	Same as for PFs	Carries out self-initiated projects	$3\frac{1}{3}$% fair market value investment assets or adjusted net income	Same as for private
Public Charities	Same as for private operating foundation	No tax on income (except UBI) Excise tax on excess lobbying and intermediate sanctions	Can lobby Grant-making or carry out own projects	None, unless excess accumulation of surplus	File if gross revenue over $25,000. Form 990 or 990EZ.

* Adjusted gross income.

- A PF cannot buy or sell property, nor enter into financial transactions (called *self-dealing*) with its directors, officers, contributors, or their family members, under most circumstances.[5] (Public charities can have business dealings with their insiders, within limits, subject to reasonableness standards. If excessive salaries or purchase price is paid to an insider, intermediate standards may be imposed.)[6]
- Annual returns must be filed by all PFs regardless of support levels and value of assets. (No return is required for public organizations with gross revenue less than $25,000, and an EZ form is available for many others.)[7]
- Fund-raising between PFs is constrained by expenditure responsibility requirements that prohibit one private foundation from giving to another without contractual agreements and follow-up procedures.[8] (No such similar documentation is required for grants paid from one public charity to another.)
- Absolutely no lobbying activity by PFs is permitted.[9] (A limited amount of lobbying is permitted for public charities under two different systems for measuring permissible amount.)[10] Absolutely no political activity is permitted either for public or for private charities.
- A PF's annual spending for grants to other organizations and charitable projects must meet a "minimum distribution" requirement.[11] (A public charity has no specific spending requirement, other than those imposed by its funders.)[12]
- Holding more than 20 percent of a business enterprise, including shares owned by board members and contributors, is prohibited for PFs, as are jeopardizing investments.[13] (No such limits are placed on public charities by the tax code, although fiduciary responsibility standards apply.)[14]

11.2 "INHERENTLY PUBLIC ACTIVITY" AND BROAD PUBLIC SUPPORT: §509(a)(1)

A wide variety of organizations qualify as public charities under IRC §509(a)(1). The (a)(1) category includes all those organizations tax exempt under IRC §501(c)(3) that are described in IRC §170(b)(1)(A)(i)-(vi), which lists organizations eligible to receive deductible charitable contributions. The definition is complicated and rather unwieldy because it includes six distinctly different

[5] Discussed in Chapter 14.
[6] See Section 20.9 for discussion of intermediate sanctions applicable to public charities, and Chapter 14 for discussion of self-dealing rules applicable to private foundations.
[7] See Chapter 18, and Jody Blazek, *IRS Form 990 Tax Preparation Guide for Nonprofits* (Hoboken: Wiley, 2004).
[8] See Chapter 17.
[9] See Chapter 17.
[10] See Chapter 23.
[11] Described in Section 15.3.
[12] Except for the commensurate test discussed in Chapter 2.
[13] Discussed in Chapter 16.
[14] See Chapter 16.

types of exempt entities. Because of the code's design, the categories are labeled with numerical letters.

The first five categories include those organizations that perform what the Internal Revenue Service (IRS) calls "inherently public activity."[15] The first three achieve public status because of the nature of their activities without regard to sources of funds with which they pay their bills—even if they are privately supported. The fourth and fifth are closely connected with governmental support and activities. Last, but certainly not least, because it includes a wide variety of charities, the sixth category includes those organizations balancing their budgets with donations from a sizeable group of supporters, such as the United Way, American Red Cross, governmental bodies, and many donors. They must meet a mathematically measured and contribution-based formula and can be referred to as *donative public charities.* A consideration of the rules that pertain to both donative public charities and service provider entities is important to understanding public charities. A comparison of the differences between the categories can be found in Section 11.5.

(a) Churches

The first category includes a "church, convention, or association of churches." Churches are narrowly defined and not all religious organizations are eligible to be classified as churches. Chapter 3 is devoted to these distinctions. Perhaps due to the need to separate church and state, neither the Internal Revenue Code nor the IRS regulations define a church.[16]

(b) Schools

Although the title does not say "school," the second category basically includes formal schools. A school is an "educational organization that normally maintains a regular faculty, has a regular curriculum, and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." The IRS very strictly scrutinizes what are referred to as the "four regulars" in granting classification as a school. Note that the world of educational organizations for purposes of IRC §501(c)(3) is much broader.[17]

(c) Hospitals and Medical Research Organizations

This class of public charity includes hospitals, the principal purpose or function of which is to provide medical or hospital care, medical education, or medical research. An organization directly engaged in continuous, active medical research in conjunction with a hospital may also qualify if, during the year in which the contribution is made, the funds are committed to be spent within five years.

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[15] 1992 Exempt Organizations Continuing Professional Education Technical Instruction Program, p. 216.
[16] Discussed in Section 3.2.
[17] Discussed in Section 5.1.

Medical care includes the treatment of any physical or mental disability or condition, on an inpatient or outpatient basis. A rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may qualify. Convalescent homes, homes for children or the aged, handicapped vocational training centers, and medical schools are not considered to be hospitals.[18] An animal clinic was also found not to be a hospital.[19] The issues involved in qualifying for tax exemption as a hospital are evolving, and close attention must be paid to the latest information.[20]

Medical research is the conduct of investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of physical or mental diseases and impairments of human beings. "Appropriate equipment and qualified personnel necessary to carry out its principal function must be regularly used." The disciplines spanning the biological, social, and behavioral sciences, such as chemistry, psychiatry, biomedical engineering, virology, immunology, biophysics, and associated medical fields must be studied.[21] Such organizations must conduct research directly. Granting funds to other organizations, while possible, may not be a primary purpose.[22] The rules governing a research organization's expenditure of funds and its endowment levels are complicated, and the regulations must be studied to understand this type of public charity. A participant in a joint venture is considered to conduct the activity of the venture. Tax-exempt participants in a whole hospital joint venture may be treated as providers of hospital care for purposes of qualification as a public charity under IRC §170(b)(1)(A)(iii).[23]

(d) College and University Support Organizations

An entity operating to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university qualifying under 170(b)(1)(A)(ii) is a public charity. Such entities must normally meet the 33 ⅓ percent test that means they receive a substantial part of their support from governmental grants and contributions from the general public, rather than from exempt function and investment revenues.

(e) Governmental Units

The United States, District of Columbia, states, possessions of the United States, and their political subdivisions are classified as governmental units. They are listed as qualifying as a public charity, although they are not actually tax-exempt under §501(c)(3). In essence, they are public charities because they are responsive to all citizens. The tax code in §170(c)(1) permits a charitable contribution deduction for gifts to governmental units. The regulations contain no additional

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[18] Reg. §1.170A-9(c)(1).
[19] Rev. Rul. 74-572, 1974-2 C.B. 82.
[20] These issues are discussed in Section 4.6.
[21] Reg. §1.170A-9(c)(2)(iii).
[22] Reg. §1.170A-9(c)(2)(v)(c); see also Section 5.3.
[23] Mary Jo Salins, Judy Kindell, and Marvin Friedlander, Chapter A, "Whole Hospital Joint Ventures," *IRS CPE Text,* 1999, by page 15; see Chapter 22.

definition or explanation of the meaning of this term, but IRS rulings and procedures and the courts have provided some guidance.[24]

(f) Donative Public Charities: §170(b)(1)(a)(vi)

Public charities in this category are called "donative public charities" because they normally receive at least 33 ⅓ percent of their annual support in the form of donations from members of the general public (not including fees and charges for performing exempt functions).[25] "Normally" is based on an aggregation of the four years preceding the year in question and the succeeding year: For the years 2004 and 2005, the revenue for 2000 through 2003 forms the basis for qualification, for example.[26] A five-year period is applied during an organization's initial advanced ruling period. The calculation is illustrated in Exhibit 11.2, the IRS training form provided to its specialists. It mirrors the page in Schedule A of Form 990[27] that is used to test an organization's ongoing qualification under this public support test. Before 1996, the Schedule A version did not include lines that reflect the percentage of public support. To arrive at includable donations for this type of public charity, a number of factors must be considered.

Donative organizations that receive an advance ruling of their public charity status in connection with their initial determination must file Form 8734 at the end of the advance period. Revisions on this procedure are proposed as this edition is being prepared.[28] It is suggested that this category of public charity be combined with the §509(a)(2) test described in this chapter. Readers must be alert for new developments on this important subject.

Support. The 33 ⅓ percent support formula for donative public charities does not include revenues the organization receives from performing its exempt activities—student tuition or patient fees, for example—as does the formula for §509(a)(2) service-providing organizations.[29] Donations of services for which a contribution deduction is not allowed[30] are also excluded. Donations from other donative (§509(a)(1)) public charities and governmental entities are fully included in the numerator and denominator for this test, but other types of donations are partly or fully excluded, as next explained. An organization that is primarily dependent upon exempt function revenues may qualify as a donative public charity,[31] but only if it receives more than an insignificant amount of donations from governmental units and the general public.

Sponsorship payments that are acknowledged by the tax-exempt organization without quantitative and qualitative information so as to avoid classification as advertising revenue can be treated as contributions for public support purposes.[32]

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[24] See Section 10.2.
[25] Reg. §1.170A-9(e)(2).
[26] Reg. §1.170A-9(e)(4).
[27] Illustrated in Chapter 3, Blazek, *IRS Form 990 Tax Preparation Guide* (New York: John Wiley, 2004).
[28] See Section 18.1.
[29] Reg. §1.170A-9(e)(7).
[30] IRC §170(e).
[31] Reg. §1.170A-9(e)(7)(ii).
[32] Reg. §1.513-4(c) discussed in Section 21.8(e); Reg. §1.170A-9(e)(6).

EXHIBIT 11.2

Internal Revenue Service Training Form

4. MAKING THE CALCULATION

a. A SUPPORT TEST WORKSHEET FOR IRC 509(a)(1)/170(b)(1)(A)(VI) ORGANIZATIONS

PRECEDING YEARS	(a) 1st	(b) 2nd	(c) 3rd	(d) 4th	(e) Total
1. Gifts, grants and contributions received (Do not include unusual grants)					
2. Membership fees received					
3. Gross income from interest, dividends, amounts received from payments on securities loans (IRC 512(a)(55)), rents, royalties and unrelated business taxable income (less IRC 511 taxes) from business acquired by the organization after June 30, 1975					
4. Net income from unrelated business activities not included in line 3					
5. Tax revenues levied for the organization's benefit and either paid to it or expended on its behalf					
6. The value of services of facilities furnished by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge.					
7. Other income. Do not include gain (or loss) from sale of capital assets					
8. Total of lines 1 through 7					

9. Enter 2% of line 8(e) ________

10. Add lines 1(e), 2(e), 5(e), and 6 (e) ________

11. Less: Contributions of individual donors in excess of 2% of aggregate total support (line 9) ________

12. Total public support (numerator) ________

13. Aggregate total support from line 8(e) (denominator) ________

14. Public support percentage (line 12 divided by line 13) ________

If line 14 is $33\frac{1}{3}$% or more, the organization qualifies under IRC 509(a)(1)/170(b)(1)(A)(vi). If line 14 is less than $33\frac{1}{3}$%, consider the facts and circumstances 10% test.

1992 Exempt Organizations Continuing Professional Education Technical Instruction Program, p. 223.

Two Percent Gifts. There is a 2 percent ceiling for donations treated as public support under this test. Contributions from each donor, whether an individual, corporation, trust, private foundation, or other type of entity (after combining related parties), during each four-year period are each counted only up to 2 percent of the charity's total support. For example, say an organization receives total support of $1 million during the four-year test period. In such a case, contributions from each donor (including gifts from his or her related parties) of up to $20,000 could be counted as public donations. If one person gave $20,000 each year for a total of $80,000 for four years, only $20,000 is counted. The $1 million organization must receive at least $333,333 in public donations of $20,000 or less from each donor to satisfy the one-third support test. It could receive $666,666 from one source and $10,000 from 33 sources or $20,000 from 17 sources, for example.

Grants from Other Charities. Voluntary grants and donations received by a donative public charity from other charities listed in §170(b)(1)(A)(i)-(vi) and from governmental units, including foreign governments,[33] are not subject to the 2% percent limit and instead are fully counted as donations from the general public,[34] unless the gift was passed through as a donor-designated grant over which the donor has control.[35]

It is important to note that the 2 percent limitation on inclusion in the public support test does not apply to grants from organizations described in IRC §170(b)(1)(A)(vi)—in other words, such grants are fully counted.[36] A grant from those organizations described in 170(b)(1)(A)(i)-(iv) that have sufficient public support to also qualify as donative public charities under 170(b)(1)(A)(vi) is likewise fully counted as public support.[37] It is sometimes the case that a service-providing organization classified as a §509(a)(2) public charity is also eligible for classification as a public charity under §170(b)(1)(A)(vi). If this fine distinction makes or breaks an organization's qualification as a publicly supported one, the Forms 990 (or for a church not required to file one, a financial statement) of grantors can be evaluated to ascertain their dual qualification as a donative charity.

A grant from a service-providing entity[38] and a grant from a supporting organization are subject to the 2 percent inclusion limitation.[39]

(g) Facts and Circumstances Test

When the percentage of an organization's public donations falls below the precise 33 1/3 percent test, it may be able to sustain public charity status by applying the facts and circumstances test. The history of the organization's fund-raising efforts and other factors are considered as an alternative method to the strict mathematical formula for qualifying for public support under (a)(1). This test is

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[33] Rev. Rul. 75-435, 1975-2 C.B. 215.
[34] Reg. §1.170A-9(e)(6)(i).
[35] As discussed in Section 11.3(c).
[36] Reg. §1.170A-9(e)(6)(i).
[37] Rev. Rul. 76-416, 1976-2 C.B. 57
[38] Reg. §1.170A-9(e)(6)(i) and (v).
[39] Priv. Ltr. Rul. 9203040.

not available for charities qualifying as public under §509(a)(2). An organization can seek to apply this test to prove it qualifies for public status by submitting the information in the following lists when originally filing Form 1023 or subsequently in submitting the Form 990. The applicant should spare no details evidencing that it meets the test. Brochures, board lists, program descriptions, and fund solicitations can be furnished. When reviewing Form 1023, the IRS will scrutinize the facts and issue its approval or disapproval. When an organization needs to apply the test later in its life because its support has fallen below the 33 ⅓ percent level, it has two choices. The information can be submitted as an attachment to Schedule A of its annual Form 990. The problem with this choice is that the IRS does not customarily respond to such a filing. Though prior IRS approval is not required, an organization might instead choose to seek approval by submitting the information to the Cincinnati office responsible for determinations.[40]

For the facts and circumstances test to apply, the following series of factors must be evidenced.[41] The first two factors in the following list must be present, and a sufficient number of the other favorable factors must indicate the organization is responsive to public interests. In the author's experience, control of the board by major contributors or their family members is a fatal flaw. The factors that are considered are fully explained in the regulations, which should be carefully studied in preparation of information evidencing satisfaction of the test.

- Public support must be at least 10 percent of the total support, and the higher the better.
- The organization must have an active "continuous and bona fide" fundraising program designed to attract new and additional public and governmental support. Consideration will be given to the fact that, in its early years of existence, the charity limits the scope of its solicitations to those persons deemed most likely to provide seed money in an amount sufficient to enable it to commence its charitable activities and to expand its solicitation program.
- The composition of the board is representative of broad public interests (rather than those of major contributors).
- Some support comes from governmental and other sources representative of the general public (rather than a few major contributors).
- Facilities and programs are made available to the general public, such as those presented by a museum or symphony society.
- Programs appeal to a broadly based public (and, in fact, the public participates).
- An organization is an educational or research institution that regularly publishes scholarly studies that are widely used by colleges and universities and the general public.

[40] See Section 18.3.
[41] Reg. §1.170A-9(e)(3).

- Members of the public having special knowledge or expertise, public officials, or civic or community leaders participate in or sponsor the programs of the organization.
- For a membership organization, the solicitations for dues-paying members are designed to enroll a substantial number of persons in the community or area and the dues amount makes membership available to a broad cross-section of the interested public.

(h) Unusual Grants

When inclusion of (a) substantial donation(s) causes an organization to fail the $33\frac{1}{3}$ percent public support test, public charity status may still be sustained by excluding such gift(s). A qualifying unusual grant can be excluded from gross revenue in calculating total support for both (a)(1) and (a)(2) purposes. A grant is unusual if it is an unexpected and substantial gift attracted by the public nature of the organization and received from a disinterested party. A number of factors are taken into account, no single factor is determinative, and not all factors need be present. The eight positive factors are shown in the following list, along with their opposites in parentheses:[42]

1. The contribution is received from a party with no connection to the organization. (The gift is received from a person who is a substantial contributor, board member, or manager, or is related to one.)
2. The gift is in the form of cash, marketable securities, or property that furthers the organization's exempt purposes. (The property is illiquid, difficult to dispose of, and not pertinent to the organization's activities—useless, in other words.) A gift of a painting to a museum or a gift of wetlands to a nature preservation society would be useful and appropriate property.[43]
3. No material restrictions are placed on the gift. (Strings are attached.)
4. The organization attracts a significant amount of support to pay its operating expenses on a regular basis, and the gift adds to an endowment or pays for capital items. (The gift pays for operating expenses for several years and is not added to an endowment.)
5. The gift is a bequest. (The gift is an inter vivos transfer.)
6. An active fund-raising program exists and attracts significant public support. (Fund solicitation programs are unsuccessful.)
7. A representative and broadly based governing body controls the organization. (Related parties control the organization.)
8. Prior to the receipt of the unusual grant, the organization qualified as publicly supported. (The unusual grant exclusion was relied upon in the past to satisfy the test.)

[42] Regs. §1.170A-9(e)(6)(ii) and §1.509(a)-3(c)(4).

[43] See Rev. Rul. 76-440, 1976-2 C.B. 58 concerning gift of large tract to be used in perpetuity to preserve the natural resources of a town.

If the grant is payable over a period of years, it can be excluded each year, but any income earned on the sums would be included.[44] The IRS has provided a set of "safe harbor" reliance factors to identify unusual grants. If the first four factors just listed are present, unusual grant status can automatically be claimed and relied upon. As to item 4, the terms of the grant cannot provide for more than one year's operating expense.[45]

11.3 COMMUNITY FOUNDATIONS

Billions of dollars in charitable assets is held in the United States by public charities called community foundations (CFs) or community trusts. The first such organization was created in 1914 in Cleveland, Ohio—The Cleveland Foundation. Now there are about 600 of them. The primary purpose of a CF is to raise funds and maintain endowments to support projects benefiting a particular local community or area. A prototypical CF is controlled by a governing body representing the city or area it serves. It receives a broad base of support from many sources, enabling it to meet the mechanical 33 1/3 percent support test or the facts and circumstances test.[46] The typical CF solicits and receives lifetime and testamentary gifts. It may collect donations in the form of modest gifts from individuals and businesses and also from major donors. Some affluent philanthropists want to avoid the administrative costs and the labyrinth of rules applicable in creating and operating one's own independent private foundation. They instead choose to establish a fund within a community foundation. Such donors often wish to maintain some control over their funds and to designate and restrict the manner in which funds are expended. As CFs have evolved through the years, two very different organizational structures are typically used, although a combination of the following may be used:

1. Sole or single nonprofit corporation or trust
2. Composite organization of otherwise taxable trusts, corporations, or unincorporated restricted funds that are treated as a single entity for exemption purposes. New York Community Trust, for example, has a number of different banks acting as its trustees, each holding one or more of its trusts and funds. The IRS says CFs "are akin to holding companies."[47]

The regulations governing CFs create the legal fiction of a single entity and were designed to limit donor control. When more stringent rules were imposed on privately funded charities in 1969, some existing private foundations were collapsed into community foundations.[48] CFs also became an attractive vehicle for new entities seeking to avoid the PF rules. Two different regulations refer to such conversions and affect the establishment of a new community foundation.[49]

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[44] Reg. §1.170A-9(e)(6)(ii)(c).
[45] Rev. Proc. 81-7, 1981-1 C.B. 621.
[46] Explained in Section 11.2(g).
[47] Topic K, *IRS CPE Text,* 1993 (for FY 1994), at 136.
[48] Some private foundations establish funds within community foundations to satisfy their annual distribution requirements, as described in Section 15.4(c).
[49] Regs. §1.170A-9(e)(10)-(14) and §1.507-2(a)(8)(iii).

Interestingly, the §509 regulation governing CFs refers to community trusts without mention of a corporation. The IRS has addressed qualification of a CF in a combined corporate/trust form.[50] In its training literature, the IRS says that "many CFs combine both forms of organization," but it also admits the issue is unsettled.[51] The IRS fought recognition of one corporate CF, the National Foundation, in 1987 because it felt donors had too much control over their funds.[52] Donors were allowed to recommend charitable projects subject to National's acceptance. The standard agreement forms, though, provided that once the donor committed the funds, National fully controlled them and was free to use or not use them as the donor suggested. The IRS argued that National was merely a conduit and provided evidence that National ordinarily honored requests for redistribution of funds without exercising independent judgment about needs most deserving of support. The court disagreed and approved National's recognition as a charitable and "unitary" organization without mention of the regulation. The Fund for Anonymous Givers fought a similar challenge because it not only gave donors discretion over grants but also control over investment of assets they contributed.[53] After the Fund for Anonymous Gifts amended its organizational documents retroactively to its inception to remove the donor's ability to place conditions subsequent to the gift on their contributions, an appeals court found that it qualified as a §501(c)(3) charitable organization.[54] On remand, the lower court again found that the control retained by donors prevented its qualification as a charitable entity.

Philanthropic Research Inc. (PRI), however, received approval of public charity status for a new donor-advised fund.[55] PRI proposed to use the fund to encourage donations to charities appearing on its Guidestar.org Web site. PRI plans to use due diligence to review recommendations made by donors and retain dominion and control over the donations. This criterion is also used for accounting purposes to determine whether the revenue belongs to the fund or whether it simply serves as a pass-through, or agent, for the donations to the suggested recipient charity.[56] Although the IRS has recognized their exempt status, funds created by financial institutions, such as the Fidelity Gift Fund, have been carefully scrutinized. Fidelity has imposed an annual distribution requirement on its accounts equivalent to the 5 percent minimum distribution.

Fundamentally, the IRS will apply two tests to determine whether a new CF can qualify for tax-exempt status:

1. Single entity test
2. Component part test

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[50] Gen. Coun. Memo. 37818 (Jan. 11, 1979); Gen. Coun. Memo. 38812 (Aug. 21, 1981).

[51] *CPE Text,* supra note 47, at 135.

[52] *National Foundation, Inc. v. U.S.,* 13 Cl. Ct. 486 (1987); also see Gen. Coun. Memo. 39748, released in 1988 and withdrawn in 1992.

[53] *The Fund for Anonymous Gifts v. IRS,* 79 AFTR 2d ¶97874.

[54] *The Fund for Anonymous Donors v. IRS*, No. 97-5142 (D.D.Cir. April 1999); 88 AFTR 2d ¶2001-5351.

[55] Priv. Ltr. Rul. 200037053.

[56] See Sections 11.5(d), 24.2(b).

(a) Single Entity Test

All of the legally separate entities operating under the aegis of a particular community foundation that meet the criteria outlined here are treated as part of a single entity, rather than as separate funds. The individual funds associated with a CF—whether trusts, not-for-profit corporations, unincorporated associations, or a combination thereof—are not treated as separate legal entities for tax purposes. Essentially, they are considered as part of a consolidated group and do not separately apply for recognition or exemption.[57]

- *Name.* The organization must be commonly known as a community trust, fund, foundation, or other similar name conveying the concept of a capital or endowment fund to support charitable activities in the community or area it serves.
- *Common Instrument.* All funds of the organization must be subject to a common governing instrument or a master trust or agency agreement, which may be embodied in a single or several documents containing common language. Making the component fund subject to the CF's governing instrument in the transfer documents is acceptable.
- *Common Governing Body.* A single or common governing body or distribution committee must control all components. Any restricted funds dedicated to a particular purpose or organization must be monitored by the governing body.
- *Power to Modify or Remove*. The CF's governing body must generally have the power—in the governing instrument, instrument of transfer, bylaws, or other controlling documents—to modify any restriction or condition on the distribution of funds. Particularly when a restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served, the CF must be able to prevail in disbursing the funds or income therefrom.
- *Exercise of Powers*. There must be a written resolution to replace any participating trustee, custodian, or agent for breach of fiduciary duty under state law. A breach would result when the charitable purposes are jeopardized due to improper disbursements of funds or a failure to produce a reasonable return on assets, for example.
- *Common Reports.* The periodic financial reports must be presented in a consolidated manner treating all funds as CF funds.

The variety of funds cited by the IRS as acceptable examples of component funds that can be offered or maintained within a CF include the following[58]:

- *Unrestricted Funds.* The CF has unfettered use of these funds—both the income and the principal. No restrictions or conditions on the management or distribution of the moneys can exist. The CF, not the donor, is

[57] Reg. §1.170A-9(e)(11)(i) for purposes of §§170, 501, 507, 508, 509, and Chapter 42.
[58] *CPE Text,* supra note 47, at 139.

expected to identify community needs and distribute funds according to those needs.

- *Memorial Funds.* Funds can be named after a particular person, family, private foundation, or historic event or catastrophe.
- *Field of Interest Funds.* These funds can be dedicated to a particular area of charitable need or concern—the arts, the poor, the homeless, higher education, religion, or similar charitable and social concerns. The types of interests for which funds are made available may be broad or narrow and can be designated or requested by the donors. The manner in which the interest is pursued, however, is up to the CF itself (whether to directly conduct a program or regrant the funds to another organization serving the interest).
- *Advised Funds*. The donor is given the right to make nonbinding suggestions as to the specific organization or projects to receive funding. The CF retains final authority to determine use of its income. See further discussion later in this section regarding limitations on donor designations.
- *Designated Funds*. The donor may specify the particular charitable purpose or organization to be supported with his or her funds.
- *Agency Endowments.* A designated fund supporting a particular local charity is established within the CF. The charity solicits donations made payable into the fund for its benefit. Such an agency arrangement may be advantageous to the local charity from an investment management standpoint.
- *Pooled Income Funds.* The income is paid to the donors during their lives, and upon the donors' death the principal and income is distributed to the CF.

(b) Component Part Test

Each qualifying component must be created by a gift, bequest, legacy, device, or other transfer to a community trust treated as a single entity, and the gifts may not be directly subjected by the transferor to any material restriction or condition. A donor may not encumber a fund with a restriction that prevents the CF from "freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes."[59] Essentially, the regulations are intended to prevent the creation of pseudoprivate foundations under an umbrella CF. The following donor-imposed restrictions are not considered material and are therefore allowed:

- *Name.* The fund may take the name of a private foundation, the fund's creator, or the creator's family.
- *Purpose.* The donor may designate that the income and principal be used for specified charitable purposes or one or more §509(a)(1), (2), or (3) organizations. The CF's governing body must be given the power to stop

[59] Reg. §1.507-2(a)(8).

distributions and recover any funds that were not used for the CF's exempt purposes.

- *Administration.* A separate or identifiable fund may be required by the donor. Distribution of some or all of the principal can be delayed in time.
- *Required Retention of Gift.* A donor may require the CF to keep the property if, because of the property's peculiar features, its retention is important to accomplishing the exempt purposes of the community, such as a historic property or wildlife preserve.

(c) Donor Designations versus Donor Directions

Donors may designate the purposes for which their funds are to be expended before or at the time the gift is made—not later. Reservation of the right to choose grantees or programs (donor direction) is not permitted once the fund is established. Recognizing that moral suasion can be imposed by philanthropists even without written direction, the regulations provide a list of factors indicating that donors have not reserved a right to designate[60]:

- The CF investigates the donor's advice and its investigation shows that the advice is consistent with specific charitable needs most deserving of support in the community.
- The CF has published guidelines listing the specific charitable needs of the community and the donor's advice is consistent with those guidelines.
- The CF has begun an educational program advising donors and other persons of its guidelines that list the specific charitable needs most deserving of support. These needs must be consistent with its charitable purposes.
- The CF disburses other funds to the same or similar organizations or charitable needs as those recommended by the donor. Other funds are from sources other than, and in excess of, those distributed from the donor's fund.
- The CF's solicitation for funds specifically states that it will not be bound by any advice the donor offers.

Impermissible donor retention of control is evidenced, according to the regulations, by the presence of two or more of the following factors[61]:

- The only criterion considered by the CF in making a distribution of income or principal from the donor's fund is the donor's advice.
- Solicitations of funds by the CF state or imply that the donor's advice will be followed. Also considered is a pattern of conduct by the CF that creates an expectation that the donor's advice will be followed.
- The donor's advice is limited to distributions of amounts from his or her fund and the CF has not (1) done an independent investigation to evalu-

[60] Reg. §1.507-2(a)(8)(iv)(A)(2); see also Chapter 1, *IRS CPE Text,* 1997.
[61] Reg. §1.507-2(a)(8)(iv)(A)(3).

ate whether the donor's advice is consistent with the charitable needs most deserving of support in the community, or (2) established guidelines that list the specific charitable needs of the community.

- The CF solicits advice regarding distributions from the donor's fund only from the donor, and no procedure is provided for considering advice from others.
- The CF follows the advice of all donors concerning their funds substantially all the time.

(d) Public Support Test

A community foundation must submit each year on Form 990 complete financial information to calculate its percentage of public support. Part IV of Schedule A[62] contains a separate box to identify an organization as a "community trust." The regulations specifically say a CF must meet the 33 1/3 percent public support test or, if not, the facts and circumstances test.[63]

11.4 SERVICE-PROVIDING ORGANIZATIONS: §509(a)(2)

Like those organizations said to conduct "inherently public" activities—churches, schools, and hospitals—the second major category of public charity includes entities that also provide services to the public—museums, libraries, low-income housing projects, and the like. Unlike churches, schools, and hospitals that qualify without regard to their sources of support, these service providers must meet public support tests. Also unlike donative public charities that disregard fee-for-service revenue in calculating public support, service providers count exempt function revenues and donations and grants as support, as shown in Exhibit 11.3. Thus, this category usually includes organizations receiving a major portion of their support from fees and charges for activity participation, such as day care centers, animal shelters, theaters, and educational publishers. A two-part support test must be met to qualify under this category:

1. Investment income cannot exceed one-third of the total support. (Total support basically means the organization's gross revenue except for capital gains.)
2. More than one-third of the total support must be received from exempt function sources (called "gross receipts") made up of a combination of the following:
    - Gifts, grants, contributions, and membership dues received from nondisqualified persons. Unusual grants[64] can be excluded.
    - Admissions to exempt function facilities or performances, such as theater or ballet performance tickets, museum or historic site admission fees, movie or video tickets, seminar or lecture fees, and athletic event charges.

[62] See note 27.
[63] Reg. §1.170 A-10.
[64] Explained in Section 11.2(h).

- Fees for performance of services, such as school tuition, day care fees, hospital room and laboratory charges, psychiatric counseling, testing, scientific laboratory fees, library fines, animal neutering charges, athletic facility fees, and so on.
- Merchandise sales of goods related to the organization's activities, including books and educational literature, pharmaceuticals and medical devices, handicrafts, reproductions and copies of original works of art, by-products of a blood bank, and goods produced by handicapped workers.
- Exempt function revenues received from one source are not counted if they exceed $5,000 or 1 percent of the organization's support for the year, whichever is higher.

A qualifying service provider cannot receive more than one-third of its revenue from investment income. Dividends, interest, payments with respect to security loans, rents, royalties, and net unrelated business income (less the unrelated business income tax, or UBIT) are treated as investment income for this purpose.[65] Program-related investments, such as low-income housing loans, do not produce investment income but rather exempt function gross receipts for this purpose.[66] An organization that is primarily dependent upon exempt function revenues may qualify as a donative public charity,[67] but only if it receives more than an insignificant amount of donations from governmental units and the general public.

This limitation on inclusion of service fees means an organization performing services for a few contractors cannot reach the required 33⅓ percent support level under §509(a)(2). Say for example, an organization that studies child abuse cases receives most of its revenue from two state agencies. Because only 1 percent of each agency's support can be counted, the organization may have as little as 2 percent qualifying support. Such organizations dependent primarily on gross receipts from related activities are precluded from qualifying instead as a §509(a)(1) organization if "it receives an insignificant amount of its support from governmental units and contributions made directly or indirectly by the general public."

The clear language of the tax code says, "The term unrelated trade or business does not include any trade or business which consists of conducting bingo games for purposes of imposing a tax on the income."[68] For purposes of calculating public support, however, the Tax Court and the IRS agree that the income from legally permitted gambling—bingo, pull-tabs, or, in one case, "pickle cards"—is unrelated, rather than related, income, albeit excluded from tax under an exception. Since such income is not generated in performing a charitable service of the sort listed in the preceding bullet points, it cannot count as qualifying public support for §509(a)(2) purposes.[69]

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65 IRC §509(e).
66 Reg. §1.509(a)-3(m). For discussion of program-related investments, see Section 16.2(d).
67 Reg. §1.170A-9(e)(7ii).
68 IRC §513(f), discussed in Section 21.9(d).
69 *Education Athletic Association*, TCM 1999-75.

11.5 DIFFERENCE BETWEEN §509(a)(1) AND §509(a)(2)

Some publicly supported organizations, including most churches, schools, and hospitals, can qualify for public status under both §§509(a)(1) and (a)(2). In such cases, the (a)(1) class will be assigned by the IRS to identify the organization's category of public status. For purposes of annual reporting, unrelated business, limits on deductions for donors, and most other tax purposes, the two categories of public charity are virtually the same, with two important exceptions. To receive a terminating distribution from a private foundation upon its dissolution and for a grant from it to another charity to be fully counted for public support purposes, the charity must be an (a)(1) organization.[70] Secondly, only a grant from another 509(a)(1) organization is treated as public support for a §509 (a)(1) organization.

(a) Definition of Support

The items of gross income included in the requisite "support" are different for each category and do not necessarily equal total revenue under either class. Calculations for both categories are made on a four-year moving average basis using the cash method of accounting.[71] Those Form 990 filers reporting income and expenses on an accrual basis for financial purposes are directed to follow this "book method" for the main body of Form 990 and most other tax purposes. Accordingly, an organization computing its qualification as a public charity based upon its sources of revenue must essentially keep detailed revenue records using both a cash and an accrual method. For (a)(1) purposes, certain revenues are not counted as support and are not included in the numerator or the denominator[72]:

- Exempt function revenue, or that amount earned through charges for the exercise or performance of exempt activities, such as admission tickets, patient fees, and such
- Capital gains or losses
- Unusual grants
- Donations of in-kind services and facilities (do count facility and service donations from governmental units)

For (a)(2) purposes, total revenue less capital gains or losses, unusual grants, and in-kind service and facility donations equals total support. An increase or decrease in the equity value of an organization's for-profit subsidiary is recognized as revenue for financial statement purposes. Such revenue is essentially capital in nature. The author finds no guidance on the subject and suggests such revenue is excluded from total support for both 509(a)(1) and 509(a)(2) organizations, but she invites comments.

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70 IRC §507(b)(1)(A). See also Section 12.4 regarding termination of private foundations.

71 Gen. Coun. Memo. 39109 and Reg. §1.509(a)-3(k).

72 Reg. §1.170A-9(e)(7); an expanded discussion of the different types of revenue can be found in Blazek, *990 Handbook* (New York: John Wiley).

EXHIBIT 11.3

Internal Revenue Service Training Form

E. A SUPPORT TEST WORKSHEET FOR IRC 509(a)(2) ORGANIZATIONS

PRECEDING YEARS	(a) 1st	(b) 2nd	(c) 3rd	(d) 4th	(e) Total
1. Gifts, grants and contributions received (Do not include unusual grants)					
2. Membership fees received					
3. Gross receipts from admissions, merchandise sold or services performed or furnishing of facilities in any activity that is not a business unrelated to the organization's charitable, etc., purposes					
4. Gross income from interest, dividends, amounts received from payment on securities loans (IRC 512(a)(5)), rents, royalties, and unrelated business taxable income (less IRC 511 taxes) from businesses acquired by the organization after June 30, 1975					
5. Net income from unrelated business activities not included in line 4					
6. Tax revenues levied for the organization's benefit and either paid to it or expended on its behalf					
7. The value of services or facilities furnished by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge					
8. Other income. Do not include gain (or loss) from sale of capital assets					
9. Total of lines 1 through 8					
10. Enter 1% of line 9					

11. Add lines 1(e), 2(e), 3(e), 6(e) and 7(e) ____________

12. Deduct: Income from disqualified persons
Exempt function income exceeding $5,000/1% limit ____________

13. Line 11 less line 12 = public support (numerator) ____________

14. Total support from line 9(e) (denominator) ____________

15. Public support percentage (line 13 divided by line 14) ____________

If line 15 is 33 $^1/_3$ % or more, the public support test is met. Go on to gross investment test. If line 15 is less than 33$^1/_3$%, the organization will not qualify under IRC 509(a)(2).

16. Investment income from line 4(e) ____________

EXHIBIT 11.3 *(CONTINUED)*

Internal Revenue Service Training Form

17. Unrelated business income on line 5(e) less tax paid on that income	______
18. Total of lines 16 and 17 (numerator)	______
19. Total support from line 9(e) (denominator)	______
20. Gross investment percentage (line 18 divided by line 19)	______

If line 20 is less than 33 1/3%, the gross investment test is met. If line 20 is 33 1/3% or more, the organization will not qualify under IRC 509(a)(2).

1992 Exempt Organizations Continuing Professional Education Technical Instruction Program, p. 231.

(b) Donations/Grants Not Counted

Contributions received are counted as public support differently for each category. For planning purposes, these rules are extremely important to consider. Under the (a)(1) category, a particular giver's donations are counted only up to an amount equal to 2 percent of the total "support" for the four-year period.[73] Gifts from §170(b)(1)(A)(vi) public charities and governmental entities are not subject to this 2 percent floor; grants from those classified as public under §170(b) (1)(A)(i)-(v) are said to be counted only up to 2 percent.[74]

For (a)(2) purposes, all gifts, grants, and contributions are counted as public support, except those received from disqualified persons.[75] Such a person may be a substantial contributor or current board member and the close relatives of such persons. A substantial contributor is one who has given over $5,000, if such amount is more than 2 percent of the aggregate contributions received by the organization throughout its life.[76] For (a)(2) purposes, gifts from these insiders are not counted at all but on a year-by-year basis. Subject to the 2 percent ceiling, their gifts are counted for (a)(1) purposes. Grants from other public charities classified under 509(a)(1) are fully counted. Although they are excluded from the definition of substantial contributors under IRC §507, another 509(a)(2), a 509(a)(3), or other category of 501(c) organization is treated as disqualified persons and their grants subject to limitations on their inclusion in public support for this purpose.[77]

(c) Types of Support

Not all revenue is counted as support. The basic definition of "support" for both categories excludes capital gains from the sale or exchange of capital assets, but other types of gross revenue are counted differently under the two categories.

[73] See Section 11.2(f).
[74] Conceivably, a grant from such an organization could be fully counted if it can be shown to qualify under the 170(b)(1)(A)(vi) test.
[75] "Disqualified persons" are defined in IRC §4946 and discussed in Chapter 12; Reg. §1.507-6(a)(2).
[76] See Section 12.2 for definitions of these terms.
[77] Reg. §1.507-6(a)(2).

1. *Individual contributions.* Volunteer payments motivated by the desire to help finance the exempt activities of both types of public charities are treated as contributions. Such payments are made with the intention of making a gift with no expectation of return or consideration other than intangible recognition, such as inclusion of a name on a sponsor list or on a church pew.
2. *Business donation.* Grants from corporations or other businesses are similarly reported as direct public support by both types. Proceeds of a cause-related marketing campaign, also referred to by the IRS as *commercial co-ventures,* are treated as contributions.[78] No value is assigned to the fact that purchase of business products is encouraged by use of the charity's name in such a sales promotion. Sponsorship payments that are acknowledged by the tax-exempt organization without quantitative and qualitative information so as to avoid classification as advertising revenue can be treated as contributions for public support purposes by both categories.[79]

Membership fees for both categories may represent a charitable donation or fee for services depending on "commensurate rights and privileges" provided to members. A pure donation exists when the benefit is only the personal satisfaction of being of service to others and furthering the charitable cause in which the members have a common interest.[80] When the payment purchases admission, merchandise, services, or the use of facilities, an *exchange transaction* occurs and service revenue is realized. In some cases a combined gift and payment for services may be present. The facts in each circumstance must be examined to properly classify the revenue. Under the enhanced scrutiny of the IRS's Special Emphasis Program[81] on deductibility of charitable gifts, some organizations realized that their members are not necessarily making contributions. In such cases, the donor disclosure rules must be studied.[82] Particularly for (a)(1) purposes, this distinction is very important, because exempt function fees are not included in the public support calculations.

Government grant awards that represent support for the recipient organization to carry on programs or activities that further its exempt purposes are treated as contributions.[83] Such grants are said to give a direct benefit primarily to the general public rather than an economic or physical benefit to the payor of the grant. Instead, some grants are payments in exchange for services to serve the needs of the government agency.[84] When a sale of goods, performance of a

[78] See Section 24.2(d).

[79] For purposes of §1.170A-9(e)(6)(i) and §1.509(a)-3(f)(1), the term *contributions* includes qualified sponsorship payments (as defined in §1.513-4) in the form of money or property (but not services). See Section 21.8(e).

[80] Reg. §509(a)-3(h).

[81] See Chapter 24.

[82] Reg. §1.170-13(f)(8); see Section 24.4(b) for classification of member benefits and other donor disclosure rules.

[83] Reg. §1.509(a)-3(g).

[84] Rev. Rul. 83-153, 1983-2 C.B. 48 provides similar treatment for state agency payments to a youth care facility.

service, or admission to or use of a facility must be delivered or provided specifically to the grantor, exempt function revenue is received. Money a health-care provider collects from the state for treatment of indigent patients is referred to under GAAP as *exchange transactions.* The terms of the grant agreement indicating gross receipts from a service contract, as contrasted to those terms identifying a contribution, might include the following:

- Specific delivery of services is required within a specific time frame (time for performance at discretion of grantee).
- Penalties beyond the amount of the grant can be imposed for failure to perform (the only penalty is return of the grant for not conducting a specific program or some other restriction).
- Goods or services are furnished or delivered only to the grantor (program recipients are other than the grantor).

Under both categories, this distinction is important to determine amounts qualifying as contributions. For (a)(2) status, the distinction has yet another dimension. The amount of service fees included as public support from a particular person or organization is limited to 1 percent of gross revenue or $5,000, whichever is higher.[85] This limitation on inclusion of service fees means an organization performing services for a few contractors cannot reach the required 33 1/3 % support level under §509(a)(2). Say, for example, that an organization that studies child abuse cases receives most of its revenue from two state agencies. Because only 1% of each agency's support can be counted, the organization may have as little as 2% qualifying support. Such organizations dependent primarily on gross receipts from related activities are precluded from qualifying instead as a §509(a)(1) organization if "it receives an insignificant amount of its support from governmental units and contributions made directly or indirectly by the general public."[86] Moneys received from a third-party payor, such as Medicare or Medicaid patient receipts[87] or charges collected by a hospital as agent for a blood bank,[88] are considered as gross receipts from the individual patients for services rendered.

In-kind gifts are counted differently for each category. For (a)(1) purposes, the regulation specifically says support does not include "contributions of services for which a deduction is not allowable."[89] For (a)(2) purposes, the regulation says support includes the fair market or rental value of gifts, grants, or contributions of property or use of such property on the date of the gift.[90] Under (a)(1), the regulations and the IRS instructions to Form 990 are silent about gifts of property that are deductible. It is not stated whether the full fair market value of property whose deductibility is limited to the donor's tax basis, such as a gift of

[85] IRC §509(a)(2)28(ii).
[86] Reg. §1.170A-9(e)(7)(ii).
[87] Rev. Rul. 83-153, 1983-2 C.B. 48 says that these payments are gross receipts from an exempt function, not a government grant, because individuals choose their own health-care providers.
[88] Rev. Rul. 75-387, 1975-2 C.B. 216.
[89] Reg. §1.170A-9(e)(7)(b).
[90] Reg. §1.509(a)-3(f)(3).

clothing to a charity resale shop, is counted at full value or at basis. For accounting purposes, the organization would count such gifts at their full value.

Supporting organization grants and split-interest trust gifts to an (a)(1) public charity are subject to the 2 percent limit. Importantly for (a)(2) entities, such gifts also retain their character as investment income for purposes of limiting the amount of investment income it is allowed to receive.[91]

(d) Funds Received as Agent

Grants received from another public charity are counted totally toward public support unless the gift represents an indirect grant expressly or implicitly earmarked by a donor to be paid to a subgrantee organization. In that case, the donor for public support purposes is the individual.[92] Donor-designated grants therefore require careful scrutiny. The basic question is whether the intermediary organization received the gift as an agent or whether it can freely choose to regrant the funds. Donations received by donor-advised funds and community foundations qualify as public support to the initial recipient organization (and again to the ultimate recipient) if the fund retains ultimate authority to approve the regrants.[93]

What constitutes a variance power over a grant received by a fund-raising organization has been the subject of a lot of discussion and concern since the Financial Accounting Standards Board issued its FASB #136 in June 1999. The standard says that "when acting as an agent, trustee or intermediary," the reporting entity does not recognize revenue. A fund-raising organization is an agent when it receives gifts designated for specified beneficiaries unless the donor specifically grants "variance power' in the instrument conveying the gift. Such a power is defined as a "unilateral power to redirect the use of the transferred assets away from the specified third-party beneficiary." The United Way of America vigorously objected to the issuance of this standard. With a significant decline in its reportable revenues, the United Way's ratio of organizational costs to revenues would be unacceptably high. After losing the FASB battle, the United Way of Southeastern Pennsylvania (UWSP) asked the IRS for its opinion on the matter.[94] Based on the facts and circumstances, the IRS determined that donations to UWSP's Donor Choice/Specific Care Program were reportable as revenue. A number of factors indicated to the IRS that the UWSP exercises a significant degree of control and discretion over the designated funds. UWSP receives payment of the pledges and is entitled to income from investing the money until it is paid out on one of five annual distribution dates. UWSP has the discretion to approve, or fail to approve, the application of any organization that is suggested as a designated recipient. UWSP as a policy withholds distributions from charities in legal or other troubling situations that leave doubt as to the charities' ability to

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[91] Reg. §1.509(a)-5(a)(1); Priv. Ltr. Rul. 9203040.

[92] Reg. §1.509(a)-3(j).

[93] Gen. Coun. Memo. 39748 was issued in 1988 to clarify this subject and was later withdrawn with Gen. Coun. Memo. 39875.

[94] See also Ward L. Thomas and Leonard J. Henzke, Jr., Chapter C, "Agency: A Critical Factor in Exempt Organizations and UBIT Issues," *IRS CPE Text*, 2002, pp. 127–154.

use the funds for charitable purposes. Additionally, UWSP recovers its fund-raising costs from pledged gifts through a charge against such pledges. Because UWSP controls the amount of its costs, it "virtually controls the gift to the designated charity." The IRS ruled that UWSP had sufficient interest in the pledges it received to be considered as possessing all right, title, and interest in and to the pledges of designated gifts.[95] Therefore, the designated gifts could be counted as public support by UWSP because they were not "earmarked." The ruling also noted that UWSP's Form 990 would reflect a reconciling item in Part IV-A adding designated gifts to revenues reported for financial statement purposes.

(e) Change of Public Charity Category

Sometimes the sources of a public charity's support change, causing it to fail to qualify under one category or another. When the change indicated is reclassification from (a)(1) to (a)(2) or vice versa, the factors discussed in Section 18.3(e) should be considered. Simply reporting the financial information on Schedule A may be sufficient to allow an organization to continue its public status; the issue is whether to seek overt IRS approval and a new determination letter.

(f) Loss of Public Status

A more serious situation arises when the changes in support cause the organization to lose its public charity status. Importantly, the loss of status is not immediate; if the financial tally submitted with the organization's 2003 return reflects that support for the years 1999–2002 was less than the requisite one-third, public status continues through the year 2004. If a material change in the organization's sources of support occurs that is not caused by an unusual grant, a five-year testing period may apply.[96] Special rules also apply for new organizations.[97] Until a change of status is announced in the Internal Revenue Bulletin, contributors are entitled to rely upon the latest IRS letter. A donor who is responsible for or otherwise aware of the changes is not necessarily entitled to such reliance.[98] This issue is particularly troublesome for private foundations.[99]

A charitable organization classified as a public charity for reasons of its revenue sources should monitor its ongoing qualification with projections of future support. Development department targets should be set with a view both to the annual spending needs of the organization and also to meeting the 33 1/3 percent test. The test is based on a four-year moving average, and the results can vary significantly from year to year. Say, for example, a new organization was successful in soliciting donations for an endowment fund from a significant number of supporters in its first year of existence. Or for a different but similar situation, assume a new organization was created to receive the assets of a nonprofit hos-

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[95] Citing Reg. §1.507-2(a)(8) that applies to determine when a complete transfer of assets has been made by a terminating private foundation.

[96] Reg. §1.170A-9(e)(4) and §1.509(a)-3(c)(1)(ii).

[97] Reg. §1.170A-9(e)(5) and §1.509(a)-3(c)(1)(iv).

[98] Reg. §1.170A-9(e)(5)(iii) and §1.509(a)-3(c)(1)(iii).

[99] See Section 17.4(a).

pital (meeting the §170(b)(1)(A)(vi) tests) that sold its health care operations to another entity. The funds are to be invested to raise funds to support public health programs. In both cases, the support in its first year of existence results in a very high public support level of 80 percent. The donations in the first year impact (and improve) the ratio for four years. It is in the fifth year, when they are not counted, that the ratio could fall to below 33 ⅓ percent (when most of the funding comes from investment income).

An organization that expects its support level to fall below 33 ⅓ percent can take a number of steps. First, the accounting classification of its revenues and the category of public support should be evaluated to be sure they are correct. It is often the case that an organization can qualify as both a §509(a)(1) and a §509(a)(2) organization; thus, the calculations should be made under both categories. Accounting standards treat some government grants as fee-for-service revenue that, under tax standards, can be treated as donations.[100] Next, past donations can be reviewed to determine if any major grants can be excluded from the calculation because they possess most of the eight criteria for an "unusual grant."[101] The organization would also review its satisfaction of the nine criteria for meeting the "facts and circumstances" test.[102] Both of these tests involve some amount of subjective judgment as to qualification. In the latter test, however, there are facts that an organization can seek to achieve with advance planning. The board can be expanded to prove it represents broad public interests. Programs can be designed that involve public institutions and government and community leaders. The scope and participation in programs could be targeted for expansion. New solicitation techniques could be attempted. The point of the "facts and circumstances" test is to show that, despite its receipt of large donations from a few sources, the organization is responsive to and designed to benefit a broad public constituency and is not controlled by private individuals. Lastly, if the projects indicate the organization will not be able to meet any of the public support tests, the organization might initiate its merger with or acquisition by another public charity.

11.6 SUPPORTING ORGANIZATIONS: §509(a)(3)

The third category of organizations that escape the stringent requirements placed upon private foundations is supporting organizations (SOs). If such organizations are sufficiently responsive to and controlled or supervised by or in connection with one or more public charities, they are classified as public charities themselves, even if they are privately funded.

Basically, supporting organizations dedicate all of their assets to one or more public charities that need not necessarily control them (except an SO cannot be controlled by disqualified persons). Beneficiary organization(s) must be specified, but can be changed under certain conditions. This flexibility makes SOs popular with benefactors who want neither to create a private foundation nor to

[100] Discussed in Section 11.5(c).
[101] Discussed in Section11.2(h).
[102] Discussed in Section 11.2(g).

make an outright gift to an established charity. The rules are not entirely logical, and the regulations are quite detailed and extensive. The questions that must be answered on Form 1023, Schedule D[103] for organizations seeking this classification are also instructive. An SO must meet three unique organizational and operational tests as follows:

1. It must be organized and, at all times thereafter, operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified public charities (purpose test).
2. It must be operated, supervised, or controlled by or in connection with one or more public charities (organizational test).
3. It cannot be controlled, directly or indirectly, by one or more disqualified persons.[104]

The IRS rather reluctantly issues public charity status to organizations claiming to qualify as supporting organizations. The IRS chart in Exhibit 11.4 provides an excellent overview of the complicated tests that must be satisfied for an organization to gain the SO classification.[105] In its fiscal 2000 *CPE Text,* the IRS focused on "Inappropriate Use of Supporting Organizations." The IRS adds more examples of the tests in its fiscal 2001 *CPE Text.*[106] One of three very different types of relationship must exist between the supporting organization and the organization(s) it supports, as described in the following section.

(a) Purpose Clause

A supporting organization must be organized and at all times thereafter be operated exclusively (1) for the benefit of, (2) to perform the functions of, or (3) to carry out the purposes of one or more specified IRC §509(a)(1) or (2) organizations—a "public charity."[107]

The articles of organization must limit the purposes to those previously listed, in addition to the regular constraints on operations imposed upon 501(c)(3) organizations.[108] The categories of purpose—whether charitable, religious, or educational—may be very broad. Classic examples of suitable SO purposes would be to raise money for the publicly supported hospitals in an urban medical center, to fund the medical library of the center, or to build and maintain a chapel for the center.

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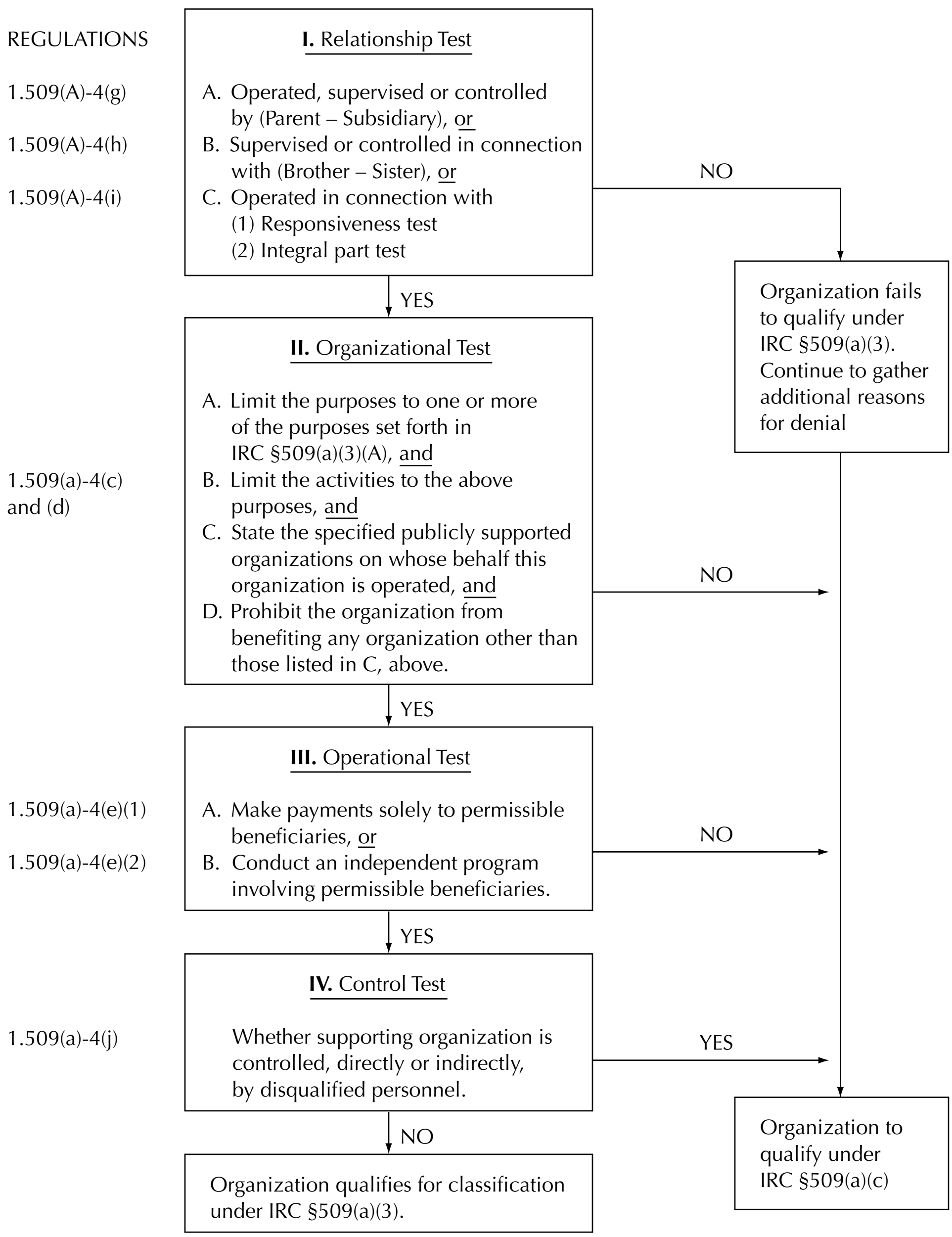
[103] Watch for author's web-based book on a revised Form 1023 expected in fall of 2004.
[104] IRC §509(a)(3)(A).
[105] 1992 Exempt Organizations Continuing Professional Education Technical Instruction Program, p. 233.
[106] Ron Shoemaker and Bill Brockner, Chapter G, "Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions," *IRS CPE Text,* 2001, pp. 107–134.
[107] IRC §509(a)(3)(A).
[108] Reg. §1.509(a)-4(c)(1); see discussion in Chapter 2.

EXHIBIT 11.4

Basic Steps in Making an IRC §509(a)(3) Determination

Of the tests set forth in the statute, the relationship test of IRC §509(a)(3)(B) is the most important. Therefore, whether there is a proper relationship between the organizations should be determined first. The order to proceed in making a determination under IRC §509(a)(e) is as follows:



Source: Chart prepared by Jeanne S. Gessay, Chief of Exempt Organization Rulings Branch II, IRS National Office, Washington, DC.

(b) Specified Public Charities

Supporting organizations most commonly operate to benefit one or more specified public charities as literally required by the code and regulations. Nonetheless, a complex labyrinth of terms allows nondesignation to occur. When the Type A relationship exists ("operated, supervised or controlled by"), a class of organizations dedicated to a specific purpose can be named.[109] A class of beneficiary organizations, such as "Catholic churches in Milwaukee" or "institutions of higher learning in California" may be named (rather than naming individual churches or schools) if the public charities are in control. The SO's charter can have the following latitude[110]:

- It may permit the substitution of public charities.
- It may permit new or additional beneficiaries of the same class.
- It may permit the SO to vary the amount of support among different public organizations within the class.

Slightly different rules exist for Type B, or entities "operated in connection with." First and foremost, specific beneficiaries must be named in the charter. However, the articles may permit certain changes.[111] Particularly when one of the benefited organizations loses its tax exemption, fails, or abandons operations, substitution is permitted. However, it is not permissible to retain the right to change when the supported organization becomes "unnecessary, undesirable, impractical, impossible, or no longer adapted to the needs of the public."[112]

(c) Operational Control

The supporting organization must have one of three special types of relationship, described here, with its supported public charity(ies).[113] Simply turning over all of the SO's income to a specifically named charity in accordance with the SO's articles of incorporation is not sufficient. An entity may not meet this operational test even though it satisfies the §501(c)(3) operational tests. The three types of relationships are as follows[114]:

- *Type A: Operated, Supervised, or Controlled By.* An SO is operated, supervised, or controlled by its beneficiary organization(s) when it essentially functions in a parent-subsidiary relationship. A substantial degree of direction is exercised by the parent over programs, policies, and activities. The SO, or subsidiary, is accountable and responsible to the parent, or supported organization. This type is found when a majority of the controlling officials of the SO are appointed by the supportees, although any one of a group of beneficiaries need not control if all are represented.

[109] Reg. §1.509(a)-4(d).
[110] Reg. §1.509(a)-4(d)(3).
[111] Reg. §1.509(a)-4(d)(4).
[112] *William F., Mable E., and Margaret K. Quarrie Charitable Fund v. Commissioner,* 70 T.C. 182, 187 (1978), aff'd., 603 F. 2d 1274 (7th Cir. 1979).
[113] IRC §509(a)(3)(A), (B), and (C).
[114] Reg. §1.509(a)-4(f).

- *Type B: Supervised or Controlled in Connection With.* This type of relationship exists when the same persons control both the supporting and the supported organization, or, in other words, there is common control or supervision.
- *Type C: Operated in Connection With.* This type of SO is the most independent of its supportee(s), as it may have a totally independent board with specific named beneficiary organization(s). Because of its relative freedom, it must meet two additional tests to qualify: the responsiveness and the integral part tests.

Responsiveness. To meet the responsiveness test, the supported organization must have a significant voice in the SO's governance.[115] This voice is gained when one or more officers or directors of the SO are appointed or elected by the supported organization's board or officers. In the case of a charitable trust, responsiveness is present when the supportee is named, and the named supportee has the power to enforce the trust and to compel an accounting under state law.

Integral Part. The integral part test essentially determines whether the supportee is dependent upon the SO for the type of support it provides.[116] The SO must maintain a significant involvement in and devote its assets to the supportee's activities. The SO can conduct active programs, it might provide and maintain facilities or equipment, it might conduct a function or activity that the supportee itself would normally carry out, and it can simply grant its income to the supportee (if the attentiveness test is satisfied).[117] The SO might also conduct fund-raising programs and unrelated businesses (on a limited scale) to raise funds in support of its publicly supported organization.

The amount of an SO's income that must be expended to meet the integral part test is, as a general rule, substantially all of its annual income. Income for this purpose is defined by reference to the private operating foundation rules[118] and includes short-term, but not long-term, capital gains.[119] Some 85 percent of annual income is the substantial amount the IRS wants to see distributed each year.[120] All of the income need not be paid over in the year in which it is earned but can be accumulated if a good reason can be shown.[121]

Attentiveness. A subset of the income test portion of the integral part test is called "attentiveness" and says the SO's support must be sufficient in amount to ensure that the supported organization will be attentive to its operations.[122] The regulations suggest that the test is passed when it can be shown that the funds

[115] Reg. §1.509(a)-4(i)(2).
[116] Reg. §1.509(a)-4(i)(3).
[117] Reg. §1.509(a)-4(e)(2).
[118] IRC §4942(f)(1).
[119] Priv. Ltr. Ruls. 9714006 and 9730002 based upon the definition as interpreted by Rev. Rul. 76-208, 1976-1 C.B. 161.
[120] Rev. Rul. 76-208, 1976-1 C.B. 161.
[121] Gen. Coun. Memo. 36523.
[122] Reg. §1.509(a)-4(i)(3)(iii)(d).

are needed to avoid an interruption of the supported organization's particular functions or activities. Attentiveness manifested by required reporting, investment oversight, or scope of accomplishments is taken into consideration. The IRS has privately ruled that merely granting the supportee organization's annual income to the supported organization is insufficient to constitute "performs(ing) the functions of, or carrying out the purposes of" test.[123] A trust that paid all of its income to a city to maintain a science center named after its creator was found to fail the first part of the integral part test. To compare a good example of suitable attentiveness, see *Cockerline Memorial Fund*[124] and compare Roe Foundation Charitable Trust as an entity that failed to meet the "in connection with" relationship test.[125]

In evaluating satisfaction of the attentiveness test, the portion of the supportee's overall support that is provided by the SO is considered. While there is no specific numerical test in the regulations, the amount of monetary support received by the supported organization must constitute a sufficient part of its total support (spending) to represent attentiveness. In one situation, less than 10 percent was considered to be unlikely, by itself, to ensure attentiveness.[126] This 1975 General Counsel Memo (GCM) is still followed by the IRS determination group in evaluating approval of an exemption application. Another example in the memo approved of an organization that provided 2 to 6 percent of the support of each of four supported organizations. Although the percentage for each supportee would not normally be enough to meet the integral part test, the support, when combined with other facts, was satisfactory. The individual grants were substantial and had been paid for more than 20 years, and various financial and tax reports were provided to allow the supportees to exercise requisite attentiveness. If payments are in support of a particular department or school of a university, hospital, or church, the denominator will be that department's overall support.

In another example, "attentiveness" was achieved under the "all pertinent factors" test.[127] The facts indicate that the organization, a trust, was making grants to a zoo, a part of the city government, for the purpose of aiding the zoo in animal acquisition and housing. Among the factors indicating attentiveness was that the zoo was historically a component part of the city government and that the trust was only one of two nongovernmental organizations to support the zoo. Where a supported organization is not dependent on the supporting organization for a sufficient amount of support, the integral part test is not met merely because the supported organization has enforceable rights under state law.[128]

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[123] Priv. Ltr. Rul. 9730002.

[124] *Cockerline Memorial Fund v. Commissioner*, 86 T.C. 53 (1986).

[125] *Roe Foundation Charitable Trust v. Commissioner*, T.C.M. 1989-566 (1989).

[126] Gen. Coun. Memo. 36379; Reg. §1.501-4(i)(3)(iii)(c). An anticipated annual contribution of $7600 to the supported organization's $7 million budget was insufficient to qualify (*Lapham Foundation, Inc. v. Commissioner*, 84 TCM 586 (2002), aff'd by 6th Cir. Nov. 2003. Similarly a 5.44 percent funding level did not qualify (*Christie E. Cuddeback & Lucille M. Cuddeback Memorial Fund v. Commissioner*, 84 TCM 623 (2002).

[127] Reg. §1.509(a)-4(i)(3)(iii)(b).

[128] The IRS 1997 Exempt Organizations *CPE Text* contains a chapter entitled "Public Charity Status on the Razor's Edge" that reviews the fine distinctions made in evaluating satisfaction of these tests.

(d) Control by Disqualified Persons

An SO cannot be controlled by disqualified persons other than its own managers or the public charities that it benefits.[129] Indirect control is also not allowed; a funder's employees, for example, cannot substitute for the funder. An organization will be considered controlled by disqualified persons if, by aggregating their votes or positions of authority in the organization, they can require the organization to perform any act that significantly affects its operations. Lack of control is evidenced when the disqualified persons have under 50 percent of the voting power or lack the right to veto actions of the board.

(e) Conversion to Private Foundation

If the circumstances of the benefited organization or the funders change, it is possible for an SO to cease to operate solely to benefit the current public charity(ies) and convert itself into a private foundation (or a public charity if requisite support is received). Two important questions arise in such a conversion:

1. The supported organization should agree to cease to be supported. As a practical matter, since it normally controls the SO, this factor is almost always present. There may be a price for agreement. In one situation, a retiring public charity supportee was given about half of the foundation's assets upon the SO's conversion.[130]
2. The conversion must not be part of a plan arranged when the SO was created, to enable the creators or donors to circumvent some tax limitation or private foundation sanction.

A supporting organization is often formed when the property to be given is closely held corporate stock. A private foundation cannot hold more than 2 percent of the shares of a company owned more than 20 percent by the PF and the persons who control or created it, and such "excess business holdings" must be sold by the PF within five years of their receipt. Thus, in the case of conversion of an eight-year-old SO to a private foundation in the same year that its stock holdings were purchased in a public offering, it might well be asked if such a conversion was originally intended. Without question, a conversion within a few years of original creation would be suspect, when the SO's public status afforded the donors a contribution carryover or higher percentage limitation on deductions than that allowed to a private foundation.

(f) Noncharitable Beneficiaries

Business leagues, chambers of commerce, civic leagues, social welfare organizations, labor unions, and agricultural and horticulture organizations normally receive funding from many members and could qualify as publicly supported under the IRC §509(a)(2) tests. For that reason, they may also be beneficiary

[129] IRC §509(a)(3)(C); Reg. §1.509(a)-4(j).
[130] Priv. Ltr. Rul. 9052055.

organizations of an SO. Since the SO qualifies for receipt of deductible contributions, an SO formed with such a beneficiary must, of course, meet the organizational and operational tests of §501(c)(3).[131] In other words, an organization performing the charitable or other IRC §170(c)(2) purpose activities for an IRC §501(c)(4),(5), or (6) organization and meeting the IRC §509(a)(3)(B) control tests may qualify as a supporting organization.

11.7 TESTING FOR PUBLIC SAFETY: §509(a)(4)

An organization that is organized and operated exclusively for testing for public safety is also treated as a public charity. This category is of limited use, however, because IRC §170 does not provide for deductibility of donations to such organizations. Thus, organizations seeking this status must also satisfy the requirements for a research organization in order to qualify to receive donations.[132]

[131] See Chapter 2.
[132] See Chapter 5.

PART TWO

Standards for Private Foundations

CHAPTER TWELVE

Private Foundations—General Concepts

Private foundations were segregated by Congress in 1969 from public charities—those organizations that traditionally receive their contributions from a wide range of supporters—rather than from particular individuals. In the exempt organization community and throughout this book, private foundations are sometimes referred to as PFs. The persons who create, contribute to, and manage PFs are "disqualified persons" and are sometimes referred to as DPs.

12.1 WHY PRIVATE FOUNDATIONS ARE SPECIAL

Private foundations are viable and valuable types of nonprofit organizations, despite the fact that the special rules applicable to them warrant six chapters in this book.[1] A PF is often the best tool to accomplish an individual's philanthropic goals. Unfortunately, some professional advisors discourage the formation of PFs because of the sanctions outlined in Exhibit 12.1. Granted, the rules

[1] For an expanded consideration of this subject, see B. Hopkins and J. Blazek, *Private Foundations: Tax Law and Compliance, Second Edition* (New York: Wiley, 2003).

are a bit more complicated than those for publicly supported charities, but they can be mastered and become easier once their logic is understood.[2] All organizations qualifying for exemption under §501(c)(3)—private and public—are technically subject to a requirement that they not provide private benefits to those that create and manage them.[3] For years, some suggested that all charities should be subject to rules similar to the self-dealing prohibitions applicable to private charities. For reasons more thoroughly described in Chapter 20, in 1996 Congress added penalties, called *intermediate sanctions,* for public charities that pay excess benefits to certain individuals.

A private foundation is a perfect vehicle for philanthropists who want total control over their charitable funds. A charitable trust or corporation whose sole trustee/director/member is also the creator can qualify for exemption. Commonly, the donor and his or her children constitute the board members of a private foundation. Although financial transactions with the creators, and certain other activities, are strictly constrained by the PF rules, nothing prevents absolute control of the organization by founders and their families.

Funders who wish to be flexible in their grant-making programs may prefer a privately controlled foundation for a similar reason. A modest (compared to that spent by most public charities) grant payout requirement, annually equal to 5 percent of the value of the PF's investment assets,[4] must be maintained. The private operating foundation[5] is a perfect example of this latitude. The funder can establish a PF, hire a staff, and work to further his or her own charitable purposes, as long as genuine public interest programs are undertaken and the rules are followed.

Another positive attribute is the fact that family members or other disqualified persons[6] can be paid reasonable compensation for work they genuinely perform in serving on the organization's board. Disqualified persons can also be paid salaries for services rendered in a staff capacity. Those who learn the rules and plan well to adhere to them need not allow sanctions to discourage creation of a private foundation.

Finally, a private foundation can serve as a perfect income and estate tax-planning tool for taxpayers with charitable interests. The classic example is a philanthropist who is ready to realize a large capital gain on the sale of corporate stock. A PF can be created in the year of sale, gifting the shares to the foundation

[2] The January 2000 (vol. 27, no.1) issue of *The Exempt Organization Tax Review* contained four special reports focused on private foundations (PFs) and their public counterparts, donor-advised funds. Thomas A. Troyer wrote "The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings." John G. Simon made suggestions for changes in an article entitled "Private Foundations as a Federally Regulated Industry: Time for a Fresh Look." Robert H.M. Ferguson suggested "Avoiding Private Foundation Status." Victoria B. Bjorklund surveyed "Charitable Giving to a Private Foundation: The Alternatives, the Supporting Organization, and the Donor-Advised Fund."

[3] Discussed in Section 2§2 and Chapter 20.

[4] Described in Chapter 15; during years when the value of endowments and interest rates decline, the 5 percent rate is arguably too high.

[5] Discussed in Section 15.5.

[6] Defined in Section 12.2(c).

Exhibit 12.1

Private Foundation Excise Taxes

Sanction	Tax Imposed On		Initial Tax		Additional Tax	
	Private Foundation	Managers	1st Tier Rate	Amount Imposed	2nd Tier Rate	Assessed
Section 4940 Investment Income Tax	X		2%*	of investment income imposed annually when Form 990-PF filed	N/A	not applicable
	X		1%	tax reduced by one percent for PFs increasing grants annually	N/A	not applicable
Section 4941 Self-Dealing		on self-dealer X	5%**	of "amount involved" for each year transaction outstanding	200%	if self-dealing not "corrected" if manager refuses to agree to part or all of correction. Maximum additional tax $10,000
		on manager X	$2\frac{1}{2}$%	of "amount involved" for each year transaction outstanding; participating managers jointly and severally liable; can agree to allocate among themselves; maximum for managers $10,000	50%	if manager refuses to agree to part or all of correction. Maximum additional tax $10,000
Section 4942 Underdistribution	X		15%	of "undistributed income" for each year undistributed	100%	for each year income remains undistributed
Section 4943 Excess Business Holdings	X		5%	on fair market value of excess holdings each year	200%	of excess holdings at end of "taxable period"
Section 4944 Jeopardizing Investments	X		5%	on amount so invested for each year of "taxable period"	25%	of amount not removed from jeopardy
		X	5%	on amount so invested for each year of investment; participating managers jointly and severally liable for maximum tax of $5,000 per investment	5%	of amount on managers who refused to agree to part or all of removal from jeopardy; maximum for management $10,000
Section 4945 Taxable Expenditures	X		10%	of each taxable expenditure	100%	of uncorrected expenditure at end of "taxable period"
		X	$2\frac{1}{2}$%	of each taxable expenditures for any manager who knew of and agreed to the expenditure; maximum for all managers $5,000	50%	of expenditure manager who refuses to correct all or part of taxable amount; maximum amount $10,000

* Watch for possible reduction to a single 1% rate.

** Watch for possible increase to 25%.

before the sale is finalized, thereby avoiding tax on the gain. As much as 30 percent of the philanthropist's income can be given to an operating foundation (up to 20 percent to a normal PF) to substantially reduce his or her income tax burden.[7] The best part is that the money given to create the foundation need not be given away immediately. The foundation must essentially spend only a minimum of 5 percent of the value of the capital gift for its charitable purposes.

Philanthropists who make charitable bequests under their wills can create private foundations to begin to receive a portion of the bequests as donations while they are still living, and thereby obtain a double deduction. Current gifts to the PF are deductible and increase the estate by reducing income tax. The property gifted to the PF and the undistributed income accumulating in the PF are not subject to estate tax. The foundation can also serve as the beneficiary of a charitable remainder trust created during one's lifetime. Such plans usually result in more after-tax money for the charity and for other beneficiaries. There are many possibilities for the charitably minded taxpayer, though a detailed discussion of the giving rules is beyond the scope of this book.

12.2 SPECIAL RULES PERTAINING TO PRIVATE FOUNDATIONS

Private foundations are defined negatively, by what they are not. Any domestic or foreign charity qualifying for exemption under IRC §501(c)(3) is presumed to be a private foundation *unless* it is a church, school, hospital or affiliated medical research organization, donative or service-providing charity, supporting organization, or an entity that tests for public safety.[8]

Those charities not able to qualify as public are those most often supported by a particular individual, family group, corporation, or endowment. They accomplish their charitable purposes by making grants to public organizations of the types listed in the previous paragraph and, less frequently, by spending money directly for charitable projects. It is interesting to note, however, that the first four categories of public organizations listed are public, even if they are privately supported, because of the nature of their activities.

Throughout this part of the book, note the importance of public charities to PFs, both as the usual recipients of their annual gift-giving bounty and as potential recipients of "terminating distributions." Exhibit 11.1 charts some of the distinctions between public and private charitable organizations, and may make it easier to recall the differences. IRS Publication 578, Tax Information for Private Foundations and Foundation Managers, can still be used as a guide, if it's available.[9]

The burden of proving non-PF status rests with each exempt organization. A charitable exempt organization cannot qualify as a §501(c)(3) entity and is presumed to be a private foundation until proper notice is filed with the IRS on Form 1023.[10] If the exempt organization fails to file its notice for determination

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[7] IRC §170(e)(5) was extended permanently by the Taxpayer Relief Act of 1998.

[8] IRC §509(a); see Chapter 11 for a thorough explanation of each category of public charity.

[9] Last updated in 1989, the IRS has begun again to distribute it; but one may not find it on their website.

[10] IRC §508(b); the determination process is discussed in Chapter 18.

on time, it is treated as a taxable entity until the date of filing. The IRS does not count support received during the delinquency period in determining qualification as a public charity, and only an advance ruling can be obtained.

Unless state law effectively does so automatically, the charter or instrument creating a PF must contain language that prohibits violation of the private foundation sanctions. Every state except Arizona and New Mexico has passed such a statute.[11] Without proper organizational restraints, the PF cannot be exempt, nor is it eligible to receive charitable contributions.

If circumstances change or if its creators, for whatever reason, wish it, a PF can terminate its status. For example, its public support might have increased to the point that it can qualify as a public charity. It can also distribute all of its assets to a public charity, or to another private foundation, and go out of business. It can split itself into two or more parts. Voluntary and involuntary termination of PF status is discussed in Section 12.4.

(a) Types of Private Foundations

Most private foundations are grant-making organizations that devote their assets to supporting public charities and can be thought of as standard, or normal, private foundations. They meet a minimum distribution requirement essentially equal to 5 percent of the value of their assets[12] and must adhere to all of the special sanctions listed in the next subsection. Some different rules and privileges are afforded to the following special types of private foundations:

- *Private Operating Foundations.* A private foundation that actively conducts its own charitable programs has somewhat lower distribution requirements. Though it may make grants to public charities, it must devote its income to its own programs. The allowable income tax deduction for gifts to a private operating foundation is more favorable than that for a normal private foundation.[13]
- *Exempt Operating Foundation.* This category of foundation customarily applies to museums, libraries, and other quasi-public charities that meet very specific requirements.[14] They are not required to pay the excise tax on investment income.
- *Foreign Foundations.* These may be subject to tax on their U.S.-based income. A foreign organization is treated as a private charity unless it seeks recognition of its public charity status from the IRS.[15] A foreign charity would also seek classification as a public charity to be eligible to receive grants from a domestic private charity.[16]
- *Conduit Foundation.* A private foundation becomes a conduit foundation during a year in which it makes qualifying distributions that are treated

[11] Rev. Rul. 75-38, 1975-1 C.B. 161.
[12] See Section 15.3.
[13] See Section 15.5.
[14] See Section 13.7.
[15] See Section 13.5.
[16] See Section 17.5.

as distributions out of corpus in an amount equal to 100 percent of the contributions it receives during the year.[17] A conduit foundation is sometimes referred to as a "pass-through" foundation because it receives, but does not keep, and instead redistributes donations to allow its donor(s) to receive a higher deduction limitation for contributions to the foundation.[18] The status as a conduit foundation applies on a year-by-year basis. The election to treat the gifts as being made out of corpus does not impact the succeeding-year distributions.

(b) Special Sanctions

When Congress segregated privately funded charities and gave them special status, it was in an antifoundation mood, resulting in the following sections being added to the Internal Revenue Code. These sections have operational constraints to govern the conduct of private foundations and impose excise taxes for failures to adhere to the rules. Private foundations were scrutinized again by the Congress during 2003 in view of complaints that some foundations paid excessive compensation to their disqualified persons. Among the issues of discussion was the fact that the IRS, in view of its very limited resources, seldom examines private foundations. A proposal to eliminate administrative expenses as qualifying distributions, essentially treating them as noncharitable expenditures, correspondingly increased the required annual charitable disbursements. A long-suggested reduction of the excise tax rate to 1 percent was also approved. Out of the 35 newly identified industry segments of tax-exempt organizations announced by the IRS in its 2003–2004 IRS Workplan, private foundations were among the seven types on the list to be examined during the fiscal year.

The first section is actually imposed on all private foundations—an annual tax of 2 percent of the foundation's investment income.[19]

This tax is calculated annually on the foundation's Form 990-PF.[20]

- IRC §4940 Excise Tax Based on Investment Income (Chapter 13)
- IRC §4941 Taxes on Self-Dealing (Chapter 14)
- IRC §4942 Taxes on Failure to Distribute Income (Chapter 15)
- IRC §4943 Taxes on Excess Business Holdings (Chapter 16)
- IRC §4944 Taxes on Investments Which Jeopardize Charitable Purpose (Ch. 16)
- IRC §4945 Taxes on Taxable Expenditures (Chapter 17)
- IRC §4946 Definitions and Special Rules (Section 12.2)
- IRC §4947 Application of Taxes to Certain Nonexempt Trusts (Section 12.3)
- IRC §4948 Foreign Private Foundations

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[17] IRC §4942(h).
[18] See Section 13.4(c).
[19] Discussion of this tax and ways to reduce it follow in Chapter 13.
[20] See Blazek, Chapter 4, *IRS Form 990 Tax Preparation Guide for Nonprofits* (New York: Wiley, 2004) for suggestions about the unique issues faced in completing this form.

Appendix 12-1 contains capsule definitions of these provisions to use as a reference guide. Sanctions for failure to comply with PF rules of §§4941 through 4945 potentially include a tax (called the "Chapter 42 tax") on both the PF and its disqualified persons, loss of exemption, and repayment of all tax benefits accrued during the life of the PF. Exhibit 12.1 tabulates the tax rates and the entity(ies)—sometimes several—subject to the tax. The standards for imposing the penalties on taxable events are somewhat different for each section, as described in Chapters 14 through 17. Form 4720, Return of Certain Excise Taxes on Charities and Other Persons under Chapters 41 and 42 of the IRC, is filed to report the incidents and calculate any taxes due.

The penalty provisions of IRC §4942, 4943, 4944, and 4945 contain no exception, or excuse, for imposition of the penalty on the private foundation itself for failure to comply with the specific provisions of these code sections. The regulations under these sections do contain relief for those foundation managers who do not condone, or participate in the decision to conduct, a prohibited action. Until 1984, the penalties were very strictly applied.[21] In 1984, Congress added IRC §§4961, 4962, and 4963 to permit abatement of the penalties imposed on both the foundation and its managers if it is established to the satisfaction of the secretary (by the IRS under responsibility delegated by the Treasury Department) that

- The taxable event was due to reasonable cause and not to willful neglect.
- The event was corrected within the correction period for such an event.

To allow abatement, it is the actions of the responsible foundation officials that must be considered. Although IRC §4962 is entitled "Definitions," neither it nor the regulations define the terms *reasonable cause* or *willful neglect*. There have been no court decisions concerning abatement of these penalties and the author could find no private rulings construing their meaning for this purpose, though her experience in this regard has been positive. In a ruling concerning a taxable expenditure penalty for failure to seek advance approval of a scholarship plan, there was no mention of abatement.[22] The congressional committee reports says, "A violation which was due to ignorance of the law is not to qualify for such abatement."[23] The regulations pertaining to the penalties imposed on self-dealers and on managers approving of self-dealing, jeopardizing investments, and taxable expenditures, however, do contain definitions that hopefully can be applied to justify abatement of the penalties. The definitions of *reasonable cause* and *willful neglect* are the same as those listed here. The PF officials must show that they used good business judgment exercised with ordinary business care and prudence. They must show they made a good faith effort to follow the rules by seeking the advice of qualified professionals. All of the facts and circumstances of the foundation's activities must be fully disclosed to such advisors.

[21] *Charles Stewart Mott Foundation v. U.S.*, 91-2 USTC ¶50340 (6th Cir. 1991); *Hans S. Mannheimer Charitable Trust v. Commissioner,* 93 T.C. 5 (1989).
[22] IRS Priv. Ltr. Rul. 9825004.
[23] P.L. 98-369, Deficit Reduction Act of 1984.

(c) Definitions of Special Terms

The special sanctions applicable to private foundations contain unique and specific definitions of those persons whose actions are curtailed and of those who will be held responsible when violations of the rules occur.

Disqualified Persons. To determine who is in control of a private foundation and thereby subject to restraints against self-dealing and other sanctions, persons and entities in certain relationships to a foundation are treated as disqualified persons (DPs).[24] Individuals, corporations, trusts, partnerships, estates, and other foundations can be DPs. The list of DPs encompasses substantial contributors to the foundation, foundation managers, entities that own more than 20 percent of a "substantially contributing" business, family members, and corporations, trusts, or estates that are more than 35 percent owned by disqualified persons.

Substantial Contributors. Using the cumulative total of all contributions and bequests received during the PF's existence, a substantial contributor (SC) is one who has given more than $5,000 or 2 percent of the total aggregate contributions the organization has ever received, whichever is greater. A creator of a trust is also a substantial contributor, regardless of support level. There is no provision for exclusion of unusual grants to calculate aggregate contributions for purposes of identifying substantial contributors.[25]

One becomes a substantial contributor the moment after the transaction in which he or she (or it) makes the substantial gift, as a result of the transaction.[26] Thus, self-dealing does not occur with respect to the transaction in which one becomes an SC. Importantly, the cumulative contributions forming the basis of the calculation are tallied at the close of each year. A testamentary bequest causes the testator to become an SC, so her or his children and ancestors become disqualified persons upon the testator's death.

With one exception, once one becomes an SC, one remains an SC, regardless of changing PF support levels or death. The exception is this: If, for 10 years, an SC has made no contribution to the PF, is not himself or herself a manager (or related to one), and his, her, or its aggregate contributions are insignificant, that person ceases to be treated as an SC.[27]

Foundation Managers. A private foundation's officers, directors, and trustees, and individuals having similar powers or responsibilities, are its managers.[28] If an employee has actual or effective responsibility or authority for the foundation's action or failure to act, he or she is a manager. A person is considered to be an officer if he or she is specifically so designated under the certificate of incor-

[24] IRC §4946(a).

[25] IRC §507(d)(2) and Reg. §1.507-6

[26] Reg. §1.507-6(b).

[27] IRC §507(d)(2)(c). Note: A disqualified person for reasons of being a manager or stockholder ceases to be a DP the day that status changes. See Priv. Ltr. Rul. 9210029 for example of use of this rule to avoid self-dealing.

[28] IRC §4946(b); Reg. §53.4946-1(f).

poration, bylaws, or other constitutive documents of the PF, or if he or she regularly exercises general authority to make administrative or policy decisions on behalf of the PF. Advisors, engaged as independent contractors with no direct legal authority, are not managers. However, employees of a bank that serves as a PF trust officer—although employees of the bank, not the PF—are treated as PF managers for accounts over which "they are free, on a day-to-day basis, to administer the trust and distribute the funds according to their best judgment.[29]

20% Owners. An owner of more than 20 percent of a substantially contributing business is a DP. Ownership is measured differently for different businesses.[30]

- For a corporation, it means ownership of over 20 percent of the "combined voting power."
- For a partnership, it means ownership of an interest of 20 percent or more of net profits.
- For an unincorporated business, the distributive share of profits determines ownership. If there is no fixed agreement, the portion of the entity's assets receivable upon dissolution determines.
- For a trust, ownership is actuarially calculated.

Voting power is determined by attributing stock owned directly or indirectly by or for a corporation, partnership, or estate of trust, as owned proportionately, to its shareholders, partners, or beneficiaries.[31] Shares or other economic ownership held by family members described in the next subsection are also attributed. A right to vote dependent upon exercising some option, converting shares, or the occurrence of some event, is not treated as voting power.[32]

Family Members. A family member of any of the aforementioned persons—a disqualified person, a substantial contributor, a foundation manager, or a 20%+ business owner—is also considered as a disqualified person. The term "family member" includes the following[33]:

- Spouse
- Ancestors
- Children, grandchildren, and great-grandchildren
- Spouses of children, grandchildren, and great-grandchildren
- Legally adopted children[34]

Not defined as family members for this purpose are siblings, cousins, aunts, uncles, nieces, nephews, and any more-distant relatives.

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[29] Rev. Rul. 74-287, 1974-1 C.B. 327.
[30] Reg. §53.4946-1(a)(3).
[31] Reg. §1.267(c); Reg. §53.4946-1(d).
[32] Reg. §53.4946-1(a)(6).
[33] IRC §4946(d).
[34] Reg. §53.4946-1(h).

35%+ Business. A corporation of which more than 35 percent of the total combined voting power is owned by one or more disqualified persons is disqualified itself, as is a partnership of which more than 35 percent of the profit interest is owned by a DP. If a disqualified person owns more than 35 percent of the beneficial interest of a trust or estate, then the trust or estate is also considered a DP.[35]

Other Disqualified Persons. For two limited purposes, other private foundations and government officials are treated as disqualified persons.

Related Private Foundations. For the sole purpose of calculating excess business holdings,[36] another private foundation that is effectively controlled, either directly or indirectly, by the PF in question is treated as a DP. The related PF's stock ownership is therefore attributed to the other PF. A PF that, for its entire existence, has received at least 85 percent of contributions from the same persons contributing to another PF is also related for this purpose.[37]

Government Officials. For self-dealing purposes only, a government official is a DP with whom financial transactions are generally prohibited. A person who, at the time of the act of self-dealing, holds one of the following offices is a governmental official[38]:

- An elective public office in the executive or legislative branch of the government of the United States
- An office in the executive or judicial branch of the United States government that is appointed by the president
- A position in the executive, legislative, or judicial branch of the government of the United States that is listed in schedule C of rule VI of the Civil Service Rules, or the compensation for which is equal to or greater than the lowest rate of compensation prescribed for GS-16 of the General Schedule under IRC §5332 of Title 5 of the United States Code
- A position under the House of Representatives or the Senate of the United States held by an individual receiving gross compensation at an annual rate of $15,000 or more
- An elective or appointive public office in the executive, legislative, or judicial branch of the government of a state, possession of the United States, or political subdivision or other area of any of the foregoing, or of the District of Columbia, held by an individual receiving gross compensation at an annual rate of $20,000 or more
- A position as personal or executive assistant or secretary to any of the foregoing

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[35] IRC §4946(a)(1)(E), (F), and (G).
[36] Discussed in Chapter 16.
[37] Reg. §4946-1(b).
[38] IRC §4946(a)(c); Reg. §53.4946-1(g).

12.3 APPLICATION OF TAXES TO CERTAIN NONEXEMPT TRUSTS

Trusts and estates are permitted an unlimited charitable deduction against their otherwise taxable income for donations made pursuant to their governing instrument.[39] Though a non-tax-exempt trust cannot qualify as recipient of an income tax deductible charitable contribution, it can escape income tax itself by paying out all of its income to 501(c)(3) organizations. To prevent the creation of trusts for the purpose of avoiding the PF rules, a wholly charitable trust is treated as a private foundation despite the fact that it does not have formal recognition as an exempt charitable organization.[40] To be so classified, "all of the unexpired interests of the trust" must be devoted to charitable purposes[41] and income, estate, or gift tax deductions must have been allowed for gifts made to the trust. The tax on investment income and all the other PF sanctions are imposed on a wholly charitable trust; Form 990PF is filed annually and possibly Form 990-T if the trust has unrelated business income.

Split-interest trusts, or those holding property devoted to both charitable and noncharitable beneficiaries, are subject to some of the PF rules.[42] For example, such a trust might have a remainder interest payable to a named charity with the current income payable to the creator's son. Such a trust cannot formally seek tax-exempt status because of its unexpired noncharitable interests, but a deduction is allowable for the value of the charitable interests placed in them. The sanctions against self-dealing (Chapter 14) and excess business holdings and jeopardizing investments (Chapter 16) apply to such trusts as if they were private foundations. Form 1041A, accompanied by Form 5227 are filed annually for charitable remainder and lead trusts and pooled income funds.

12.4 TERMINATION OF PRIVATE FOUNDATION STATUS

A private foundation may wish to either terminate its existence or change its PF classification for a number of reasons. Some foundations have charter provisions requiring that they terminate after a designated number of years. Second-generation trustees may choose to divide a PF's assets into several foundations so each can manage its own.[43] A foundation's mission may be accomplished by spending its assets to buy a historic building and donating the site to a preservation society. An existing private foundation or a public charity reclassified as private because it was unable to sustain the requisite public support levels[44] can seek IRS approval for its conversion to a public charity because it plans to seek public support.[45] In a rare circumstance, there could be some action[46] that would

[39] IRC §642.

[40] IRC §4947(a)(1); Reg. §53.4947-1(b).

[41] According to IRC §170(c)(2)(B); Reg. §53.4947-1(b)(2)(i).

[42] IRC §4947(a)(2).

[43] See Section 12.4(e).

[44] See Section 11.2(f).

[45] See Section 12.4(d).

[46] The self-dealing rules of IRC §4941 prohibit, for example, the purchase or sale of an asset by a PF to its insiders and vice versa; see Chapter 14.

be impermissible if the organization remained a private foundation. Such organizational changes are referred to as *voluntary terminations*.

The IRS can also cause an *involuntary termination* of a foundation for reasons of repeated violations of the PF sanctions. For either type, a PF must carefully follow the rules for terminating its existence because missteps can be costly. The tax code begins with the following draconian language:

> Internal Revenue Code §507(a) entitled "Termination of Private Foundation Status," says as a "general rule—except as provided in §507(b), the status of any organization as a private foundation shall be terminated only if:
> (1) Such organization notifies the Secretary of its intent[47] to accomplish such termination, or
> (2) (A) With respect to such organization, there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to a liability for tax under chapter 42, and
> (B) The Secretary notifies such organization that it is liable for the tax imposed by §507(c).

The amount of the termination tax is equal to the lower of (1) aggregate tax benefits resulting from the §501(c)(3) status of the foundation or (2) the value of its net assets of the foundation.[48] As quoted here, the statute starts with the pronouncement that a private foundation can terminate—commonly meaning "to cease to exist"—only if it gives advance notice to the IRS of its intention to do so. Additionally, it must either pay back all the tax benefits it and its donors ever received or secure IRS abatement of such tax through a private ruling.

The fact that these steps are not required for most types of PF terminations is buried deep in the long and complicated regulations. It is with good reason, therefore, that during the 30-plus years since PFs were created as a special subset of charitable organizations, professional advisors have recommended that a foundation file a private letter ruling to seek IRS approval for their termination and to determine that the termination tax is not due.

Happily, in an effort to discourage unnecessary ruling requests, the IRS issued very helpful guidance verifying that IRS notice is not required for several types of terminations.[49] The first ruling applies to transfers of assets between commonly controlled private foundations,[50] and the second, to transfers of assets to public charities.[51] To understand the reason the new guidance was possible, it is useful to focus on the words "except as provided in subsection (b)." The termination tax is imposed by §507(a) in only two situations: (1) The foundation itself voluntarily gives notice of its intention to terminate and seeks abatement of any tax, or (2) what the regulations refer to as an "involuntary" termination[52] occurs because the foundation has voluntarily, consciously, and intentionally disregarded the special constraints placed on the conduct of PF affairs by §§4941 through 4945.

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[47] The person currently designated to receive the notice of termination described in §507(a)(1) is Manager, Exempt Organizations Determinations (TE/GE), or in other words, a private letter ruling is filed.

[48] IRC §507(c).

[49] Rev. Rul. 2002-28, IRB 2002-20, 912 and Rev. Rul. 2003-13, 2003-4 IRB 1.

[50] See Section 12.4(e).

[51] See Section 12.4(c).

[52] Reg. §1.507-1(c).

(a) Involuntary Termination

The ultimate penalty for failure to play by the excise tax rules Congress designed to curtail PF operations is involuntary termination, also called the *third-tier tax.* When a PF has willfully repeated flagrant act(s) or failure(s) to act, giving rise to the imposition of the sanctions set out in IRC §§4941 through 4945, the IRS will notify the PF that it is liable for a termination tax.[53] The termination tax equals the lower of the aggregate tax benefit resulting from §501(c)(3) status or the foundation's net assets.

Aggregate Tax Benefit. The sum of the tax benefits resulting from the PF's exempt charitable status is potentially due to be paid—all of the income, estate, and gift taxes saved by the PF's contributors. The amount equals the total tax that would have been payable if deductions for all contributions made after February 28, 1913, had been disallowed. The aggregate increase in income tax that would have been due in respect of income earned by the foundation during its existence is added. Lastly, interest is due on the increases in tax between the day the taxes would have been due and the date of termination.

Repeated Acts. At least two acts or failures to act, which are voluntary, conscious, and intentional, must be committed.[54] The offense must appear to a reasonable person to be a gross violation of the sanctions, and the managers must have "known" that they were violating the rules. The "knowing" rules are discussed in Section 16.2(c).

Foreign Private Foundations. The termination tax does not apply to termination of a foreign private foundation that has received substantially all of its support, other than gross investment income, from sources outside the United States.[55]

(b) Voluntary Terminations

When the directors or trustees decide for whatever reason that they cannot continue to operate a private foundation, they can dissolve or terminate the foundation existence in the following ways:

- All of the foundation's assets can be given away to a public charity (§12.4(c)).
- The foundation can convert itself into a public charity by virtue of activities it will begin to conduct—operate as a church, school, or hospital—or by seeking public funding that will equal at least one-third of its annual revenues. (§12.4(d))
- A private foundation can merge with, split itself up into, or contribute its assets to one or more other private foundations.(§12.4(e))

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[53] IRC §507(a).
[54] Reg. §1.507-1(c)(1).
[55] IRC §4948.

(c) Transfer of Assets to a Public Charity

A private foundation that wishes to cease to exist, or terminate, can transfer or donate all of its assets to one or more public charities qualified under IRC §509(a)(1). Such a terminating foundation must not have had any flagrant or willful acts or failure to act giving rise to the penalty taxes. A foundation terminating in this fashion is not required to notify the IRS in advance and does not incur a termination tax.

Eligible Public Charity Recipients. The recipient organization must have been in existence for at least 60 continuous months.[56] The statute is somewhat confusing because it only mentions "organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)). That would mean only churches, schools, hospitals, and donative public charities would qualify as recipients, to the exclusion of a symphony society, theater, or scientific research organization, for example. Public charities that support one or more other public charities are also not mentioned. The regulations expand qualifying public charity recipients to include those embodied in §509(a)(2)[57] and (3).[58] The list is expanded in private rulings to include service-providing public charities and supporting organizations.[59]

A published ruling has now been issued to clarify the eligibility of all public charities classified under §509(a)(1), (2), and (3).[60] The ruling takes into account the basic fact that situations involving this type of transfer may occur. The four situations discussed in this ruling are predicated on the following assumptions:

- The private foundation has not committed either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to tax liability under the private foundation rules.
- The foundation is not a private operating foundation.
- The transferee organization or organizations are not controlled, directly or indirectly, by the foundation or by one or more disqualified persons with respect to it.
- The foundation has not previously terminated (or had terminated) its private foundation status.
- The transferee organization(s) is a public charity (an entity described in IRC §509(a)(1), (2), or (3)) that retains its public charity classification for at least three years following the date of the distribution.
- The foundation does not impose any material restrictions on the transferred assets.

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[56] IRC §507(b)(1)(A); Reg. §1.507-2(a)(2).

[57] Supported by combination of donations and revenues from performance of exempt functions; see Section 11.4.

[58] Called supporting organizations because they operate to benefit one or more other public charities; see Section 11.6.

[59] Listed in 170(b)(1)(a)(viii); Priv. Ltr. Ruls. 199905027, 9823050, and 8723038.

[60] Rev. Rul. 2003-13, 2003.

- The foundation retains sufficient income or assets to pay any private foundation taxes, such as the tax on investment income for the portion of the tax year prior to the distribution, and pays these taxes when due.

Situation 1. A private foundation (PF) distributes, pursuant to a plan of dissolution, all of its net assets to a public charity (PC). PC is a public charity by reason of classification pursuant to IRC §509(a)(1), because it is an entity described in IRC §170(b)(1)(A)(i)-(vi).[61] PC has been in existence and a public charity for a continuous period of at least 60 calendar months immediately preceding the distribution. After PF completes the transfer, it files articles of dissolution with the appropriate state authority.

Situation 2. The facts are the same as in the first situation, except that PC has been in existence for fewer than 60 calendar months immediately preceding the distribution. Moreover, it was not formed as a result of a consolidation of other public charities of the same classification that would have been in existence for a continuous period of 60 calendar months prior to the distribution had they continued in existence.

Situation 3. The facts are the same as in the first situation, except that PC is a public charity by reason of classification pursuant to IRC §509(a)(2). This type of public charity is usually a service-providing organization.

Situation 4. The facts are the same as in the first situation, except that PC is a public charity by reason of classification pursuant to IRC §509(a)(3). This type of public charity is a supporting organization.

IRS Conclusions. In Situation 1, the distribution was made in accordance with the rules concerning favored terminations. This means that PF's status as a private foundation is termination at the time of the distribution to PC. PF is not subject to the termination tax. PF is not required to give notice to the IRS to terminate its foundation status.

The distributions in Situations 2, 3, and 4 were not made in accordance with the favored termination rules. Thus, the status of PF as a private foundation is not terminated until it gives notice to the IRS. If PF does provide the notice (and thus terminates), it must ask for abatement of, or become subject to, the termination tax. If, however, PF does not have any net assets on the day it provides the notice (for example, because it gives the notice the day after it distributed all of its net assets), the tax is zero.

In all four situations, the distributions do not constitute an investment by PF for purposes of the investment income tax.[62] Therefore, the distributions do not give rise to net investment income. In these four situations, the distributions are to tax-exempt charitable organizations, which are not disqualified persons. Thus, the self-dealing rules are not implicated.[63] In these instances, the payments are

[61] Types of charities included are listed in text for note 8.
[62] See Chapter 13.
[63] See Chapter 14.

made in accomplishment of charitable purposes and are not to organizations controlled by PF. Thus, the transfers are qualifying distributions. These distributions do not cause PF to have excess business holdings, nor are they jeopardizing investments. Further, the distributions are to public charities and thus are not taxable expenditures; therefore, expenditure responsibility is not required. Complete details should be included in Form 990-PF for the year of the termination. Proof of public status must be maintained in the files of the terminating PF.

Restrictions and Conditions. "All right, title, and interest in and to all of the net assets" must be transferred. No material restrictions or conditions can be imposed preventing free and effective use of the assets by the public charity. The following questions are used to find restrictions[64]:

- Does the public charity become owner in fee of the transferred assets?
- Are the assets used by the public charity for its exempt purposes? Are the assets subject to liabilities, leases, or other obligations limiting their usefulness?
- Does the public charity's governing body have ultimate authority and control over the assets?
- Is the public charity operated separately and independently of the PF?
- Were members of the public charity board chosen by the PF?

As illustrated by the acceptable and unacceptable conditions outlined in the preceding list, the transfer of private foundation assets must be complete. The recipient public charities must have absolute dominion and control over the use of the assets it receives. Similar to terms allowed for donor-designated funds, however, the foundation officials can ask that they be allowed to advise, or make suggestions, about the use of its funds.

Acceptable Terms. It is permissible for the public charity to name a fund to hold the assets after the donor foundation or its founders. The charitable purpose for which the transferred funds are to be used can be designated. Finally, the transferor can require that the property be retained and not sold when it is important to the charitable purpose, such as a nature preserve or historic property. Such a restriction cannot be placed on assets to be placed in an endowment fund.

Unacceptable Terms. The private foundation, its disqualified persons, or others designated by it cannot retain a right, directly or indirectly, to name the persons to which distributions are made by the recipient public charity, nor the timing of the distributions. The transfer agreement cannot require that the recipient public charity perform some action that the private foundation transferee was not permitted to perform. The recipient public charity must not receive the PF's assets subject to some obligation or liability inconsistent with its own purposes or best interests. The transferee must not agree to give a first right of refusal to purchase or sell transferred property to persons connected with the transferor PF. An irre-

[64] Reg. §1.507-2(a)(8).

vocable agreement to continue a management and maintenance relationship with a bank, brokerage firm, or other advisor is not permitted. Essentially, the agreement cannot impose any action on the recipient organization that would restrict and limit its ultimate control over the assets for its own tax-exempt purposes. The regulations contain a long list of factors that might suggest that the agreement results in the reservation of impermissible rights.[65]

(d) Conversion of Private Foundation into a Public Charity

A private foundation can change its method of operation or sources of support and become a public charity.[66] Basically, the PF adopts plans to qualify under IRC §509(a)(1), (2), or (3) and submits an application for approval to the Cincinnati district office. All of the information outlined in the regulations[67] must be submitted. Beware, as timing here is very important—the termination notice must be filed in advance of the year in which it is effective. Lastly, information evidencing its success or failure in achieving attributes to qualify as a public charity must be submitted at the end of the 60 months.

60-Month Termination. This type of conversion is called a 60-month termination because the requirements are to be met throughout and by the end of the continuous period of 60 months. The foundation does not have to qualify as publicly supported at the beginning of the termination period. The statute of limitations is extended during the 60 months to impose excise taxes for any year in which the reformed PF fails to qualify as publicly supported. Actually, the converted PF could revert from public back to PF status if its plans fail in the sixth, or sixteenth (or whatever), year beyond 60 months. Form 990-PF is filed during the 60-month period. Subject to an extension of time for its assessment, the excise tax is not paid as long as public status is achieved.

Reasons to Convert. A variety of circumstances could arise to make conversion to a public charity desirable. For example, because of a delay in start-up of operations and attendant fund-raising programs, an organization classified as public during its advance-ruling period might mathematically fail to receive over one-third of its support from the general public. The current-year support levels might qualify it as public, but the cumulative totals for the first five years do not. Thus, it becomes classified as a private foundation during its advance ruling period. In a timely fashion, this organization might be able to continue its public status by adopting a 60-month termination. The possibility of using the facts and circumstances test or unusual grant rules to retain public status should also be explored.[68]

Another example would be a privately endowed operating foundation—say, a museum—that plans to undertake a major public campaign to expand its operations. It is privately funded in the early years, but converts as soon as possible to

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[65] Reg. §1.507-2(a)(8)(iv)(A)(*2*).
[66] IRC §507(b)(1)(B).
[67] Reg. §1.507-2(b) and (d).
[68] Section 11.2(g) and (h).

public status. Sometimes a private foundation ceases grant making and converts its operations to a type that qualifies for public status, such as a hospital or school.

(e) Mergers, Split-Ups, and Transfers Between Foundations

When one private foundation "transfers its assets to another private foundation, pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, the transferee (recipient) foundation shall not be treated as a newly created organization."[69] Furthermore, the transferor foundation will not have terminated its private foundation status under §507(a)(1)[70] and need not notify the IRS in advance of its intentions.[71]

When 25 percent or more of a foundation's assets are transferred, called a "significant disposition of assets" to one or more other private foundations, the recipient private foundation(s) "shall be treated as possessing those attributes and characteristics of the transferor."[72] As discussed in detail later, any undistributed income, excess business holdings, expenditures responsibility reporting, cumulative contributions to define substantial contributors, and other tax attributes transfer proportionately along with the assets whether the transferor foundation is commonly controlled or not. When the recipient private foundation is not commonly controlled,[73] the only attribute that does not transfer is the aggregate tax benefits in excess of the fair market value of assets transferred.

IRS Road Map for Reforming a Foundation. In 2002 the IRS addressed three specific types of private foundation reorganizations involving commonly controlled private foundations.[74] The ruling describes the filing obligations and excise tax issues that arise when a private foundation transfers assets to one or more other private foundation(s). The ruling is based upon the following presumptions, the last of which limits the applicability of the ruling to commonly controlled foundations:

- All of the foundations involved are classified as tax-exempt §501(c)(3) organizations, are treated as private foundations under §509, and are not private operating foundations according to §4942(j)(3).
- None of the foundations involved have committed willful and flagrant acts, or failures to act, giving rise to tax under Chapter 42 so as to be subject to the termination tax under §507(a).

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[69] Thus, a termination does not occur; IRC §507(b)(2); Reg. §1.507-3(a)(1).

[70] Since the termination is not involuntary; Reg. §1.507-1(b)(6).

[71] Rev. Rul. 2002-87, 2002.

[72] Reg. §1.507-3(a)(1).

[73] Within the meaning of Reg. §1.482-1(a)(3) according to Reg. §1.507-3(a)(2)(ii). The IRS chose not to give any further definition of these terms for this purpose. The instructions to Form 990 for purposes of reporting compensation paid by related organizations say control exists where 50 percent or more of the officers, directors, and trustees directors of one organization are also officials of the second, or over 50 percent of the second are appointed by the first organization.

[74] IRS Rev. Rul. 2002-87, I.R.B. Due to the complicated nature of the issues involved, the IRS limited this ruling to private foundation transformations. See Section 12.4(c) for discussion of subsequent ruling on transfers of foundation assets to public charities.

- The private foundations have not terminated under §507(a)(2) or (b)(1).
- The transferor foundation has outstanding expenditure responsibility grants requiring future monitoring and reports.
- All of the foundations, both the transferor(s) and transferee(s), are effectively controlled, either directly or indirectly, by the same persons.

The ruling considers the reporting requirements and factors that carry over to the successor foundations in the following three situations:

1. Situation 1: PF **P** split into PFs **X**, **Y**, and **Z**.
2. Situation 2: PF **T** (a trust) transfers assets to PF **W** (a nonprofit corporation).
3. Situation 3: PF **J** and PF **K** merge to create PF **V**.

Situation 1. A private foundation, due to the divergent interests of its current directors, distributes all of its remaining assets in equal shares to three other private foundations. Pursuant to the plan of dissolution, the foundation satisfies all of its outstanding liabilities, causes the recipient foundations to satisfy its expenditure responsibility reporting requirements, and, after all of its assets are transferred, files articles of dissolution with the appropriate state authority.

Situation 2. The trustees of a private foundation trust create a not-for-profit corporation to carry on the trust's charitable activities, which the trustees have determined can be more effectively accomplished by operating in corporate form. All of the trust's assets and liabilities are transferred to the new not-for-profit corporation.

Situation 3. Two private foundations that confine their grant-making activities to programs in the particular city in which they are located transfer all their assets and liabilities to a newly formed private foundation.

Questions Answered in Ruling. The IRS poses and answers the following four questions. Quotation marks indicate where the exact words of the ruling are reprinted.

- *Question 1:* If a private foundation transfers all of its assets to one or more private foundations, is the transferor foundation required to notify the IRS of its plans to terminate its private foundation status and pay the termination tax?
- *Answer*: The IRS answer is no to both parts of the question. Advance IRS notification is not required when a private foundation voluntarily disposes of a significant portion of its assets to one or more private foundations.[75] A transfer of all of a private foundation's assets to one or more private foundations constitutes a significant disposition.[76] In Situations 1, 2 and 3 described previously, no termination has occurred.[77]

[75] Other than transfers for full and adequate consideration or distributions out of current income; IRC §507(b)(2); Reg. §1.507-3(c)(1).

[76] Reg. §1.507-3(c)(2).

[77] Notice is not required; Regs. §§ 1.507-1(b)(6) and 1.507-3(d).

This conclusion is so simple that it makes one very glad the IRS has provided this guidance. Finally there is clarity that the §507(a) language that prompted so many private letter-ruling requests over the past 30 years does not always apply. Plain and simple, the transfer of assets from one private foundation to another does not constitute a termination unless the private foundation voluntarily provides notice of its intent to terminate. According to the ruling, the fact that the foundation dissolves under state law has "no effect on whether it terminated its private foundation status for federal tax purposes." If the foundation chooses to provide notice, and thereafter voluntarily terminates, it is potentially subject to the §507(c) tax, unless it requests and achieves abatements of the tax. If the foundation has no assets on the day it provides notice (e.g., it provides notice at least one day after it transfers all of its assets), the 507(c) tax will be zero. The answer is true even if the ruling does not apply because the foundations involved are not commonly controlled.

- *Question 2*: What are a private foundation's tax return filing obligations after it transfers all of its assets to one or more transferee private foundations and (a) its legal existence is dissolved or (b) it continues to exist in a dormant condition?
- *Answer*: A private foundation that has disposed of all its assets must file a Form 990-PF for the tax year of the disposition and comply with any expenditure responsibility reporting obligations on the return.

Although the ruling does not mention it, any unfinished steps in the expenditure responsibility process, such as securing and reporting follow-up grantee reports, become the obligation of the transferee foundation(s). These filing requirements apply both for a private foundation that terminates by giving 507(a) notice and for one that does not terminate its private foundation status pursuant to the conclusion to question 1. The due date of the return is the fifteenth day of the fifth month following complete liquidation, dissolution, or termination.

The transferor foundation attaches a statement to its Form 990-PF for the year in which it has a liquidation, dissolution, termination, or substantial contraction.[78] A certified copy of the liquidation plan or resolutions (if any), schedule of the names and addresses of all recipients of assets, and an explanation of the nature and fair market value of the assets to each recipient are requested.[79] If the foundation has ceased to exist, the "Final" box on page one of the form is checked.

If the entity remains in existence as a dormant shell without equitable title to any assets and without activity, it does not need to file returns in the following tax years.[80] If, in later years, it receives new assets or resumes activities, it must resume filing Form 990-PF. The ruling also says such a shell foundation should remain qualified as a §501(c)(3) organization eligible to receive charitable contributions.

[78] IRC §6043.

[79] By General Instruction T for Form 990-PF.

[80] Reg.§1.507-3(a)(10). Some question whether this no-filing rule could apply in other circumstances.

- *Question 3*: If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled,[81] directly or indirectly, by the same person or persons who effectively control the transferor foundation, what are the implications under §4940, §4941, §4942, §4943, §4944, and §4945? [82]
- *Answer:* The IRS's answer to this question focuses on the fact that the successor foundation(s) inherit virtually all of the tax attributes of the transferor foundation. The recipient private foundation is not considered a newly created organization,[83] whether it is commonly controlled or not. All tax obligations and attributes stemming from the code sections listed above, with one important exception noted in answer to question 4, carry over to the successor foundations.

If a private foundation incurs liability for one or more of the taxes imposed under Chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making the asset transfer(s), in any case where transferee liability applies, each transferee foundation is treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.[84] Further, a substantial contributor with respect to the transferor foundation is treated as a substantial contributor with respect to each recipient foundation receiving its assets, whether or not such person meets the $5,000, 2 percent test with respect to the transferee(s) at any time.[85] The consequences of the transfers and resulting carryovers are described as follows for each applicable code section.

Section 4940. The transfers do not give rise to net investment income and are not subject to tax under §4940(a). The basis for this answer is the fact that the transferred assets do not represent taxable income.[86] Private foundations each year pay an excise tax on net investment income at the rate of 1 or 2 percent. Only four specific types of income are subject to the tax: dividends, interest, rents, or royalties. From an accounting standpoint, the value of the net assets received by the transferee(s) would be reported as a donation if the recipient foundation is not commonly controlled. When the recipient foundation is controlled by one or more of the same persons who controlled the transferor, the value of the assets transferred is not reported as revenue, but instead would be reflected as an extraordinary increase in net assets.[87]

The recipient foundations may use their proportionate share of any excess §4940 tax paid by the transferor to offset their own §4940 tax liability. This transfer could occur on the transferor's final return in the form of a special request that its tax credit be applied to its transferee(s). Since the IRS has acknowledged

[81] Within the meaning of Reg.§1.507-3(a)(2); supra note 73.

[82] See Chapters 13 through 17 for additional discussion of these code sections.

[83] Section 507(b)(2).

[84] Reg. §1.507-3(a)(4).

[85] Reg. §1.507-3(a)(3).

[86] See Section 13.1.

[87] The accounting presentation for such transactions involving nonprofit organizations is evolving, but is governed generally by Statement of Financial Accounting Standard 136.

that the transferee is entitled to the funds, it might be preferable to simply request a refund. In the author's experience, a transfer of tax deposits from one entity to another is sometimes a flawed process. When underpayment penalties will not result, it would be preferable to avoid this issue by causing the final return to reflect a tax liability rather than an overpayment of tax.

Since an overpayment of tax is an asset, a foundation with such a receivable should specify in the transfer documents that it is donating the overpayment to the transferee. This step may protect it from an assertion that it has not transferred all of the assets. An unanswered question is the impact of the transfer on the estimated tax requirements for the transferee foundation(s). When the tax attributes carry over, theoretically it would be reasonable to allow the successor to base its safe estimate amount on the transferor's tax liability for the prior year. Absent guidance, the successor should follow the normal rules for newly created private foundations that require tax deposits based upon its actual income received throughout the year using the annualization method provided in the instructions for Form 2220.

Another investment income issue not mentioned in the ruling or the regulations is the calculation of depreciation or depletion on investment properties, such as rental buildings, mineral interests, and assets utilized to manage such properties. Again due to the carryover of tax attributes, the foundation receiving such assets would continue to follow the tax methodology and basis used by the transferor for those assets. Similarly, the basis of transferred assets for purposes of calculating taxable gain or loss for an investment property subject to the excise tax on investment income would be the same as the tax basis for the transferor.

Section 4941. The transfers do not constitute self-dealing.[88] The reason for this conclusion is the fact that the foundations involved in such transfers are charitable organizations pursuant to §501(c)(3). Self-dealing occurs only in transactions between a foundation and its disqualified persons.

In planning for a transfer to another foundation, the possibility that relatives not currently treated as disqualified persons might become disqualified should be anticipated. Certain relatives—particularly aunts, uncles, nieces, and nephews—who are not treated as disqualified persons in respect to the transferor could have some connection to relatives of board members or businesses owned by the transferee foundation. This caution is indicated when the transfers involve excess business holdings or partial interests in property that might need to be disposed of as a result of the transfers.[89]

Section 4942. The transfers do not constitute qualifying distributions for the transferor foundation because the example foundations are commonly controlled. A transfer to an uncontrolled foundation does qualify, as discussed later in this chapter. The transferee foundation assumes its proportionate share of the transferor foundation's undistributed income and reduces its distributable amount by its proportionate share of the transferor's excess qualifying distributions.[90]

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[88] See Chapter 14.
[89] The complicated rules concerning co-owned property are discussed in Section 14.3(e).
[90] See Section 15.6; Rev. Rul. 78-387, 1978-2 C.B. 270 reached the same conclusion.

To understand this conclusion, one must start with the fact that the transferor foundation is required to meet its own distribution requirements for the year in which the transfer occurs.[91] Generally, this payout amount is equal to 5 percent of the average value of the transferor's investment (referred to as "nonexempt function") assets for the year preceding the transfer, called its "minimum investment return." Assume a foundation has $10 million of investment assets, the distributable amount equals $500,000 less its excise tax on investment income for the year, plus returned grants previously claimed as distributions. This "undistributed income," adjusted for over- or underdistributions from prior years, must be paid out before the end of the foundation's next succeeding year. The payout requirement is satisfied by payments of qualifying distributions—charitable grants, expenditures for the foundation's own charitable programs, and administrative expenses.

Final Year Issues. The final year for the transferor foundation ends on the day it is dissolved. In many circumstances, the year will, therefore, be less than a full 12 months. A distributable amount is calculated for the transferor foundation as if it continued in existence. If the recipient foundation(s) is commonly controlled, the distributable amount must be paid out by the transferee(s). That amount equals 5 percent of the average value of its assets for the months of the year it is in existence. For a tax year of less than 12 months, the payout percentage is apportioned for the number of days it was in existence. Assume it's a calendar year in which a foundation distributes all of its assets to a successor foundation and dissolves its charter as a nonprofit corporation on June 30. The required payout percentage equals the number of days it was in existence, or 182 days, over 365 days times 5 percent, or 2.5 percent. If, for example, the average value of investment assets equals $10 million, a payout amount of $250,000, adjusted for over- or underdistributions, must be spent for charitable purposes by the transferee foundation because it inherits all of the tax attributes of the transferor foundation.

Multiple successor transferees, such as those in ruling Situation 1, become proportionately responsible to distribute or succeed to any excess distributions. In Situation 2, the newly created nonprofit corporation would be solely responsible for, or accede to, any under- or overdistributions from the charitable trust. Lastly, in Situation 3, the new private foundation would inherit the remaining distribution requirement or excess distribution carryover of both of its transferors.

It is important to note that the ruling stipulating the results in the preceding paragraph applies to foundations that are effectively controlled. The definition of qualifying distributions includes any amount paid to accomplish a charitable purpose, other than a contribution to a foundation controlled directly or indirectly by the foundation or one or more disqualified persons in respect to the foundation.[92] Therefore, the transfer of assets to an uncontrolled foundation offsets the distribution requirement in the final tax year.

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[91] Reg.§1.507-3(a)(5).

[92] See Section 15.4(b).

The requirement that the transferee foundation(s) make qualifying distributions on behalf of the transferor necessitates good planning and attention to this detail and to timing details. Normally, newly created private foundations, such as the successors in Situations 2 and 3, have no distribution requirements in the first year. However, the next succeeding year of the transferor is the year the transferee receives its assets. Thus, the remaining distributable amount must be paid out in that year.

Consider Situation 2 and assume charitable trust T transfers assets on June 30 and closes its six-month tax year with a remaining distributable amount. Assume that recipient nonprofit corporation W is created on November 1 and adopts a calendar tax year so that it has a two-month tax year beginning on that date. W would be required before December 31 of the transfer year to complete the required distributions for Trust T. Similarly, the newly created foundation V in Situation 3 would be required to satisfy the remaining payout requirements for foundations J and K before the end of their first tax year.[93] When the transferee foundation has already been in existence (as may be the case in Situation 1), the transferor's remaining distributable amount would be payable in addition to any requirement it had from its own succeeding tax year. Similarly, the transferor's excess distribution carryovers would be available to offset the transferee's distributable amount.[94] It is important to note that the aforementioned provisions do not apply when a foundation transfers its assets to a private foundation(s) that its disqualified persons do not effectively control. The transfer of assets to an uncontrolled foundation is considered to be a qualifying distribution if an expenditure responsibility report is due in its final return.[95] This result seems a bit inequitable and may explain one of the reasons the rulings apply only to controlled entities.

Section 4943. Whether the transfer causes a transferee foundation to have excess business holdings[96] depends on the facts and circumstances of the combined ownership after the transfer. When the foundations involved in the transfers are effectively controlled, the disqualified persons, including substantial contributors, of both the transferor and the transferee foundations are treated as disqualified persons of the transferee in determining whether the transferee has excess business. In addition, the transferee's holding period includes both the time that the transferred assets were held by the transferor(s) and the time they were held by itself. When the predecessor and successor foundation(s) are not commonly controlled, this attribution does not occur.

Section 4944. The transfers of assets do not constitute investments jeopardizing the transferor foundation's exempt purposes. Whether or not an asset is a jeopardizing investment is determined at the time of its acquisition. The determina-

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[93] Principal author of the ruling, Theodore R. Lieber of the Exempt Organizations, Tax Exempt and Government Entities Division, said he had not anticipated the hardship this might create when the transfers occur late in the tax year.

[94] A chart illustrating the application of carryovers can be found in Section 15.6 in Exhibit 15.2.

[95] Reg.§1.507-3(a)(7) says no reporting is required once the foundation has disposed of all of its assets.

[96] See Chapter 16.

tion of jeopardy for an asset received by the transferee foundation would be based upon the facts and circumstances existing when the transferor originally acquired it. If jeopardy is found to have existed, the transferee is responsible to remove the asset from jeopardy and pay the penalties due.

Section 4945. The transferor foundation is not required to exercise responsibility with respect to the transfers.[97] With respect to any outstanding grants it had previously made, the transferor foundation is required to exercise expenditure responsibility until the time it disposes of all of its assets and makes reports of such grants on its final Form 990-PF. Expenditure responsibility is an obligation that a private foundation incurs when it makes a grant to another private foundation, an organization exempt under a category of §501(c) other than (3), or to a nonexempt business for a charitable project or program-related investment.[98]

The obligation to make a report and monitor expenditure responsibility with respect to outstanding grants transfers with the assets and transferee foundation(s). When multiple transferee foundations are involved, each is responsible to monitor and report on outstanding grants. That responsibility, however, can be shared, or assumed, by any one or more of the transferees in regard to particular grants.

When assets are transferred by a private foundation to one or more other foundations that it does not control, the transfer requires an expenditure responsibility report in its final return. Such transfers occur without consideration and can therefore be treated as qualifying distributions if the transferor submits an expenditure responsibility report in its final return.[99] However, the uncontrolled transferee foundation has an obligation to exercise responsibility and report on outstanding grants of its transferor.

- *Question 4:* If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled, directly or indirectly, by the same person or persons who effectively control the transferor foundation; what are the implications for the transferor foundation's aggregate tax benefits under §507(d)?
- *Answer:* The transferor foundation's aggregate tax benefits are transferred to the transferee foundations in proportion to the assets received by each transferee. The aggregate tax benefits,[100] as the words imply, represent all of the tax savings realized to the foundation and its funders during the foundation's lifetime.

When there is more than one transferee, the benefit is allocated to the successors by multiplying the amount by a fraction whose numerator is the fair market value of the assets, less encumbrances, transferred to such transferee and whose

[97] Reg.§1.507-3(a)(9)(iii), Example 2.
[98] See Section 16.3.
[99] Reg.§1.507-3(a)(7) says no reporting is required once the foundation has disposed of all of its assets.
[100] Defined in Section 12.4(a).

denominator is the fair market value of the assets of the transferor, less encumbrances, immediately before the transfer.[101]

The impact of this provision is to subject other assets and future enhancements in assets of a commonly controlled transferor to the termination tax for acts it might not have committed. Also, if it is ever determined that a transferee foundation committed willful violations of the private foundation sanctions itself, the termination tax could equal not only those benefits accrued since it received the transfer but also that of the transferor up to the value of all of its assets at the time of its termination. When the transferee foundation is not effectively controlled by the transferor foundation, the carryover is limited to the fair market value of assets received.

The Unanswered Question. IRS guidance for private foundation transfers does not address the carryover of tax attributes to one or more other private foundations that are not effectively controlled by the transferor(s). The statute and the regulations contain no mention of the controlled/uncontrolled distinction and clearly state that the transferee is treated as possessing those attributes and characteristics of the transferor.[102] The regulations provide methodology for allocating tax attributes in the ratio of assets transferred.[103] The only distinction expressed in the regulations is the provision that allows a distribution to another private foundation that is not effectively controlled to be treated as a qualifying distribution.[104] An unanswered question is whether expenditure responsibility must be exercised forevermore when more than 25 percent of one foundation's assets are transferred to one that is not commonly controlled. It must be expected that the answer is yes.

(f) Conversion to a Taxable Entity

Listed first in the statute, but the least likely choice for termination, is a voluntary termination by conversion to a taxable entity.[105] The PF can notify the IRS of its intent to terminate and request abatement (very unlikely) or pay tax, which, of course, it will probably have to pay at a confiscating level.

In most cases, the assets remain dedicated to charitable purposes under charter provisions or a trust instrument, and thereby under state law. Once notice is given, the PF is treated as a newly created organization. If, for some unlikely reason, it wanted to resecure tax-exempt status, it would have to refile Form 1023 to be recognized as exempt.[106]

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[101] Reg. §1.507-3(a)(2).
[102] §507(b)(2); Reg. §1.507-3(a)(1).
[103] Reg. §1.507-3(a)(2), Example 3.
[104] IRC §4942(g)(1)(A).
[105] IRC §507(a)(1).
[106] Reg. §1.507-1(b)(3).

APPENDIX 12–1

Brief Description of Tax Sanctions Applicable to Private Foundations

A private foundation is given special treatment by the federal income tax code because it is funded by a single donor (or a particular family or small number of persons). The U.S. Congress, in 1969, added provisions to the tax code to prevent the operation of a private foundation for the benefit of its creators and insiders. The rules, in a negative fashion, call those that fund and control the foundation *disqualified persons.* The disqualified persons and the foundation can be subject to excise tax rules if the rules contained in Chapter 42 of the Internal Revenue Code are violated. The rules are sometimes identified by the code section numbers, §4940 to §4946. This memo briefly describes those code sections and is not intended to fully inform one about the rules, but only to provide enough information to enable one to know when to ask a question.

EXCISE TAX ON INVESTMENT INCOME—§4940 TAX

A private foundation must annually pay an excise tax on the income earned on its investments, including dividends, interest, royalties, rents, and capital gains from properties producing such income. The tax rate is 2 percent, but can be reduced to 1 percent in a year in which the foundation's percentage of charitable giving in relation to its total assets increases (or law changes). Essentially, some say the foundation can choose to give away half of the tax to grantees rather than to the government.

If a foundation receives a net investment income of $100,000, for example, the foundation would owe a tax of $2,000 (2 percent of the income). This excise tax is paid with tax deposit vouchers at a federal bank throughout the year on a quarterly basis, following the similar system for paying the estimated income tax. See Chapter 13 for tax-planning and reporting issues. This tax is calculated on the Form 990-PF all private foundations are required to file annually.

Self-Dealing—§4941

In 1969 Congress thought private foundations were being used as extra pocketbooks for funds not necessarily available to a foundation's related parties from other sources and set out to completely eliminate self-interested financial activity between a privately funded charity and its insiders. A foundation is constrained from having financial transactions with persons who create, control, and fund it, as a general rule. The prohibition applies even if the foundation benefits from the transactions. As an absurd example, a foundation cannot buy for $1 an asset owned by a funder that is worth $1 million.

As with many tax rules, some exceptions may apply. Though the following list of specific transactions that constitute prohibited self-dealing forbids the use of property, the PF's creator can provide rent-free office space. Similarly, although payment of compensation is literally prohibited, director's fees and salaries can be paid so long as the amount is reasonable for the services rendered. If a prohibited self-dealing transaction occurs, the money must be returned and the insider is subject to a 5 percent excise tax (an increase to 25% was proposed in 2003). Directors or trustees who approved the transaction may also be penalized. The following specific transactions between the foundation and its disqualified persons are identified as self-dealing and are forbidden by the code, although exceptions apply, as discussed in Chapter 14:

- Sale, exchange, or leasing, of property between a PF and a DP
- Lending of money or other extension of credit between a PF and a DP
- Furnishing of goods, services, or facilities by a PF to a DP and vice versa
- Payment of compensation/reimbursement of expenses by a PF to the DP
- Transfer to, or use by, or for benefit of a DP of any income or assets belonging to the PF
- Agreement by the PF to pay a government official

Minimum Distribution Requirement—§4942

The foundation must annually spend a minimum amount for grants and other charitable disbursements. The required amount of the charitable payments, called *qualifying distributions,* is 5 percent of the average fair market value of the PF's investment assets for the preceding year. A PF in its first year of existence has no distribution requirement. Assume for simplicity that a foundation's investments have an average value of $1 million during year 1. Its mandatory distribution amount for year 2 is $50,000, payable before the end of year 2. In each succeeding year of its existence, the foundation must continue to distribute the mandatory amount based upon the prior year's average asset value. If charitable disbursements in a year exceed the required amount, the excess can be carried over five years to offset the mandatory amount in succeeding years. See Chapter 15.

Excess Business Holdings—§4943

A private foundation, when its ownership in an active business corporation or partnership is combined with the holdings of its disqualified persons, cannot own more than 20 percent of the total shares of that enterprise, unless the PF itself owns not more than 2 percent. A foundation cannot operate its own business, or be what is called a *proprietor* of a business. If a foundation receives a donation of property that creates an excess business holding, the PF is allowed five years in which to dispose of the excessive amount. See Chapter 16.

Jeopardizing Investment—§4944

A private foundation's directors and trustees must exercise prudence and good business judgment in investing the foundation's assets. They are penalized if they invest any amount in a manner that jeopardizes the PF's ability to carry out its tax-exempt purposes. This rule parallels state laws under which the managers of a PF have a fiduciary responsibility to safeguard its assets on behalf of its charitable constituents. The long- and short-term financial needs of the PF can be taken into account in evaluating the inherent risk of an investment in accord with the Institutional Investor Act adopted by many states. The *Prudent Investor Rules* outlined by the American Bar Association in its *Restatement of the Law Trust Series* contain guidance on this subject. See Chapter 16.

Taxable Expenditures—§4945

Lastly, a foundation must devote its income and principal exclusively to the charitable purposes for which it was created and maintain records that prove its disbursements accomplish a charitable purpose. Payments made for noncharitable purposes and those without suitable documentation are called *taxable expenditures* and are subject to a 10 percent excise tax. Most PFs make grants to support the activities of churches, schools, hospitals, museums, and other publicly supported tax-exempt organizations and can rely upon the recipient's IRS status as proof of the charitable nature of the grant made. The suggested Grants Checklist, Grant Agreement, and Grant Payment Transmittal found in Chapter 17 can be used as a guide in gathering the appropriate documentation for such grants. It is very important that the foundation ascertain—*before* it pays a grant—the public charity status of proposed grant recipients.

Although special documentation is required, one private foundation's support of another private foundation and individual scholarship and research grants can also serve its charitable purposes. A foundation that makes individual scholarship grants must seek advanced IRS approval for its program as evidenced by a written plan designed to ensure such grants are awarded on an objective and nondiscriminatory basis that allows no benefit to the foundation's insiders. One foundation granting funds to another must enter into a contract with the other foundation, called an *expenditure responsibility agreement,* and make special reports to the IRS, also discussed in Chapter 17.

Administrative Issues

Grant Documentation. A foundation should maintain a permanent file for each of its grant recipients. At minimum, a grant application should be required for each potential grantee and a Grants Checklist should be completed prior to the issuance of any grant payment. Due to the specific rules governing their charitable expenditures and the paperwork involved in the grant-making process, a private foundation must carefully describe its charitable mission and the specific types of programs it supports. Even if the foundation's charter contains a broad charitable purpose, its grant decision makers may find it useful to narrow the categories of programs it supports. Some foundations develop written grant criteria to inform interested persons of the purposes for which the foundation will grant funds. It is very important that the information entered in Part XV of Form 990-PF be accurate because it is published nationwide in printed and electronic directories for grant seekers.

Many foundations ask if they are required to keep the paperwork regarding grants that are not awarded. For federal tax purposes there is no requirement, but some foundations find it useful to keep such requests for a few years (in alphabetical order) for reference, in the event the organization reapplies or someone inquires about the grant deliberation process.

Donation Acknowledgments. Just like all other charitable organizations, a private foundation must provide the type of receipt shown in Exhibit 24-1 to its contributors to acknowledge their donation and reveal whether any goods or services of value were provided in connection with the donation(s). Note that the furnishing of goods or services might constitute prohibited self-dealing, as discussed in Chapter 14.

Tax Compliance. Although private foundations are exempt organizations under IRC §501(c)(3), they are taxpayers in other respects. Annually a 12-page Form 990-PF is filed to report financial activity, assets with individual listing of investments, details of charitable programs and grants, and satisfaction of mandatory distribution requirements; to calculate the excise tax on investment income; and more.[107] Form 990-PF is required for all PFs regardless of income level. Persons engaged to serve the foundation may be employees from whom the foundation must withhold deposit and report employment taxes, as discussed in Chapter 25. Real and personal property held for investment may be subject to state and local property taxes. Certain types of business income may be taxed as unrelated income, as explained in Chapter 21. A foundation selling books, reproductions, or other items may be required to collect local sales tax.

[107] See Blazek, *IRS Form 990 Tax Preparation Guide for Nonprofits* (Hoboken: Wiley, 2004) for line-by-line guidance in completing this form.

CHAPTER THIRTEEN

Excise Tax Based on Investment Income: IRC §4940

To pay the cost of "extensive and vigorous" enforcement of sanctions imposed upon privately funded charities, Congress, in 1969, adopted a tax on private foundation investment income. Congress thought that foundations should continue to be exempt from income tax, so the tax was enacted as an excise tax rather than the normal income tax imposed by Internal Revenue Code (IRC) §1.

The private foundation excise tax on investment income was described by the Congress as a "charge or audit fee" and was initially set at 4 percent of the foundation's investment income. When the tax being collected was revealed to actually be much more than the cost of examining foundations, the tax was cut to 2 percent in 1978.

In 1984 the tax was reduced again, but only for foundations that essentially pay out part of the tax in the form of charitable grants and projects, as described fully in Section 13.4(b). If the foundation sustains its historical percentage of giving in relation to the current value of its investment assets, it can divert the 1 percent tax to grantees and need not pay it to the government—it only pays a 1 percent tax.[1]

A private foundation can qualify for this rate reduction only if it has met its mandatory payout requirements and has not been subject to a sanction for underdistribution[2] during the base period. [3] This does not, however, mean the historic payout rate must be above 5 percent. In studying Part V of Form 990-PF, one sees that the payout formula compares the qualifying distributions (based on preceding-year values) to the current-year average value of the assets. It is common, during a period of rising asset value, for the historic payout rate to be less than 5 percent. The original committee reports for this section contained a sentence saying, "The rate is not reduced for a year if the foundation's average percentage payout for the base period is less than five percent (3 ⅓ percent in the case of a private operating foundation)." [4] The tax code, the form design, and the IRS instructions to the form do not contain this provision, presumably because someone recognized the good possibility that the result could be less than 5 percent.

Proposals to reduce the tax to 1 percent, or eliminate it, have been introduced in Congress in recent years. To discourage foundations from purposefully losing exempt status to avoid this excise tax, IRC §4940(b) provides that a taxable foundation must still pay the 2 percent excise tax plus the unrelated business income tax, unless the ordinary income tax on its overall income is higher.

13.1 FORMULA FOR TAXABLE INCOME

The calculation of excise tax on investment income is made each year when the foundation files Form 990-PF.[5] The excise tax is imposed on the foundation's *net investment income* for each taxable year, which equals:

$$\begin{matrix}\text{Gross}\\\text{Investment}\\\text{Income}\end{matrix} + \begin{matrix}\text{Net}\\\text{Capital}\\\text{Gains}\end{matrix} - \begin{matrix}\text{Allowable}\\\text{Deductions}\end{matrix} = \begin{matrix}\text{Net}\\\text{Investment}\\\text{Income}\end{matrix}$$

(a) Gross Investment Income

Only five specifically named types of income are included in gross investment income for a private foundation: interest, dividends, rents, payments with respect to securities loans,[6] and royalties from all sources. Any such income subject to the unrelated business income tax (UBIT) of IRC §511 is not taxed twice and, therefore, is excluded from the excise tax.[7] The income and associated

[1] IRC §4940(e).
[2] See Section 15.6
[3] IRC §4940(e)(2)(B).
[4] House Committee Report for P.-L. 98-369, Deficit Reduction Act of 1984.
[5] See Chapter 18 and Jody Blazek, Chapter 4 , *IRS Form 990 Tax Preparation Guide for Nonprofits* (New York: Wiley, 2004).
[6] As defined in IRC §512(a)(5).
[7] IRC §4940(c)(2) and Reg. §53.4940-1(d); see Chapter 21.

deductions are reportable using the method of accounting, either cash or accrual, normally used by the foundation for financial reporting purposes, with certain exceptions discussed subsequently.[8] Income of the specifically named five types, listed here, that is produced by both investment and exempt function assets is taxed.[9]

(b) Interest

Interest income is taxed if it is earned on the following types of obligations and investments:

- Bank savings or money market accounts, certificates of deposit, commercial paper, and other temporary cash investment accounts
- Commercial paper, U.S. Treasury bills, notes, bonds and other interest-bearing government obligations, and corporate bonds
- Interest on student loans receivable,[10] on mortgage loans to purchasers in low-income housing projects, and on loans to minority business owners as a program-related investment
- Payments on collateral security loans
- Municipal bond interest paid by state and local government is excluded and is not taxed, and any expenses allocable to the nontaxable interest are not allowable as deductions. Municipal interest is included in "adjusted net income" for a private operating foundation.
- Series E bond interest, not previously reported by a decedent or by the estate, is taxed to the foundation.[11]

Distributions attributable to interest income earned by an estate do not retain their character as interest, but instead are treated as contributions to the foundation. Proceeds of a qualified employee plan, except for interest accrued after the date the gift is effective, are not among the specified types of income. Plan proceeds are deferred compensation, do not constitute investment income earned by the foundation, and are not taxable under IRC §4940.[12] The IRS has privately ruled that the proceeds of a donated retirement account were not taxable because the excise tax is limited in its application to the specifically listed types of income—dividends, interest, rents, and royalties.[13]

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[8] Reg. §53.4940-1(c); Rev. Rul. 80-18, 1980-1 C.B. 103.

[9] Reg. §53.4940-1(d)(1).

[10] Reg. §53.4940-1(d)(1).

[11] Rev. Rul. 80-118, 1980-1 C.B. 254; retirement plan proceeds payable to a foundation were deemed to be income in respect of a decedent in Priv. Ltr. Rul. 9818009. Watch for a subsequent ruling in which the IRS may further address this issue.

[12] Chapter P, *IRS CPE Text,* 1999, p. 316, and Priv. Ltr. Rul. 9341008; though in Priv. Ltr. Rul. 9818009 concerning a Keogh plan the IRS took a contrary view, but the training text clarifies that matter; see also Priv. Ltr. Rul. 200003055 that agrees with this conclusion.

[13] Priv. Ltr. Ruls. 20003055 and 9838028; the rulings specifically are said to apply only to §4940 tax. The rulings do not opine on the potential for unrelated business income tax.

Another unanswered question is whether income earned on an annuity contract is subject to the investment income tax.[14] The increase in the annual value of an annuity contract is thought of as interest and calculated at an expressed rate. The annual increase, however, is not taxed as interest under certain income tax rules. The increase is taxable to holders other than natural persons, such as a private foundation, as ordinary income from the annuity contract.[15] When a private foundation holds an annuity, several questions arise. The increase in value of an annuity should not be reportable for §4940 purposes because it is not interest, nor is it a dividend or rental or royalty income. Second, the unrelated business income tax rules specifically modify or exclude annuity income from that tax.[16] Finally, the proceeds of redemption of the annuity contract would similarly be the disposition of an asset that does not produce the type of income subject to the investment income tax resulting in a nontaxable gain for that purpose. Similarly, the gain, or difference between the tax basis of the contract and the proceeds, would not be subject to the unrelated business income tax.[17]

(c) Dividends

Dividends that are taxable include the following:

- Dividends paid on all types of securities, whether listed and marketable or privately held and unmarketable
- Mutual fund dividends (capital gain portion is also taxed, but as a capital gain)
- For-profit subsidiary dividends
- Corporate liquidating distributions classified as dividends under IRC §302(b)(1), but not including payments on complete redemption of shares that are classified as capital gains[18]

The redemption of stock from a private foundation to the extent necessary to avoid the excess business holdings tax is a sale or exchange not equivalent to a dividend, and the proceeds are not taxed as investment income.[19] Similarly, a conversion of the foundation's shares in a tax-free reorganization is not considered as taxable investment income.[20] Dividends earned on a paid-up life insurance policy that was donated to the foundation were found to be taxable.[21] Dividends and other distributions of income from a Subchapter S corporation are subject to the unrelated business income, rather than the investment excise tax.[22]

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[14] The author thanks Jim Possin of Grant Thornton for raising this question and found, as he did, no guidance on the question. That same issue arises with a whole life insurance policy.

[15] IRC §72(u)(1); if the contract is gifted to a private foundation, the excess fair market value of contract over donor's tax basis is taxable as ordinary income to the donor under IRC §72(e)(4)(C)(iii).

[16] IRC §512(b)(1).

[17] See Chapter 21.

[18] Priv. Ltr. Ruls. 8512090, 8326125, 8043112, and 8001046.

[19] Rev. Rul. 75-336, 1975-2 C.B. 110.

[20] Priv. Ltr. Rul. 7847049.

[21] Priv. Ltr. Rul. 8449069.

[22] IRC §512(e).

Certain types of peripheral security transactions do not produce dividends or interest and are therefore not subject to the excise tax. An option to buy (a put) or sell (a call) a security produces gain or loss if it is sold or expires, but does not produce, and is not capable of producing, income subject to the excise tax. Options to buy commodities, such as corn or wheat, or gold futures have similar characteristics. Other sophisticated types of investments, such as derivatives, were not anticipated when §4940 was written. IRS guidance on income earned on these so-called alternative investments is meager.

(d) Rentals

Amounts paid in return for the use of real or personal property, commonly called rent, are taxable—whether the reason for renting the property is an investment purpose or is related to the foundation's exempt activities.[23] The portion of the rental income attributable to that portion of the property that is debt financed is taxed as unrelated income and therefore excluded from the investment income excise tax.[24]

(e) Royalties

Payments received in return for assignments of mineral interests owned by the foundation, including overriding royalties, are taxed. Only cost, not percentage, depletion is permitted as an offseting deduction. Royalty payments received in return for use of a foundation's intangible property, such as the foundation's name or a publication containing a literary work commissioned by the foundation, are also taxable. Income from a working interest in a mineral property is excluded. Instead, it is UBI (and the property may be an excess business holding).

(f) Estate or Trust Distributions

Payments to the foundation from an estate or trust do not generally "retain their character in the hands" of the foundation. In other words, such payments do not pass through to the foundation as taxable income.[25] Even if the estate income is recognized for financial purposes because the foundation follows the accrual method of accounting, income earned during administration of a trust estate is not treated as foundation investment income.[26] The estate assets, including accumulated income, are also not treated as foundation assets for the purpose of calculating grant payout requirements.[27] Part of the reason for this rule lies in the fact that the wholly charitable trust pays its own 2 percent excise tax, and its distributions are not taxed again to the foundation upon their receipt. Income earned during administration of an estate that is set aside or earmarked for payment to a foundation is deductible as a charitable contribution. Such income is

[23] Instructions to Form 990-PF (2003 version), Part I, column (b), at p. 10.
[24] IRC §514(a)(1) and 4940(1)(2).
[25] Reg. §53.4940-1(d)(2) and §53.4947(b)(2)(i); Priv. Ltr. Rul. 20224035.
[26] Regs. §53.4940-1(d)(2) and §53.4947(b)(2)(i); Priv. Ltr. Rul. 200224035.
[27] See Section 15.1(b).

not taxable to either the estate or the foundation (unless administration is unreasonably continued).[28]

Payments from a split-interest trust created after May 26, 1969, do pass through to the foundation as taxable income if they are attributable to trust income from interest, dividends, or the other specific types of taxable investment income. However, capital gains distributed from a split-interest trust are treated as donations and do not retain their character as capital gains.[29]

(g) Partnerships

When a private foundation buys, or is given, an interest in a partnership, its proportionate share of interest, dividends, rents, and royalties earned by the partnership is reportable for excise or unrelated business income tax purposes. The partnership income retains the same character in the foundation's hands. Form K-1 must be provided each year, reflecting each partner's share of the various types of income earned by the partnership. Detailed information to allow a tax-exempt partner, including a private foundation, to report its share of unrelated business income and calculate its tax liability must be provided. Rentals from indebted real estate are the most common type of unrelated income distributed from partnerships.[30] As mentioned previously under Section (c), "Dividends," all income distributed to a foundation from a Subchapter S corporation is subject to the unrelated business income, rather than the excise, tax, even if the character of the income in the hands of the corporation is interest, dividends, rent, or royalty.

Income earned from investment in foreign partnerships or corporations may not be currently taxable under the Subpart F income tax rules.

13.2 CAPITAL GAINS

Net short- and long-term capital gains from the sale of property used for the production of the specific types of income subject to the investment income tax—interest, dividends, royalties, rents, and security loan payments—are also taxed.[31] Mutual fund capital gain dividends, both short- and long-term, are classified as investment income.[32] Gains or losses from sales of assets used directly by the foundation in conducting its exempt activities are not taxed, including program-related investments.[33] The investment-use portion of a dually used property is taxed. The gain from property used in an unrelated trade or business is not taxed for this purpose, if it is subject to the normal income tax.

Capital losses only offset capital gains from sale of assets and capital gain dividends. Capital losses may not offset other investment income, and a net capital loss for a year cannot be used to offset gains in a succeeding year.[34] The tax

[28] Priv. Ltr. Rul. 8909066.
[29] IRC §§642(c) and 663(a)(2).; Reg. §53.4940-1(f) and Priv. Ltr. Rul. 9724005.
[30] See Section 21.10(g).
[31] IRC §4940(c)(4)(A).
[32] Rev. Rul. 73-320, 1973-2 C.B. 385.
[33] Priv. Ltr. Rul. 9320054.
[34] IRC §4940(c)(4)(A).

code itself makes no reference to carryback of losses, although the regulations state that the "excess may not be deducted from other income . . . nor used to reduce gains in either prior or future years."[35] Year-end tax planning to avoid a net capital loss for the year is particularly important to a foundation with security, other investments that have decreased in value. In view of the extensive capital losses they realized during the period from 2001 to 2002, some foundations question the validity of the regulation prohibiting loss carrybacks. In 2003, a few filed refund claims and made plans to challenge what they see as an overreach of the statute in court.

(a) Basis

The tax basis for calculating gain or loss is equal to the amount paid by the PF for the assets it purchases or constructs, less any allowable depreciation or depletion. Assets acquired by gift, however, retain the donor's, or a so-called carryover, basis, and holding period.[36] Accounting principles suggest that a foundation record donated property at its value on the date the gift is made. For tax purposes, however, it may not step up the tax basis to such value. Essentially, the PF pays the tax unpaid by the donor (even when the alternative minimum tax applies). A foundation holding low-basis securities may be able to reduce this tax burden if it can dispose of the shares in a year (other than its first year) in which its tax rate is reduced to 1 percent.[37]

The basis of inherited property is equal to its Form 706 (estate tax return) value, which is ordinarily its value on the date of the decedent's death. For property held by a foundation on December 31, 1969—the date when the tax became effective—special rules apply. The tax basis for any property held on that date is equal to its December 31, 1969, valuation, unless a loss is realized on the sale using such a value.[38] The IRS *Private Foundation Handbook* contains 25 pages of stock quotations from that date for reference.[39] Property held in a trust or in an estate created before 1969 may also use the 1969 basis.[40]

Appreciation of assets held by a newly classified private foundation attributable to the time it was a support organization may not necessarily be subject to the §4940 excise tax on capital gains.[41] A health-care conglomerate asked the IRS to consider the issue concerning its reorganization. It planned to convert itself into a grant-making private foundation and to sell its assets, including (c)(3) health centers, a publicly traded HMO, a for-profit physician practice management group, and an insurance subsidiary, over a period of years. Although IRC

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[35] Reg.§53.4940-1(f)(3).
[36] Reg. §53.4940-1(f)(2) refers to IRC §1015.
[37] Illustrated in Exhibit 13-1.
[38] IRC §4940(c)(4)(B); Rev. Rul. 74-403, 1974-2 C.B. 381.
[39] IRS Manual 7752, Exhibit (12)00-1.
[40] Rev. Rul. 76-424, 1976-2 C.B. 367. See also Priv. Ltr. Ruls. 8539001 and 8150002 regarding property distributed after a life tenant's death.
[41] Priv. Ltr. Rul. 9852023; the ruling also cited Rev. Rul. 76-424, 1976-2 C.B. 367, which allowed the basis of property received by a foundation from an estate created before1970 to be stepped up to 12/31/69.

§4940 and its regulations contain no provision regarding the basis of assets of a converted public charity, the IRS privately allowed a generous position. It allowed a step-up of basis of fair market value on the date a public charity was converted to a private foundation (PF). Essentially, it treated the built-in gains as if they had been realized during the period the organization was a public charity (and therefore free of the PF excise tax). The ruling cited the transition rule allowing a step-up to value as of December 31, 1969, when the excise tax was first imposed, as rationale for not requiring recognition of gain realized while the now private foundation was classified as a support organization.[42]

(b) Questionable Types of Gain

Gain from sale of property capable of producing the specified types of taxable income (interest, dividends, rents, security loans, and royalties) are taxed even if the property is disposed of immediately after the foundation receives it. Since the statute applies to "property used for the production" of the specified income, clever foundations in the early days were hopeful they could escape the tax on low-basis property gifts by selling them as soon as the property was given.[43] The foundations argued that they never held the property to produce the specified types of income, so the tax should not apply. Effective December 31, 1972, a sentence was added to the regulations to provide that the tax applies even if the property is immediately disposed of upon its receipt, if "the property was of a type which generally produces interest, dividends, rents, royalties or capital gain through appreciation" (for example, rental real estate, stocks, bonds, mineral interests, mortgages, and securities).[44] The courts agreed with the IRS.[45]

A case involving a sale of timberland further clarified the application of the tax to such properties. Even though it was conceivable that the real estate in question could have been used to produce rental income, it was not. Instead, it was "economically prudent and reasonable" for the Zemurray Foundation to grow and cut the timber. Since the foundation did not use the land to produce a type of income specified in the statute, gain on its sale was not subject to the tax. The court held that only property that "can be reasonably expected to generate one or more of the five types of income" is subject to the tax.[46] Other assets that fall into this nontaxable category include collectibles such as art works, gold, antiques, cattle, and undeveloped raw land. Non-dividend-paying common stock is, for example, a type of property *capable* of producing dividends, and the appreciation is, therefore, subject to the tax.

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[42] Additionally, the for-profit subsidiaries were considered donated property not required to be disposed of under the excess business holdings discussed in Section 16.1(e), nor jeopardizing investments, as discussed in Section 16.2.

[43] Rev. Rul. 74-404, 1974-2 C.B. 382.

[44] Reg. §53.4940-1(f)(1).

[45] *Ruth E. and Ralph Friedman Foundation, Inc. v. Commissioner,* 71 T.C. 40 (1978*); Greenacre Foundation v. U.S.,* 762 F.2d 965 (Fed. Cir. 1985, aff'g. 84-2 USTC ¶9789 (Ct. Cl. 1984); *and Balso Foundation v. U.S.*, 573 F. Supp. 191 (D. Conn. 1983).

[46] *Zemurray Foundation v. U.S.,* 84-1 USTC ¶9246 (E.D. La. 1983), aff'd. 755 F.2d 404 (5th Cir. 1985).

(c) Nontaxed Gains

Certain capital gains are not taxed:

- Gain from sale of exempt function assets, including program-related investments, are not taxed. Such property producing "incidental" income is fully excluded from the tax. Property used both for exempt and for income-producing purposes, such as an office building partly used for administrative offices and partly rented to paying tenants, however, will produce pro rata nontaxable and taxable gain or loss.[47]
- Distribution of property for charitable purposes is not considered a sale or other disposition for purposes of this tax. Thus, the gain inherent in appreciated property distributed as a grant to another charity is not taxed.[48]
- Gain from disposition of "excess business holdings" held on December 31, 1969 (or received as a bequest under a trust irrevocable on May 26, 1969), and sold to or redeemed by a disqualified person to reduce the holdings[49] is not taxed.
- Gain realized in a merger or corporate reorganization ruled to be tax free under IRC §368 or other section of IRC Subchapter C[50] is not taxed.
- Gains from selling, or the expiration, of an option to buy or sell stock and other types of property[51] are not taxed.
- Capital gains distributed by a split-interest trust[52] are not taxed.
- Gain from sale or expiration of any option to buy or sell an asset.
- Gains earned from investment in foreign partnerships or corporations may not be currently taxable under the Subpart F income tax rules.

13.3 DEDUCTIONS FROM GROSS INVESTMENT INCOME

Gross investment income can be reduced by "all the ordinary and necessary expenses paid or incurred for the production or collection of property held for the production of gross investment income or for the management, conservation, or maintenance of property held for the production of such income." A private foundation's operating expenses include compensation of officers; other salaries and wages of employees; outside legal, accounting, and other professional fees; office rent, interest, rents, and taxes on property used in the foundation's operations; travel; memberships; publications; and other administrative expenses.[53] Expenses must be paid or accrued and have a connection or nexus to taxable income. A termination fee paid by a foundation upon receipt of the

[47] Reg. §53.4940-1(f)(1); Priv. Ltr. Rul. 8425114.
[48] Reg. §53.4940-1(f)(1); see discussion in Section 13.4(c).
[49] Reg. §53.4940-1(d)(3); Priv. Ltr. Rul. 8214023.
[50] Priv. Ltr. Ruls. 8906013 and 8730061.
[51] Priv. Ltr. Ruls. 8852001, 8846005, 8752033, and 8650049.
[52] See Section 13.1(f).
[53] IRC §4940(c)(3); Reg. §53.4940-1(e)(1)(i).

remainder interest in a trust was, accordingly, not deductible (value of the property received is also not taxable).[54] Interest expense paid on debt attributable to bonds to be used for construction of an exempt facility was deductible only to the extent of income from temporary investment of the bond proceeds.[55]

Where a private foundation's officers or employees engage in activities on behalf of the foundation for both investment purposes and exempt purposes, their compensation and salaries must be allocated. No particular expense allocation method is prescribed, so that the foundation can use any reasonable method that is used consistently from year to year. For personnel costs, the preferred allocation method is for the employees involved to maintain actual records of their time devoted to investment and exempt activities. The concepts and rules applicable to deductible expenses for unrelated business income tax purposes can be used as a guideline.[56] Documentation should be maintained to evidence the manner in which the allocations are made.

(a) Deductions Allowed

The following deductions are permitted:

- Depreciation on property the income of which is taxed using a straight-line method (calculated over the estimated useful life of the property), but no accelerated system is allowed.[57] The basis for calculating depreciation for purchased or constructed assets is equal to their cost. Donated property retains the donor's, or a carryover, basis. The normal income tax rules are used to measure basis.[58] Special rules apply to assets held by a foundation before 1969, when it began to claim depreciation for the first time in 1970.
- Cost, but not percentage, depletion on mineral interests[59]
- Investment management and counseling fees, except for that portion attributable to tax-exempt interest or unrelated business income
- Legal, accounting, and other professional fees allocable to investment income activity. A private foundation can ask its advisors to render billings specifically identifying such an allocation based upon time actually spent.[60]
- Taxes, insurance, maintenance, and other direct and specifically identifiable costs paid for property producing rental income, and an allocable part of such costs for administrative offices. Space rental would be similarly deductible to the extent the space is occupied by persons responsible for managing the properties that produce income subject to the excise tax.

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[54] *Lettie Pate Whitehead Foundation, Inc. v. U.S.,* 606 F.2d 523 (5th Cir. 1979) aff'g. 77-1 USTC ¶9157 (N.D. Ga. 1977).

[55] *Indiana University Retirement Community, Inc. v. Commissioner,* 92 T.C. 891 (1989).

[56] See Blazek, *990 Handbook* Chapter 5 (New York: Wiley).

[57] IRC §4940(c)(3)(B)(i).

[58] IRC §1015.

[59] IRC §4940(c)(3)(B)(ii).

[60] Rev. Rul. 75-410, 1975-2 C.B. 446.

- A proportionate part of operating expenses, including director, trustee, officer, and staff salaries and associated costs, meetings, dues, office and clerical costs, and bank trustee fees
- An allocable portion of expenses paid or incurred incident to a charitable program that produces taxable investment income is deductible to the extent of the income earned.[61]
- Bond premium amortization is deductible under IRC §171.[62]
- An allocable portion of the costs of setting up the foundation, if the cost was associated with planning for investments and their tax consequences

(b) Deductions Not Allowed

No deduction is permitted for costs associated with a foundation's grant-making and other charitable or exempt function projects. When a project or asset produces or is operated to produce some income, the deductions for the activity are allocated between the exempt and the investment uses.[63] With such joint-purpose activities, the primary motivation for undertaking the project (investment or gratuitous) must be determined. When the expenses are incurred in connection with an exempt function project, allocable expenses are deductible only to the extent of the gross investment income from the project.[64] An investment project conceivably could result in a deductible loss. The typical historic restoration project is not expected to produce net income. Since admission charges for visiting such buildings are normally incidental to the overall cost of the project, it would be hard to prove that the building loss is deductible against other investment income. The following items are examples of nondeductible expenses for investment income purposes:

- Charitable distributions and administrative expenses associated with grant-making program costs are not deductible.[65] Similarly, expenses of programs directly conducted by the foundation are not deductible. These expenses are treated as qualifying charitable disbursements.
- Purchase of exempt function assets, depreciation of their cost, and cost of their maintenance, repair, or conservation are not deductible, except to the extent of income generated by the property.[66]
- Capital losses in excess of capital gains are not deductible, nor is a carryover permitted to the succeeding year.[67] This is a potentially costly rule to a foundation that does not properly time its asset dispositions.

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[61] Reg. §53.4940-1(e)(2)(iv) and Priv. Ltr. Rul. 8047007.

[62] Rev. Rul. 76-248, 1976-1 C.B. 353.

[63] Reg. §53.4940-1(e)(1)(ii).

[64] Supra note 61.

[65] *Julia R. and Estelle L. Foundation, Inc.*, 79-1 USTC ¶9363 (2d Cir., 1979), aff'g. 70 T.C. 1, Dec. 35,086; no charitable deduction similar to IRC §170 or §642(c) is permitted.

[66] *Historic House Museum Corp.*, 70 T.C. 12, Dec. 35,087.

[67] Reg. §53.4940-1(f)(3); this regulation prohibiting loss carrybacks may be challenged, as discussed in Section 13.2.

- Operating losses incurred in a preceding year do not carry forward from year to year.[68]
- The allocable portion of expenses of exempt function income-producing property or activity in excess of the income produced therefrom and reportable as investment income are not deductible.[69]
- Expenses allocable to taxable unrelated business income are not deductible. (The income is also not includable.)[70]
- Interest paid on borrowing to acquire exempt function assets is not deductible. For example, interest paid on a bond issue floated to finance the building of a retirement community is not paid on behalf of an investment.[71] If the building is rental property, however, the interest and other property maintenance and operational expenses should be deductible[72] but subject to possible limits on loss deductions.
- Interest paid to borrow funds that a foundation relends to another charitable organization (presumably at low interest or interest-free) has been ruled not deductible. Such interest expense is deductible only to the extent of any interest income collected from the relending or temporary income earned on the funds.[73]
- A trust termination fee paid by the sole beneficiary private foundation was not paid for the production of income, nor were the unused deductions from the final trust return (customarily deductible to a noncharitable beneficiary under §642(h)(2)) deductible to the PF.[74]
- The special corporation deductions, including the dividends received deduction, are not allowed.[75]

13.4 TAX-PLANNING IDEAS

This section explores the interaction of the §4940 excise tax on investment income, the §4942 minimum distribution requirements, and the §170 deduction for appreciated property donations. As the excise tax rate on foundation investment income has fallen over the past 30 years, the PF excise tax has become an accepted cost of retaining private control over donated funds. Perhaps because of the tax rate, very little is written on the subject. Its modest annual amount may be less than the cost of engaging advisors to perform year-end tax planning. Given the right circumstances, substantial savings can result from taking advantage of two relatively simple tax-planning methods systematically over a period of years. Say, for example, a foundation with net investment income of $500,000

[68] Reg. §53.4940-1(e)(1)(iii).
[69] Supra note 61.
[70] Reg. §53.4940-1(e)(1)(i); See Chapter 21.
[71] Priv. Ltr. Rul. 8802008; Rev. Rul. 74-579, 1974-2 C.B. 383.
[72] *Indiana University Retirement Community, Inc.*, 92 T.C. 891, Dec. 45, 674 (Acq.).
[73] Rev. Rul. 74-579, 1974-2 C.B. 383.
[74] *L. P. Whitehead Foundation, Inc. v. U.S.*, 79-2 USTC ¶9706 (5th Cir. 1979).
[75] IRC §4940(c)(3) and Reg. §53.4940-1(e)(1)(iii).

pays an annual excise tax of $10,000. Although this tax is modest in some eyes, most foundations could reduce and partly avoid the tax using the techniques described in the following sections.

(a) Distributing, Rather than Selling, Property

For several very different—but interacting—reasons, a foundation might sell assets that result in recognized capital gains subject to tax. The typical foundation invests its assets for total return.[76] Under this investment philosophy, more than 50 percent of the average security portfolio is invested in common stocks. The aim is a combined income from current dividends, interest, and capital appreciation. It is expected that capital gains will be regularly earned as portfolio holdings are sold in response to market changes. When the desired result—capital gain—occurs, tax is due.

The dividends and interest, sometimes referred to as the *current return,* from a total return security portfolio often equal less than the foundation's 5 percent payout requirement.[77] A foundation with such a portfolio essentially distributes its capital gains to meet the requirement. Thus, tax occurs for the second reason: Securities are sold to raise the cash to make qualifying distributions. Herein also lies one possibility for tax savings. If the securities (or other property), rather than cash from their sale, are distributed to grantees, the capital gain earned on the property is not taxed. Such a distribution is not treated as a sale or other distribution for excise tax purposes.[78]

For example, suppose one-half, or $500,000, of a PF's $1 million of income is capital gains on appreciated securities. Assume also that the PF plans to make grants of $100,000 each to five charitable grantees. As much as $10,000 in tax is saved if the grants are paid with the securities themselves ($500,000 x 2% tax). The higher the untaxed gain in a PF's portfolio, the greater the possibility for savings. The tax basis for calculating the gain for donated securities is equal to the donor's basis, meaning that many PFs have a good chance to realize the savings. Readily marketable securities are most suitable for delivery to grantees, because of the ease with which they can be converted to cash. However, any investment property producing dividends, interest, rents, or royalties is subject to this special tax exception; such property might include a bond or a rental building.

Implementing the savings requires some advance planning and cooperative grantees. Grants are normally pledged and paid in round numbers (e.g., $5,000 or $50,000). Securities do not normally sell for round numbers, and the price changes constantly. The grantee rather than the granting PF will have to pay the sales commission. The PF may want to gross up the number of shares to be delivered to ensure that the grantee receives the intended funding. The potential savings can be compared to the costs before such noncash grants are made. The size

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[76] *Foundation Management Report* (7th ed., Council on Foundations, 1993).

[77] See Section 15.3.

[78] Reg. §53.4940-1(f)(1). The regulations specifically say, "For purposes of this paragraph, a distribution of property for purposes described in section 170(c)(1) or (2)(B) which is a qualifying distribution under section 4942 shall not be treated as a sale or other disposition of property."

of the grant and the likelihood that the grantee will retain the securities in its own portfolio can enhance the attractiveness of this medium for grant funding.

Consider an example. A foundation is funded with zero-basis shares donated by a now publicly traded company's founding family. The PF keeps a supply of stock certificates in a variety of share numbers. When a grant is due to be paid, one or more certificates for the number of shares approximating the amount pledged are delivered to the grantee. If the shares are selling for $60 and a $100,000 grant is due, approximately 1,670 shares would be delivered (the few extra shares cover the commission). The full fair market value of the shares on the delivery date is treated as a qualifying distribution. Thus, the difference between the value and the foundation's basis ($100,000 of capital gain in this example) is not taxed, saving the PF $2,000.

(b) Qualification for 1 Percent Tax Rate

A foundation's excise tax rate on investment income is reduced to 1 percent for each year, not including its first year, during which the foundation's qualifying distributions equal a hypothetical distribution amount plus 1 percent of net investment income.[79] The average of the foundation's annual qualifying distributions as a portion of its average investment assets each year is calculated. For example, a foundation has $1 million of assets and makes grants of around $60,000 each year. Its distribution payout ratio is 6 percent of its assets. Taking into account the payout percentage for the five-year period preceding the current year, an average payout ratio is determined. If the current year's distributions equal the average plus 1 percent of the current-year investment income, only a 1 percent excise tax is due.

Some say that a PF can essentially choose to distribute 1 percent of its investment income to charitable recipients rather than the U.S. Treasury. The qualifying formula, as illustrated here, basically calculates a historic minimum distribution ratio by applying the past five-year average percentage of distributions to the current endowment value and adding half of the normal tax. If the foundation makes distributions equal to and $1 more than its past percentage (times the current fair market value, or FMV), it can qualify for a reduced tax of 1 percent rather than 2 percent. The calculation briefly compares:

Average monthly FMV 3 5-year average payout: ($2,000,000 x 3 5%)	$100,000
11% of PF's net investment income	$ 1,000
Baseline to compare to current distributions	$101,000
Qualifying distributions for the year	$102,000

Because the qualifying distributions made by this hypothetical foundation during a year equal or exceed the $101,000, the PF's tax rate is 1 percent rather than 2 percent. Essentially, some say a foundation may be able to pay half of the tax to grantees. Note, though, that the calculation is based on the average monthly value of the foundation's investment assets, including the last day of its year;

[79] IRC §4940(e); legislaion to reduce tax overall to 1% was introduced in Congress in 2003.

hence, planning for the savings is not easy. Since this tax reduction opportunity came into effect in 1985, foundations that realize the reduction often do so by accident rather than by specific planning. Unless the value of the PF's assets fluctuates widely, it is possible to deliberately time grant payments to reduce the tax to 1 percent in alternate years. For a foundation paying $20,000 to $30,000 in tax, a $10,000 biannual savings may be worth the trouble. To illustrate, Exhibit 13.1 contains a six-year projection for XYZ Foundation, which potentially redirects $48,000 in tax.

(c) Redistributing Donated Property

A donation to a nonoperating private foundation is not necessarily fully deductible, under a number of §170 constraints. The fair market value of noncash gifts, other than readily marketable securities to nonoperating private foundations, is not fully deductible. For a donor to receive a deduction for full fair market value of long-term capital gain property (such as real estate or a partnership interest), the foundation essentially must give away the full value of the gift, or the gift itself, within 2½ months after the end of its year in which the donation was received.[80] A noncash donation retained by the foundation and essentially added to its endowment is limited in its deductibility to the donor's tax basis for calculating gain or loss for federal income tax purposes.[81]

During the years 1984 to 1994, and again since July 1, 1996 (the rule is now permanent),[82] the redistribution issue did not apply to gifts of certain securities. A special exception for marketable securities applies to encourage inter vivos gifts that would build endowments for private foundations. A full fair market value deduction is permitted for the donation of *qualified appreciated stock* or shares of a corporation for which "market quotations are readily available on an established securities market."[83]

For gifts of property other than securities, foundations must make distributions equal to the FMV of the appreciated property to afford their donors an income tax deduction for the full value of the property. Such a foundation must choose whether to redistribute the property itself or cash. Choosing redistribution of the property rather than selling it or other property may present an opportunity for the foundation to avoid paying the excise tax on the capital gain.

For the redistribution "not [to] be treated as a sale or other distribution of property" so as to qualify the gain for exclusion from excise tax, the foundation must grant property in a manner that is considered a *qualifying* distribution. The grant must be made for purposes described in §170(c)(1) or (b)(2) and must basically be made payable to an unrelated and uncontrolled public charity.[84] Additionally, the gift must be treated as a distribution out of corpus.[85] The fact that the

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[80] IRC §170(b)(1)(E)(ii).
[81] IRC §170(e)(1)(A)(ii).
[82] Full deductibility without redistribution temporarily restored by the Small Business Job Protection Act of 1996, §1206.
[83] IRC §170(e)(5).
[84] IRC §170(e)(5); §4942(g).
[85] IRC §170(e)(5); §4942(g).

EXHIBIT 13.1

Distribution Timing Plan to Reduce Excise Tax

XYZ Foundation—2003

	Qualifying Distribution	FMV Inv. Assets	Distribution Ratio
2002	1,000,000	20,000,000	5.00%
2001	950,000	19,000,000	5.00%
2000	1,100,000	22,000,000	5.00%
1999	1,000,000	20,000,000	5.00%
1998	900,000	18,000,000	5.00%
Avg.—five years			5.00%
Avg. FMV investment assets 2003			21,000,000
Yr. end FMV times average			1,050,000
Add 1% taxable income			20,000
Base line for qualification			1,070,000
2003 distributions			1,300,000

XYZ Foundation—2004

	Qualifying Distribution	FMV Inv. Assets	Distribution Ratio
2003	1,300,000	21,000,000	6.19%
2002	1,000,000	20,000,000	5.00%
2001	950,000	19,000,000	5.00%
2000	1,100,000	22,000,000	5.00%
1999	1,000,000	20,000,000	5.00%
Avg.—five years			5.24%
Avg. FMV investment assets 2004			22,000,000
Yr. end FMV times average			1,152,381
Add 1% taxable income			20,000
Base line for qualification			1,172,381
2004 distributions			850,000

XYZ Foundation—2005

	Qualifying Distribution	FMV Inv. Assets	Distribution Ratio
2004	850,000	22,000,000	3.86%
2003	1,300,000	21,000,000	6.19%
2002	1,000,000	20,000,000	5.00%
2001	950,000	19,000,000	5.00%
2000	1,100,000	22,000,000	5.00%
Avg.—five years			5.01%
Avg. FMV investment assets 2005			23,000,000
Yr. end FMV times average			1,152,489
Add 1% taxable income			30,000
Base line for qualification			1,182,489
2005 distributions			1,200,000

XYZ Foundation—2006

	Qualifying Distribution	FMV Inv. Assets	Distribution Ratio
2005	1,200,000	23,000,000	5.22%
2004	850,000	22,000,000	3.86%
2003	1,300,000	21,000,000	6.19%
2002	1,000,000	20,000,000	5.00%
2001	950,000	19,000,000	5.00%
Avg.—five years			5.05%
Avg. FMV investment assets 2006			23,500,000
Yr. end FMV times average			1,187,761
Add 1% taxable income			30,000
Base line for qualification			1,217,761
2006 distributions			950,000

XYZ Foundation—2007

	Qualifying Distribution	FMV Inv. Assets	Distribution Ratio
2006	950,000	23,500,000	4.04%
2005	1,200,000	23,000,000	5.22%
2004	1,182,489	22,000,000	3.86%
2003	1,300,000	21,000,000	6.19%
2002	1,000,000	20,000,000	5.00%
Avg.—five years			5.17%
Avg. FMV investment assets 2007			22,000,000
Yr. end FMV times average			1,136,316
Add 1% taxable income			30,000
Base line for qualification			1,166,316
2007 distributions			1,250,000

XYZ Foundation—2008

	Qualifying Distribution	FMV Inv. Assets	Distribution Ratio
2007	1,250,00	22,000,000	5.68%
2006	950,000	23,500,000	4.04%
2005	1,200,000	23,000,000	5.22%
2004	850,000	22,000,000	3.86%
2003	1,300,000	21,000,000	6.19%
Avg.—five years			5.00%
Avg. FMV investment assets 2008			22,000,000
Yr. end FMV times average			1,099,819
Add 1% taxable income			30,000
Base line for qualification			1,129,819
2008 distributions			950,000

distribution is charged to corpus (to meet the §170 requirement), rather than applied as a current distribution, does not cause the redistribution to fail as a qualifying distribution. Thus, a literal reading of the two applicable tax code sections and referenced regulation seems to allow the gain inherent in the redistributed property to be excluded from the excise tax.

13.5 FOREIGN FOUNDATIONS

Foreign private foundations are taxed at a rate of 4 percent on their U.S.-source investment income determined under the rules applicable to domestic private foundations.[86] Tax treaties with some foreign countries provide an exemption from the tax.[87] The U.S.-Canadian tax treaty does not, and presumes that Canadian charities are to be treated as private foundations unless they seek recognition of public status.[88]

The tax treaty between Mexico and the United States, adopted in 1994, establishes a protocol under which Mexican charitable organizations can be recognized as public charities for private foundation purposes. The treaty also provides for an income tax deduction against a U.S. resident's Mexican-source income reportable in the United States, and vice versa. Private foundations that are interested in supporting charitable activities in Mexico and other foreign countries should be alert for similar provisions in income tax treaties impacting the status of such organizations.

The §4940 excise tax must be specifically mentioned in a tax treaty for an exemption to apply to a foreign foundation.[89] The U.S.-source investment income of nonexempt foreign organizations, both privately and publicly supported, is otherwise subject to a 4 percent tax withholding requirement.[90] Though the excise tax is applied to U.S.-based investment income earned by a foreign private foundation, those that receive substantially all (at least 85 percent) of their support (other than capital gains) from sources outside the United States are not subject to the sanctions imposed on domestic private foundations by IRC §§4941 through 4945. The termination tax and notice requirements of IRC §§507 and 508 are also not applicable.[91]

A foreign organization that can qualify for classification as a public charity, however, can be excused from the tax on its U.S.-based investment income and other rules pertaining to private foundations. If it operates a school, church, or hospital, or receives sufficient revenues from public sources to satisfy the more than 33 1/3 percent support test, it is a public charity by definition.[92] A foreign

[86] IRC §4948(a); IRC §861.
[87] Rev. Rul. 74-183, 1974-1 C.B. 328.
[88] Updated by IRS Notice 99-47. Being treated as a private charity limits the ability to seek funding from other private foundations; see Section 17.5.
[89] Rev. Rul. 84-169, 1984-2 C.B. 216.
[90] IRC §1443(b); Gen. Coun. Memo. 38840.
[91] IRC §4948(b).
[92] Rev. Rul. 66-177, 1966-1 C.B. 132; the classification of foreign organizations as private or public charities under IRC 509§(a)(1), (2), or (3) is determined by applying the same rules that apply to domestic organizations, discussed in Chapter 11; Rev. Rul. 75-435, 1975-2 C.B. 215.

organization with over 15 percent of its gross income from U.S. sources is entitled to seek recognition of tax-exempt status by filing Form 1023.[93] Although it does not become eligible to receive donations deductible for U.S. income tax purposes,[94] it will receive proof of its eligibility to receive deductible donations for gift and estate tax purposes. If it wishes to seek funding from U.S. private foundations, it will also have proof that it qualifies as a public charity. Without such status, the domestic foundation must exercise expenditure responsibility or prepare its own affidavit of public charity equivalency in regard to the foreign grantees. Many domestic charities are unwilling to take those steps, particularly in view of the enhanced scrutiny suggested by the Treasury Department.[95] Finally, the foreign organization with U.S. recognition of public charity status can claim exemption from the withholding tax on any U.S. source investment income that will be paid at the normal rate of 4 percent, absent proof of exemption.

A foreign charitable organization (private or public) is required to file Form 990 or 990-PF only when its U.S.-source gross income exceeds $25,000 and has significant U.S. activity.[96]

13.6 TIMELY PAYMENT OF EXCISE TAX

The balance of any excise tax shown due on Form 990-PF is payable by the return due date or 4 1/2 months after the year-end (May 15 for a calendar-year PF). Any unpaid tax is subject to an underpayment penalty of 1 percent per month unless an extension of time to pay has been allowed.[97] Interest at the current prevailing rate is also charged.[98] Additionally, a penalty may be imposed if the foundation fails to pay adequate estimated tax.

Effective for the 1987 tax year, the excise tax became payable in advance under the corporate estimated tax system when a foundation's annual tax liability is $500 or more. The tax for each year is estimated or projected, and paid quarterly on or before the fifteenth day of the fifth, sixth, ninth, and twelfth months of the tax year.[99] Form 990-W is used to calculate the quarterly liability. The foundation's unrelated business income tax liability must similarly and separately be prepaid. As in the corporate system, most foundations can make "safe" payments based upon the immediately preceding tax year. As long as 100 percent of the prior tax year's liability is paid quarterly, or 90 percent of the tax actually due for the year is paid, no penalty is imposed on any balance of tax due at year end. Form 2220 is attached to Form 990-PF to calculate any penalty.

Large foundations whose annual income was $1 million or more in any one of its three preceding years can base only the first quarterly payment on the

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[93] IRC §4948(b) denies the application of IRC §508 (notice of exemption) for a foreign organization that receives substantially all of its support (other than gross investment income) from sources outside the United States.
[94] IRC §170(c).
[95] See Section 17.5.
[96] Rev. Proc. 94-17, 1994-1 C.B. 579.
[97] IRC §6651.
[98] IRC §6621.
[99] IRC §6655.

prior-year tax.[100] For the second, third, and fourth installment, the tax must be projected based upon actual income and deductions earned through the end of the month before the payment is due. At the other end of the scale, a foundation whose tax is $500 or less is excused from paying the excise tax in advance.

Any excise tax due must be deposited with an authorized federal depository bank using preprinted depository receipts (Form 8109) or through electronic transfer if the tax exceeds $50,000. The forms are customarily sent to a new foundation when it is issued an employer identification number.

13.7 EXEMPT OPERATING FOUNDATIONS

No excise tax is due from a special category of private foundation known as an exempt operating foundation, created in 1984 by Congress.[101] This rule is intended to eliminate tax liability for endowed museums and libraries. To be exempt, the foundation must have the following characteristics:

- It qualifies as a private operating foundation.[102]
- It has been publicly supported for at least 10 years.[103]
- At least 75 percent of its board members cannot be disqualified persons,[104] and numbers must be broadly representative of the general public.
- No officer can be a disqualified person at any time during the taxable year.

[100] Since Form 990-PF is not due until the fifteenth day of the fifth month following the close of the foundation's fiscal year, this exception is convenient.
[101] IRC §4940(d), added by H. Rep. No. 98-861, 98th Cong. 2d Sess. 1084 (1984).
[102] See Section 15.5.
[103] See Section 11.2.
[104] Defined in Section 12.2(c).

CHAPTER FOURTEEN

Self-Dealing: IRC §4941

Despite the general prohibition against inurement of a charity's assets to the benefit of its insiders,[1] Congress, in 1969, found certain loans, stock bailouts, and other financial transactions between privately funded organizations and their creators' families troubling. Former Internal Revenue Code (IRC) §503 (now repealed) permitted such transactions as long as a reasonable rate of interest was charged and the fair market value (FMV) was paid. Nevertheless, Congress felt

[1] See Section 2.1(c) and Chapter 20.

that private foundations were being used as extra pocketbooks for funds not necessarily available from other sources. This chapter describes the labyrinthine tax code section designed to prevent most financial transactions between foundations and the persons who create, fund, and manage them. In 1996, Congress imposed similar sanctions on excessive compensation or other benefits paid by public charities to their disqualified persons.[2]

14.1 DEFINITION OF SELF-DEALING

As a basic concept, all direct and indirect financial transactions are prohibited between a private foundation (PF) and its disqualified persons (DPs)—those persons who control, manage, and fund the foundation. There are exceptions, but most of the rules are draconian. It is immaterial whether the transaction results in a benefit or a detriment to the foundation.[3] Even if only $1 is paid by the PF for a director's $1 million building, such a bargain sale is absolutely prohibited, regardless of the financial benefit to the charity. Such a sale can occur between the PF and a person who at the time of the sale is not a disqualified person, even though the transaction causes the person to become a substantial contributor and, consequently, a DP. Also drawn into the web are "indirect acts," those between the DPs and organizations controlled by the PF, or vice versa. This chapter addresses the complex subject of self-dealing from several different perspectives by presenting the following:

- The six absolute rules as found in the Internal Revenue Code
- Exceptions found both in the statute and in the regulations
- Examples of acceptable and unacceptable self-dealing transactions
- Suggestions for documenting associations that could conceivably produce self-dealing
- Procedures and rules to follow if self-dealing occurs

(a) Statutory Language

Six specific acts of prohibited self-dealing between a private foundation and a disqualified person are listed in the statute.[4] The specified transactions cannot occur directly between the PF and its insiders, nor indirectly through an entity controlled by such DPs or by the PF. These transactions are as follows:

1. Sale, exchange, or leasing of property
2. Lending of money or other extension of credit
3. Furnishing of goods, services, or facilities
4. Payment of compensation (or payment or reimbursement of expenses)
5. Transfer to, or use by or for the benefit of, a DP of any income or assets of the PF
6. Agreement to pay a government official

[2] See Section 20.9.
[3] Reg. §53.4941(d)-1(a).
[4] IRC §4941(d)(1).

A private foundation converting to public charity classification is not treated as a private foundation for self-dealing purposes during its 60-month termination period. Therefore, transactions prohibited for private foundations may be allowed.[5]

(b) Statutory Exceptions

What the statute calls *Special Rules* provide both clarification and certain exceptions, remove some of the absoluteness of the six prohibitions, and bring some reasonableness to the rules. The basic concept underlying these exceptions is to permit certain transactions that actually provide benefit to the PF without producing economic benefit to any DPs. The following transactions are permitted[6]:

- Transfer of indebted real or personal property is considered a sale to the PF, if the foundation assumes a mortgage or similar debt, or if it takes the property subject to a debt placed on the property by the DP within a 10-year period ending on the date of gift.
- A DP can make a loan that is without interest or other charge to the PF if the funds are used exclusively for 501(c)(3), or charitable, purposes.
- Offering a no-rent lease or furnishing free use of a DP's goods, services, or facilities to the PF is permissible, as long as they are used exclusively for exempt purposes.
- Furnishing a DP with exempt function goods, facilities, or services that the private foundation regularly provides to the general public is not self-dealing, if conditions and charges for the transaction are the same as for the public.
- Reasonable compensation for personal services, payment of expenses, and reimbursement of expenses for a DP can be paid by the PF to a DP, if the amounts are reasonable and necessary to carry out the PF's exempt purposes. The definition of reasonable compensation relied upon by the Internal Revenue Service (IRS) national office is "such amount as would be ordinarily paid for like services by like enterprises under like circumstances—think of it as the "like, like, like rule."[7]
- Proceeds of a corporate liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, can be received by a PF if "all securities of the same class as that held by the PF are subject to the same terms and such terms provide for receipt by the PF of no less than FMV."
- Certain scholarship, travel, and pension payments to elected or appointed federal and state government officials are not considered self-dealing.[8]

[5] Reg. §1.507-2(f)(2); Priv. Ltr. Rul. 199911054; see Section 12.4(d).
[6] IRC §4941(d)(2).
[7] Reg. §1.162-7(b)(3) and Tech. Adv. Memo. 9008001. This important issue is discussed in Section 14.4.
[8] See Section 14.6.

- Leasing by a DP to a PF of space in a building with other unrelated tenants is acceptable if
  - The lease was binding on October 9, 1969, or pursuant to renewals of such lease.
  - Execution of the lease was not a prohibited transaction under former IRC §503, now repealed.
  - The lease terms and its renewals reflect an arm's-length transaction.

(c) Exceptions Provided in Regulations

Additional exceptions to the (at first glance) absolute rules are found in the regulations, which provide that the following types of "indirect" transactions also do not constitute self-dealing[9]:

- Certain business transactions between an organization controlled by the PF and its DPs. Control, for purposes of these exceptions, means that the PF or its managers, acting in their capacity as such, can cause the transaction to take place.
- A grant to an uncontrolled intermediary organization that plans to use the funds to make payments to governmental officials is not self-dealing, as long as the intermediary is, in fact, in control of the selection process and makes its decision independently.
- Transactions during administration of an estate or revocable trust in which the PF has an interest or expectancy are not self-dealing, if the specific requirements are satisfied.[10]
- Transactions totaling up to $5,000 a year and arising in the "normal course" of a retail business are permitted between a DP and a controlled business, as long as the prices are the same as for other customers.
- Stocks owned on May 26, 1969, and required to be distributed to avoid the IRC §4943 tax on excess business holdings can be sold, exchanged, or otherwise disposed of to a DP.[11]

14.2 SALE, EXCHANGE, OR LEASE OF PROPERTY

Sales and exchanges of property between a PF and its DPs are absolutely prohibited by rules that are strictly applied in comparison to those applicable to compensation for services. The sale of an asset by a disqualified person to a private foundation or vice versa, even for a bargain price, is self-dealing. Even the "sale of incidental supplies" is self-dealing.[12] A PF's purchase of a mortgage held by its bank trustee (a DP) was found to be self-dealing, even when the rate of interest was much more favorable than would otherwise have been available to the foundation. The self-dealing occurred because the bank was selling its own property, not simply handling the purchase of an investment instrument issued

[9] Reg. §53.4941(d)-1(b); see Section 14.6.
[10] See Section 14.9.
[11] Reg. §53.4941(d)-4(b)(1); Rev. Rul. 75-25, 1975-1 C.B. 359.
[12] Reg. §53.4941(d)-2(a).

by an independent source.[13] The sale to an unrelated party of an option to buy shares in a corporation that is a disqualified person is not self-dealing, even though the exercise of the option by the PF would be.[14] A contribution of shares of its own stock by a corporation that is already a disqualified person is not an act of self-dealing because the transaction is not one of the specified acts of self-dealing.[15] If the foundation's ownership of the shares was in some way able to influence the price of the shares to the benefit of the corporation, indirect self-dealing of the sort discussed in Section 14.8 might occur.

(a) Transactions through Agents

A sale handled by an outside agent will not necessarily circumvent the rules, but can be attributed to the foundation. In a case involving an art object consigned to a commercial art auction house, the purchase of the object by a DP constituted self-dealing.[16] However, even though the same banking institution served as trustee for both parties, a sale to a PF by a testamentary trust (which is not a DP of the purchasing PF) was not considered as self-dealing.[17] A sale to the bank itself by either party would be self-dealing, because the bank is a DP of both parties—neither is to the other. The leasing of property to a DP by a management company resulted in self-dealing when the PF controlled the manager's actions through a retained veto power.[18]

(b) Exchanges

A transfer of shares of stock in payment of an interest-free loan is "tantamount to a sale or exchange."[19] Similarly, a transfer of real estate equal to the amount of the DP's loan (in an effort to correct self-dealing) was ruled to be a second act of self-dealing.[20] However, a transfer of real estate in satisfaction of a pledge to pay cash or readily marketable securities was held not to be a "sale or exchange" because the pledge was not legally enforceable and because a pledge is not considered a debt.[21] No self-dealing resulted in such a transfer because it is essentially a gift.[22]

An exchange of a PF's securities in a reorganization or merger of a corporation that is a DP is not necessarily an act of self-dealing. When all of the securities of the same class as those held by the foundation (prior to the transaction) are subject to the same, or uniform, terms and the foundation receives the full FMV for its securities, no self-dealing occurs.[23]

The partition of property a foundation holds as a tenant-in-common with a disqualified person did not produce reportable gain or constitute self-dealing for

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[13] Rev. Rul. 77-259, 1977-2 C.B. 387.
[14] Priv. Ltr. Rul. 8502040.
[15] See Priv. Ltr. Ruls. 199930048 and 199905038 regarding stock options.
[16] Rev. Rul. 76-18, 1976-1 C.B. 355.
[17] Rev. Rul. 78-77, 1978-1 C.B. 378.
[18] Priv. Ltr. Rul. 9047001.
[19] Rev. Rul. 77-379, 1977-2 C.B. 387.
[20] Rev. Rul. 81-40, 1981-1 C.B. 508.
[21] See Section 14.5(e).
[22] Priv. Ltr. Rul. 8723001.
[23] Reg. §53.4941(d)-3(d)(1).

a foundation.[24] Without saying so directly, the IRS deems a partition not a prohibited sale or exchange. The foundation had received the undivided interest in the unproductive property as a gift from the DP. Local law prohibited a non-profit corporation from holding unproductive property, and the PF wanted to make the property marketable by creating a divided interest.

(c) Furnishing or Use of Property

Property can be leased to or used by a private foundation on a rent-free basis if the use accomplishes a charitable purpose. The foundation cannot permit a DP to use its property unless there is some exempt purpose for the usage. No rent can be charged, either by the PF or by the DP, for use of property. The lease is considered to be without charge even though the foundation pays a proportionate part of the janitorial services, utilities, and other maintenance costs, as long as payments are not made directly or indirectly to the DP.[25]

A special exception permits a foundation to furnish a disqualified person with exempt function goods, facilities, or services that the PF regularly provides to the general public, such as a park, a museum, or a library. The terms for use by the DP must be no more favorable than those provided to non-DPs.[26]

The IRS has considered a number of property usages that it found did not result in self-dealing. In one situation, a private foundation borrowed an art object from its creator at no cost, to display in its museum. The PF paid the maintenance and insurance to independent parties. The IRS ruled that this "use of property" is not self-dealing. The PF was allowed to pay the DP's costs of owning the art object, which could be said to represent a substantial benefit. It is important to note that the PF did not reimburse the DP; it paid the costs directly to unrelated parties. The reason for permitting this arrangement is that the public benefits: Art that would not otherwise be available can now be seen. However, placement of PF art in the DP's private home, away from public view, is clearly not allowed.[27] Displaying art on the DP's property that is open to the public has been permitted, but only because the PF's collection was displayed throughout the city, primarily on public lands, as a part of a comprehensive Outdoor Museum program.[28]

Furnishing living quarters in a historic district to a substantial contributor (who worked 25 to 35 hours a week overseeing the complex and managing the foundation's financial affairs) was also found not to be self-dealing, as long as

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[24] Priv. Ltr. Rul. 8136085; see also Priv. Ltr. Ruls. 8141074, 8038049, and 8327051.

[25] Reg. §53.4941(d)-2(b)(2); see Section 14.7(a) regarding who can pay for what in such a sharing arrangement.

[26] See Section 14.7(b).

[27] Rev. Rul. 74-600, 1974-2 C.B. 385.

[28] Tech. Adv. Memo. 9221002. But see Priv. Ltr. Rul. 8824001 for the opposite result when, due to the fact that the sculptures were placed on the DP's private residential grounds not physically open to the public but only available for viewing from the street, self-dealing occurred. See also Priv. Ltr. Rul. 9119009 in which the "unavoidable driving of the antique automobiles by a foundation's creator from time to time on behalf of the foundation to maintain and show them" did not result in self-dealing.

the fair value of the space is treated as compensation,[29] and as long as the total compensation is reasonable.[30] A PF's rental of a charter aircraft from a charter aircraft company that is itself a disqualified person is an act of self-dealing.[31] Donating use of the plane to the PF, however, would be allowed. If the charter company officials travel on bona fide foundation business, the foundation could directly pay for their direct out-of-pocket expenses, such as fuel or hangar rental in the city visited, as long as the goods and services were purchased from an independent party.[32]

Providing a residence to the foundation president and his wife, who also serves as treasurer, on foundation property while they supervise the development of a retreat, conference, and ministry center was found to serve a foundation's organizational objectives.[33] The couple was said to be uniquely qualified to manage the project because they had shaped the ministry's vision and the president was a civil engineer familiar with the zoning and other local property regulations. Once the project was complete, a retreat-center director would be hired and the disqualified persons would move away. Because their overall compensation, including the value of the rent-free housing, was reasonable and their services integral to accomplishment of the mission, no self-dealing occurred from the furnishing of housing.

(d) Co-Owned Property

Mere co-ownership of a property by a foundation and its disqualified person(s) does not, in and of itself, result in self-dealing.[34] Therefore, a PF can receive and hold a gift or bequest of an undivided interest in property from its disqualified persons. The catch is that only the PF can "use the property," because the statute specifically prohibits the use of any income or assets of the PF by the DP.[35] A transitional exception to the rule provided by Congress applies only to property jointly owned before October 9, 1969.

Essentially, the PF may hold and use co-owned property; the DP co-owner can hold but cannot use or otherwise reap any benefit from the property. A number of private rulings have illustrated why limited-use or shared ownership can still be of some advantage to the DPs retaining an interest. In one case, a decedent and his spouse owned an extensive art collection that they both planned to bequeath to a museum they were creating. Upon the husband's death, the PF museum and the spouse became joint tenants holding an undivided interest in each object in the art collection. The IRS would not permit the spouse to display a small portion of the co-owned objects in her home and strictly applied the stat-

[29] Regardless of whether it is actually taxable under IRC §119.
[30] Priv. Ltr. Rul. 8948034; see also Priv. Ltr. Rul. 9327082 concerning housing on a ranch.
[31] Rev. Rul. 73-363, 1973-2 C.B. 383.
[32] Section 14.7 explores permissible sharing of spaces, people, and expenses and provides samples of required documentation.
[33] Priv. Ltr. Rul. 199913040.
[34] Priv. Ltr. Rul. 7751033.
[35] IRC §4941(d)(1)(E).

ute to prohibit her use of the art in any way.[36] On a positive note, the museum was permitted to pay the insurance on all of the artworks.[37]

A gift of an undivided interest to a PF in property the donor planned to subsequently sell was sanctioned.[38] The donor relinquished all rights to use the improved real estate and retained only the right to inspect the property. Expenses were to be shared proportionately between the donor and the PF. Upon subsequent sale of co-owned property, the proceeds were divided proportionately. No self-dealing resulted from the gift, from holding the property jointly (note that in other situations, payment of expenses has been found to result in self-dealing), or from the sale. The restrictions on use have also been found to include the making of improvements to the property.[39]

Another private letter ruling permitted a private foundation to enter into passive investment arrangements with disqualified persons that appear to be self-dealing based on a literal application of the rules. In this case, the IRS labeled permitted co-ownership of real property as an *investment relationship*.[40] The foundation and its disqualified persons each received their ownership by gift, held property as tenants-in-common, and had separate interests in the 40-year lease on the property. Because no sale, lease, or transfer of the property occurred between the PF and its DPs, no self-dealing occurred as to holding property. As for the lease, the PF received its portion of the rental payment directly, "precluding its interest in the lease being used by a disqualified person."

(e) Partnerships

An alternative to holding property as co-owners—becoming partners—has also been sanctioned by the IRS.[41] A limited partnership interest given to a charitable remainder trust treated as a private foundation was distinguished from the "jointly owned property" contemplated by the regulations because "the holding and use of separate interests in a limited partnership is not the use of jointly owned property." Instead of donating an undivided interest in a shopping center, the donors contributed the property and became general partners in a limited partnership. Formation of a partnership between a private foundation and its three benefactor split-interest charitable lead trusts did not result in self-dealing.[42] Caution must be used in planning such arrangements to ensure that the terms of the partnership agreement permit each partner to have exclusive control, or use, of their respective interests, and create no common or shared interests.

A foundation's purchase of limited partnerships and limited liability company (LLC) interests in an investment fund managed and also owned by the foundation trustees and investment advisor was found not to be self-dealing. The IRS thought

[36] Priv. Ltr. Rul. 8842045.
[37] See Section 14.2(c).
[38] Priv. Ltr. Rul. 7751033.
[39] Priv. Ltr. Ruls. 8038049 and 200014040.
[40] Priv. Ltr. Rul. 9651037
[41] Priv. Ltr. Ruls. 9114025 and 7810038.
[42] Priv. Ltr. Rul. 9015070 concerning §4947(a)(2) trusts.

there was no direct or indirect transfer of assets to or for the use of disqualified persons.[43] The factors on which the IRS based its approval were as follows:

- The foundation and the funds will (and did) not pool their investments to meet any minimum investment requirement.
- The fund's investment return will not vary based on the foundation's investments.
- Foundation investment will not affect the cost of the fund's investment.
- Funds will not advertise the foundation's participation in or connection to the investment or use it to attract other investors.
- Unrelated parties control and operate the partnerships and LLCs.
- The foundation trustee will not receive additional fees from the foundation attributable to the investments.

Participation in a condominium association, as compared to owning an undivided interest in property, was found not to constitute an act of self-dealing and, importantly, the disqualified persons could use their separately owned spaces.[44] The private foundation, focused on acquisition, display, and distribution of works of fine art, wished to acquire an art gallery space. Its creators purchased a warehouse building that was converted to a condominium consisting of five units. The largest unit was donated (free of encumbrances) to the foundation plus an undivided interest in the common areas and parking lot. Another unit was donated to the foundation to be used as an investment rental property. The remaining three units, comprising only 15 percent of the total square footage, were retained to be used as offices of the disqualified persons. The offices would also be available, plus a secretary/receptionist, free of charge to the foundation. Common costs, such as maintenance, repairs, and operational (presumably utilities and janitor) costs were to be shared on an "objective basis according to the respective square footage of each owner's unit." Though not said to be a requirement in the decision, the foundation held a majority of the building's square footage and, thereby, voting control of the association. If, instead, this foundation had been given an undivided interest in 85 percent of the property, the disqualified persons would not have been able to use the property.

14.3 LOANS

The lending of money or extension of credit is a self-dealing act. Even if a circuitous route is followed, with the foundation not being the first lender, indebtedness payable to or from the foundation is prohibited. If a PF sells property in return for a mortgage to a third party who later resells the property to a DP in relation to the PF, self-dealing occurs with the second sale.[45] A loan without interest from a DP to a PF is permitted[46] if the proceeds of the loan are used

[43] Priv. Ltr. Rul. 9844031.
[44] Priv. Ltr. Rul. 200014040.
[45] Reg. §53.4941(d)-2(c)(1).
[46] Reg. §53.4941(d)-2(c)(2).

exclusively in carrying out the foundation's exempt activities. Repayment of such a loan with property other than cash is an act of self-dealing.[47] A new self-dealing transaction occurs on the first day of each tax year the loan is outstanding, referred to as the *taxable period*.[48]

A loan by the PF to an individual before he or she becomes a disqualified person is not self-dealing, even though the transaction causes the person to become a DP.[49] However, the loan cannot remain outstanding beyond the first day of the year in which the loan is made; an act of self-dealing occurs in each year in which there is an uncorrected extension of credit.[50]

(a) Donation of Indebted Property

A transfer of indebted real or personal property is considered an assumption of debt if the donor placed the loan on the property within a 10-year period ending on the date of the transfer.[51] A gift of a whole life insurance policy subject to a cash surrender loan is an act of self-dealing, unless the loan was placed on the policy more than 10 years before the gift. Even though the insurer does not demand repayment of the loan and failure to repay simply reduces the death benefits, the loan is valid indebtedness that causes self-dealing.[52] The date on which the loan is made, not when the loan or line of credit was approved, is the date from which the 10-year exception is measured. It is normally the date a lien is actually placed on the property for purposes of the exception.[53]

A gift of stock in a rental property holding company that was indebted to the substantial contributor was ruled not to result in self-dealing. The loan was made for business reasons prior to the transfer of the shares.[54] A future obligation to pay expenses to maintain gifted property is not indebtedness for this purpose.

(b) Interest-Free Loans

A loan or other extension of credit bearing no interest or other charge from a disqualified person to a private foundation is not self-dealing so long as the loan funds are used for exempt purposes.[55] Likewise, a pledge or promise, written or oral, to make a gratuitous payment to the foundation is a permissible loan.[56]

The payment of expenses by a disqualified person in connection with conducting foundation affairs is considered to be an interest-free loan. Such expense

[47] Rev. Rul. 77-379, 1977-2 C.B. 387.

[48] See Section 14.10; Rev. Rul.2002-43, 2002-28 I.R.B. 85 illustrates calculation of penalty when a retirement plan loan spanned more than one year.

[49] Reg. §53.4941(d)-1(a).

[50] See Priv. Ltr. Ruls. 9343033, 9417018, and 9530032 concerning a loan to a newly hired PF executive director to purchase a home. Initially, the transaction was sanctioned on the rationale that the loan was part of compensation; the IRS later reconsidered and ultimately revoked the ruling.

[51] IRC §4941(d)(2)(A).

[52] Rev. Rul. 80-132, 1980-1 C.B. 255.

[53] Rev. Rul. 78-395, 1978-2 C.B. 270.

[54] Priv. Ltr. Rul. 8409039.

[55] Reg. §53.4941(d)-2(c)(2).

[56] See Priv. Ltr. Rul. 200232036 concerning the payment of premiums on a life insurance policy on a disqualified person.

advances (loans) can be repaid or reimbursed by the foundation. Expense advances to foundation managers can also be made, but are limited to $500.[57] When the expenses pertain to property that is shared by the foundation and its disqualified persons, the regulations (in a contradictory fashion) prohibit the foundation's payment of its share of expense to the disqualified person. Instead, the allocated expense is expected to be paid directly to the vendor.[58]

14.4 COMPENSATION

An extremely important and frequently used exception to the absolute self-dealing rule[59] is the provision allowing payment of compensation for personal services provided by a private foundation's managers, officers, and directors or trustees.

Though the code literally says payment of compensation is self-dealing, a statutory exception permits such payment of compensation, and the payment or reimbursement of expenses, by a PF to a disqualified person for personal services that are reasonable and necessary to carry out the exempt purpose of the PF. Therefore, a PF can pay reasonable, meaning not excessive, salaries and fees and reimburse expenses incurred in serving a foundation. The services rendered must be *personal* and must be rendered by an individual, a partnership, or another form of service provider.[60] It is very important to note that excessive compensation results not only in self-dealing, but also in a taxable expenditure.[61]

It is sometimes difficult to decide what constitutes permitted personal services. The regulations name only the services of a broker acting as agent for the foundation, legal services, investment counseling, and commercial banking services as examples. By contrast, payments under a contract to manufacture microscopes is deemed not to constitute a permissible payment for personal services.[62] Presumably, the personal services are rendered for the company making the scopes and not for the foundation purchasing the finished product. Why the rental of a safety deposit box and maintenance of a checking account are treated as personal services under the regulation could be debated. What about remodeling a building or painting the office? Is the result different if the PF pays the workers directly rather than through a separate company? The Tax Court agreed with the IRS, in a case involving property management, that this exception is limited to payments that are "essentially professional and managerial in nature."[63] One author suggests that the IRS should issue guidance and that the

[57] See Section 14.4(d).
[58] Reg. §53.4941(d)-2(d); see Section 14.7 for discussion of sharing arrangements.
[59] The fourth item in the specific prohibitions of the statute listed at the beginning of Section 14.1.
[60] Reg. §53.4941(d)-3(c)(1).
[61] See Section 17.7.
[62] Reg. §53.4941(d)-3(c)(2), example (4).
[63] *Madden, Jr. v. Commissioner,* T.C. Memo. 1997-395(1997); see also Priv. Ltr. Rul. 8732064 in which the IRS sanctioned payments to conduct a six-week scientific research project with a monthly retainer for chemical advisory services; Priv. Ltr. Rul. 8351111 concerning architectural services; and 1995, Topic O, IRS *CPE Text,* pp. 247, 269, and 274, which discusses personal services.

definition of personal services be "any services which require specialized skill, training, or expertise."[64]

The IRS has privately ruled that grant-making services represented professional and managerial services of the type meeting the self-dealing exception.[65] Payments made to a corporation formed to provide administrative services, including bookkeeping, check preparation, bill payment, tax services, and handling legal matters, were considered permissible. Legal accounts were found to be paid for personal services.[66] Trust function–type services are also on the list of IRS-approved personal services a private foundation can purchase from disqualified persons. The IRS sanctioned the engagement of investment management services by a §4947(a)(2) split-interest trust from a corporation owned by its co-trustees and founders.[67] Although the IRS did not rule on the reasonableness of the compensation, the facts indicated that the fee would be computed partly as a percentage of the value of the assets managed and not exceed that amount normally charged by independent commercial companies for such services.

(a) Definition of Reasonable

The self-dealing regulations define *reasonable* by reference to the rules applied to evaluate *ordinary and necessary business expenses*.[68] Those standards have evolved over the years from court cases and IRS guidance and should form the basis for evaluating the reasonableness of compensation paid by a PF. The factors listed in Section 20.2 can be applied to determine whether the compensation a private foundation pays to a disqualified person is equal to "such amount as would ordinarily be paid for like services by like enterprises under like circumstances." The factors for evaluating whether private inurement has occurred can also be applied to determine whether the compensation is reasonable.[69]

The best way for a foundation to determine whether compensation it pays to its officials is reasonable is to compare itself to its peers—those foundations and public charities of similar assets, size, and activity in its location. There are a number of ways to gather comparable salary information. The easiest source is the actual Form 990-PF filed by private foundations and available on the Internet.[70] A copy of the form must be provided by a foundation to anyone who requests it and pays a modest fee.[71] Part VIII of the form reports the compensation of all foundation officials. The Association of Small Foundations, the Coun-

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[64] Andrea Kushner Ross, "Proposal for Guidance Regarding the Personal Services Exception to Section 4941, Tax Analysts' *Exempt Organization Tax Review*, July 2003, vol. 4, no. 1. pp. 43–48.

[65] Priv. Ltr. Rul. 199927046.

[66] Priv. Ltr. Rul. 200211705.

[67] Priv. Ltr. Ruls. 200228027, 200228028, and 200228029.

[68] Reg. §1.162-7.

[69] See Section 20.1.

[70] www.guidestar.org. The *Guidestar Nonprofit Compensation Report* provides detailed information indexed by job category, gender, geography, type of nonprofit, budget size, state, and more. National, state, and regional reports are also available. On March 20, 2003, the cost of reports ranged from $199 to $599.

[71] See Chapter 4, Blazek, *IRS Form 990 Tax Preparation Guide for Nonprofits* (Hoboken: Wiley, 2004) for public inspection rules.

EXHIBIT 14.1

Compensation of Disqualified Person Checklist

This checklist can serve as a guide to documenting the reasonableness of compensation a private foundation (PF) pays to the persons that create, control, and manage it. The general rule prohibits such payments (Sec. 14.1). A statutory exception permits the payment of reasonable compensation to such persons for personal services rendered in carrying out the tax-exempt purposes of the foundation.

NAME OF FOUNDATION ______________________________

Self-dealing occurs, and penalties can be imposed, when a disqualified person receives unreasonable compensation for services rendered.

Unreasonable compensation results when the total economic benefit provided directly or indirectly to a disqualified person (DP) exceeds the value of the personal services provided by the DP.

Disqualified person is one with substantial influence over the PF's affairs, including a substantial contributor, officer, director, trustee, or one with similar responsibilities, owners of certain businesses that contribute to the PF, and their family members (Sec. 12.1(c)).

QUESTION 1. IS THE COMPENSATION PAID TO A DISQUALIFIED PERSON REASONABLE?

- Is there a job description, employment contract, engagement letter, or other agreement that fully describes the duties, hours, and responsibilities of the disqualified person? (Sec. 14.4 (a)) ________
- Are all types of compensation, including benefits, fringes, and allowances, taken into account to determine total annual compensation? ________
- If a commission or other type of revenue sharing (incentive pay) is paid, has evidence that the rate is in line with industry standards been obtained? (Sec. 20.2(c)) ________

QUESTION 2. IS THE REASONABLENESS OF COMPENSATION PROPERLY DOCUMENTED?

- Is comparable data—surveys, offers the DP received from others, the availability of others for the job, the opinion of consultants, and other evidence of value—gathered? ________
- Is the compensation reported to the IRS on Form W-2 or 1099? ________
- Is the compensation approved (when possible) by non-disqualified persons? ________
- Is a written record of the meeting (minutes) when the engagement was approved kept, with notations of votes, abstentions (conflict), and any other discussions? ________

Prepared by ________________ *with (PF representative)* ____________ *date* __________

cil on Foundations, and the Society of Nonprofit Organizations compile national surveys reflecting compensation information by region of the country, foundation assets size, focus or purpose (education, health care, and the like), and job position (director, financial officer, program manager, and the like).[72] Associations of regional and affinity grant makers also share such information. The Compensation of Disqualified Person Checklist found in Exhibit 14-1 can serve as a foundation's guide in documenting the reasonableness of compensation paid to disqualified persons.

[72] The *Chronicles of Philanthropy* periodically publishes compensation reports, the most recent at the time this chapter was revised was the October 2, 2003, issue.

All payments to or made on behalf of a disqualified person are tallied to determine total compensation—salaries, bonuses, fringe benefits (medical and life insurance, nonaccountable auto allowance, and child care, for example), qualified and nonqualified deferred compensation, retirement plan contributions, contractor fees, and the like. In the instructions to the part of Form 990-PF where officers, directors, trustees, and key employees must be individually listed, the IRS directs the foundation to report "all forms of cash and noncash compensation received by each person whether paid currently or deferred."[73] Some expenses paid on behalf of foundation officials are not considered compensation, such as the expense of board members and managers attending board meetings and otherwise participating in the conduct of foundation activities. De minimus working condition fringe benefits, such as meals during meetings or parking, also are not counted as compensation.[74] That portion of the foundation's liability insurance premiums attributable to the Chapter 42 taxes is, however, treated as compensation paid to the directors, officers, and managers, though it is considered a nontaxable fringe benefit.[75] Expenses paid on behalf of or reimbursed to disqualified persons should be carefully documented to evidence their connection to the accomplishment of the foundation's exempt purposes.

Annual compensation 75 percent higher than the average for a private foundation of comparable size listed in the Council on Foundations' 1986 Foundation Management Report was found to be excessive and an act of self-dealing.[76] The salary also represented 35 percent of the foundation's grant expense. Personal services provided "at a rate consistent with and no greater than the rates charged to its other clients" were found to be reasonable in a private ruling.[77] The question arose in regard to services provided to maintain a historic site. The often-cited *Kermit Fischer* case provides another version of the IRS's standard for determining reasonable compensation. A foundation with a little over $200,000 in assets paid its sole trustee annual compensation of $45,000 and furnished him with two cars and a fully equipped office. At trial, the IRS's expert witness, Herbert L. Kurras, testified that "most foundations use a formula to determine annual compensation of their trustees of $4 to $5 per $1,000 of foundation assets, plus 5 percent of foundation income." Under this formula, Kurras testified, the proper compensation for the foundation's trustee would range from $1,450 to $2,000 during each of the years at issue.[78] The IRS also revoked the foundation's exempt status on the basis that the foundation's earnings had inured to the private benefit of its officers.

(b) Intermediate Sanction Connection

A private foundation that pays compensation to disqualified persons should pay careful attention to commentary and developments regarding intermediate

[73] Part VIII of Form 990-PF, see Blazek, *IRS Form 990 Tax Preparation Guide for Nonprofits* (Hoboken: Wiley, 2004).
[74] Reg. §53.4941(d)-2(f)(8).
[75] Discussed in Section 14.5(a).
[76] Priv. Ltr. Rul. 9008001.
[77] Priv. Ltr. Rul. 9307026
[78] *Kermit Fischer Foundation v. Commissioner*, 59 TCM 898 (1990).

sanctions. These rules, applicable to public charities since 1995, impose penalties upon persons receiving, and persons approving of, excess benefit transactions. The regulations on the intermediate sanctions imposed on public charities and civic leagues are cross-referenced to the self-dealing provisions. Foundation managers can refer to these regulations for guidance in establishing the reasonableness of compensation paid to foundation personnel.[79]

The congressional committee reports discussing intermediate sanctions also say the tax-law standards[80] apply in determining reasonableness of compensation and fair market value. Though the intermediate sanctions differ in some respects from the self-dealing rules, many of the standards are the same. Persons receiving excessive compensation from either a private or a public charity must return the excess. The penalties imposed on public charity officials is a flat 25 percent of the excess paid compared with the 5 percent penalty imposed each year until the excess is returned by the self-dealer. A significant difference lies in the fact that the self-dealing penalties cannot be abated; if the IRS can prove excessive compensation has been paid, sanctions apply. Instead, penalties are not assessed against public charity officials if a rebuttable presumption exists.[81] A presumption of reasonableness can be established under a three-prong test:

1. The board of directors, trustees, or committee thereof is composed *entirely* of persons independent of and unrelated to the disqualified persons.
2. The amount paid is based on appropriate data as to comparability of value paid.
3. Adequate documentation of data forming the basis for the approval is accumulated and maintained.

Many private foundations are unable to meet the first condition. The second and third conditions, however, can be attained. Compensated officials should keep time sheets or other evidence of time devoted to the foundation's work. The evidence on which the foundation relies in arriving at appropriate compensation amounts, preferably gathered from outside sources, can be compiled and maintained, using Exhibit 14-1 to allow it to meet the rebuttable presumption, even though it does not technically apply. The checklist reproduced in Exhibit 20-1 and the questions found in Section 20.2 are also useful to a private foundation documenting compensation decisions.

(c) Commissions

Compensation based on a percentage of sales of a foundation's property or the value of the property managed is permitted so long as the amount is reasonable. The terms for payment of commissions should be based on a customary scale prevailing in the normal marketplace for sale of the type of property involved. The reasonableness standard must be followed. Commissions paid to an art dealer who was a disqualified person in relation to a foundation, for example, were

[79] §53.4958-2; see Hopkins, *The Law of Intermediate Sanctions* (Hoboken: Wiley, 2002).
[80] IRC §162.
[81] Reg. §53.4958-6.

found not to be self-dealing when the art was sold by the same dealer who had represented the artist while living. Moneys were to be used to fund the foundation's programs. The IRS set out "comparability factors" the foundation should use to determine whether commissions were reasonable, including the following[82]:

- Commissions charged by nondisqualified persons for selling the (same) artist's work
- Commissions paid by the artist during his or her lifetime to persons who are now disqualified persons and to others
- Commissions that agents charge to sell art of the same school as the artist
- Commissions that are received by agents who sell art generally from the foundation's geographic area

Brokerage commissions and investment management fees[83] can similarly be paid to an investment manager who is a related party as long as the amount is customary and normal for the industry. Total compensation that included the normal transaction fees plus 50 percent of the account's annual equity value increases in excess of 15 percent was deemed reasonable because it was consistent with practices in the industry.[84]

(d) Advances

Advances that are "reasonable in relation to the duties and expense requirements of a foundation manager" are permitted.[85] According to the regulations, cash advances should not ordinarily exceed $500—a 1970 amount often too low by current standards. If the advance is to cover anticipated out-of-pocket current expenses for a reasonable period (such as a month), self-dealing will not occur

- When the PF makes an advance
- When the PF replenishes the funds upon receipt of supporting vouchers from the manager
- When the PF temporarily adds to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of a special assignment, such as long-distance travel

Expenses of travel and meals incurred in connection with conducting foundation affairs can also be advanced or reimbursed. A foundation with directors and personnel in different locations, for example, can pay for the cost of travel to attend a meeting in one of the locations. The expense of site visits to potential grantees can be paid. When a foundation pays such expenses on behalf of its disqualified persons, a written policy should describe the terms for reimbursement, and documentation required should be developed. For example, it is prudent for a foundation to adopt a policy against payment of lavish traveling expenses.

[82] Priv. Ltr. Rul. 9011050.
[83] Reg. §53.4941(d)-3(c), Example (2).
[84] Priv. Ltr. Rul. 9237035.
[85] Reg. §53.4941(d)-3(c)(1), legislation to limit reimbursements for air fares to coach class was introduced in Congress in 2003.

Limiting the reimbursement to prevailing per diem rates published by the IRS or coach class fares might be considered. Full and complete reports of the expenditures, along with descriptions of the nature of the work performed, meetings held, or other foundation business that necessitated the travel should be compiled to document the expenditure.

An advance for reasonable and necessary expenses to be incurred by a disqualified person to perform a professional service for a foundation can also be made. For example, a lawyer might incur translation fees for legal documents in connection with a foundation grant to a foreign organization. An architect's charges might include blueprints. Or a computer consultant can be advanced funds for software and hardware purchases planned for the foundation.

(e) Bank Fees

Banks and trust companies often serve as foundation trustees, and in this role they often face self-dealing possibilities. Certain functions that the bank performs for all of its customers can be performed for a foundation. Taking into account a fair interest rate for the use of the funds by the bank, reasonable compensation can be paid. The "general banking services" permitted are[86]

- Checking accounts, as long as the bank does not charge interest on any overdrafts. Payment of overdraft charges not exceeding the bank's cost of processing the overdraft have been ruled to be acceptable.[87]
- Savings accounts, as long as the foundation may withdraw its funds on no more than 30 days' notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit
- Safekeeping activities

Transactions outside the scope of these three relationships can be troublesome. When a PF left funds earning no interest in a DP's bank, self-dealing was found.[88] The bank's purchase of securities owned by independent parties for a PF's account is not self-dealing, but purchase of the bank's own mortgage loans would be.[89] The purchase of certificates of deposit by a PF is unacceptable if the certificates provide for a reduced rate of interest if they are not held to the full maturity date.[90] Purchase of a foreign currency with which the foundation purchased foreign securities (unrelated to the bank) was found not to result in self-dealing.[91]

14.5 TRANSACTIONS THAT BENEFIT DISQUALIFIED PERSONS

The use of a foundation's income or assets by or for the benefit of a disqualified person generally constitutes self-dealing.[92] Self-dealing can occur even if money is not transferred directly to or from the foundation and its insiders. It is impor-

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[86] Reg. §53.4941(d)-2(c)(4).
[87] Rev. Rul. 73-546, 1973-2 C.B. 384.
[88] Rev. Rul. 73-595, 1973-2 C.B. 384.
[89] Rev. Rul. 77-259, 1977-2 C.B. 387.
[90] Rev. Rul. 77-288, 1977-2 C.B. 388.
[91] Priv. Ltr. Rul. 9616040.
[92] IRC §4941(d)(1)(E).

tant to again note that payment of such benefits not only results in self-dealing but also results in a taxable expenditure.[93] A foundation may not pay any obligation or debt of its disqualified persons, such as a pledge to make church tithes. This somewhat vague standard—no use of assets or income—is exemplified in the following situations:

- The purchase or sale of securities by the foundation for the purpose of manipulating the price of the stock or other securities to the advantage of a disqualified person is considered self-dealing.[94]
- Foundation investment assets taken into account to satisfy a disqualified person's security investment margin requirement is an act of self-dealing.[95]
- Guarantee of a disqualified person's loan by a foundation is considered self-dealing, as is indemnification of the lender.[96]
- A student loan guarantee program funded by a foundation through a public charity resulted in self-dealing when a DP's children received loans.[97]

Any *incidental or tenuous benefit* bestowed on a disqualified person because of a private foundation's actions does not result in self-dealing. This concept is normally applied in name recognition situations.[98] The IRS has, however, privately approved a variety of immeasurable benefits that might be thought to convey prohibited benefits on disqualified persons. The IRS has yet to opine on potential problems of foundation Web sites.[99]

A company foundation's disaster and financial relief program provided more than incidental benefit to its sponsoring corporation and resulted in acts of self-dealing.[100] While there was some public benefit from the foundation's provisions of assistance in times of disaster or financial crisis, the IRS "found no assurance that selection of beneficiaries solely among employees of a particular employer serves the best interests of the public." Instead, the foundation served "the private interests of X and its subsidiaries who utilize such benefit programs to recruit and retain a more stable and productive workforce." Because the beneficiaries were a designated or limited group—employees of a specific company—they did not constitute a charitable class and the foundation could not qualify for a 501(c)(3) exemption. For the same reasons, the disbursements made by the foundation were taxable expenditures[101] of benefit to the company officials and owners. Because the benefit to the company was more than incidental and tenuous, the grants distributed by the foundation also resulted in acts of

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93 See Section 17.7.
94 Reg. §53.4941(d)-2(f)(1).
95 Tech. Adv. Memo. 9627001.
96 Reg. §53.4941(d)-2(f)(1).
97 Rev. Rul. 77-331, 1977-2 C.B. 388; see also Priv. Ltr. Rul. 200332019.
98 See Section 14.5(e).
99 See Section 2.2(j).
100 Priv. Ltr. Rul. 199914040, revoking Priv. Ltr. Rul. 9516047; see Section 17.3(e).
101 Defined and discussed at length in Chapter 17.

self-dealing. Additionally, the expenditures did not constitute qualifying distributions[102] because they did not serve a charitable purpose.

(a) Indemnification of Disqualified Persons

Noncompensatory indemnification occurs, and no self-dealing results, as a general rule, when a foundation indemnifies its managers with respect to civil,[103] judicial, or administrative proceedings involving the private foundation sanctions and state laws relating to mismanagement of funds of a charitable organization. The indemnification can extend to all expenses, including attorneys fees, judgments, and settlements (other than taxes, penalties, or expenses of correction of Chapter 42 violations) if the following conditions exist[104]:

- Such expenses are reasonably incurred by the manager in connection with the proceedings.
- The manager is successful in the defense, or the proceedings are terminated by settlement and the manager has not acted willfully and without reasonable cause with respect to the act or failure to act that led to liability for tax under IRC Chapter 42.

Likewise, the purchase of liability insurance to reimburse the foundation for costs associated with this type of indemnification does not result in self-dealing.[105]

Compensatory indemnification occurs when the foundation indemnifies its managers for the following expenses:

- Any penalty, tax (including a Chapter 42 tax), or expense of correction that is owned by the foundation manager
- Any expense not reasonably incurred by the manager in connection with a civil, judicial, or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation
- Any expense resulting from an act or failure to act with respect to which the manager has acted willfully and without reasonable cause

The payment of such expenses results in self-dealing unless the payment(s) are added to other compensation paid to such manager and the total compensation is reasonable. Insurance premiums attributable to compensatory coverage must be counted as a part of the manager's compensation for purposes of determining its reasonableness.[106] After some years of confusion, the fringe benefit regulations now make it clear that such premiums can be classified as nontaxable fringe benefits to the foundation managers—both those who are salaried and

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[102] See Section 15.4.
[103] Priv. Ltr. Rul. 8202082.
[104] Reg. §53.4941(d)-2(f)(4) as amended; see B. Hopkins and J. Blazek, *Private Foundations: Tax Law and Compliance, 2nd Edition* (New York: Wiley, 2003), Section 5.7, for a history of these rules.
[105] Rev. Rul. 82-223, 1982-2 C.B. 301.
[106] Reg. §53.4941(d)-2(f)(4); see Section 14.4(a).

those that serve as volunteers.[107] A PF's payment of legal defense fees awarded by a court on behalf of a director, who brought suit against the other directors to require them to carry on the foundation's charitable program, was held not to constitute an act of self-dealing.[108]

(b) Excise Taxes

A foundation cannot pay the excise taxes imposed upon disqualified persons for their participation in a violation of any of the private foundation sanctions. The payment is considered a transfer of PF property for the benefit of the DP and is therefore self-dealing.[109]

(c) Memberships and Galas

Payment of church membership dues for a foundation donor was found to be self-dealing because the membership provided a direct economic benefit to the individual.[110] It is common for grant recipient organizations to identify contributors as members eligible for special privileges. When the foundation makes such a gift, the individual trustees or other foundation representatives are customarily provided member benefits. The question in such a situation is whether the individual can accept such benefits as a representative of the foundation. It is also important to ascertain whether the PF is satisfying a personal obligation of the DP to support the grantee. The IRS did observe in the church membership ruling that the benefits provided could be regarded as incidental and tenuous. Nonetheless, some foundations disclaim membership perks or have the managers pay for their own individual memberships to avoid any question that the foundation is satisfying a personal obligation of its DPs.

A similar problem arises in connection with fund-raising event benefits. Self-dealing was found when a foundation shared the cost of purchasing benefit tickets with a disqualified person. The foundation paid the donation portion of the ticket; the DP paid that part of the ticket price allocable to the fair market value of the dinner and entertainment.[111] To attend the benefit, the full price for the ticket must be paid. The IRS found the DP reaped benefit when the foundation paid an expense he would otherwise have been expected or required to pay. Thus, the partial purchase of the ticket by the PF constituted direct economic benefit to the DPs and resulted in self-dealing. Some foundation managers believe it is appropriate for them to attend fund-raising events as representatives of the foundation. Their attendance is said to show support for a grantee and thereby does not result in private recreational benefit. In an earlier ruling, the IRS agreed the cost of benefit tickets used by foundation officers was "reasonable administrative expenses." Tickets given to a disqualified person not serving as an officer (friends) was deemed to result in self-dealing and a taxable expenditure.[112]

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[107] Reg. 1.132-5(r), effective on December 30, 1992.
[108] Rev. Rul. 73-613, 1973-2 C.B. 385.
[109] Id.
[110] Rev. Rul. 77-160, 1970-1 C.B. 351; see also IRS Priv. Ltr. Rul. 200114035.
[111] Priv. Ltr. Rul. 9021066.
[112] Priv. Ltr. Rul. 8449008.

(d) Charitable Pledges

If a foundation satisfies a legally enforceable charitable pledge made by one of its disqualified persons and thereby relieves the DP of an obligation, self-dealing may occur.[113] Payment of church membership dues for a DP was found to be self-dealing when the membership provided a personal benefit to the individual.[114] A foundation created by a group of corporations committed an act of self-dealing when it paid pledges entered into by and legally binding on the corporations before the PF was established.[115] However, pledges obligating a DP to make a gift to the PF itself may not create self-dealing. The regulations say:

> The making of a promise, pledge or similar arrangement to a PF by a DP, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit before the date of maturity.[116]

Modification of a DP's charitable pledge to a foundation prior to its maturity is acceptable. The IRS looked at the case of a PF that operated both with current contributions from its substantial contributor and with loans made by a bank against pledges made periodically by the DP. When the DP reduced his current promised payments before their maturity, but pledged a larger amount later, self-dealing was held not to occur.[117]

A foundation created and funded by a corporation was allowed to match the contributing corporation's employees' gifts to various charities.[118] Similarly, a grant by the corporate foundation to a museum that would be open to the public primarily to display articles manufactured by the corporation was found not to be an act of self-dealing.[119] Return of a conditional gift by the PF to a contributor who stipulated that it be returned if his donation was disallowed was found not to be self-dealing.[120]

(e) Incidental or Tenuous Benefit

What the regulations call *incidental or tenuous benefit* can be bestowed upon disqualified persons without adverse consequence.[121] Any public recognition or prestige that a person may receive, arising from the charitable activities of a PF to which that person (or business) is a substantial contributor, does not, in itself, result in self-dealing.[122,123] The fact that the foundation trustees are also board members of the grant recipient does not cause a self-dealing transaction to result from the grant payment.[124]

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[113] Reg. §53.4941(d)-2(f)(1) and Rev. Rul. 77-160, 1977-1 C.B. 351.
[114] Rev. Rul. 77-160, 1970-1 C.B. 351.
[115] Priv. Ltr. Rul. 8128072; see Priv. Ltr. Rul. 9540042 for a more lenient result.
[116] Reg. §53.4941(d)-3(c).
[117] Tech. Adv. Memo. 8723001.
[118] Priv. Ltr. Rul. 8130172.
[119] Priv. Ltr. Rul. 8719041.
[120] *G. M. Underwood, Jr. v. U.S.*, 78-2 USTC ¶9831 (N.D. Tex. 1978).
[121] Reg. §53.4941(d)-2(f)(2).
[122] Rev. Rul. 77-331, 1977-2 C.B. 388.
[123] Rev. Rul. 73-407, 1973-2 C.B. 383.
[124] Rev. Rul. 80-310, 1980-2 C.B. 319; Rev. Rul. 82-136, 1982-2 C.B. 300, clarifying Rev. Rul. 75-42, 1975-1 C.B. 359.

Name Recognition. A PF grant to a public charity made on the condition that the charity change its name to that of the PF's substantial contributor (and that it not change it again for 100 years) did not result in self-dealing. The recognition that board members receive for causing a grant to be awarded does not amount to self-dealing. The right of a corporate foundation official (or any corporate employee) to recommend grants to be made by the corporation's foundation in his or her name provides an intangible benefit that should not result in self-dealing unless the foundation is satisfying an obligation of the employee. Likewise, a program that matches employee gifts with a gift from the corporate foundation is an intangible and incidental benefit to an employee. Similarly, a foundation grant made in honor of a disqualified person's child, relative, or any other person does not result in self-dealing.

The name recognition Corporation Y receives (through promotions planned by the Corporate Foundation X it funds) was found to be tenuous and incidental and therefore not to result in self-dealing. The foundation intended to celebrate its anniversary by conducting a publicity campaign discussing and reviewing its support of American education through grants for enhanced teaching and learning and the management of schools, colleges, and universities. The publicity was intended to stimulate the general public to support education and also to make Y's shareholders more aware of its public service so as to be supportive of future gifts to the foundation[125].

Disregarded Economic Benefit. The public exposure enjoyed by a corporation for sponsorship of a public television program is considered an incidental benefit.[126] The goodwill generated by a company foundation scholarship program is also treated as incidental. As long as the program meets the *objective and nondiscriminatory* requirements,[127] the awarding of grants to children of the corporation's employees is not self-dealing. Similarly, the fact that a corporation plans to recruit and hire graduates of a university engineering program results only in an incidental benefit. The company's foundation can fund the program without self-dealing unless the corporation is given preferential treatment in access to the graduates.[128] The general improvement of the area is considered an incidental benefit that does not result in self-dealing to DPs that have business interests in the same area.[129] Similarly, a grant to expand the public library located in an area of town where disqualified persons hold property interests was deemed to be of incidental benefit. The foundation's gift was a minor portion of the cost of the entire project.[130] Provision of a personal office space to the foundation's 90-year-old donor was an incidental benefit because, due to her age, the use did not

[125] Priv. Ltr. Rul. 9615046; see also Priv. Ltr. Rul 199939049 for a lenient ruling that permitted an educational institute to be named its disqualified person's company that planned to provide it planning services.

[126] Priv. Ltr. Rul. 8644003.

[127] See Section 17.3(d).

[128] Rev. Rul. 80-310, 1982-2 C.B. 319.

[129] Reg. §53.4941(d)-2(f)(4); Rev. Rul. 85-162, 19985-2 C.B. 275.

[130] Priv. Ltr. Rul. 200129041; see also Priv. Ltr. Rul. 9819045

have value.[131] A loan by a private foundation to a client of its sole trustee, however, was found to have economic value and resulted in an indirect self-dealing transaction with the trustee.[132]

The fact that the improvements to a slum area financed by a foundation grant might raise the value of property owned by a disqualified person was, however, deemed "incidental and tenuous" benefit.[133] For similar reasons, a grant to a public charity to build a science center was found not to be an act of self-dealing.[134] The new center is located across the street from an underground parking lot owned by the foundation's disqualified persons, and it is expected that the science center will create increased demand for parking and increased revenue for the garage's owners. Nonetheless, the IRS concluded that because the grant to the science center is a contribution to a public charity for a public purpose, the grant will not constitute an act of self-dealing.

14.6 PAYMENTS TO GOVERNMENT OFFICIALS

The statutory provision absolutely prohibits payments to government officials, but there are a number of exceptions. Self-dealing results when a private foundation enters into an agreement to make payments of money or other property to a government official[135] other than an agreement to employ the person, unless the official's government service is terminating within 90 days of the date of the offer.[136] Certain de minimus payments to government officials are permitted, as follows[137]:

- A prize or award that is not includable in gross income[138] if the government official receiving the prize is selected from the general public. (The prize must be paid over to a charitable institution.)
- A scholarship or fellowship grant that is excludable from gross income[139] and that is to be utilized for study at an educational institution[140] (but only for tuition, fees, and books)
- Certain types of pension plans and annuity payments[141]
- Contributions, gifts, services, or facilities provided to or made available to a government official totaling no more than $25 in any one year
- Government employee training program payments

[131] Priv. Ltr. Rul. 9604006.
[132] Tech. Adv. Memo. 8719004
[133] Priv. Ltr. Rul. 9819045.
[134] Priv. Ltr. Rul. 9547019; see also Priv. Ltr. Rul. 8453081 concerning loans for redevelopment.
[135] Defined in Chapter 12.
[136] IRC §4941(d)(1)(F).
[137] IRC §4941(d)(2)((G); Reg. 53.4941(d)-3(e).
[138] Pursuant to IRC §74(b).
[139] Pursuant to IRC §117(a).
[140] As defined by IRC §151(e)(4).
[141] Priv. Ltr. Rul. 9510073.

- Reimbursement of the actual cost of travel within the United States for attendance at a charitable function, not to exceed 125 percent of the prevailing per diem rate

14.7 SHARING SPACE, PEOPLE, AND EXPENSES

As a practical matter, many private foundations are operated alongside their creators, corporations, family groups, and individuals. At least until the foundation achieves a certain volume of assets with consequential grant activity (and perhaps thereafter), rental of a separate office and engagement of staff is beyond the PF's reasonable economic capability, particularly when such expenditures take funds away from grant-making activity. Exhibit 14.2 suggests an expenditure documentation agreement suitable to document a sharing arrangement between a foundation and its donors and managers.

(a) Can the Foundation Pay for Its Share?

The rules are not particularly clear about when a foundation can pay for its portion of the expenses in a sharing situation involving disqualified persons. The tax code specifically prohibits the "furnishing of goods, services or facilities" between (to or from) a PF and a DP. The types of property intended to be covered by this rule include office space, automobiles, auditoriums, secretarial help, meals, libraries, publications, laboratories, and parking lots.[142]

When Congress imposed these strict rules in 1969, it provided a transitional period until 1980, during which existing and contractual sharing arrangements could be phased out.[143] As time passed and the costs of the absolute rule became unreasonable in certain circumstances, the IRS, in private letter rulings, relaxed what looked like an impenetrable barrier to any arrangements in which a PF and DPs share space, people, or other expenses. Three very important factors have been present in the private rulings issued by the IRS:

1. The foundation pays its share of cost directly to an independent vendor.
2. Time and other suitable usage records are maintained to measure and evidence the portion of the shared costs attributable to the foundation.
3. Space and personnel are used by the foundation in conducting its charitable programs.

Payment of the foundation's share of costs directly to an independent vendor was not required in a situation in which the expenses were paid directly by a condominium association.[144]

Office Space. A number of foundations have sought and received approval for shared expenses. One foundation was permitted to rent contiguous space with a common reception area, but with separate offices, from its disqualified persons. Separate leases were entered into, and the DPs received no benefit in the form of

[142] Reg. §53.4941(d)-2(d)(1).
[143] Reg. §53.4941(d)-4(d).
[144] See text accompanying note 44.

EXHIBIT 14.2

Expenditure Documentation Policy

SAMPLE FOUNDATION

INTRODUCTION

As a private foundation (PF), Sample Foundation (Sample) is responsible for proving that all of its expenditures are made for charitable purposes, and that it makes no expenditures on behalf of, nor has any financial transactions with, its disqualified persons (DPs), meaning major contributors and managers. Sample will establish its headquarters and laboratory in the office building owned by its president and contributor, XYZ, who is a DP in relation to Sample. Therefore, Sample wishes to adopt procedures to meet its responsibility. Specifically, the *self-dealing* provisions of the Tax Code prohibit the following:

- Sale, exchange, or lease of property between a PF and a DP, except at no charge
- Lending of money or extension of credit between a PF and a DP
- Furnishing of goods, services, or facilities between a PF and a DP, unless the DP furnishes them to the PF without charge
- Payment of compensation or reimbursement of expenses from a PF to a DP, unless such payments are reasonable and necessary to carrying out the exempt purposes of the PF

POLICY

To ensure adherence to these requirements, Sample adopts the following rules:

Office Space. Sample is entering into a lease agreement with XYZ stipulating that the space is furnished to Sample at no charge. Maintenance, repair, and utilities attributable to the space occupied by Sample will be paid by Sample directly. For example, the space leased to Sample represents _____% of the total square footage of the building. Therefore, _____% of the utility bill will be paid by Sample. Any expenses not directly attributable to Sample space will be paid by XYZ.

Personnel. Sample will hire a project manager, and possibly other personnel, to work exclusively on foundation projects. Because Sample is small and is just getting started, it does not need a full-time secretary or accountant. Therefore, it will hire the current employees of XYZ on a part-time basis. It is estimated that the receptionist and business manager will devote approximately half of their time to Sample's business. Therefore, half of their salaries, employee benefits, and taxes will be paid by Sample. Each person will maintain a record of his or her actual time, and the ratio will be evaluated periodically.

Office Furnishings and Equipment. XYZ owns a telephone system, copy machine, computers, and other equipment that Sample is allowed to use rent-free. To the extent that Sample incurs direct costs in connection with this equipment, it will pay the bills directly. For example, long-distance telephone calls, photocopy paper, and other expendable supplies directly related to foundation activities will be paid by Sample.

Automobile. XYZ is furnishing Sample with a vehicle for its use in connection with foundation projects. Sample will pay the expenses attributable to its actual use of the vehicle. A mileage log will be maintained to evidence the usage.

Asset Purchases, Sales, and Debt Payments. Sample hereby adopts a policy that it will not engage in any financial transactions with XYZ or with any other DP that would cause it to *self-deal*, as that term is defined in Chapter 42 of the Internal Revenue Code.

reduced rent because of the PF's rental in the related space.[145] Another PF was allowed to purchase its part of a duplicating machine and hired a shared employee with its creators. Time records were kept to determine each entity's share of the cost of the machine and the allocable time of the employee. Because "nothing was paid directly or indirectly to the DP" and there was "independent use" by the PF that was measurable and specifically paid for to outside parties, no self-dealing resulted from what certainly appears to have been a "sharing arrangement," supposedly phased out and consequently prohibited by the code.[146]

Different and safer terminology was used to secure IRS approval for payment to the DPs' family management corporation for rendering accounting, tax, and asset management services.[147] The corporation operated on a cost-recovery basis to serve the business needs of "family assets held in trusts, foundations, and partnerships." While the arrangement was essentially a sharing one, the IRS ruled that payment of a fee based on costs was reasonable compensation for services rendered and not an act of self-dealing.[148] Similarly, the IRS has permitted payments directly to a partnership in which one of the PF's directors was a partner, for shared accounting services. The payment was not excessive and "services were reasonable and necessary for the foundation's exempt purposes."[149]

A foundation's payment of the direct flight costs associated with its use of a disqualified person's airplane was found to be neither self-dealing nor a taxable expenditure.[150] The PF did not pay any portion of the DP's maintenance or acquisition costs or relieve the DP of a financial obligation. The plane use was considered to "further the PF's exempt purposes by facilitating meetings among various individuals active in its charitable, scientific, and educational programs."

Group Insurance. Employee insurance policies present similar situations. Corporate and other conglomerate groups funding private foundations have been allowed to include their private foundation employees in a common health insurance policy. The foundation pays directly for the premiums allocable to its employees or reimburses the company. Direct payment is strongly preferred, but if it is impracticable, reimbursement has been allowed. The rationale for reimbursements is found in the Special Rules that permit lending of money to a foundation if no interest is charged and the money is used for exempt purposes.[151]

(b) Public Facilities

A private foundation that operates a museum, maintains a wildlife preserve, publishes essays, or conducts other programs for which it charges is faced with a decree that it must not furnish goods, services, or facilities to its DPs. Taken literally, the rule prevents DPs from visiting the sites or purchasing the journal. A

[145] Priv. Ltr. Rul. 8331082.
[146] Tech. Adv. Memo. 7734022; see also Priv. Ltr. Ruls. 8824010, 9226067, 9307026, and 9312022.
[147] Priv. Ltr. Rul. 9019064.
[148] Due to the §4941(d)(2)(E) exception.
[149] Priv. Ltr. Rul. 8235092.
[150] Priv. Ltr. Rul. 9732031.
[151] IRC §4941(d)(2)(B).

PF's furnishing of goods, services, or facilities normally open to the general public to a DP, however, comes within another of the useful exceptions to the general rules. Such activity is not self-dealing if:[152]

- The property involved is "functionally related to the exercise or performance by the PF of its charitable, educational, or other purpose or function forming the basis for its exemption."
- The number of persons (other than the DPs) who use the facility is substantial enough to indicate that the general public is genuinely the primary user.
- The terms for DP usage are not more favorable than the terms under which the general public acquires or uses the property.

A PF's library meeting room used regularly by the community at large for exempt function–related affairs can be used by a government official who is also a disqualified person.[153] Similarly, the use of a public thoroughfare situated on the foundation's property was permitted for access to the headquarters and manufacturing plant of its corporate disqualified person.[154] The road apparently provided access to both the PF's museum and the company facility, and the company paid for the road's upkeep. An allocation of cost was not mentioned but could be permitted as discussed in Section 14.7(a).

14.8 INDIRECT DEALS

A transaction between a disqualified person and an organization controlled by a foundation may be classified as an *indirect* act of self-dealing as to the foundation itself, even though the funds never touch the PF. Say, for example, a private foundation owns a 70 percent interest in a real estate rental partnership and two of the PF's directors own a construction company. The partnership, because it is controlled by the PF, cannot hire the construction company owned by its DPs to repair its apartment buildings. An indirect transaction is defined by describing circumstances in which a business transaction will not be considered as self-dealing. The regulations provide that indirect self-dealing does not occur in the following situations[155]:

- Transactions resulting from a business relationship established prior to the creation of the control relationship that caused the self-dealing are allowed.
- Transactions at least as favorable to the PF's controlled organization (CO) as an arm's-length transaction with an unrelated party would have been allowed, but only if (1) the CO could have engaged in the transaction with someone other than the DP only at a severe economic hardship to the CO, or (2) because of the unique nature of the product or services provided by the CO, the DP could not have engaged in the transaction with anyone else.

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[152] Reg. §53.4941(d)-3(b).
[153] Rev. Rul. 76-10, 1976-1 C.B. 355.
[154] Rev. Rul. 76-459, 1976-2 C.B. 369.
[155] Reg. §53.4941(d)-1(b)(1).

- De minimus transactions with a CO engaged in a retail business with the general public, such as office supplies, are not indirect self-dealing if the transactions' total amount in one year does not exceed $5,000.[156]

The first self-dealing case to be decided involved an impermissible transfer of indebted property from a corporation owned by a foundation trustee to the PF's wholly owned subsidiary.[157] Another foundation was found guilty of indirect self-dealing when space in a building it owned was leased to a company controlled by one of its DPs. The entire building was subleased to an independent management company which, in turn, subleased the spaces, so that the foundation was not a party to the building subleases. The master lease granted the PF, as landlord, the power of approval over the form and content of any long-term leases entered into by the management company. Thus, the PF essentially controlled the management company and, for self-dealing purposes, became a party to the lease with the DP.[158] Special rules also apply to transactions between a foundation's intermediary grantee organization and a government official.[159]

14.9 PROPERTY HELD BY FIDUCIARIES

A trustee or estate executor may find that property bequeathed to a foundation, such as an undivided interest in property, is not suitable to be held by the foundation. At times, the best solution to the situation is a self-dealing transaction, either direct or indirect. Because the property has not yet become the property of the foundation, a fair degree of leeway is allowed to the estate or revocable trust officials in allocating or selling assets among beneficiaries.

Transactions during administration regarding the foundation's interest or expectancy in property (whether or not encumbered) held by the estate (regardless of when title vests in the PF on the date of death under local law) are not self-dealing under *an estate administration exception*. All five of the following conditions must be met for the exception to apply[160]:

1. The executor, administrator, or trustee has authority to either sell the property or reallocate it to another beneficiary, or is required to sell the property by the terms of the trust or will.
2. A probate court having jurisdiction over the estate approves the transaction. It is unclear whether this approval must be granted specifically for the transaction, or whether the court's acceptance of the final estate accounting and its release of the parties is sufficient.
3. The transaction occurs before the estate or trust is terminated.

[156] Reg. §53.4941(d)-1(b)(6).

[157] *Adams v. Commissioner,* 70 T.C. 373 (1978), aff'd. (unpublished) 2d Cir. 1982 and 70 T.C. 446 (1978).

[158] Priv. Ltr. Rul. 9047001; see also Priv. Ltr. Rul. 9325061 in which provision of "commercial services" by businesses owned by DPs to limited partnerships and corporations holding real estate for the PF and the DPs was deemed indirect self-dealing.

[159] Reg. §53.4941(d)-1(b)(2).

[160] Reg. §53.4941(d)-1(b)(3).

4. The estate or trust receives FMV for the PF's portion of the property.
5. The PF receives an interest at least as liquid as the one given up for an exempt function asset, or receives an amount of money equal to that required under an option binding upon the estate.

This exception, for example, applied when a private foundation was distributing its assets to two new foundations to settle litigation between feuding siblings.[161] The existing foundation owned certain property also owned by an estate still under administration. The court allowed, and thereby the exception applied, reallocation of the assets between the parties in transactions that would otherwise have constituted self-dealing. Importantly, the foundation received liquid assets with value in excess of its actual share of the combined assets. Instead, the purchase of stock by a disqualified person (that otherwise would have been transferred to a foundation) for less than its FMV constituted self-dealing.[162] The division of properties owned by an artist's estate in order to fund a statutory one-third life estate in favor of his wife did not result in self-dealing, despite the exchanges of property inherent in the settlement. The agreement satisfied the five regulation requirements. A substitution of art they preferred for objects specifically bequeathed to the artist's daughters, however, would result in self-dealing. An exchange of specific property, rather than a partitioning or dividing of property essentially owned by the estate, would occur and self-dealing result despite the fact that the PF's art collection purportedly would be enhanced by the trade.[163]

Where the foundation is bequeathed the residuary of an estate, a provision that estate taxes are to be paid from the portion given to the PF did not to result in self-dealing. Since the foundation's vested interest in the estate assets only matures after the tax obligation is satisfied, self-dealing does not occur with the payment of taxes.[164] Payments in settlement of a will contest out of an estate's residuary funds bequeathed to a foundation are also not an act of self-dealing. The decedent had left his residuary estate entirely to a foundation. The will left nothing to the son except an option to purchase certain assets from the residuary estate. After controversy surrounding the purchase, a settlement was entered into giving the son part of the shares and placing part of the shares in a 20-year unitrust for the son's benefit, with the remainder to the foundation. The five requirements listed previously were met, and no self-dealing occurred.[165] The

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[161] Priv. Ltr. Rul. 200117042; see also Priv. Ltr. Rul. 200132037.

[162] *Rockefeller v. U.S.,* 572 F. Supp. 9 (D.C. Ark. 1982), aff'd. 718 F.2d 290 (8th Cir. 1983), cert. den.,466 U.S. 962 (1984), in which it was found that the full FMV was not paid for the estate's shares and, consequently, indirect self-dealing occurred. See also Priv. Ltr. Rul 9210040 and *Reis Estate v. Commissioner*, 87 T.C. 1016 (1986) involving sales of Mark Rothko's artwork by his executor/dealer and the foundation created under his will.

[163] Priv. Ltr. Rul. 9252042.

[164] Priv. Ltr. Rul. 9307025; in Priv. Ltr. Rul. 9308045 the IRS approved the receipt and operation (as a functionally related business) of a business corporation formed to perpetuate its creator's name and musical compositions.

[165] Priv. Ltr. Rul. 8929087; see also Priv. Ltr. Ruls. 8707065 and 8527091, which reach a similar conclusion.

IRS has also approved similar transactions with a living trust[166] and a qualified terminable interest (QTIP) trust.[167]

When an estate transfers property in satisfaction of a bequest, the estate becomes a disqualified person once the amount transferred reaches the requisite amount to cause it to have contributed more than 2 percent of the total donations the foundation has ever received.[168] Care must be exercised in relying on the exception pertaining to "transactions during administration regarding the foundation's interest or expectancy in property." This rule does not shelter payments of excess compensation, loans, or indirect self-dealing that might occur between a company owned by the estate or the foundation.

14.10 ISSUES ONCE SELF-DEALING OCCURS

Once it has been determined that self-dealing has occurred, the self-dealing must be corrected or undone. The penalty tax due is self-assessed with the filing of an excise tax return, Form 4720. The steps involved in repairing the damage include *undoing* the deal, assigning an *amount* attributable to the self-dealing, deciding who has to pay an excise tax, and advancing any exceptions that might excuse the self-dealing. Unlike other foundation penalties imposed by IRC §4942 through §4945, the initial excise tax imposed upon self-dealing transactions cannot be abated.

(a) Undoing the Transaction

To undo self-dealing, the deal must be corrected and rescinded (i.e., the property returned) if possible. The financial position of the private foundation after the correction must be no worse than it would have been if the original transaction had not occurred. The highest fiduciary standards to achieve an *authentic correction* must be applied in making the correction. Specific rules govern sales by or to the PF, uses of property, and compensation deals and are outlined very specifically in the regulations.[169]

Sales by the Foundation. The sale must first be rescinded. If the purchaser still holds the property, the foundation must take back the property. Next, the foundation is to repay the purchaser the sales price or the current FMV of the property at the time of the correction, whichever is less. Any income earned by the DP buyer from the property in excess of the PF's earnings on the money (from investment of the sales proceeds) during the self-dealing period should be restored to the foundation, essentially reducing the repayment of the purchase price by the foundation. If the property has been resold, the foundation is to receive the greater of the original amount of proceeds that it received or what the DP received upon the resale.

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[166] Priv. Ltr. Rul. 9814050.
[167] Priv. Ltr. Rul. 9752071.
[168] Estate becomes a substantial contributor as defined in Section 12.2(c).
[169] Reg. §53.4941(e)-1(c).

Sales to the Foundation. Again, rescission of the sale is required. Fair market value and resale considerations similar to those previously mentioned are taken into account, to ensure that the foundation is restored to the financial position it would have been in had it not purchased the property. For example, say a PF sold 100 shares of stock to a DP for $4,000 in 1998, at a time when the FMV was $3,500. The DP sells the shares in 1999 for $6,000, although the shares had been quoted at $6,700 at one point during the year. The PF must be paid $6,700 to cure the transaction. The first-tier tax will be charged based on the $5,000. If the self-dealing is not corrected and the second-tier tax applies, the tax is calculated based on $6,700. Care must be exercised if property other than cash is used to correct a transaction to avoid yet another act of self-dealing.[170]

Uses of Property by a DP. If a disqualified person is using foundation property, the use must be stopped. If the rent paid is less than the fair market value paid in the same location for similar space, an imputed rent factor based on fair market differentials, if any, must be repaid to the foundation. Different corrections are specified in the regulations, depending on whether the PF or the DP rented the property. If money has been loaned, the loan must be repaid. Repayment of a cash loan with property other than cash will result in another act of self-dealing.[171]

Uses of Property by the PF. Again, the lease must be terminated, use must cease, and the FMV differential must be repaid. If the property is provided to the foundation rent-free and the property is used by the foundation in conducting its charitable programs, an act of self-dealing has not occurred.[172]

Unreasonable Compensation. When excessive or unreasonable salaries are paid to a disqualified person, the excess must be repaid to the foundation.[173] Termination of the employment or independent contractor arrangement, however, is not required.

(b) Amount and Date Involved

The penalties for entering into a self-dealing transaction are based on the *amount involved*, which is defined as follows:

> The greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.[174]

Thus, where a PF leases office space from a DP for $30,000, but the FMV of the space is $25,000, the amount is $30,000. If a PF loans a DP money at a below-market interest rate, the amount equals the difference between the interest actually paid and the amount that would have been charged at the prevailing market rate at the time the loan was made.[175] The highest fair market value during the cor-

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[170] Rev. Rul. 81-40, 1981-1 C.B. 508, 509.
[171] Rev. Rul. 81-40, 1981-1 C.B. 509.
[172] IRC §4941(d)(2)(D).
[173] See Section 14.4.
[174] Reg. §53.4941(e)(2) and §53.4941(e)-1(b)(2).
[175] Reg. §53.4941(e)-1(b)(4).

rection period is the amount involved in second- and third-tier taxes, discussed in the following paragraphs.

Compensation. In the case of compensation paid for personal services to persons other than government officials, the amount is the portion of the total compensation in excess of the amount that would have been reasonable. This means all types of compensation, including not only salary and wages, but fringe and retirement benefits and that portion of foundation insurance premiums treated as compensation.[176] The self-dealing nature of a transaction cannot be avoided—for example, a low-interest loan to a DP—by recharacterizing the amount involved as compensation.[177]

Stock Redemptions and Other Permitted Dealings. Sometimes a transaction that is permitted by the statutory exceptions[178] goes amiss, and a tax is imposed. This occurs particularly often under exceptions 6 and 8, in which the value is determinative. In such cases, the amount involved is only the amount by which the redemption price is deficient (i.e., the amount by which the property was undervalued) or the taxable self-dealing. Two conditions must be present to show that the parties made a good faith effort to determine the FMV (so that only the excess is taxed):

1. The appraiser who arrived at the value must be competent to make the valuation, must not be a DP, and must not be in a position, whether by stock ownership or otherwise, to derive an economic benefit from the value utilized.
2. The method utilized in making the valuation must be a generally accepted method for valuing comparable property, stock, or securities for purposes of arm's-length business transactions in which valuation is a significant factor.

For example, say a corporation that is a DP as to a PF redeems the PF's stock for $200,000. Assume that the correct valuation is later determined to be $250,000. Self-dealing has occurred in the amount of $50,000.

To calculate the first-tier tax initially imposed on a sale, exchange, or lease of property, the amount involved is determined as of the date on which the self-dealing occurred. If the self-dealing goes uncorrected and the additional or second-tier tax is calculated, the valuation is equal to the highest value during the period of time the self-dealing continued uncorrected. For a complicated saga of one foundation's attempts to cure a self-dealing transaction, see the *Dupont* case.[179]

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[176] See Section 14.5(a).

[177] Priv. Ltr. Rul. 9530032; conceivably such a loan treated as part of a compensation package at the time of hiring and regularly reported as additional compensation, such as a no-interest loan to the new CEO to purchase a home, might not result in self-dealing.

[178] Listed in Section 14.1(b).

[179] *Dupont v. Commissioner*, 74 T.C. 498 (1980).

Date. The initial, or first-tier, tax is calculated as of the date the terms and conditions for the sale, exchange, lease, or use of property are fixed and liabilities agreed to. The tax is imposed for each year, or part of a year, during which the impermissible arrangement lasts, or goes uncorrected, as explained subsequently.

(c) Who Pays What Tax?

The penalty tax is imposed on the individual(s) or corporate self-dealer(s) participating in the prohibited transaction, but not on the private foundation itself.

First-Tier Tax. The self-dealer pays an initial tax of 5 percent of the amount involved in each year in the taxable period, even if he or she was unaware that a rule was being violated. A 2½ percent tax is also imposed on the foundation managers—any persons (including the self-dealer) who approved the transaction if the following conditions exist[180]:

- An initial tax is imposed on the self-dealer.
- The foundation manager knows that the act is an act of self-dealing.
- The manager's participation is willful and not due to reasonable cause.

A foundation manager is expected to be aware of the PF sanctions and to remain sufficiently informed of the PF's affairs to prevent any violations of the sanctions.[181] The term *participation* not only includes affirmative actions of a manager, it also includes silence or inaction on the part of a manager where he or she is under a duty to speak or act; voting against the deal excuses the tax. People are considered to have participated knowingly only if:

- They have actual knowledge of sufficient facts so that, based solely upon such facts, such a transaction would be an act of self-dealing.
- They are aware that such an act under these circumstances may violate the provisions of federal tax law governing self-dealing.
- They negligently fail to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or they are, in fact, aware that it is such an act.

The managers are jointly and severally liable for the tax imposed upon them, up to a maximum of $10,000.[182] The tax is not imposed on a PF manager if a full disclosure of the facts was made to counsel, a reasoned legal opinion was issued, and the manager relied upon that opinion in deciding that no sanctions were violated.[183] The terms applied to determine whether a manager knew are further defined in Section 16.2(c).

The *taxable period* begins with the date on which the transaction occurred and ends on the earliest of the date of mailing of the notice of deficiency with

[180] IRC §4941(a)(2); Reg. §53.4941(a)-1(b).
[181] Reg. §53.4941(a)-1(b)(3); see also Section 16.2(c).
[182] IRC §4941(c).
[183] Reg. §53.4941(a)-1(b)(6).

respect to the initial tax, the date on which the initial tax is assessed, or the date on which correction of the transaction is completed.[184]

Second-Tier Tax. An additional tax of 200 percent of the amount involved is imposed on the self-dealer if a timely correction of the transaction is not made. A foundation manager who refuses to agree to the correction also faces a penalty of 50 percent of the amount involved.[185] The second-tier tax may be abated if the act was due to reasonable causes and not to willful neglect, and has been corrected.[186]

Third-Tier Tax. The ultimate penalty for failure to cure, or undo, a self-dealing transaction is the IRC §507 termination tax.[187] A foundation that conducts repeated and willful violations of the PF sanctions is liable to be terminated, with all tax benefits it and its contributors have ever received being repaid to the government—very likely, all of the assets held in the PF. Exhibit 12.1 lists all of the rates of tax and the parties upon whom the tax is imposed.

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[184] IRC §4941(e)(1).
[185] IRC §4941(b).
[186] IRC §4962.
[187] See Chapter 12.

CHAPTER FIFTEEN

Minimum Distribution Requirements: IRC §4942

Before 1970, all Internal Revenue Code (IRC) §501(c)(3) exempt organizations were subject to a vague and unenforceable prohibition against accumulating income unreasonably. Assets could be invested in a no- or low-income-producing manner, with very little money being given to charity. A family could take tax deductions, in some years, offsetting as much as 90 percent of its income, for placing shares of the family business in a foundation. The company could pay out no dividends to the shareholders and instead pay whatever money as salaries the family needed to live on. The only persons benefiting from such arrangements were the family members, not any charitable beneficiaries.

To stem such abuses, Congress enacted IRC §4942, which requires private foundations (PFs) to satisfy strict numerical tests for making annual expenditures for charitable projects and grants. A PF must annually make "qualifying distributions," or charitable grants or project expenditures, equal to its prior year's minimum investment return (MIR). The MIR is approximately 5 percent of the value of the PF's investment, or noncharitable use, assets for normal foundations and 3⅓ percent for private operating foundations. Essentially, this rule requires that an amount equivalent to the foundation's return on its investments must be spent, transferred, or used for charitable purposes. This payout requirement does not forbid a foundation's purchase of a low-yield investment (such as raw land). A foundation investing in such a fashion, however, would need to sell or distribute other assets to meet its annual payout requirement.

Before 1982, PFs were required to distribute the higher of MIR or actual net investment income. When interest rates were around 15 percent, the actual income was often a much higher amount. Foundation representatives convinced Congress that they needed to reserve some of their income against future inflation. During times when the prevailing interest rates fall below 5 percent, foundation representatives suggest further lowering of the percentage. Congress has not reacted favorably to such requests and legislation was introduced in 2003 to essentially raise the percentage by disallowing certain disbursements. Watch for new developments.

15.1 ASSETS USED TO CALCULATE MINIMUM INVESTMENT RETURN

Stated most simply, a private foundation is annually required to spend or pay out for charitable and administrative purposes at least 5 percent of the average fair market value (FMV) of its investment assets for the preceding year, less the amount of any debt incurred to acquire the property and a 1½ percent provision for cash reserves.

$$\boxed{(\text{PF Investment Assets} - \text{Debt} - \text{Cash Reserves}) \times 5\% = \text{MIR}}$$

The 5 percent distribution rate is reduced for a foundation with a short taxable year.[1] The percentage for a short year is calculated by multiplying the number of days in the year by 5 percent and dividing the result by 365, resulting in a lower percentage. So, for example, a foundation created on September 1, choos-

[1] Reg. §53.4942(a)-2(c)(5)(iii).

ing a calendar year, calculates the amount it will be required to distribute in the next succeeding year as follows:

$$\frac{\textit{Days in short year} - \textit{122 days} \times 5\%}{\text{Days in the year} - 365 \text{ days}} = 1.67\%$$

Assume instead that a foundation is created on September of one year, receives its first assets on March 1 of the following year, and adopts a calendar tax year. Since it has no assets for the first four months of its existence, it will have no payout requirement for its first partial year, nor would it file a return.[2] For the next, or second, year it would have been in existence for a full year, even though it received assets in March. Thus, its payout percentage would be a full 5 percent. Correspondingly, the average value of its assets would be calculated by considering it had zero assets for two months, thereby effectively reducing the asset base to which the percentage is applied.[3] The calculated amount would be distributable by the end of its third year—the year following its receipt of assets.[4] The partial-year allocation of the payout percentage also applies to an existing foundation that changes its year-end.

(a) What Are Investment Assets?

The minimum investment return is calculated based on "the excess of the fair market value of all assets of the foundation, other than those that represent future interests or expectations and exempt function assets."[5] Although referred to as an "investment return," neither the tax code nor the regulations define the word *investment* for this purpose. Instead, all assets are included in the calculation unless they are specifically excluded. The included assets are reduced by acquisition indebtedness with respect to those assets, plus a cash reserve for operations presumed to equal 1½ percent of the total includable assets.

Successful calculation of MIR thereby depends upon distinguishing investment assets from exempt function assets. This concept of exempt function versus investment is an important key to understanding MIR. If the foundation holds an asset as an investment, 5 percent of its value is payable annually for charitable purposes, even if it is not producing any current income. This scheme is very different from the rules for calculating the excise tax on investment income under which income from certain types of assets is excluded from tax.[6]

The typical PF investment portfolio of stocks, bonds, certificates of deposit, and rental properties usually forms the basis for calculating the distributable amount. Funds of all sorts—current, deferred grants, capital, endowment, and similar types of reserves—are all includable in the formula. If a property is used for both investment and program purposes, its value is allocated between the dual uses.[7] Business properties, such as cattle and other fixtures of a working

[2] See discussion in Section 18.2.
[3] See example in Section 15.2(b).
[4] See Section 15.3(b).
[5] IRC §4942(f)(1(A); Reg. §53.4942(a)-2(c) further discussed in Sections 15.1(b) and (c).
[6] See Chapter 13.
[7] See Section 15.1(d) for discussion of dual-use property.

ranch donated to a foundation, are included, as would be an interest in a partnership, even though the income from the assets is not subject to the investment excise tax.

(b) Future Interests or Expectancies

Certain assets provide beneficial support to the PF in an indirect fashion. Assets over which the PF has no control and in which it essentially holds no present interest are not included in the MIR formula. These assets most often are not actually in the possession or under the control of the PF, nor are they customarily included in the financial records or statements of the foundation. Excludable expectancies include[8]:

- Charitable remainders and other future interests in property created by someone other than the PF itself, until the intervening interests expire or are otherwise set apart for the PF. If the foundation is able to take possession of the property at its will or to acquire it readily upon giving notice, the property is included. The rules of constructive receipt for determining when a cash basis taxpayer receives an item of income are relevant.
- Present interests in a trust, usually called a *charitable lead trust*. However, income from any such trusts created after May 26, 1969, is includable in the adjusted net income and can affect a private operating foundation.[9]
- Pledges of money or other property to the PF, whether or not the pledges are legally enforceable.
- Property bequeathed to the PF is excluded while it is held by the decedent's estate. If the IRS treats the estate as terminated because the period of administration is prolonged,[10] the assets are treated as PF assets from the time of such Internal Revenue Service (IRS) determination.
- Options to sell property that are not readily marketable and are without an ascertainable value. Listed options to buy or sell common stocks that are traded on a security exchange are includable as investment assets.

(c) Exempt Function Assets

Income need not be imputed to property held by and actually used by the foundation in conducting its charitable programs. Such assets are called *exempt function assets*, and are not usually held for the production of income (although they do produce income in some cases), but instead are "used (or held for use) directly in carrying out the foundation's exempt purpose." To be excluded, such assets must actually be in use; cash earmarked for purchase of artwork, for example, is not an exempt function asset. The most common type of assets excluded from the MIR formula follow.[11]

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[8] Reg. §53.4942(a)-2(c)(2).

[9] *Ann Jackson Family Foundation v. Commissioner,* 97 T.C. 4, No. 35.

[10] See Reg. §1.1641(b)-3 for circumstances under which administration of an estate is considered to be unreasonably prolonged.

[11] Reg. §53.4942(a)-2(c)(3)(ii).

- *Administrative offices, furnishings, equipment, and supplies* used by employees and consultants in working on the foundation's charitable projects are not counted. However, the same property, if used by persons who manage the investment properties or endowments, is treated as investment property.

- *Buildings, equipment, and facilities used directly in projects* are clearly not counted as investment property. Examples include

  - Historic buildings, libraries, and the furnishings in such buildings
  - Collections of objects on educational display, such as works of art or scientific specimens, including artworks loaned to other organizations[12]
  - Research facilities and laboratories, including a limited-access island held vacant to preserve its natural ecosystem, history, and archaeology[13]
  - Print shops and educational classrooms
  - Property used for a nominal or reduced rent by another charity. No figures are furnished in the regulations. The asset test for private operating foundations, however, defines a rental property leased to carry out an exempt purpose. The property is considered to be exempt property if the rent is less than the amount that would be required to be charged in order to recover the cost of property purchase and maintenance.[14]

- *Reasonable cash balances* are considered to be necessary to carry out exempt functions. One and one-half percent of the included investment assets is presumed to be a reasonable cash balance, even if a smaller cash balance is actually maintained.[15] If the foundation's programs require a higher amount to cover expenses and disbursements, the PF can apply to the IRS to permit a higher amount.[16]

- *Program-related investments and functionally related businesses*[17] that further the foundation's exempt purposes are not considered investment assets. The primary motivation for making these investments is not the production of income. Examples include a low-rent indigent housing facility and student loans receivable. Stock of a restaurant and hotel complex operated by a separate taxable corporation within a historic village and an educational journal for which advertising is sold are given as examples in the regulations.[18] Such properties are also treated as related businesses.[19]

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[12] Rev. Rul. 74-498, 1974-2 C.B. 387.
[13] Rev. Rul. 75-207, 1975-1 C.B. 361.
[14] Reg. §53.4942(b)-2(a)(2).
[15] Rev. Rul. 75-392, 1975-2 C.B. 447.
[16] Reg. §53.4942(a)-2(c)(3)(iv).
[17] See Section 16.3(b).
[18] Reg. §53.4942(a)-2(c)(3)(iii).
[19] IRC §512; see Chapter 21.

By definition, a functionally related business is one that is not unrelated.[20] Thus, the value of a business run by volunteers is not counted as an investment asset for this purpose.[21] A business in which the performance of service is a material income producing factor, such as a retail shop, is not an unrelated business if substantially all of the work (about 85 percent) is performed without compensation.[22] A capital-intensive business, such as long-term leasing of heavy equipment or a parking lot, is treated as an unrelated business even if the management is donated and, by reference, its value would be included.[23] An unrelated business fragmented from within a larger aggregate of exempt activities does not, however, necessarily cause inclusion of the associated related activity assets. Notwithstanding the fact that advertising sold for a journal creates taxable unrelated business income, the overall publication program can be considered a functionally related business.[24] The larger complex of a medical research foundation's publication program determines its character as a related business.

(d) Dual-Use Property

In many cases, a PF owns and uses property for managing or conducting both its investments and its charitable projects. In such situations, an allocation between these two uses must be made. For assets used 95 percent or more for one purpose, the remaining 5 percent is ignored. An office building housing the foundation would be allocated based on the functions performed by the persons occupying the spaces, as illustrated in the following example:

Investment department	1,125 square feet	25%
Program offices	3,375 square feet	75%
	4,500	100%

In such a situation, 25 percent of the building's value would be treated as an investment asset. In a very large foundation, the formula may be more complicated. A third category, administration, may need to be included in the formula when the staff is sophisticated and separate personnel, accounting, and central supply departments serve the investment and program groups. For property that is partly used by the foundation and partly rented to others, the IRS has ruled that an allocation based on the fair rental value of the respective spaces, rather than the square feet, is appropriate.[25]

(e) Assets Held for Future Use

An asset acquired for use in the future may be treated as exempt function property where the foundation has definite plans to commence such use within a reasonable period of time (usually one year). Sometimes it takes a number of years

[20] Reg. §53.4942(a)-2(c)(3)(iii)(a)(1).
[21] Rev. Rul. 76-85, 1976-1 C.B. 357.
[22] IRC §513(a)(1) discussed in Section 21.9(a).
[23] Rev. Rul 78-144, 1978-1 C.B. 168.
[24] Reg. §53.4942(a)-2(c)(3)(iii)(b), Example (2).
[25] Rev. Rul. 82-137, 1982-2 C.B. 303.

to piece together a project using hard assets like land, buildings, and equipment. When a PF has future plans for use of property and "establishes to the satisfaction of the Commissioner" (i.e., obtains IRS approval) that its immediate use of the property is impractical, an asset held for future use is excluded. Definite plans must exist to commence use within a reasonable period of time, and all of the facts and circumstances must prove the intention to devote the property to such use. The concepts are similar to set-asides.[26] Money to be used to remodel or acquire furnishing for such property is not excluded. Acquisition of future use property is also treated as a qualifying distribution.[27]

Property acquired with the intention of using it for exempt purposes may be treated as exempt function property from the time it is acquired, even if it is temporarily rented. The rental status must be for a reasonable and limited period of time and only while the property is being made ready for its intended use, such as during remodeling or acquisition of adjacent pieces of property. IRS approval is not necessary if the property conversion takes only one year. However, if the property is rented for more than a year, it is treated as investment property during the second year and thereafter until it is devoted to exempt purposes. This change is also reflected for qualifying distribution purposes. Property reclassified as investment property would be treated as a negative distribution or added back in when calculating the annual distributable amount.[28]

(f) Acquisition Indebtedness

The formula for calculation of the minimum investment return allows a reduction in includable assets by the "amount of any acquisition indebtedness with respect to such assets (determined under section 514(c) without regard to the taxable year in which the indebtedness was incurred)."[29] The regulations repeat this phrase and provide no additional guidance for determining eligible debt for this purpose.[30] Thus, a foundation looks to tax code that says "acquisition indebtedness equals the unpaid amount of debt incurred by a foundation in acquiring or improving a property."[31] The most common type of acquisition debt incurred by a foundation is a mortgage on investment real estate. A margin account created to purchase securities would constitute such debt, but private foundations seldom borrow on margin because of the jeopardizing investment prohibitions.[32]

Some foundations with significant portfolios of marketable securities do enter into security-lending transactions to enhance the return on those investment assets. The foundation lends its securities to a financial institution in return for cash collateral equal to the value (or more) of the securities. The foundation retains its right to receive dividends or interest from the securities and is also

[26] Reg. §53.4942(a)-2(c)(3)(i). See Section 15.4(g).
[27] See Section 15.4(f).
[28] See Section 15.3.
[29] IRC §4942(e)(B).
[30] Reg. §53.4942(a)-2(c)(1)(i).
[31] See Section 21.12.
[32] See Section 16.2.

entitled to invest the cash it holds as collateral. IRC §514(c)(8)(C) states that "for purposes of this section an obligation to return collateral security shall not be treated as acquisition indebtedness." IRC §4942(e)(1)(B) refers to IRC §514(c) to define acquisition indebtedness and says the collateral security debt is not acquisition debt. This exclusion stems from the fact that the unrelated business income rules do not tax payments with respect to securities loans or income from investment of the collateral security.[33]

Effective in 2001, generally accepted accounting standards began to require reporting of both the securities and the cash collateral as foundation assets. The obligation to repay the cash is reflected as a liability for financial statement purposes so that the foundation's net assets reflect only the value of the securities it has lent. To calculate the minimum investment return, however, the collateral security loans are not acquisition indebtedness. To alleviate this unfair result, the IRS privately ruled that the collateral received in connection with a security lending transaction can be excluded as an investment asset.[34]

15.2 MEASURING FAIR MARKET VALUE

The minimum investment return is based on a percentage, now 5 percent, of the average fair market value of the includable investment assets. Different methods, revaluation times, and frequencies are provided for various types of investment assets that a private foundation might own. Valuation mistakes can cause a foundation to miscalculate its required distributable amount. When mistakes are unintentional, penalties may not necessarily be assessed.[35]

(a) Valuation Methods

Any "commonly acceptable method of valuation" may be used, as long as it is reasonable and consistently used. Valuations made in accordance with the methods prescribed for estate tax valuation are acceptable.[36] Presumably, the rules governing valuation of charitable gifts would also be acceptable.[37] The opinion of an independent appraiser is required only for real estate. For all other assets, the PF itself can establish a consistent method for making a good faith determination of the value of most of its assets.

(b) Date of Valuation

Different asset valuation dates are prescribed for different kinds of assets:

Cash	Monthly (balance on first and last day)
Marketable securities	Monthly (any day used consistently)
Real estate	Revalued every fifth year
All other assets	Annually

[33] IRC §512(b)(1).
[34] Priv. Ltr. Rul. 200329049.
[35] See Section 15.6(e).
[36] Reg. §53.4942(a)-2(c)(4)(i)(b) and (iv)(c) refers to IRC §2031 regulations.
[37] Described in IRS Publication 561.

Cash is valued on a monthly basis by averaging the amount of cash on hand on the first and last day of each month. Assets valued annually can be valued on any date, as long as approximately the same date is used each year.[38] Conceivably, real estate valuation should also be done on approximately the same date every fifth year, but no precise date is prescribed. For valuation of property newly acquired by a foundation, the price actually paid for property of a sort valued annually, should serve as its value for the year of purchase, absent abnormal acquisition circumstances. Real estate received as a gift, as a transfer from an estate or trust, or purchased by the foundation may technically be valued on any date of the year after acquisition of the property. As a practical matter, however, the acquisition date often becomes the date used for MIR valuation purposes because an appraisal is prepared on that date for the donor or transferor.

(c) Partial Year

The average value of an asset held by the foundation for part of a year is calculated by using the number of days in the year that the asset was held as the numerator, and 365 as the denominator. The includable value is thereby reduced to equate to the partial-year holding period. For example, for a $100,000 piece of real estate acquired on July 1, the includable amount would be as follows:

Asset Held for Partial Year

$$\boxed{\$100{,}000 \times 182/365 = \$50{,}000}$$

A new foundation begins its first year on the day it is created, not the day it first receives assets. Assume the preceding example applied to a new foundation created on March 1 that received the gift of real estate on July 1. The formula for calculating the includable amount of the real estate value would instead be

Calculation for New Foundation

$$\boxed{\$100{,}000 \times 304/365, \text{ or } \$83{,}300}$$

(d) Readily Marketable Securities

Securities for which a market quotation is readily available are valued monthly on any day, using any reasonable and consistent method.[39] Securities include (but are not limited to) common and preferred stocks, bonds, and mutual fund shares.[40] The monthly security valuation method applies to the following:

- Stocks listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange
- Stocks regularly traded in a national or regional over-the-counter market, for which published quotations are available

[38] Reg. §53.4942(a)-2(c)(4)(vi).
[39] Reg. §53.4942(a)-2(c)(4)(i)(a).
[40] Reg. §53.4942(a)-2(c)(4)(v).

- Locally traded stocks for which quotations can readily be obtained from established brokerage firms

The *quotation system* can be one of a variety of methods, again as long as a consistent pattern is followed. The following examples are given in the regulations.[41]

- The classic method averages the high and low quoted price on a particular day each month, which could be the first, fifth, last, or any other day.
- A formula averaging the first, middle, and last day closing prices for each month
- The average of the bid and asked price for over-the-counter stocks or funds on a consistent day, using the nearest day if no quote was available on the regular day

Portfolio reports generated by a computer pricing system and prepared monthly for securities held in trust by a bank or other financial institution are customarily used. The bank's or investment advisor's system must be accepted as a valid method for valuing securities for federal estate tax purposes. The foundation has a responsibility to inquire of the bank as to its method of valuation and to obtain evidence that its system is approved. Banks commonly have certification from bank examiners, and investment advisory firms have their license renewals from the Securities and Exchange Commission. In the author's experience, the IRS has not required proof that the bank's system has specific IRS approval, even though the regulations require it.

Blockage discounts of up to 10 percent are permitted to reduce the valuation of marketable securities when a foundation can "show that the quoted market prices do not reflect FMV"[42] for one or more of the following reasons:

- The block of securities is so large in relation to the volume of actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market.
- Sales of the securities are few or sporadic in nature, and the shares are in a closely held corporation.
- The sale of the securities would result in a forced or distress sale because the securities cannot be offered to the public without first being registered with the Securities and Exchange Commission.

Essentially, a foundation is permitted to use the price at which the securities could be sold by an underwriter outside the normal market. The blockage discount is limited to 10 percent for unrestricted listed securities and, otherwise, is unlimited.[43] Where the foundation's shares represent a controlling interest, the price at which shares of others are sold is not necessarily an accurate value of the shares.[44] The IRS has privately ruled that a foundation that failed to apply block-

[41] Reg. §53.4942(a)-2(c)(4)(e).
[42] Reg. §53.4942(a)-2(c)(4)(i)(c).
[43] IRC §4942(e)(2).
[44] Reg. §53.4942(a)-2(c)(4)(I)(c)(3); for more discussion see Section 6.3(e) of B. Hopkins and J. Blazek, *Private Foundations: Tax Law and Compliance, 2nd Edition* (New York: Wiley, 2003).

age discounts may do so currently, as well as retroactively to compute its required distributions.[45]

(e) Cash and Other Assets

The calculation of average cash balances adds together the 12 beginning and 12 ending month-end balances for all accounts and divides the result by 24. By comparison, the formula for calculating the average value of securities, instead, adds together 12 valuations on the date chosen by the foundation (usually the last trading day of the month) and divides the result by 12. Thus, a foundation cannot easily manipulate its cash balance. Note that although an imputed amount of cash, 1½ percent of all investment assets, is excluded in calculating the mandatory payout, the actual cash balances are included to arrive at total investment assets.

All other assets are valued annually, using a reasonable and consistent method, on the bases described in the following paragraphs. The valuations can be made on any day so long as the foundation values those assets on approximately the same day each year.

Common Trust Funds. Foundation funds invested in a common trust fund[46] can use the fund's valuation reports. Fund participants typically receive periodic valuations of their interests from the fund manager throughout the year and can calculate the average of these valuation reports. If the fund issues valuations quarterly, the simple average of the four reported valuations is an acceptable measure of the fund's value for this purpose. If valuations are issued monthly, the sum of 12 months of value would be divided by 12.

Real Estate. A certified, independent appraisal made in writing by a qualified person who is not a disqualified person with respect to, or an employee of, the foundation is required to be made every five years for investment real estate held by a foundation.[47] An appraisal is considered certified only if it includes a statement that, in the opinion of the appraiser, the values placed on the land appraised were determined in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. Due to the significant cost that can be entailed in such appraisals, gifts of modest parcels of real estate to a PF (or sale soon after a gift) should be avoided.

More frequent valuations can be made when circumstances dictate, as, for example, when real estate has declined substantially in value (starts a new five-year period). The rules do not require revaluation during the five-year period, even when the valuation has increased materially.[48]

Other Types of Assets. Valuations of other types of assets must be updated annually, again following a reasonable and consistent method. Independent appraisals are not required.

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45 Priv. Ltr. Rul. 9233031.
46 Defined in IRC §584.
47 Reg. §53.4942(a)-2(c)(4)(iv)(b).
48 Id.

Mineral interest valuations are customarily based on reserve studies conducted by petroleum evaluation engineers. Although there is no mention of oil properties in the IRS literature on the subject, minerals are treated as real property for most purposes. Valuations are normally updated every five years following the rules for real estate.

Shares of a *closely held business* or an interest in a *partnership* can be valued on any day of the year. Generally, the month of valuation should be used consistently from year to year and is often the year-end of the business or partnership. The fair market value of the entity's assets, earning history, goodwill, and other valuation factors germane to the industry in which it operates are taken into account following estate tax valuation methods. Due to the excess business holdings rules[49] and income tax consequences[50] of such investments, a foundation often owns a minority interest in such properties. If so, the valuation might be reduced by a discount attributable to lack of marketability. The terms of a partnership or stockholders' agreement might provide for the valuation method. The foundation that purchases interests in partnerships organized and managed by financial institutions should expect and, if not readily offered, request the value of the interest to be provided annually. Valuation of such assets is often quite difficult, in the author's experience.

Valuation of *computers, office equipment, and other tangible assets* used in managing the investment activity can be obtained from the local newspaper's classified advertisements for used equipment, or by obtaining a quotation from a used office furniture dealer. There is no prescribed method for valuating leasehold improvements to the foundation's leased office space. A practical method would be to use the unamortized cost basis of the improvements. Other assets capitalized for accounting purposes, such as custom-designed software or reference library books, might be similarly valued.

The value of a *whole life insurance policy* is its cash surrender value.

Notes and accounts receivable are included at their net realizable value or their face value, discounted for any uncollectible portion.

Collectibles held for investment purposes, such as gold, paintings, and gems, are valued under estate tax valuation rules. Under those rules, the value equals the amount a willing buyer, under no special compulsion to buy, would pay the foundation to acquire the asset. Reports of auction sales of comparable items or the opinion of dealers of such items could be used to document valuation used for this purpose.

15.3 DISTRIBUTABLE AMOUNT

A nonoperating private foundation is subject to an excise tax if it fails to spend a minimum specified amount for charitable purposes. It may spend more, but not less. When it spends more, the excess can be carried over for five subsequent years. The minimum investment return that represents most of the required payout has absolutely no relationship to the foundation's actual investment

[49] See Section 16.1(c).
[50] See Section 21.10(g).

income.[51] Confusion sometimes arises because the regulations still contain the rules applicable before 1982, when a normal private foundation was required to distribute its actual adjusted net income or the minimum investment return, whichever was higher.[52] To arrive at what the Internal Revenue Code now calls the *distributable amount*, or the amount required to be paid out annually, the foundation follows this formula:

$$A + B - C = \text{Distributable Amount}$$

A = Minimum investment return (5% of value of investment assets)[53] plus

B = Any amounts previously included as qualifying distributions, but now not qualifying, such as:

- Grants, student loans, and program-related investments repaid or returned to the foundation for any reason[54]
- An asset that ceases to be an exempt function asset, whose purchase or conversion was previously included as a qualifying distribution. The sale proceeds or fair market value at the time of conversion of the asset is the amount added back.
- Unused set-aside funds that are no longer earmarked for a charitable project or which are ineligible because of excessive time lapse.

C = Less the excise tax on investment income and unrelated business income tax imposed for the year

To illustrate how the formula for calculation of the distributable amount works, assume the following facts about a private foundation:

Average value of noncharitable assets for the year	$ 1,000,000
Acquisition indebtedness	–50,000
	950,000
– Cash deemed held for charitable activities (1½% of $950,000)	–14,250
Net value of noncharitable assets	$ 935,750
Minimum investment return (5% of net value)	46,787
+ Recovery of amounts previously treated qualifying distributions	+3,000
– Excise and income tax	-2,200
DISTRIBUTABLE AMOUNT	**$ 47,787**

(a) Controversial Addition

Despite the fact that IRC §4942(d) literally does not, Part XI of Form 990-PF, the instructions to the form, and the regulations[55] require that income paid or pay-

[51] See Section 15.5(e) for discussion of tests based on "adjusted net income" applicable to private operating foundations.

[52] This requirement still applies to private operating foundations, as discussed in Section 15.5(e).

[53] See Section 15.1.

[54] See IRC §4945 for grant agreements and expenditure responsibility grants.

[55] Reg. §53.4942(a)-2(b)(2); IRS Publication 578, *Tax Information for Private Foundations and Foundation Managers* (last revised in January 1989), also contains this requirement.

able by certain trusts be added to the distributable amount of all foundations. Since 1982, this addition has been applicable only to private operating foundations[56] in calculating their adjusted gross income.[57] Prior to 1982, all foundations were required to distribute either their adjusted gross income, including such trust distributions, or the hypothetical minimum investment return, whichever was higher. To preserve the principal value of their assets, foundations convinced Congress to lower the annual distribution requirement solely to the minimum investment return adjusted as shown previously for the excise tax and recoveries of amounts previously claimed as qualifying distributions. Nonetheless, the IRS form continues to prompt addition of distributions, actually paid or payable, from split-interest trusts.

The Ann Jackson Family Foundation challenged the IRS and convinced the Tax Court that the regulation was an "unwarranted extension of the statutory provision."[58] Interestingly enough, another section of the regulations pertaining to distribution requirements provides that the corpus of a split-interest trust is not counted as an investment asset for purposes of calculating the foundation's minimum investment return.[59] Thus, a foundation that is a beneficiary of a split-interest trust faces a dilemma in view of this controversy.

(b) Distribution Deadline

The distributable amount that must be paid out each year is equal to the calculated amount based on the preceding-year asset values,[60] with adjustments shown above. For example, a foundation must, before September 30, 2004, distribute the amount calculated and shown on its September 30, 2003, year-end return. This one-year time lag essentially gives a new foundation two years in which to establish its grants systems and to earn the income required to be distributed. A new foundation has no distribution requirement in its first year. Additionally, the MIR percentage for a short year is prorated according to the number of months in the year, and assets held less than a year are similarly prorated.[61] A cash-distribution test may further reduce this amount for a new foundation with plans qualifying for set-aside.[62]

The distributable amount is calculated each year on Form 990-PF. A summary schedule entitled "Undistributed Income" is also completed to compare the qualifying distributions[63] (discussed next) to the required amount. Though a foundation is penalized if it underdistributes, a five-year carryover is allowed for excess distributions.[64] A foundation that changes its fiscal year ending (which it,

[56] Discussed in Section 15.5.

[57] Defined by IRC §4942(f) to include the guaranteed annuity amount paid or payable to a foundation by a split-interest trust attributable to amounts placed in trust after May 26, 1969.

[58] *Ann Jackson Family Foundation v. Commissioner,* 97 T.C. No. 35 (1991), aff'd., 94-1 USTC ¶50068 (9th Cir. 1994).

[59] Reg. §53.4942(a)-2(b)(2)(iii).

[60] See Sections 15.1 and 15.2.

[61] Reg. §53.4942(a)-2(c)(4)(vii) and (5) (iii); see Sections 15.1 and 15.2(b).

[62] See Section 15.4(c).

[63] Discussed next, in Section 15.4.

[64] See Section 15.6 for discussion of satisfying the distribution test.

incidentally, can do automatically by filing Form 990-PF within 4½ months of the end of the short year) must pay out the distributable amount by the end of the short period.

The payout percentage is essentially .4,166 percent per month (5 percent/ 12). For the year in which a foundation is created or changes its fiscal year, the partial-year percentage is determined by the number of days it was in existence for the year.[65] Assume a foundation changes its financial reporting year-end from September 30 to December 31. The change of year requires no permission and is accomplished by simply filing a short-period Form 990-PF return for the four months ending in December.[66] The percentage applied to calculate its minimum distribution requirement for the next succeeding full calendar year would be 1.67 percent (.4,166 percent × 4). Although the reduced percentage could be thought of as an advantage, the normal 5 percent MDR attributable to its last full year ending in September will have to be distributed within the four months of its short tax year.

A foundation that is required to accumulate its income or prohibited from distributing its capital or corpus by its governing instruments in effect and unchanged since May 26, 1969, is not subject to the normal payout rules.[67]

15.4 QUALIFYING DISTRIBUTIONS

An excise tax is due when a foundation has *undistributed income* for the year, defined as the distributable amount less qualifying distributions.[68] Not all contributions or disbursements qualify or count when a foundation tallies up its expenses to see whether it meets the minimum distribution requirements. There are two sets of tests to meet: Of primary importance is that the expenditure must be in pursuit of a charitable purpose.[69] Secondly, distributions are counted only on a cash basis of accounting. The foundation must actually let go or deliver its cash or other property to a qualifying recipient; it cannot retain any control or earmark the funds for its own restricted purpose. The rules are designed to ensure that the distributable amount is used to serve broad charitable purposes each year. The term *qualifying distributions* is specifically defined to include the following[70]:

- Any amount, including reasonable and necessary administrative expenses, paid to accomplish one or more tax-exempt purposes, other than a grant to a controlled organization
- Any amount paid to acquire an asset used or held for use directly in carrying out tax-exempt purpose(s)
- Qualified set-asides[71] and program-related investments[72]

[65] See Section 15.2(c).
[66] See Section 18.2.
[67] Reg. §53.4942(a)-2(e).
[68] Illustrated in Section 15.6.
[69] As defined in IRC §170(c)(1) or (c)(2)(B); a noncharitable distribution may additionally be a taxable expenditure, as described in Section 17.7.
[70] IRC §4942(g)(1).
[71] See Section 15.4(g).
[72] See Section 16.3.

A pledge, a promise, or board approval to make a gift in the future, or earmarking funds for a restricted future purpose, does not qualify as actual distributions, even though for financial purposes the funds may be treated as a current expense.[73] To be counted in the current year, the distribution of cash or other property must actually be *paid* out. Thus, a foundation that pledged a gift to a public charity to help build a museum could not count the gift until the funds were actually paid. Holding the funds to earn interest for the three-year period before construction began so that the foundation could earn interest precludes treating the funds as distributed.[74] However, grants paid with borrowed funds are treated as a distribution when the grant is paid, not when the loan is made or repaid.[75]

(a) Direct Grants

Charitable grants paid directly to publicly supported charitable organizations,[76] for general support or for a wide range of specific charitable purposes, comprise by far the bulk of qualifying distributions made by private foundations. A grant can also be paid to an instrumentality of a national, state, local, or foreign government. Grants to accomplish a charitable purpose to any type of exempt or nonexempt organization anywhere throughout the world can qualify, if the proper procedures are followed.[77] Although a foundation is not prevented from making such grants, payments to two particular types of organization do not qualify to offset the distributable amount:

1. A grant to another private foundation does not count unless the receiving PF redistributes the funds or is an unrelated private operating foundation.
2. A controlled organization, either private or public, again does not count, unless the funds are properly redistributed.

(b) Controlled Grantees and Redistributions

Payments to a controlled charitable grantee are not qualifying distributions unless the grantee properly redistributes the funds. The recipient organization (or donee, in the language of the regulations) is controlled by the PF or by one or more of its disqualified persons when any of such persons can, by aggregating their votes or positions of authority, require the recipient organization to make an expenditure, or prevent it from making an expenditure, regardless of the method by which control is exercised or exercisable.[78] Control for this purpose is deter-

[73] Priv. Ltr. Rul. 8839003; see also Priv. Ltr. Rul. 8750006 concerning the proper reporting for deferred grant awards.
[74] Rev. Rul. 79-319, 1979-2 C.B. 388; but see Rev. Rul. 77-7, 1977-1 C.B. 354.
[75] Reg. §53.4942(a)-3(a)(4). Interest on such debt is not itself counted as a qualifying distribution nor as a reduction of investment income for excise tax purposes.
[76] See Chapter 11.
[77] See Chapter 17 for a discussion of grant-making requirements and particularly Section 17.4 for discussion of grants to public charities and Section 17.5 for discussion of grants to foreign organizations.
[78] Reg. §53.4942(a)-3(a)(3).

mined on an organizational level without regard to restrictions placed on the grantee. It is acceptable for the foundation to designate the particular grantee programs it chooses to support. It should not, however, direct the fashion in which a program is operated. Requiring the creation of a separate fund or special budgetary controls is acceptable, but there must be no material restriction on how the recipient uses the funds to accomplish its own exempt purposes.[79] Funds cannot be earmarked for lobbying, a specific individual grant, or any other expenditures that the foundation itself would not be permitted to make.

Redistribution by the controlled organization or related foundation is accomplished where, not later than the close of the first taxable year after the donee organization's taxable year in which such contribution is received, the donee organization makes a distribution equal to the full amount of such contribution. Additionally, the donee may not count the distribution toward satisfying its own requirement, but instead must treat its regranting of the money as a payment out of corpus. The donor foundation must obtain adequate proof that the redistribution was accomplished. The donee should provide a report describing the names and addresses of the charitable organizations to which it redistributed the funds. Most important, the donee must declare that it did not claim its regrants as qualifying distributions.[80]

A similar donation redistribution may be needed to entitle the foundation's donors to a contribution deduction. The income tax deduction for gifts of appreciated property (other than cash and marketable securities) is limited to the donor's tax basis unless the foundation redistributes the property or other assets of equal value. To qualify the gift for full fair market value deduction, the foundation must become what is called a *conduit foundation* for the year. It must redistribute 100 percent of all donations received by the fifteenth day of the third month of the following year, and the redistribution cannot be counted as a qualifying distribution.[81]

(c) Community Foundation Grants

The extraordinary increase in the value of private foundation investment portfolios in the late 1990s created ever-increasing minimum distribution requirements for many foundations.[82] For such a foundation that has difficulty choosing grant recipients, a grant to a community foundation may be treated as a qualifying distribution if the right steps are carefully taken. Most important, the grant must be a completed gift, or disposition, of the property by the PF, with no strings attached. The PF must retain no ultimate control over the property; although it can retain the privilege of making suggestions, it can place no material restrictions or conditions on the transferred assets.[83] The IRS has responded to a number of requests for approval of such grants.

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[79] Reg. §53.4942(a)-3(a)(3) refers back to §1.507-2(a)(8) to define materials restriction.

[80] Reg. §53.4942(a)-3(c).

[81] For a more thorough discussion of conduit foundations, see B. Hopkins and J. Blazek, *Private Foundations: Tax Law and Compliance, 2nd Edition* (New York: Wiley, 2003), Section 3.2; see also Section 24.3(b) for deductibility and disclosure rules for charitable donations.

[82] Unfortunately, by late 2001 some of the gains were lost.

[83] Regs. §1.170A-9(e)(11)(ii)(B), §1.507-2(a)(8), and §53.4942(a)-3(a)(3).

In one acceptable situation, a community foundation sought approval for creation of a designated fund within itself to regrant funds for economic development.[84] The ruling found that "unconditional" grants by private foundations to the fund were qualifying distributions. In a series of complicated rulings concerning the Kansas City Royals baseball team, grants to the community foundation established to support the team were considered as qualifying grant distributions.[85] Interestingly, this is the one ruling the author would recommend for study by a foundation, considering such a grant does not reach a conclusion about the §4942 status of the transfer.[86] The ruling reached a conclusion that assets representing 10 percent of a PF's assets granted to the community foundation would become a component part of the receiving public charity and not be classified as a separate fund that is a private foundation. The basis for the decision is the long list of factors evidencing that a termination PF releases control over assets it places in a public charity.[87] The ruling applied transition rules written for community trusts in existence before November 1976 that were unable to meet all of the requirements of the then-issued community trust regulations.[88] The standards imposed on the asset transfer are intended to divest the private foundation of any control or discretion over the fund it creates. In brief, the following facts must exist:

- The trust is a publicly supported organization.
- The community trust's governing body is composed of members who may serve a period of not more than 10 years.
- No person may serve within a period consisting of the lesser of five years or the number of consecutive years the member has immediately completed serving.
- The transferor private foundation may not impose any material restriction or condition that prevents the transferee public charity from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes.
- Whether a restriction or condition is material depends on the facts and circumstances. Some of the more significant facts are as follows:
  - Whether the transferee public charity or participating trustee is the owner in fee of the assets received
  - Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes
  - Whether the governing body of the public charity has ultimate control over the assets and income
  - Whether and to what extent the public charity's governing body is organized and operated so as to be independent of the transferor

[84] Priv. Ltr. Rul. 8831006; see also Priv. Ltr. Rul. 9604031.
[85] Priv. Ltr. Rul. 9530024 through 9530026.
[86] Priv. Ltr. Rul. 9807030.
[87] See Section 12.4(c).
[88] Reg. §1.170A-9(e)(12) and (13).

A cautious private foundation making a grant to a community trust might follow these criteria to ensure its grant is treated as a qualifying distribution to an uncontrolled entity.

(d) Noncash and In-Kind Grants

A qualifying grant can be paid in either cash or property. The fair market value of the property is counted as a qualifying distribution. Because the tax basis of property the foundation receives as a gift retains the same basis as that of the donor, some private foundations have assets with a value significantly higher than the tax basis. These appreciated noncash assets held for investment purposes, particularly marketable securities or real estate, provide a tax-planning opportunity. The excise tax on investment income is not imposed on the unrealized gain inherent in the property that is distributed in the form of a charitable distribution. This significant tax advantage makes it important for a foundation to consider distributing appreciated property to a grantee, rather than selling the property to be able to give it cash.[89] The value of distributed property must be reduced by any amount previously treated as a qualifying distribution. For example, when a building purchased by the foundation for use in its own exempt activities was subsequently donated to another charity, only the current FMV in excess of its cost in the property was counted.[90]

An unanswered question is whether a foundation counts in-kind grants, such as the rent-free use of space, as qualifying distributions. The issue is whether noncash lending of foundation property or forbearance of income produces an expenditure that can be counted for qualifying distribution purposes. Say, for example, the foundation lends office space to a charity rent-free. For accounting purposes, the fair market value of the rent is treated as a charitable disbursement.[91] Similarly, a no-interest loan made to another charity or to an indigent person and a loan of an object from the foundation's art collection to a museum have economic value. Because no income tax deduction is allowed for such gifts, the IRS says they cannot be counted as qualifying distributions.[92] However, there is no official guidance on this subject and one could argue that an in-kind gift reportable for financial purposes should be counted.

(e) Distributions to Foreign Recipients

Payments in support of charitable programs conducted outside the United States can also be counted as qualifying distributions. The difficulty with such grants lies in documenting the charitable nature of the activities. Foreign organizations may seek IRS determination that they qualify as §501(c)(3) organizations, but few do so. Instead, U.S. foundations that want to support foreign recipients follow one of two routes:

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[89] See this and other tax-planning ideas in Section 13.4.
[90] Rev. Rul. 79-375, 1979-2 C.B. 389.
[91] Financial Accounting Standards Board #116.
[92] Priv. Ltr. Rul. 8719004.

1. They obtain adequate documentation to evidence that the foreign entity is "equivalent to" and would qualify as a U.S. public charity if it sought such recognition.
2. They exercise expenditure responsibility.

This choice for foundations wishing to gather evidence about their foreign programs has been made easier with the 2001 IRS Information Letter. Details of the choices are discussed in Section 17.5(c).

(f) Direct Charitable Expenditures

Amounts paid to accomplish a charitable purpose, including a portion of the foundation's reasonable and necessary administrative expense, are eligible to be treated as qualifying distributions. The following are examples of the types of nongrant expenditures that can be counted as qualifying distributions.

The purchase of *exempt function assets*[93] used, or held for use, in conducting a foundation's programs, rather than for investment purposes, is treated as charitable disbursement. The full purchase price of an exempt function asset is counted as a qualifying distribution even if part or all of the purchase price is borrowed. Amounts expended to improve and furnish the property can also be counted.[94] Depreciation does not count because it would be redundant.[95]

Conversion of an asset previously held for investment purposes, an active business property, or a future exempt purpose, to use as an exempt function asset, is counted. For example, a building rented to commercial tenants might be converted to rent-free use (could be part or all of the building) by a public charity. The distribution amount is equal to the fair market value on the date of conversion. The date on which the foundation approves the plan for conversion, rather than the date the physical change or occupancy is completed, is the effective date of change.[96] The precise conversion date should be planned to take full advantage of the inclusion of the value of the property as a qualifying distribution.

The value of an exempt function asset previously counted as a qualifying distribution must be added back if the foundation sells the property.[97] If the asset is instead donated to another charitable organization, the difference between the amount previously claimed and the value at the time of the grant can be treated as a qualifying distribution. When a foundation receives an exempt function–type asset as a gift, the author has found no guidance on whether a conversion to such use occurs after the foundation receives the property.

Administrative expenses expended by the foundation in conducting its exempt activities, rather than managing its investments, are includable as qualifying distributions. The design of Form 990-PF prompts a foundation to allocate its expenditures between those associated with its investments and those associated

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[93] Defined in Section 15.1(c).
[94] Priv. Ltr. Rul. 9702040.
[95] Rev. Rul. 74-560, 1974-2 C.B. 389.
[96] Rev. Rul. 78-102, 1978-1 C.B. 379.
[97] See formula in Section 15.3.

with its charitable programs.[98] Expenses directly attributable to grant-making activity might include program officer salaries and associated costs, computerized grant-tracking systems, and grantee technical assistance. An allocable portion of the organizational administrative costs not solely pertaining to grants, including personnel costs, professional advisors, facilities, and other expenses, must be allocated on some reasonable basis between grants administration and management of investment properties. Legal fees paid in a suit involving an exempt charitable trust seeking to clarify its beneficiaries were treated as a qualifying distribution, for example.[99] Legal, accounting, state registration, and other fees and expenses paid in connection with creation and qualification of a new private foundation as a tax-exempt organization can also be treated as disbursements for charitable purposes.

For years beginning after 1984 and before 1991, a limitation was placed on the amount of administrative expense added to qualifying distributions. During that time, no more than 0.65 percent of a foundation's net investment assets over a three-year period could be claimed. During 2003, legislation to limit inclusion of certain expenses was considered in the Congress.

Self-sponsored charitable program expenses paid directly (of a sort a private operating foundation must incur) by the traditional private foundation also count. Examples are numerous, including operating a museum or library, running a summer camp for children, conducting research and publishing books, and preserving historic houses. Charitable projects can be carried out in any location. There is no constraint against a private foundation conducting activities outside the United States.[100]

Individual grants count as qualifying distributions if they are paid under a program meeting the nondiscrimination requirements.[101] Academic grants are considered to be fully counted when the recipients can expend a portion of the funds granted on child care, as long as such spending enables the grantees to continue research and is not done in accordance with the individuals' personal or family needs.[102]

Program-related investments that satisfy the jeopardizing investment and taxable expenditure rules,[103] including interest-free or low-interest loans to other exempt organizations or individuals, also are counted as qualifying distributions.

(g) Set-Asides

Money set aside or saved for specific future charitable projects rather than being paid out currently can be considered to be qualifying distributions in the year earmarked for the project.[104] Such funds are treated as a foundation liability and

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[98] See Part I of the filled-in form in Chapter 4, Blazek, *IRS Form 990 Tax Preparation Guide for Nonprofits* (Hoboken:Wiley, 2004).
[99] Rev. Rul. 75-495, 1975-2 C.B. 449.
[100] See Sections 15.4(g) and 17.5.
[101] See Section 17.3.
[102] Priv. Ltr. Rul. 9116032.
[103] See Chapters 16 and 17.
[104] IRC §4942(g)(2); Reg. §53.4942(a)-3(b).

are charged against corpus, rather than being counted again, when they are actually paid out in a subsequent year.[105] The amount set aside need not be increased by income earned on the funds, but the income and set-aside funds are included in the asset base for purposes of calculating the minimum investment return. There are two very different types of set-asides. For the first type, the foundation must have plans to use the money within 60 months after its set-aside for a specific project and meet a suitability test. Prior IRS approval is required for this type before reserved funds can be claimed as a qualifying distribution.[106] In a second type, a newly created organization with a plan that could achieve IRS approval must simply satisfy a mathematical test.

Type 1—The Suitability Test. To qualify for this type of set-aside, the foundation must convince the IRS that a project is worthy and that it can be better accomplished with several years of income (but not more than five, initially), which it plans to save rather than pay out. Approval must be sought before the end of the year of the set-aside. To be approved, the project should include "situations where relatively long-term grants or expenditures must be made to assure the continuity of particular charitable projects or program-related investments, or where grants are made as part of a matching grant program."[107] Specific projects for this purpose include, for example, the following:

- A plan to erect a museum building to house the foundation's art collection, even though the exact location and architectural plans have not been finalized
- A plan to purchase an art collection offered for sale as a unit at a price in excess of one year's income[108]
- A plan to fund a specific research program of such magnitude as to require an accumulation of funds before beginning research, even though not all of the details of the program have been finalized[109]

However, setting aside all three years of the pledged amount of fixed-sum research grants and renewable scholarships did not qualify as a set-aside.[110] Such a plan is equivalent to a pledge to make a future grant.

[105] Rev. Rul. 78-148, 1978-1C.B. 380.

[106] To obtain approval, a PF must write to the IRS National Office in Washington and submit detailed information as outlined in IRS Publication 578, Tax Information for Private Foundations and Foundation Managers.

[107] Rev. Rul. 77-7, 1977-1 C.B. 540.

[108] In Priv. Ltr. Rul. 9302015, because the date of availability and the cost of artworks are unpredictable and the cost could be prepaid, the IRS agreed that additional set-aside periods would best accomplish the museum's goals as long as the museum funds pledged were actually expended on artworks; see also Priv. Ltr. Rul. 9409025.

[109] Reg. §53.4942(a)-3(b)(2); see Rev. Rul. 74-450, 1974-2 C.B.388 for conversion of land into a wildlife sanctuary and public park; see also Priv. Ltr. Rul. 9619070 in which, due to excessive rainfall, a foundation was unable to complete its planned wildlife habitat restoration project.

[110] Rev. Rul. 75-511, 1975-2 C.B. 450; see also Priv. Ltr. Rul. 9616041 in which a foundation was permitted to set aside funds while it sought approval to expand the geographic area in which it was permitted to make scholarship grants.

The set-aside period can be extended by the IRS where good cause can be shown.[111] An extension was granted, for example, because a local building moratorium caused a delay in acquiring the necessary property.[112] A foundation that initially applied the cash distribution test was allowed to continue set-asides for its self-help construction program for the poor.[113] There are many private letter rulings on this subject that readers can study for additional guidance.[114]

Type 2—The Cash Distribution Test. A new foundation is permitted to claim a set-aside distribution for a specific project that can be better accomplished by accumulating funds under the standards applied to Type 1 set-aside standards. Prior IRS approval is not required.[115] Essentially, such a foundation's distributable amount is reduced during its first four years following the year it was established in what is called a *start-up period minimum amount*, as follows:

- 1st year: 20 percent of normal distributable amount paid out in qualifying distributions
- 2nd year: 40 percent of normal distributable amount paid out in qualifying distributions
- 3rd year: 60 percent of normal distributable amount paid out in qualifying distributions
- 4th year: 80 percent of normal distributable amount paid out in qualifying distributions
- 5th year: Full-payment period minimum amount must be paid out.

Although the distribution is delayed, the full amount of the set-aside must eventually be distributed. If the foundation makes payments not attributable to the set-aside project during the first four years, the start-up period minimum amount is not reduced by such payments. Distributions in excess of the minimum amounts can, however, be carried forward to offset future distributable amounts. Details of how a foundation plans to meet these requirements must be attached to the Form 990-PF for each year the set-aside is applicable, along with a report of actual expenditures against the committment. The rules are very specific, so it is important to study the regulations and instructions to Form 990-PF in detail before claiming such a set-aside.[116]

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[111] Reg. §53.4942(a)-3(b)(1).

[112] Priv. Ltr. Rul. 7821141.

[113] Priv. Ltr. Rul. 9305018.

[114] For example, study a trio of 1999 rulings: Priv. Ltr. Rul. 199907028, approving construction of new foundation headquarters that would be mostly rented at below cost to other tax-exempts; Priv. Ltr. Rul. 199906053, permitting redevelopment of a city block as a part of a downtown rejuvenation; Priv. Ltr. Rul. 199905039, allowing construction of facilities in Central America for abandoned and underprivileged children.

[115] IRC §4942(g)(2)(A) added to the code in 1976 to aid new foundations hampered by IRS reluctance to approve set-asides; Reg. §53.4942(a)-3(b)(4)(I).

[116] Reg. §53.4942(a)-3(b)(3) and (4). See Priv. Ltr. Rul. 9301022, in which a foundation that failed to claim the Type 2 set-aside on its original return was allowed to elect to treat the amounts as a qualifying distribution on amended returns.

15.5 PRIVATE OPERATING FOUNDATIONS

The tax code creates a special type of foundation that is essentially a cross between a private foundation and a public organization. A private operating foundation (POF) is a charity that does its own thing, or, in the language of the statute, "actively conducts activities constituting the purpose or function for which it is organized and operated." A POF makes qualifying distributions by sponsoring and managing its own charitable projects rather than making grants to other organizations.[117] A common type of operating foundation is an endowed institution operating a museum, library, or other charitable pursuit not included in the list of organizations that qualify as public charities without regard to their sources of support.[118] Many POFs are privately funded entities started by a person of means who has strong ideas about charitable objectives he or she wants to accomplish through self-initiated projects.

A POF must meet two annual distribution requirements: one based on its income levels and another on its assets or sources of its revenues. The code simply provides that the POF meet a "qualifying distribution" test by spending the requisite amount in support of its own projects and that it "normally" satisfy the asset or the endowment test. The term *normally* is based on a four-year compliance period, discussed in the "Compliance Period" section later in this chapter.

A new private foundation can request classification as a POF before it conducts any activity by submitting an affidavit of its intention to so qualify prospectively with its Form 1023. The IRS accepts the organization's assertion, based on a good faith determination, that it plans to qualify.[119] The requirements for a foundation converting to a POF are not specifically provided, but suggestions are provided later in this chapter.[120]

Most important for its funders, donations to a private operating foundation are afforded the higher deductibility limits allowed for gifts to public charities.[121] Additionally, the penalty for failure to meet the mandatory payout requirements is not imposed.

(a) Active Charitable Programs

The most significant attribute of a POF is sometimes the most difficult quality to possess. To qualify as a POF, the foundation must focus—it must be significantly involved in its own projects in a continuing and sustainable fashion. To be involved might mean the foundation purchases goods and services to operate a museum, to conduct scientific research, to develop low-income housing, or to conduct some other charitable program. A POF maintains a staff of researchers,

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[117] IRC §4942(j)(3); Reg. §53.4942(b)-1(b).

[118] Churches, schools, hospitals, and certain medical research organizations, as described in Chapter 11.

[119] Reg. §53.4942(b)-3; a filled-in Form 1023 for a new POF can be found in Chapter 2 of B. Hopkins and J. Blazek, *Private Foundations: Tax Law and Compliance, 2nd Edition* (Hoboken: Wiley, 2003).

[120] See a discussion of conversions in Section 15.5(h)

[121] See Section 15.5(g) for advantages and disadvantages of POFs.

teachers, curators, or other program specialists. Its staff can be partly or wholly made up of volunteers and can include its funders or trustees, if their work involvement is genuine.

The typical operating foundation acquires and maintains program assets used in its programs—buildings, artworks, research facilities, and the like. A POF might buy, restore, and rent historic houses to preserve them. It would engage realtors, architects, contractors, and other specialists needed to acquire and fix up the property. It would pay utility, maintenance, and insurance costs; engage property managers; and pay administrative expenses necessary to operate the properties. Optimally, a POF is identified in the public eye with and by its projects. The regulations provide the following examples.[122]

Ghetto Improvement Project. An organization is created to improve conditions in an urban ghetto. Ten percent of its income is spent to conduct surveys of the ghetto's problems. The remaining 90 percent is used to make grants to other nonprofit organizations doing work in the ghetto. Since only 10 percent of its funds is directly expended, it cannot qualify as a POF. If, instead, it spent all of the money directly to analyze the results, develop recommendations, publish the conclusions of its studies, and hire community advisors to assist business developers and other organizations working in the area, it might qualify.

Teacher Training Program. An entity is formed to train teachers for institutions of higher education. Fellowships are awarded to students for graduate study leading toward advanced degrees in college teaching. Pamphlets encouraging prospective college teachers and describing the POF's activity are widely circulated. Seminars attended by fellowship recipients, POF staff, and consultants and other interested parties are held each summer, and papers from the conference are published. Despite the fact that a majority of the organization's money is spent for fellowship payments, the program is comprehensive and suitable to qualify as an active project.

Medical Research Organization (MRO). An MRO is created to study heart disease. Physicians and scientists apply to conduct research at the MRO's center. Its professional staff evaluates the projects, reviews progress reports, supervises the projects, and publishes the resulting findings. Note that a medical research organization associated closely with a hospital may qualify as a public charity.[123]

Historical Reference Library. A library organization is established to hold and care for manuscripts and reference material relating to the history of the region in which it is located. Additionally, it makes a limited number of annual grants to enable postdoctoral scholars and doctoral candidates to use its library. Sometimes, but not always, the POF can obtain the rights to publish the scholar's work.

Senior Citizen Center. A foundation that was originally created to operate residential living quarters for seniors changed its focus. Instead, it converted the

[122] Reg. §53.4942(b)-1(d).
[123] See Section 11.2(c).

former living space into a senior citizens center to serve as a central intake and assessment point for identifying and addressing the needs of seniors in the area.[124] Part of the space is rented at a reduced rate to "program partners," other tax-exempt organizations that provide services to senior citizens. The remaining space is used for foundation programs benefiting the elderly—support group meeting rooms, a training and placement center, a resources and information room, and classrooms. The foundation reimburses (grants) the partners for expenses incurred in assisting the foundation with its own or "jointly operated programs." The foundation sought approval of its ongoing classification as a private operating foundation. The IRS found rental of space on a low-cost basis and partnering programs with other tax-exempt organizations to be active program activity.

Set-asides of funds for a specific future project are permitted for POFs. The requirements discussed in Section 15.4(g) must be met for the amounts set aside to be counted as qualifying distributions.

Additional examples of active programs provided in the Form 990-PF instructions include the following:

- Provide goods, shelter, or clothing to indigent or disaster victims if the foundation maintains some significant involvement in the activity rather than merely making grants to the recipients
- Conduct educational conferences and seminars
- Operate a home for the elderly or disabled
- Support the service of foundation staff on boards or advisory committees of other charitable organizations or on public commissions or task forces
- Provide technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either, in response to a written request by the governmental body, committee, or subdivision
- Conduct performing arts performances
- Provide technical assistance to grantees and other charitable organizations concerning fund-raising, reducing costs or increasing program accomplishments, and maintaining complete and accurate financial records. (This assistance must have significance beyond the purposes of the grants made to the grantees and must not consist merely of monitoring or advising the grantees in their use of the grant funds.)

(b) Grants to Other Organizations

While one or more other charitable organizations may be involved in some manner, an operating foundation must expend a prescribed amount of its funds directly. The regulations provide that qualifying distributions are not made by a foundation directly for the active conduct unless such distributions are used by the foundation itself, rather than by or through one or more grantee organizations.[125]

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[124] Priv. Ltr. Rul. 9723047.
[125] Reg. §53.4942(b)-1(b).

A grant to another organization is presumed to be indirect conduct of exempt activity, even if the activity of the grantee organization helps the POF accomplish its goals. However, in one instance a grant to another organization was found to qualify as direct involvement on a charitable trust's part. The trust granted all of its income to a conduit organization that had been established for liability reasons to serve in a fiduciary capacity on behalf of the trust. Although the corporation actually operated the cultural center, its activities were attributed to the POF.[126]

It is important to note that a POF is not prohibited from making grants to other organizations; such grants simply do not count toward satisfying the POF's distribution requirements. So long as the POF distributes the requisite annual amount for its active programs, it may, in addition, make grants to other organizations. A special limitation applies if the operating foundation's minimum investment return is less than its adjusted net income. If its active project distributions are less than adjusted gross income, more than 85 percent of the total qualifying distributions must be active.[127] The point is that as long as the POF meets the income and asset tests, it may spend additional amounts on any form of charitable activity it chooses.

(c) Individual Grant Programs

Payments to individuals under a scholarship program, a student loan fund, a minority business enterprise capital support project, or similar charitable effort can qualify as appropriate activity for a POF.[128] The facts and circumstances surrounding the project must indicate that the POF is significantly involved. Merely selecting, screening, and investigating applicants for grants or scholarships is insufficient. When the recipients perform their work or studies alone, such as in pursuit of a doctoral degree or exclusively under the direction of some other organization, the individual grants are not considered to be direct qualifying payments. The administrative costs of such screening and investigation, as opposed to the individual grants themselves, may be treated as direct activity disbursements.

Significant involvement of the POF and its staff exists when the individual grants are part of a comprehensive program. The regulations say the test is qualitative, rather than quantitative, and give two examples of such programs. In one, the POF's purpose is to relieve poverty and human distress, and its exempt activities are designed to ameliorate conditions among the poor, particularly during national disasters. The POF provides food and clothing to such indigents, without the assistance of an intervening organization or agency, under the direction of the POF's salaried or voluntary staff of administrators, researchers, or other personnel who supervise and direct the activity.

In the second example, a POF develops a specialized skill or expertise in scientific or medical research, social work, education, or the social sciences. A salaried staff of administrators, researchers, and other personnel supervise and conduct the work in its particular area of interest. As a part of the program, the

[126] Rev. Rul. 78-315, 1978-2 C.B. 271; see also Priv. Ltr. Rul. 9203004.
[127] Reg. §53.4942(b)-1(a)(1)(i).
[128] Reg. §53.4942(b)-(1)(b)(2).

POF awards grants, scholarships, or other payments to individuals to encourage independent study and scientific research projects and to otherwise further their involvement in the POF's field of interest. The POF sponsors seminars, conducts classes, and provides direction and supervision for the grant recipients.

The Elizabeth Leckie Scholarship Fund was found to maintain a significant involvement in its ongoing attempt to ameliorate poverty among persons in rural Alabama. The fund assisted needy young people in the county by providing scholarships, finding them summer jobs, and getting students involved with local civic affairs and other activities designed to educate and improve the circumstances of young people and make it possible for them to remain in the area.[129] The fact that a foundation screened, investigated, and tested all applicants to make sure they complied with academic and financial requirements set for scholarship recipients is insufficient activity to constitute an educational program, according to the regulations.[130]

(d) Tests to Qualify as a Private Operating Foundation

To qualify as a private operating foundation, the private foundation must meet two tests:

1. The income test[131]
2. The asset, endowment, or support test[132]

Income Test. Under this test, the POF must expend substantially all (85 percent) of the lesser of its adjusted net income or its minimum investment[133] on its actively conducted projects.

Asset Test. To meet this test, at least 65 percent of the FMV of the POF's assets must be devoted to the active conduct of its charitable activities, a functionally related business, or stock of a controlled corporation substantially all of the assets of which are so devoted. The concepts of exempt function and dual-use assets used in calculating the MIR are followed to identify assets qualifying for this test.[134] An asset that is not capable of being valued, such as a botanical garden, can be included at its historical cost.[135]

Endowment Test. For this test, the POF's annual distributions must equal at least two-thirds of its minimum investment return ($3\frac{1}{3}$ percent of investment assets). This test is designed to prevent a private foundation from seeking POF

[129] *The Miss Elizabeth D. Leckie Scholarship Fund v. Commissioner,* 87 T.C. 250 (1986), acq. 1987-2 C.B. 1.
[130] Reg. §53.4942(b)-1(d), Example (10).
[131] Reg. §53.4942(b)-1(a)(1).
[132] Reg. §53.4942(b)-2.
[133] MIR is the same as for standard private foundations, as discussed in Section 15.1.
[134] See Section 15.1(c). One distinction is made in the regulations that, in a possibly confusing fashion, say amounts receivable under a charitable loan program (students, disabled persons, or the like) are treated as investment assets for this purpose.
[135] Reg. §53.4942(b)-2(a)(4).

status to take advantage of the income test that requires distribution of income or MIR, whichever is lower. Assuming a PF holds marketable securities that pay no dividends, the income test, taken alone, would require no current charitable spending. A POF with a portfolio of low-current-yield securities would have to distribute part of its principal or contributions received to meet this test.[136]

Support Test. Under this test, the POF's support (meaning donations and not including investment income) must be received from the general public and from five or more noncontrolled §501(c)(3) organizations, with none giving more than 25 percent of the POF's support. An organization wishing to meet this test must carefully study the regulations.[137]

(e) Adjusted Net Income

Before 1982, all private foundations were required to distribute their adjusted net income or their MIR, whichever was higher. For traditional foundations effective for years beginning in 1982, only MIR need be paid out, and adjusted net income is not relevant. Private operating foundations, however, distribute their MIR or the adjusted net income, whichever is lower. Adjusted gross income is calculated using the following formula[138]:

A = Gross income of all types for the year (not limited to income subject to the investment income tax)

B = Long-term capital gains

C = Contributions received

D = "Ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income[139]

Over the years, a few rulings have been published to clarify the amounts includable in adjusted net income. A brief summary follows:

- Bond premium amortization is permitted, following the rules of IRC §171.[140]
- Annuity, IRA, and other employee benefit plan payments are includable to the extent that the amount exceeds the value of the right to receive the payment on the decedent's date of death.[141]
- Capital gain dividends paid or credited for reinvestment by a mutual fund are not included, because they are considered as long term by IRC §852(b)(3)(B).[142]

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[136] Reg. §53.4942(b)-2(b)(1).
[137] Reg. §53.4942(b)-2(c).
[138] Reg. §53.4942(a)-2(d)(1); IRS Form 990-PF Instructions, p. 8.
[139] Reg. §53.4942(a)-2(d)(4); see also Section 13.3.
[140] Rev. Rul. 76-248, 1976-1 C.B. 353.
[141] Rev. Rul. 75-442, 1975-2 C.B. 448.
[142] Rev. Rul. 73-320, 1973-2 C.B. 385.

(f) Compliance Period

A private operating foundation is expected to make active program distributions beginning in its first year of qualification; it is not allowed the one-year delay[143] for making qualifying distributions permitted for normal private foundations. The income test and the asset, endowment, or support tests are applied each year for a four-year period that includes the current and past three years. The POF has a choice of two methods to calculate its compliance with the tests, but it must use the same method for both tests:

- All four years can be aggregated; that is, the distributions for four years are added together. The POF must use only one of the asset, endowment, or support tests for all four years.
- For three of the four years, the POF meets the income test and any one of the asset, endowment, or support tests.

An operating foundation may calculate its required distributions using either a four-year average method or a three-out-of-four test in any year (can change from one year to the next). For an operating foundation applying the three-out-of-four test, the required distributions must be made each year without any carryover resulting from excessive expenditures. Use of this method thereby eliminates the benefit, or carryover, of any excess distributions from a prior year *and* does not count the expenditures made in the failed year. Application of the aggregation (four-year average) method instead essentially allows the operating foundation to carry over excess qualifying distributions from year to year, similar to the rules for normal foundations. A new operating foundation delayed in the commencement of its active programs might qualify by using the cash distribution test.[144]

If the POF fails to qualify for a particular year, it is treated as an ordinary private foundation for that year. It can return to POF classification as soon as it again qualifies under both the income test and the assets, endowment, or support test. There is no requirement that a POF that applies method two make up the deficient year.[145]

(g) Advantages and Disadvantages of Private Operating Foundations

Private operating foundations have several special advantages and one disadvantage.

Contribution Deduction Limits Are Preferential. The percentage limits for charitable deductions are higher for POFs than for private foundations. They are the same as the deductions permitted for public charities. A full 50 percent of an individual's income can be sheltered by contributions to a POF, but only 30 percent of one's income can be deducted for gifts to a normal PF. The full fair market value of all property gifts, including marketable securities, real estate,

[143] Illustrated in Exhibit 15-1, "Application of Qualifying Distributions and Carryovers."
[144] See set-aside rule discussion in Section 15.4(g).
[145] Priv. Ltr. Rul. 9509042.

artworks, and other appreciated property is deductible for donations to a POF. Only marketable securities donated to a traditional private foundation are fully deductible, and the deduction is limited to 20 percent of the donor's income.[146]

Distributable Amount May Be Lower. The minimum distribution requirement for a POF may be lower than for normal private foundations. In some cases, given a sufficient return on investment, a POF can better build an endowment over the years. It must only distribute its actual net income when it is lower than MIR and only needs to pay out two-thirds of its MIR.

No Penalty Tax. The penalty tax on the failure to make qualifying distributions does not apply to private operating foundations, and the deficiency of distributions need not be corrected.

Disadvantage. The primary disadvantage is that the one-year delay afforded to PFs to meet the minimum distribution requirement is lost. An operating foundation is expected to make active program distributions beginning in its first year of qualification; it is not allowed the one-year delay[147] for making qualifying distributions permitted for normal private foundations.

(h) Conversion to or from Private Operating Foundation Status

An IRS ruling is not technically required for a private foundation to convert itself into an operating foundation or conversely for an operating foundation to become a normal private foundation since the qualification is based on numerical tests. Any foundation is qualified if it meets the tests by changing its method of operation or mix of assets. A POF can fail the test in one year and again qualify the next year.[148] Interestingly, both active program expenditures and grants to other organizations count as qualifying distributions for a normal PF, though only amounts spent on the POF's own programs count toward meeting the POF tests. Careful tracking of qualifying distributions is necessary for a foundation that switches from one type to the other (and/or back).

The impact of the conversion on the cumulative qualifying distribution tests must be evaluated prior to making the change (hopefully, it will not be inadvertent). An operating foundation must meet its minimum distribution requirements within the year; a normal PF must make distributions one year later, as illustrated in Exhibit 15.1. An operating foundation converting to a normal private foundation may therefore gain a one-year grace period. Converting to an operating foundation instead accelerates the time for required distributions. Funders of an operating foundation can be adversely affected by conversion to a private foundation. An operating foundation is treated like public charities for charitable donation percentage limitations, making donations to operating foundations more favorable.[149] The effective date for conversion to operating classification is not clearly set out in the tax code or in the regulations.

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[146] IRC §170(e)(5); See Section 24.1(b).
[147] Illustrated in Exhibit 15-1, "Application of Qualifying Distributions and Carryovers."
[148] As noted in Section 15.5(f).
[149] As explained in Section 15.5(g).

EXHIBIT 15.1

Application of Qualifying Distributions and Carryovers

	2003	2004	2005	2006	2007	2008	Cumulative Excess Distributions
Qualifying distributions for the year	0	250	70	40	160	100	
Distributable amount for year	100	100	100	100	100	100	
Net distributions for year	–100	+150	–30	–60	+60	0	
Application:							
Apply '04 to '03	+100	–100					+50 ('03 yr end)
Apply '04 to '05		–30	+30				+20 ('03 yr end)
Apply '04 to '06		–20		+20			0
Apply '07 to '06				+40	–40		+20 ('07 yr end)
'07 Excess can be carried as far as 2012	0	0	0	0	+20	0	+20 ('07 yr end)

An IRS advance ruling is not technically required for a PF to convert to operation as a POF. The foundation is qualified if it meets the tests by changing its method of operation or mix of assets. Most foundation officials, however, seek the comfort of an IRS determination to sanction a conversion. The conversion decision is also complicated because the transition takes four years and the one-year time lag for making charitable distributions is lost. For a converting traditional foundation, distributions are accelerated with the payment of both the prior-year distributable amount and active program distributions before year-end.

A private foundation seeks IRS approval for its conversion to a POF by submitting a letter to the IRS Service Center in Cincinnati, Ohio, informing them of the change of operation and requesting a revision of the determination letter. Although a Form 1023 is not required, similar information to that submitted with that form should be furnished. Detailed descriptions of the programs to be conducted along with brochures, class schedules, architectural drawings, or other written and visual (a video or photos) information that illustrates the programs the foundation conducts (or plans to) should be sent. Financial information reflecting detailed expenditure categories to accomplish the programs should be included.

An existing foundation does not get the fresh start permitted for new foundations mentioned at the beginning of this section. The IRS has concluded that "a private foundation in existence for at least four years and not heretofore qualified for operating foundation status may satisfy the operating foundation requirements by showing that it has met the Income Test and one of the three alternative tests over a four-year period." Unfortunately, such a foundation is "considered an operating foundation effective the final year of the four-year period."[150] Because a converting PF is not a new organization, this conclusion is logical. One founda-

[150] IRS Exempt Organization CPE Technical Training Program for 1984, p. 249, citing Reg. §53.4942(b)-3(a).

tion was able to qualify in the year of its conversion by receiving approval for a single, but substantial, set-aside to operate a facility to assist persons with limited employability due to temporary or permanent disabilities.[151] Despite the fact that it could not meet the tests during its first through third years, it did meet the test on an aggregate basis of all four years.

15.6 SATISFYING THE DISTRIBUTION TEST

Each year a normal private foundation is required to make qualifying distributions equal to its distributable amount (DA) for the prior year, reduced by any carryovers of prior-year excess distributions. A new $1 million foundation created on January 1, 2003, and adopting a calendar year, for example, would be required to pay out $50,000 for charitable purposes by December 31, 2004.[152] A private foundation that fails to pay out this amount and has undistributed income must make up the deficiency, and a penalty tax may apply. A private operating foundation is not subject to this tax but instead is subject to losing its operating status, as discussed in the previous section. Failure to correct a deficiency and repeated deficiencies can result in loss of exemption. Undistributed income equals current-year distributable amount[153] less qualifying distributions[154] that are not applied either to offset prior deficits or to corpus. An initial tax of 15 percent is imposed for each year that the deficit goes uncorrected.[155] The underdistribution must be corrected by making grants that are qualifying distributions.

(a) Timing of Distributions

To identify a deficiency of distributions and to correct the condition, one must understand how payments are applied. A foundation's charitable expenditures that are considered qualifying distributions are totaled for each year in which they are paid, but they are not necessarily applied in that year. The terminology can be confusing here because the current-year distributable amount is based on the prior year's minimum investment return.[156] Nevertheless, qualifying distributions are applied as follows[157]:

- First, the qualifying distributions are applied to make up any prior year's deficiency of distributable amount (for a year in which the PF has undistributed income subject to the excise tax).
- Next, the remaining qualifying distributions are applied to the current year's DA (essentially, the prior year's adjusted minimum investment return[158]).

[151] Priv. Ltr. Rul. 9108001; a set-aside for summer enrichment program scholarships was also approved in Priv. Ltr. Rul. 9018033.
[152] Unless a set-aside distribution applies, as explained in Section 15.5.
[153] Defined in Section 15.3.
[154] Defined in Section 15.4.
[155] IRC §4942(a)(1).
[156] Defined in Section 15.3.
[157] IRC §4942(h).
[158] Illustrated in Section 15.3.

- Finally, any remaining distributions are taken out of corpus or applied against any remaining distribution deficiencies.[159] Remember, the redistribution of a grant received by one PF from another PF must be charged against corpus and cannot reduce the donee PF's own DA.[160] Also, a gift from a contributor who wishes to receive a higher percentage contribution deduction limitation must be paid from corpus.[161]

Distributions in excess of the DA applied to corpus are carried forward for five years, a period of time called the *adjustment period*. Exhibit 15-1 provides an illustration of the way in which excess distributions are applied. The IRS Chief Counsel issued a memorandum entitled "Adjustments of Excess Distribution Carryovers from Closed Years," taking the position that adjustments to years closed by the statute of limitations are permissible.[162] The memorandum recognizes the fact that in any one year a nonoperating PF has excessive or deficient distributions and, therefore, a carryover of excess distributions is an accumulation of all post-1969 years. It is an unusual foundation that pays out the exact minimum distribution amount.

A single error in calculating the amount required to be distributed or qualifying distributions in any one year causes all years to be wrong. Thus, the IRS takes the position, as yet unchallenged in court, that the years from 1970 forward are open years for this purpose.[163] As shown in Exhibit 15-1, the excesses (designated as out of corpus) are available for carryforward over a five-year period in the order in which they occur.

A private foundation is required to meet its distribution requirements in the year in which it makes a distribution of its assets to another private foundation. Such a transfer itself "shall be counted towards satisfaction of such *requirements to the extent the amount transferred meets the requirements of section 4942(g)*" [emphasis added].[164] A grant to another private foundation, however, counts as a qualifying distribution only if the recipient foundation regrants, or pays out, the amount to be counted as qualifying. Thus, either the terminating or the transferee foundation must make qualifying disbursements to the extent the transferor foundation has undistributed income and the same persons control the transfer foundation.

(b) Planning for Excess Distributions

Some foundations spend more money than required in supporting charitable programs and, as a result, have excessive distribution carryovers. A foundation might be created by a philanthropist who wishes to distribute much more than the required 5 percent payout amount. Another foundation's charter might stipulate it is to dispose of all of its assets within 10 to 20 years. A careful foundation

159 Reg. §53.4942(a)-3(d).
160 See Section 15.4(a).
161 IRC §170(b)(1)(E).
162 IRS Gen. Coun. Memo. 39808.
163 Priv. Ltr. Rul. 9116032.
164 Reg. §1.507-3(a)(5); see Section 12.4 for details of the complicated rules for terminating foundations.

might also time its distributions from one year to the next to take advantage of the 1 percent tax rate.[165] In such situations, the excess may serve a useful purpose.

(c) Cushion against Decline in Income

A foundation can use accumulated excess distributions to meet its current-year requirements during years in which its investment yields are low or negative. Within the five-year limit and the tolerance of the organizations it normally funds, the foundation can reduce or eliminate spending until it uses up the carryover.

Allow Deduction to Funder. Excess distributions can be treated as qualifying distributions to satisfy the §170(e) requirement to remove the donation limit for its funders.[166] A full fair market value charitable deduction is not allowed for gifts of appreciated property, other than marketable securities, to a normal private foundation. This limitation is lifted if the foundation essentially distributes the gift.

Substantial Contraction. Excess distributions might require enhanced reporting on the foundation's Form 990-PF and might cause an eventual dissolution of the foundation. There is no particular negative tax consequence for such a situation, except enhanced IRS reporting. Form 990-PF asks a foundation each year whether it has a partial or complete liquidation, dissolution, termination, or substantial contraction. The definition of a substantial contraction is a distribution of more than 25 percent of a foundation's assets in one year. Details of such distributions, plus explanation of any organizational changes, are reported on the annual tax form. When a foundation distributes all of its assets, its tax attributes may be transferred to the grantee under the so-called termination rules outlined in Section 12.4.

(d) Calculating the Tax

A foundation that fails to make the required charitable expenditures in a timely manner is subject to an excise tax of 15 percent on the undistributed amount. The tax is charged for each year or partial year that the deficiency remains uncorrected. Essentially, the tax calculation starts on the first late day and continues until a notice of the deficiency is issued by the IRS (but in whole-year increments). This taxable period also closes on the date of voluntary payment of the tax.[167] Note that there is no tax on the foundation managers.

Assume that a calendar-year PF fails to distribute $50,000 of its 2004 DA by December 31, 2005. If the amount is distributed within the first year after the deadline (by December 31, 2006), a 15 percent tax is due. If the correction takes two years, or is not fixed until the second year after it was due (on or before January 1, 2008), another 15 percent is due, or a total of 30 percent. The additional 15 percent would be due even if the payment is made on January 2, 2008.

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[165] See Section 13.4(b) for an illustration of this timing plan.
[166] See Section 13.4(c) for more discussion of this important planning tool.
[167] Reg. §53.4942(a)-1(c)(1)(ii).

An additional 100 percent tax is triggered if the PF fails to make up the deficient distributions within 90 days of receiving IRS notification of the problem. The allowable correction period is 90 days after the date of mailing of the deficiency notice.[168] The notice date is critical to calculating the tax. If the deficiency is self-admitted on the face of Form 990-PF, Part XIII or XIV, an accompanying Form 4720 is due to be filed to calculate the tax due. If the deficiency is not self-admitted, the IRS computers should recognize the problem and generate a notice within a few months beyond the return filing date.

In the more common situation, the underdistribution is found by the foundation itself and less often by the IRS upon examination. When the IRS mails a notice when the examination is completed, the PF has 90 days from the date of the notice to correct the problem by making grants. If it does not, the 100 percent additional penalty tax is imposed.

(e) Abatement of Penalty

Valuation Mistakes. When a PF fails to make the required annual charitable distributions due solely to an incorrect valuation of assets, the statutory sanction may be excused. In the interest of being fair, the underdistribution can essentially be corrected if four conditions for abatement listed in the code are satisfied[169]:

1. The failure to value the assets properly was not willful and was due to reasonable cause.
2. The deficiency is distributed as a qualifying distribution by the PF within 90 days after receipt of the IRS notice of deficiency.
3. The PF notifies the IRS of the mistake by submitting information on its Form 990-PF and recalculating its qualifying distributions.
4. The extra distribution made to correct the deficiency is treated as being distributed in the deficiency year.

To prove that the undervaluation was not willful and was due to reasonable cause, the PF must show that it made all reasonable efforts in good faith to value the assets correctly.[170] A system regularly maintained for collecting the information, such as saving a month-end copy of stock quotes, evidencing good faith, satisfies this requirement. In seeking abatement for mistakes in valuing real estate or a partnership, the foundation must prove it acted in good faith to determine the value. Reliance on an invalid appraisal received from an unrelated, but accredited, appraiser, based upon fully disclosed information pertaining to the property to be valued, should be considered as reasonable.

Underdistribution Mistakes. The IRS has discretion to abate the first-tier, or 15 percent, penalty applicable to distribution mistakes.[171] A private foundation that

[168] IRC §4942(j)(2).
[169] IRC §4942(a)(2).
[170] Reg. §53.4942(a)-1(b)(2).
[171] IRC §4962.

EXHIBIT 15.2

Request for Abatement Regarding Underdistribution

SAMPLE FOUNDATION

ATTACHMENT TO FORM 4720

STATEMENT REGARDING UNDERDISTRIBUTION OF INCOME

During the fiscal year ending June 30, 2004, the SAMPLE FOUNDATION (SAMPLE) inadvertently distributed $70,000 less than the required amount. This mistake was discovered when SAMPLE's annual form 990-PF was being prepared by its accountants on October 28, 2004. During the period July 1, 2004, through October 31, 2004, SAMPLE has, in fact, already distributed more than the deficient amount of $70,000 for charitable purposes.

Each year during June, SAMPLE's accountants are provided an eleven-month report of financial activity. The accountants then calculate the distributable amount, compare that amount with the actual payments to date, look at pledges for grants due to be paid, and advise what additional amount, if any, must be paid out. Due to calculation mistakes and a misunderstanding about a particular grant payment, the amount deemed to be distributable was wrong. SAMPLE's officers intended to pay out, and thought they were paying out, the correct amount.

Pursuant to Internal Revenue Code §4962, SAMPLE respectfully requests that the first-tier §4942 penalty for underdistribution of income, or initial tax of $10,500, be abated because the underdistribution was due to reasonable cause and without willful neglect. By the time the mistake was discovered four months after SAMPLE's year-end, SAMPLE had made the required distributions and was no longer deficient. Therefore, SAMPLE submits it is entitled to an abatement of the tax because it meets the requirements of §4962.

I swear that this information is true and correct and that the foundation's underdistribution of income was inadvertent, accidental, and without intention or knowledge on my part or on the part of any of SAMPLE's other officers.

____

A.B. Sample, President

fails to meet the minimum distribution requirement may be excused from penalty in certain cases. The second-tier taxes may also be abated.[172] The exception applies if

- The taxable event was due to reasonable cause and not to willful neglect.
- The event was corrected within the correction period for such events.

The standards for evaluating reasonable cause are discussed in Section 16.2(c). A foundation seeks abatement of the penalty by filing Form 4720 along with an explanation of the reasons why the penalty should be forgiven. Exhibit 15.2 illustrates a request for abatement. In the author's experience, the IRS has been fair in permitting abatement where reasonable cause can be shown. Reliance in good faith on incorrect legal advice may be a good cause.[173]

[172] IRC §4961.
[173] Priv. Ltr. Rul. 200347023.

CHAPTER SIXTEEN

Excess Business Holdings and Jeopardizing Investments: IRC §4943 and §4944

16.1 EXCESS BUSINESS HOLDINGS

A private foundation's level of ownership in an operating business, other than one conducted as a charitable activity or holding only passive investments, is limited by Internal Revenue Code (IRC) §4943, entitled Excess Business Holdings. A foundation is entitled to receive a gift that causes it to have impermissible ownership in a business, but cannot retain it. Specific time periods are prescribed for disposition of such holdings received by a foundation through donation or inheritance. The basic rule is that the combined ownership of the private foundation (PF) and those that fund and manage it (its insiders that are formally referred to as disqualified persons) in a business enterprise of any legal form—corporation, partnership, joint venture, or other unincorporated company—must not exceed 20 percent. If it can be proved the foundation and its insiders lack control of the business, the allowable percentage rises to 35 percent. A foundation may own up to 2 percent of a business (other than a solely owned proprietorship) without regard to the ownership of its insiders.

(a) Definition of Business Enterprise

The Tax Code provides only a negative definition of a business enterprise by saying what is not.[1] The two enterprises it says can be owned without limitation include a functionally related business and a business 95 percent of whose income is from passive sources. The regulations define business enterprise broadly as follows:

> A business enterprise includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under IRC §513.[2]

The ownership limits apply regardless of whether the business produces a profit. A bond or other form of indebtedness is treated as a business holding if it is essentially a disguised equity holding. A leasehold interest in real estate, the rent from which is based, in whole or part, on profits, is customarily not considered to be a business interest, unless the leasehold constitutes an interest in the lessor's business.[3]

Functionally Related Business. A business conducted to accomplish program-related purposes is not treated as a business enterprise.[4] Such businesses include those that are excused from the unrelated business income tax as being basically not businesslike, and these include the following[5]:

- A business the conduct of which is substantially related (aside from the mere provision of funds for the exempt purpose) to the exercise or performance by the private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption. A music publishing company concentrating on classical or serious music was considered related to the purposes of a PF promoting music education and the choice of music as a career.[6]
- A business in which substantially all of the work is performed for the foundation without compensation
- A business carried on by the foundation primarily for the convenience of its members, students, patients, officers, visitors, or employees, such as a cafeteria operated by a hospital or museum
- A business that consists of selling merchandise, substantially all of which has been received by the foundation as gifts or contributions
- An activity carried on within a larger combination of similar activities related to the exempt purposes of the foundation

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[1] IRC §4943(d)(3).
[2] Reg. §53.4943-10(a).
[3] Reg. §53.4943-10(a)(2).
[4] IRS Publication 578, *Tax Information for Private Foundations and Foundation Managers*, Chapter X, p. 32.
[5] Defined by reference to Reg. §53.4942-2(c)(3)(iii) regarding businesses that are not unrelated pursuant to IRC §§513(a)(1), (2), and (3).
[6] Priv. Ltr. Rul. 8927031.

Passive Holding Company. A company that obtains at least 95 percent of its gross income from the passive sources listed in IRC §§512(b)(1), (2), (3), and (5) is not considered a business. The word *passive* was provided in this Code section in 1969, well before the Tax Reform Act of 1986 gave it another dimension. For purposes of excess holdings, passive income is classified as investment income, and includes the following.[7]

- Dividends, interest, and annuities
- Royalties, including overriding royalties, whether measured by production or by gross or taxable income from the property. Working interests in mineral properties are active businesses.[8]
- Rental income from real property and from personal property leased alongside real property, if the rent is incidental (less than 50 percent of the total rent)
- Gains or losses from sales, exchanges, or other dispositions of property other than stock in trade held for regular sale to customers
- Income from the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or keep inventories in the goods

Income classified as passive for this purpose does not lose its character merely because the property is indebted so as to make the foundation's income from the holding subject to the unrelated business income tax.[9]

(b) Corporate Holdings

Permitted holdings of business enterprises by a private foundation vary according to the form of ownership, type of entity, and other variables. A foundation may hold 20 percent of the voting stock of an incorporated business enterprise, reduced by the percentage of voting stock owned by all disqualified persons (DPs).[10] In other words, the foundation and its contributors and managers and their families cannot generally together control more than 20 percent of a corporation.

Nonvoting Stock. If all of the insiders together own no more than 20 percent of the corporation's voting stock, the foundation can own any amount of nonvoting stock.[11] Stock carrying contingent voting rights is treated as nonvoting until the event triggering the right to vote occurs. An example is preferred stock that can be voted only if dividends are not paid; such shares are considered nonvoting until the voting power is exercisable. This exception applies only to an incorporated entity, not to a partnership or other form.[12] Entering into a binding

[7] Reg. §53.4943-10(c)(2).
[8] Priv. Ltr. Rul. 8407095.
[9] Reg. §53.4943-10(c)(2).
[10] IRC §4943(c)(2); Reg. §53.4943-3(b)(1).
[11] IRC §4943(c)(2).
[12] Reg. §53.4943-3(c)(4)(i).

agreement (scripted on the shares and transferable to any purchaser of the shares) not to vote the PF's stock does not reduce excess business holdings.[13]

Thirty-Five Percent. Up to 35 percent ownership in a corporate business can be held aggregately by the foundation and its insiders, when the foundation establishes to the satisfaction of the Internal Revenue Service (IRS) that the enterprise is controlled by a third person (unrelated parties). *Control,* for this purpose, means possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the enterprise, whether through ownership of voting stock, the use of voting trusts, contractual arrangements, or otherwise. It is the reality of control that is decisive, not its form or the means by which it is exercisable.[14] The IRS has required actual proof of outside party control.[15]

Two Percent. The PF can own up to 2 percent of voting stock and up to 2 percent in value of all outstanding shares of all classes of stock, called a *de minimus amount,* regardless of the insider's holdings.[16] Any commonly controlled PF's holdings are combined with the PF's for this purpose.

(c) Partnerships, Trusts, and Proprietorships

The permitted holdings in partnerships and other forms of ownership are determined using the same concepts as those applicable to corporations—using different terms to identify the ownership. For a general or limited partnership or a joint venture, the terms *profit interest* and *capital interest* are substituted for voting stock and nonvoting stock.[17] The interest of the foundation and its insiders in a partnership is determined using the distributive share concepts of IRC §704(b). Absent a formal partnership agreement, the foundation's ownership is measured by the portion of assets that the foundation is entitled to receive upon withdrawal or dissolution, whichever is greater.

A private foundation's interest in a partnership makes it an owner of a proportionate part of the properties owned by the partnership for purposes of measuring excess business holdings. The 20/35 percent limitations apply as if the foundation owned the property directly. Therefore, a foundation owning 45 percent of a partnership is deemed to own 45 percent of properties owned by the partnership. Say, for example, the partnership owned 50 percent of the outstanding shares of a corporation. The PF is considered to own 45 percent of 50 percent, or 22.5 percent of such corporation. Unless the foundation can prove the corporation is controlled by third parties, as discussed previously, excess business holdings are present and the partnership's share of the corporation must be reduced. If, instead, the foundation holds a limited partnership interest, 35 percent may be permitted.[18] A right on the part of the limited partner PF to veto the general partner's actions may constitute sufficient control to cause the lower 20 percent limit to apply.[19]

[13] Priv. Ltr. Ruls. 9325046 and 9124061.
[14] Reg. §53.4943-3(b)(3).
[15] Rev. Rul. 81-811, 1981-1 C.B. 509.
[16] IRC §4943(c)(2)(C); Reg. §53.4943-3(b)(4).
[17] IRC §4943(c)(3); Reg. §53.4943-3(c)(2).
[18] Reg. §53.4943-3(b)(3)(ii).
[19] Priv. Ltr. Rul. 9250039.

For trusts, the term *beneficial interest* is used to measure ownership, and the permitted holdings are limited to 20 percent.

A foundation may not hold an interest in a proprietorship.[20] An interest in a proprietorship given or bequeathed to a foundation (but not purchased) must be disposed of within five years. An interest of less than 100 percent of a proprietorship is treated as an interest in a partnership.

(d) Constructive Ownership

The stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.[21] Corporations engaged in active business are exempt from this attribution rule.[22] Stock held in a split-interest trust for which the foundation has only an income interest or is a remainder beneficiary is not considered constructively owned by the foundation unless the foundation can exercise primary investment discretion with respect to such interest.[23]

Powers of Appointment. Any interest in a business enterprise over which the foundation or a disqualified person has a power of appointment exercisable in favor of the PF or the DP is also treated as owned by the PF or person holding the power of appointment.

Material Restrictions. If the PF disposes of any interest in a business with the retention of any material restrictions or conditions that prevent free use of or prevent disposition of the transferred shares, then the PF is treated as owning the interest until the restrictions or conditions are eliminated.[24]

(e) Disposition Periods

Five-Year Period. A private foundation is given five years to dispose of excess business holdings acquired by gift or bequest. During the disposition period, the foundation is not treated as owning the shares. The statute says:

> If there is a change in the holdings in a business enterprise (other than by purchase by the private foundation or by a disqualified person) which causes the PF to have excess holdings, the interest of the PF shall be treated as held by a disqualified person during the five-year period beginning on the date of such change in holdings.[25]

For shares received under a will or from a trust, the five-year period begins at the time of actual distribution from the fiduciary.[26] If the foundation already holds excess shares of the business at the time it is given additional shares, special rules apply.[27]

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[20] IRC §4943(c)(3)(B); Reg. §53.4943-3(c)(3).
[21] Reg. §53.4943-8.
[22] Reg. §53.4943-8(c).
[23] IRC §4943(d)(1); Reg. §53.4943-8(b)(2).
[24] Reg. §53.4943-2(a)(1)(iv).
[25] IRC 4943(c)(5).
[26] Reg. §53.4943-6(b)(1).
[27] Reg. §53.4943-6(a)(i)(iii).

Extension of Time. A foundation that is attempting to sell its excess business holdings within the permissible time period (ending on or after November 1, 1983) but is unable to do so can request an additional five-year extension of the time. To obtain permission, the foundation must demonstrate the following[28]:

- The gift is an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures.
- It has made diligent efforts to dispose of the holdings within the initial five-year period.
- Disposition of the holdings was not possible during the first five years because of the size and complexity or diversity of the holdings, except at a price substantially below fair market value (FMV). Congressional hearing testimony considered 5 percent below FMV to be substantial.
- Before the close of the first five years, the foundation submits a disposition plan to the IRS and seeks approval of its state attorney general (or similar responsible authority).

Private letter rulings show a favorable pattern of granting extensions for PFs that have "made diligent effort" to dispose of their excess holdings.[29] A plan developed by an independent financial consultant to assist the foundation to sell its holdings, in conjunction with the substantial contributor's family members who also owned the same holdings, was approved by the IRS.[30]

Ninety-Day Period. When a purchase by a DP creates excess business holdings, the PF has 90 days from the date it knows, or has reason to know, of the event that caused it to have such excess holdings.[31] The excise tax is not applied if the holdings are properly reduced within the 90-day period. The period can be extended to include any period during which a foundation is prevented by federal or state securities law from disposing of the excess holdings.

No Period. An interest purchased by the PF itself that causes the combined ownership to exceed the limits must be disposed of immediately, and the foundation is subject to tax. If the foundation had no knowledge, nor any reason to know, that its holdings had become excessive, the 90-day period is applied and the tax is excused.

Twenty, Fifteen, and Ten Years. Interests held on May 26, 1969 (when these rules were added to the code) were called *present interests.* Any excess ownership held at that time was disposable over 10, 15, or 20 years, depending on the amount of combined ownership. An interest received from a trust irrevocable on May 26, 1969, or from a will in effect and never revised since that date, is still

[28] IRC §4943(c)(7).

[29] Priv. Ltr. Ruls. 8514098, 8508114, 8737085, and 9029067. In the 1990 ruling, the IRS found that the PF had not been diligent and denied an extension.

[30] Priv. Ltr. Rul. 9115061.

[31] Reg. §53.4943-2(a)(1)(ii).

subject to these longer time periods.[32] The selling off of excess business holdings by many PFs during the 1970s and 1980s was a major undertaking. The regulations contain 30 pages of instructions, exceptions, downward ratchet rules, and complicated procedures that must be carefully studied by any PF under such disposition period.

(f) Business Readjustments

Any increases in a foundation's holdings due to a readjustment are treated as if they were not acquired by purchase. This means that the PF has either 90 days or five years to dispose of them, as a general rule.[33] A readjustment may be a merger or consolidation, a recapitalization, an acquisition of stock or assets, a transfer of assets, a change in identity, a form or place of organization, a redemption, or a liquidating distribution.[34] If the readjustment results in the PF owning a larger percentage than owned prior to the change, a taxable event may occur, and the rules need to be carefully studied.

(g) Tax on Excess Holdings

If the excess holdings are not disposed of within the time periods previously described, an initial tax is due. The tax is imposed only on the private foundation and is equal to 5 percent of the highest value of the excessive amount of the shares during each year. The tax is payable for each tax year during what is called the *taxable period.* Form 4720 is filed to calculate and report the tax due. The valuation is determined under the estate tax rules.[35]

Taxable Period. The taxable period begins with the first day that excess business holdings exist, and ends on the earlier of the following dates:

- The date on which the IRS mails a deficiency notice under §6212
- The date on which the excess is eliminated
- The date on which the tax is assessed. If the deficiency is self-admitted by voluntarily filing Form 4720, the period ends when the return is filed. Excess holdings found by the IRS upon examination result in the IRS issuing the assessment.

Additional Tax. If excess holdings exist at the end of the taxable period, an additional 200 percent tax is imposed on the value of the excess still held.[36] In an egregious case, a third-tier, or termination, tax can be assessed.[37]

Tax Abatement. The IRC §4962 tax abatement rules discussed in Section 16.4(c) may also apply, if the excess holdings were due to reasonable cause and not to

[32] IRC §4943(c)(4); Reg. §§53.4943-4 and 5.
[33] Reg. §53.4943-6(d).
[34] Reg. §53.4943-7(d)(1).
[35] IRC §4943(a); Reg. §53.4943-2(a).
[36] IRC §4943(b); Reg. §53.4943-2.
[37] See Section 12.4.

willful neglect. The excess holding condition must be corrected by disposing of the excess before the penalty can be abated.

16.2 JEOPARDIZING INVESTMENTS

The managers of a private foundation have a fiduciary responsibility under most state laws to safeguard the assets on behalf of the foundation's charitable constituency. In a similar spirit, the Tax Code says that a private foundation should not

> invest any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes.[38]

To deter a foundation from making investments that might imperil its assets, an excise tax is imposed on the foundation itself and on any of its managers who approve of the making of a jeopardizing investment. Managers are expected to exercise a high degree of fiduciary responsibility in investing foundation funds. The purpose is to shield private foundation assets from risk, so as to maximize both capital and income available for charity.

Investments made to advance a charitable purpose, such as student loans or low-income housing, are classified as program-related investments and are not subject to the same standards of risk/reward applicable to normal investments. The following investments are not considered to be jeopardizing:

- Program-related investments the primary purpose of which is to accomplish one or more charitable purposes rather than to produce income[39]
- Property received as gifts or by gratuitous transfers, unless the foundation F pays some consideration in connection with the gift, such as a bargain sale[40]
- Stock received in a corporate reorganization within the meaning of IRC §368

(a) Identifying Jeopardy

A manager fails to exercise the appropriate level of responsibility if he or she fails to exercise

> [o]rdinary business care and prudence, under the facts and circumstances prevailing at the time the investment is made, in providing for the long- and short-term needs of the foundation to carry out its exempt purposes.[41]

The existence of jeopardy is made on an investment-by-investment basis, in each case taking into account the foundation's portfolio as a whole. The identification of jeopardy is based on facts available to the foundation managers at the time the investment is made, not subsequently on the basis of hindsight. Once it is ascertained that an investment is prudent and not jeopardizing, the investment, according to the regulations, can never be considered to be a jeopardizing one,

[38] IRC §4944(a)(1).
[39] Discussed in Section 16.3.
[40] Reg. §53.4944-1(a)(2)(ii).
[41] Reg. §53.4944-1(a)(2).

even though the foundation ultimately loses money. A change in the form or terms of an investment is considered to be a new investment as of the date of the change, and a new determination is to be made at that time.[42]

Certain types of investments are said by the regulations to possess a higher degree of risk and must be closely scrutinized. After conceding that no category of investment will be treated as per se jeopardizing, the following types are listed as investments requiring close scrutiny:

- Trading in securities purchased on margin
- Trading in commodity futures
- Working interests in oil and gas
- Puts, calls, and straddles
- Purchases of warrants
- Selling short

On April 30, 1998, the IRS expanded the list of investments that require close scrutiny to include what it calls recent investment strategies (that by reference are not necessarily prohibited) to include the following[43]:

- Investment in junk bonds
- Risk arbitrage
- Hedge funds
- Derivatives
- Distress real estate
- International equities in third-world countries

The IRS expansion of the list reflects the reality of financial markets in the 1990s, which were not anticipated when the regulations were written in 1970. The American Law Institute (ALI) revised its Restatement of the Law, Trusts: Prudent Investor Rule, a compendium of the basic rules governing the investment of trust assets in 1992.[44] The ALI guide reflects modern investment concepts and practices apparently now recognized by the IRS. The *prudent investor rule* acknowledges that return on investment is related to risk, that risk includes the risk of deterioration of real return owing to inflation, and that the risk/return relationship must be taken into account in managing trust assets. Based on this rule, maintaining all of a foundation's assets in certificates of deposit or other fixed money obligations—a policy thought by many to be secure—could theoretically be treated as a jeopardizing situation.[45] The significant declines in the equity markets accompanied by a drastic decline in interest rates evidence the need for great caution in making decisions about future market performance.

[42] Reg. §53.4944-1(a)(2).

[43] Internal Revenue Manual 7.8.3, Private Foundation Handbook, Chapter 16.

[44] American Law Institute Publishers, St. Paul, Minnesota.

[45] See Chapter 5, "Asset Management," in J. Blazek, *Financial Planning for Nonprofit Organizations* (New York: Wiley, 1996), for more information.

The prudent investor rules have been codified and have been adopted by many states. The Uniform Prudent Investor Act (UPIA) was finalized in 1995 and is applicable to trusts. The Uniform Management of Institutional Funds Act (UMIFA) was finalized in 1972 to apply to incorporated and unincorporated charitable organizations and certain government organizations. Most all of the states have adopted this standard.

Under both acts, trustees and directors are permitted to delegate their responsibility to third-party managers. UPIA directs trustees to review the entire portfolio, but does not require diversification. UMIFA endorses the total return concept (discussed later in this chapter) and encourages diversification into a range of assets to achieve a balance of risks.

(b) Examples of Prudent and Jeopardizing Investments

There is precious little guidance on the subject from a Tax Code standpoint. The regulations, unchanged since issuance in 1972, contain three examples that describe stocks and contrast factors that indicate jeopardy with those that do not:

- Corporation X has been in business a considerable time, its record of earnings is good, and there is no reason to anticipate a diminution of its earnings. (Not jeopardizing.)
- Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. (Is jeopardizing unless Y's shares are purchased in a new offering of an amount intended to satisfy Y's capital needs.)
- Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. (Is jeopardizing unless the management has a demonstrated capacity for getting new businesses started successfully and Z has received substantial orders for its new products.)

Unimproved Real Estate. Another example finds E Foundation's purchase of unimproved real estate not to be jeopardizing where E was following the advice of a professional manager. E sought recommendations on how best to diversify its investments to provide for its long-term financial needs and protect against inflation. E's short-term financial needs could be satisfied with its other assets.

Whole Life Insurance Policy. The only published ruling on jeopardizing investments concerns a whole life insurance policy. A PF received a gift of an indebted policy covering an insured person with a 10-year life expectancy. Based on the scheduled death benefit, the PF could expect to pay more in premiums and loan interest than it would receive. Each payment on the policy was found to be a jeopardizing investment.[46]

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[46] Rev. Rul. 80-133, 1980-1 C.B. 258.

Bank Stock. In the only case, placement of the entire foundation corpus in a Bahamian bank without inquiring about the integrity of the bank was found to be jeopardizing since the bank at the time had actually lost its license to do business.[47]

Gold Stocks. In private rulings, the IRS has approved investments of the type that it says require close scrutiny. In one ruling, gold stocks purchased as a hedge against inflation were not jeopardizing despite a net loss of $7,000 on a $14,500 investment. The PF bought the shares over three years, made money on one block, and lost on two others. The ruling noted that the PF had realized $31,000 in gains and $23,000 in dividends during the same period on its whole portfolio. Importantly, the portfolio performance as a whole was found to enable the PF to carry out its purposes.[48]

Commodities. A "managed commodity trading program" was found to give diversity to a PF's marketable security portfolio and not to be a jeopardizing investment. Since commodity futures have little or no correlation to the stock market, the added diversity may provide less risk for the PF's overall investment. The foundation invested 10 percent of its portfolio.[49]

Nontraditional Investments. Distressed real estate, a U.S. hedge fund, commodities, oil and gas funds, and limited partnerships were also deemed not to be jeopardizing investments by the IRS. Based on professional advice that its stock and bond portfolio be diversified, a foundation asked if it could increase its investment in those "nontraditional investments" by a "certain percentage."[50] The foundation also was advised that it could invest about 10 percent of its portfolio in a market-neutral fund. Though no ruling has discussed the subject, selling covered options against stocks in an investment portfolio is considered under the prudent investor rules to enhance yield without risk.

Many private foundations are choosing to place some of their investment assets in so-called alternative investments, such as hedge funds and offshore partnerships. These investments embody a number of tax and legal considerations not present in a portfolio of marketable securities. Exhibit 19.1, Checklist for Alternative Investments, prompts foundation representatives to ask those questions in evaluating such alternatives.

Limited Partnership. An interest in a limited partnership trading in the futures and forward markets was also found not to be a jeopardizing investment, despite the fact that a "significant amount' of the foundation total assets were invested (amount not disclosed).[51] An IRS agent had proposed that the investment was jeopardizing because the foundation could have otherwise received a better return with less risk. The IRS privately ruled, however, that the foundation managers had exercised ordinary business care and prudence in entering into the partnership based on the following facts:

[47] *Thorne v. Commissioner*, 99 T.C. 67(1992).
[48] Priv. Ltr. Rul. 8718006.
[49] Priv. Ltr. Rul. 9237035.
[50] Priv. Ltr. Rul. 9451067.
[51] Priv Ltr. Rul. 200218038.

- Foundation managers were actively involved in establishing the partnership and choosing four different advisors to make allocations to diversify the investments.
- The foundation could withdraw funds at any time.
- Two legal opinions concluding the investment was not a jeopardizing one were obtained prior to entering into the partnership agreement.
- There was no relationship between the investment advisors and the foundation managers that would be furthered by the investment.

For-Profit Venture Fund. A foundation's investment in a for-profit venture capital fund limited to achieving environmental and economic development goals, subject to environmental guidelines and oversight, accomplishes an exempt purpose. The foundation supports biodiversity and sustainability and believes there is a link between economic development and reduction of poverty and conservation of the biological resources on which nearly all economics are based. Therefore, the foundation's fund investment qualified as a program-related one. The investment was not thereby jeopardizing, and the expenditure was not a taxable one.[52]

(c) Donated Assets

An investment asset donated to a foundation is not considered a jeopardizing one as it regards the foundation.[53] Similarly, an investment asset acquired by the foundation solely as a result of a corporate organization is not treated as jeopardizing unless the foundation furnishes some consideration in connection with the exchange. [54] The reason for this rule is that the foundation is not treated as having made the investment. When receiving a gratuitous transfer, the foundation is not committing its existing assets that are protected by the charitable covenant imposed by the tax statute and its organizational documents. An IRS answer to a request by the estate of a foundation's founder to approve a proposed asset transfer is instructive.[55] The IRS found the foundation stood to gain and had nothing to lose in accepting the assets. It noted the foundation would not incur any obligation to use its other resources in the future in connection with maintenance of the bequeathed assets. In this context, it is important to be reminded that donated property can, however, be subject to the excess business holdings rules.

16.3 PROGRAM-RELATED INVESTMENTS

A *program-related investment* is not subject to the same standards of risk/reward applicable to normal investments because it serves a charitable, rather than an income-producing, purpose. Program-motivated investments are not treated as

[52] Priv. Ltr. Rul. 200136026.
[53] Reg. §53.4944-1(a)(2)(iii).
[54] Reg. §53.4944-6.
[55] Priv. Ltr. Rul. 9614002.

jeopardizing investments even if they bear no interest or dividend and possess a high degree of risk of loss. They are best described by the criteria used in the Code and regulations to define them[56]:

- The primary purpose of the investment is to accomplish an exempt charitable purpose.
- No significant purpose of the investment is the production of income or the appreciation of property.
- No purpose of the investment may be the furthering of substantial legislative or political activities.

Funds expended to make a program investment are treated as qualifying distributions for purposes of the foundation meeting its annual payout requirements. Return of the principal amount of such a loan or other form of investment will be added back to the distributable amount when it is collected.[57] Since such funds are normally paid to a non-tax-exempt person or entity, it is important to note that the disbursement is not a taxable expenditure. The foundation, however, must report and monitor a program investment throughout its life, following the *expenditure responsibility* rules for the entire period the investment is held.[58]

Program-related investments are those that "would not have been made" but for the relationship between the investment and the accomplishment of the foundation's exempt purposes. In evaluating the foundation's motivation, it is "relevant whether investors solely engaged in investment for profit would be likely to make the investment on the same terms as the foundation." The fact that such an investment produces significant income or capital appreciation is not, in the absence of other factors, evidence that a charitable purpose does not exist.[59] To evaluate qualification of the borrowers or investment beneficiaries, the charitable class rules should be applied.[60] The following regulation examples illustrate the concept[61]:

- A small business enterprise, X, is located in a deteriorated urban area and is owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to the enterprise. A PF makes a below-market interest rate loan to encourage economic development.
- The PF described above allows an extension of X's loan in order to permit X to achieve greater financial stability before it is required to repay the loan. Since the change is not motivated by attempts to enhance yield but by an effort to encourage success of an exempt project, the altered loan is also considered to be program related.

[56] IRC §4944(c); Reg. §53.4944-3(a)(1).
[57] See Section 15.4.
[58] See Section 17.6.
[59] Reg. §53.4944-3(a)(iii).
[60] See Section 2.2(a).
[61] Reg. §53.4944-1(b).

- Assume instead that a commercial bank will loan X money if it increases the amount of its equity capital. PF's purchase of X's common stock, to accomplish the same purposes as the loan described in the first two bullet points, is a program-related investment.
- Assume instead that substantial citizens own X, but continued operation of X is important for the economic well-being of the low-income persons in the area. To save X, PF loans X money at below-market rates to pay for specific projects benefiting the community. The loan is program related.
- The PF wants to encourage the building of a plant to provide jobs in a low-income neighborhood. The PF loans the building funds at below-market rates to SS, a successful commercial company that is unwilling to build the plant without such inducement. Again, the loan is program related.
- A loan at a rate less than that charged by financial institutions to a non-profit community development corporation that markets agricultural products to aid low-income farmers in a depressed rural area fosters a charitable purpose.
- A PF loans X, a socially and economically disadvantaged individual, funds to attend college interest-free.

In rulings, the IRS has considered program investments to include the following:

- A loan program established to make low-interest-rate loans to blind persons unable to obtain funds through commercial sources constitutes a program-related investment.[62]
- Land purchased for land conservation, wildlife preservation, and the protection of open and scenic spaces is program related.[63]
- Investment in a for-profit company established to encourage creation of jobs in a region targeted for this purpose by a state government.[64]
- Loans and investments to promote economic development in a foreign country that has energy and food shortages, natural disasters, and a low standard of living.[65]
- A program to support media companies spreading the institution-building process toward open societies and democratic systems in Central and Eastern Europe, Russia, Latin America, Southeast Asia, and Africa.[66]

A change in the terms of a program-related investment will not create jeopardy, if the change continues to advance the exempt purposes for which the investment was originally made. A change made in order to produce income or appre-

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62 Rev. Rul. 78-90, 1978-1 C.B. 380.

63 Priv. Ltr. Rul. 8832074; see also Priv. Ltr. Rul. 9109068 in which a tract of undeveloped land located along a city harbor was found to be a program-related investment because it was part of a plan to encourage civic beautification.

64 Priv. Ltr. Rul. 199943044.

65 Priv. Ltr. Rul. 199943058.

66 Priv. Ltr. Rul. 200034037.

ciation could be considered jeopardizing.[67] When the change of circumstances removes the charitable nature of the investment, the investment must be recouped or sold, the terms altered, or other steps taken to restore its program nature.[68] The foundation is expected to remove the jeopardy within 30 days of the time the managers have actual knowledge of the change in circumstances. An investment is considered to be removed from jeopardy when the foundation sells or otherwise disposes of the investment and the proceeds constitute property that is not itself jeopardizing.

16.4 PENALTY TAXES

An initial tax of 5 percent on the amount invested for each year in the taxable period is imposed on both the private foundation and certain of its managers for any investment that jeopardizes carrying out the private foundation's charitable purposes. The taxable period begins on the date the amount is so invested and ends on the earliest of the following[69]:

- Date of mailing of a notice of deficiency with respect to the tax
- Date on which the tax is assessed
- Date on which the amount so invested is removed from jeopardy

An investment is removed from jeopardy when it is sold or otherwise disposed of and the proceeds are not reinvested in a jeopardizing fashion. Correction may be difficult or impossible if the asset is not marketable. Evidence that the foundation is making every effort to maximize available funds from the investment may help to avoid the additional tax.

(a) When the Manager *Knows*

Foundation managers who participate in making a decision to purchase an investment knowing that it is a jeopardizing one are taxed unless their participation is not willful and is due to reasonable cause. A manager is treated as knowing only if three factors are present[70]:

1. She or he has actual knowledge of sufficient facts so that, based solely on such facts, such investment would be a jeopardizing one.
2. She or he is aware that such an investment under such circumstances may violate IRC §4944.
3. She or he negligently fails to make reasonable attempts to ascertain whether the investment is a jeopardizing investment, or she or he is, in fact, aware that it is such an investment.

Knowledge. Knowing does not mean "having reason to know" an investment was jeopardizing. The question is whether there is evidence tending to show the manager had reason to know. The actual facts and circumstances are examined to

[67] Reg. §53.4944-3(a)(3).
[68] Reg. §53.4944-5(b)
[69] IRC §4944(e).
[70] Reg. §53.4944-1(b)(2).

find out why the manager did not know. To be excused, the manager has to be essentially ignorant of the law or pertinent facts that indicate a bad deal. Assume that a foundation's board has ten members, with a three-member finance committee. The written investment policy of the foundation provides that the board approves investment actions proposed by the finance committee, based on the advice of independent counselors. Non-finance-committee board members should not be expected to be aware of details discussed in finance committee meetings.

Willfulness. A manager's participation must be willful to subject him or her to tax. A motive to avoid the restrictions of the law or incurrence of a tax is not necessary to make this type of participation willful. Voluntary, conscious, and intentional ignorance of the facts pointing to jeopardy is willful participation (ignoring reports of pending difficulties, for example). However, a manager's participation is not willful if the manager does not know that the investment is jeopardizing.

Reasonableness. The manager must have a good reason for not knowing. To show reasonable cause for not knowing, the manager must prove that good business judgment was exercised with ordinary business care and prudence.[71]

Participation. Any manifestation of approval of the investment in question is considered to be participation in the decision to make the investment. Clearly, a vote as a board member to approve a purchase is participation. Board members who do not attend meetings but sanction investment decisions may be derelict in their fiduciary responsibility, but their inability to participate in the decision and resulting lack of knowledge may shield them from the tax. If they receive a board information packet revealing the questionable investment, they have knowledge, but the tax applies only if they participate in the approval.

(b) Advice of Counsel

A manager who relies on legal counsel (including house counsel) will not be treated as knowingly and willfully participating in a jeopardizing investment, and may be excused from the tax. The opinion of counsel for this purpose must be written, *reasoned,* and based on the fully disclosed facts of the situation. The fact that a manager failed to seek advice is one of the factors pointing to willful participation.[72] The types of reliance permitted may be different for different types of investments:

- For program-related investments, a manager may rely on a reasoned written legal opinion that a particular investment would not jeopardize the carrying out of any of the foundation's exempt purposes. The opinion must state that, as a matter of law, the investment is a program-related one not classified as a jeopardizing investment under the Internal Revenue Code.

[71] Reg. §53.4944-1(b)(2)(iii).
[72] Reg. §53.4944-1(b)(2)(v).

- For financial investments from which the PF derives its operating income, it is appropriate to rely on qualified investment counselors. Again, all facts must be disclosed to the advisor. Advisors must render advice "in a manner consistent with generally accepted practices" of persons in their business. The written advice must recommend investments that provide for the foundation's long- and short-term financial needs.

Managers found to be guilty are jointly and severally liable for the tax.[73] On a positive note, the maximum tax in the case of the first-tier tax for managers (5 percent rate) is $5,000 and for the second-tier (25 percent rate), the maximum is $10,000 for all.

Removal from Jeopardy. If the jeopardy is not removed within the taxable period, the foundation must pay an additional 25 percent tax. Managers who refuse to agree to part or all of the removal of the investment from jeopardy must pay an additional tax of 5 percent. Removal of jeopardy is accomplished when the investment is sold or otherwise disposed of, and the proceeds are reinvested in a fashion that is not jeopardizing.[74]

(c) Abatement of Penalty

The private foundation excise tax sanctions contain no exception, or excuse, for imposition of the penalty on the private foundation itself for failure to comply with the specific provisions of these Code sections. The regulations under these sections do contain relief for those foundation managers who do not condone, or participate in the decision to conduct, a prohibited action. Until 1984, the penalties were strictly applied. Congress, in 1984, added IRC §§4961, 4962, and 4963 to permit abatement of the penalties imposed by §§4942, 4943, 4944, and 4945 on both the foundation and its managers if it is established to the satisfaction of the secretary (by the IRS under responsibility delegated by the Treasury Department) that both of the following conditions exist:

- The taxable event was due to reasonable cause not to willful neglect.
- The event was corrected within the correction period for such event.

To claim abatement of the penalty, the foundation files Form 4720, including explanations of all of the facts as illustrated in Exhibit 15.2. To allow abatement, it is the actions of the responsible foundation officials that must be considered. Although IRC §4962 is entitled "Definitions," neither it nor the regulations define the terms "reasonable cause" or "willful neglect." There have been no court decisions concerning abatement of these penalties. Reliance, in good faith, on incorrect legal advice was deemed a reasonable cause.[75] In a ruling concerning a taxable expenditure penalty for failure to seek advance approval of a scholarship plan, there was no mention of abatement.[76] The congressional committee

[73] IRC §4944(d).
[74] Reg. §53.4944-5(b).
[75] Tech. Adv. Memo 200347023.
[76] Priv. Ltr. Rul. 9825004.

reports says, "A violation which is due to ignorance of the law is not to qualify for such abatement."[77]

The regulations pertaining to the penalties imposed upon self-dealers and upon managers approving of self dealing, jeopardizing investments, and taxable expenditures, however, do contain definitions that hopefully can be applied to justify abatement of the penalties. The definitions of *reasonable cause* and *willful neglect* are the same as those mentioned previously. The PF officials must show they used good business judgment exercised with ordinary business care and prudence. They must show they made a good faith effort to follow the rules by seeking the advice of qualified professionals. All of the facts and circumstances of the foundation's activities must be fully disclosed to such advisors.

For the foundation's penalty to be abated, its managers must also prove the failure was due to reasonable causes and not to willful neglect. These terms are not defined in the Code or regulations under §4962 or 4963. No clarifying rulings have been issued to date, nor is the term defined for this purpose in the *IRS CPE Texts*.[78] A bankruptcy judge found a trustee had not demonstrated conscious, intentional, or reckless indifference in failing to file a return or obtain an extension so that reasonable cause for abating penalties existed.[79]

Under the general rules pertaining to tax penalties[80] the determination of whether a taxpayer's actions were due to reasonable cause in good faith is made on a case-by-case basis. According to this regulation, "Generally, the most important factor is the extent of the taxpayer's effort to access the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." These regulations say that reliance upon the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. However, such reliance constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Reliance on the opinion or advice of a professional is considered reasonable cause if

- The taxpayer did not know, or should not have known, that the advisor lacked knowledge in the relevant aspects of federal tax law.
- The advice was based upon all pertinent facts and circumstances of the transaction(s) and the tax law as it relates to the matter involved, including the taxpayer's purpose for entering into the transaction and for structuring a transaction in a particular manner.
- The advice is based upon reasonable factual or legal assumptions and does not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.

[77] P.L. 98-369, Deficit Reduction Act of 1984.

[78] The IRS Exempt Organizations Continuing Education Technical Training Program for 1985 at page 16 mentions the then new abatement provision but contains no definitions.

[79] *U.S. Bankruptcy Court of Central District of California re Molnick's Inc.*, 95-1 USTC ¶95751.

[80] Reg. §6664-4(b).

The second-tier taxes may also be abated under circumstances described in IRC §4961.

(d) Double Jeopardy

The private foundation excise taxes are not applied exclusively. As a result, an investment can conceivably cause three taxes to occur simultaneously.[81] If the foundation buys a disqualified person's 40 percent share of an insolvent computer software development company, the following occurs: (1) self-dealing[82] (because the purchase takes place between the PF and a DP), (2) excess business holdings (because the combined ownership exceeds 20 percent), and (3) a jeopardizing investment (assuming the foundation is not focused on scientific or scholarly development of software and the company is not a functionally related business). The unrelated business income tax might also apply to the income from such a business investment.

[81] Reg. §53.4944-1(a)(2)(iv).
[82] See Section 14.2.

CHAPTER SEVENTEEN

Taxable Expenditures: IRC §4945

In response to abuses uncovered by the Filer Commission and reported to the Congress,[1] a sanction was added to the Internal Revenue Code (IRC) to limit the manner in which a private foundation (PF) can spend its money to accomplish its exempt purpose. Whereas other types of exempt organizations can engage in

[1] Summarized in Rep. Wright Patman's reports to the House Select Committee on Small Business during 1963–1968, entitled "Tax Exempt Foundations and Charitable Trusts: Their Impact on Our Economy."

some amount of nonexempt activity without losing their exempt status, private foundations have no such leeway and are subject to a tax on any violations if any money is spent for noncharitable purposes.

A private foundation (a "foundation" or "PF") must first meet the organizational and operational tests of IRC §501(c)(3)[2] requiring that it operate exclusively—meaning its major focus, but not necessarily 100 percent, must be for charitable purposes. IRC §4945, however, adds the absolute. Thus, a foundation operates under a higher standard than a public charity: It can conduct absolutely no nonexempt activity. Potential foundation creators and managers need not be discouraged by this fact, however. The rules are actually broader than they sound and many realize. Once the rules are understood and procedures are in place to review compliance, a PF has a fairly high degree of latitude in developing its grant and program activity. Efforts directed at improving matters of broad social and economic impact, such as health care or the environment, have needlessly been forgone by some foundations. Educational and scientific efforts involving such subjects are not necessarily legislative efforts, even if the problems are of a type that government would be ultimately expected to deal with.[3]

Essentially, IRC §4945 prohibits transactions called taxable expenditures. The private foundation and its disqualified persons (DPs) will incur an excise tax, and possibly lose its tax-exempt status,[4] if any amounts are paid or incurred for the following purposes[5]:

- To carry on propaganda or otherwise attempt to influence legislation
- To influence the outcome of any specific election, or to carry on any voter registration drive, except efforts involving at least five states
- As a grant to an individual for travel, study, or other similar purpose, except according to a preapproved plan
- As a grant to an organization unless one of the following is true:
  - It is a publicly supported §501(c)(3) organization as defined in IRC §509(a)(1), (2), or (3).
  - It is an exempt operating foundation,[6] a special type of PF controlled by a public board.[7]
  - The PF making the grant exercises expenditure responsibility.
- For any purpose not specified in IRC §170(c)(2)(B), that is, religious, charitable, scientific, literary, educational, to foster national or international amateur sports competition, or to prevent cruelty to children or animals[8]

[2] Described in Chapter 2.
[3] Reg. §53.4945-2(d)(4).
[4] Since 1969, there have been few published instances of revocation and the sanctions were designed to impose sanctions, rather than revocation. A notable exception, involving excessive compensation in the Kermit Fischer case, is discussed in Section 14.4(a).
[5] IRC §4945(d).
[6] IRC §4940(d)(2).
[7] See Section 13.7.
[8] The many examples of qualifying charitable activities are discussed in Chapters 3–5.

17.1 LOBBYING

A private foundation is strictly prohibited from carrying out propaganda or otherwise attempting to influence legislation, defined to include any attempt to influence any legislation through

- An attempt to affect the opinion of the general public or any segment thereof (called grassroots lobbying)
- An attempt to influence legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of the legislation (called direct lobbying), except technical advice or assistance provided to a governmental body or to a committee or other subdivision thereof in response to a written request by such body or subdivision, other than through making available the results of nonpartisan analysis, study, or research[9]

The definition of impermissible lobbying for a private foundation is cross-referenced to the regulations applicable to those public charities that elect to lobby.[10] Those rules provide a clear framework to distinguish a foundation's educational activity involving public issues that may eventually be or are now the subject of legislation from those activities that are actually impermissible lobbying. There was uncertainty for the many years between passage of the Tax Code on which the following rules are based (1976) and issuance of the final regulations in 1990 after several versions were proposed and reproposed.[11] Under those rules, a lobbying communication is one that refers to *specific legislation*, defined as follows:

- Legislation that has been introduced in a legislative body or a specific legislative proposal that the organization supports or opposes
- In the case of a referendum, ballot initiative, constitutional amendment, or other measure that is placed on the ballot by petitions signed by a required number or percentage of voters. The subject issue becomes specific legislation when the petition is first circulated among voters for signature.[12]

A *grassroots lobbying communication* is an attempt to influence any legislation through an attempt to affect the opinion of the general public or any segment of it.[13] Such a communication must encompass all three of the following elements to constitute impermissible lobbying:

1. Refer to specific legislative proposal(s)
2. Reflect a view on such legislation
3. Encourage its recipient to take action with respect to the legislation

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[9] IRC §4945(e).
[10] Reg. §53.4945-2(a)(1).
[11] Regulations for §4911 are further discussed in Chapter 23.
[12] Reg. §56.4911-2(d)(1)(ii).
[13] Reg. §56.4911-2(b)(2)(i).

To constitute encouragement of the recipient to take action, also referred to as *a call to action*, the communication must specifically do the following:

- State that the recipient should contact a legislator, staff member, or other governmental official,
- Give the address, telephone number, or similar information (e-mail or Web site) about the individual(s) to be contacted, *and*
- Provide some material to facilitate the contact (such as a petition or post-card), or
- Identify one or more legislators who will vote on the legislation as opposing the communication's view of the legislation, being undecided with respect to it, being the recipient's representative in the legislature, or being a member of the committee or subcommittee that will consider the legislation.

(a) Germane Lobbying

A foundation can spend its money to make an appearance before, or communicate to, any legislative body with respect to a possible decision of such body that might affect the existence of the PF, its powers and duties, its tax-exempt status, or the deduction of contributions to it. This type of activity is referred to as *self-defense lobbying.*

The existence of the organization is not threatened for this purpose by a possible loss of economic support that might bear on the scope of a foundation's programs.[14] Lobbying in favor of an appropriations bill funding a program under which the PF has received support in the past is not self-defense. Similarly, a PF that provides care for the elderly is lobbying when its executive director appears before the state legislature to favor or oppose a bill authorizing the state to provide nursing care for the aged. Likewise, a PF receiving governmental grants to support its research programs is lobbying when it testifies about the advisability of continuing the program (unless it was asked to testify). It is the economic condition and the resulting scope of the PF's operation, not its underlying existence, at issue in these examples.

Examples of legislation that could affect the foundation's existence or its powers, and is thereby permissible, might include the following:

- A state's reformation of its charitable corporation statutes to include provisions not now in a foundation's charter, such as a rule limiting the life of a foundation to some term certain
- Provision that would restrict the power of a foundation to engage in transactions with certain related parties
- Change in the excess business holdings provisions that would cause the foundation to have a self-dealing transaction
- Proposal to require inclusion of outside directors on a foundation's governing body

[14] Reg. §53.4945-2(d)(3)(ii), Examples 3 and 4.

- Limitation on administrative expenses included as qualifying distributions that effectively increase the mandatory payout and result in diminution use of foundation principal[15]

(b) Nonpartisan Study of Social Issues

Sponsoring discussions or conferences, conducting research, and publishing educational materials about matters of broad social and economic subjects, such as human rights or war and peace, are appropriate and permissible activities for a private foundation. These topics are often the subject matter of legislation, involve public controversy, and raise the possibility of the foundation being treated as conducting prohibited legislative activity. However, a foundation is safe in sponsoring such discussions and studying such issues as long as the activity (1) constitutes engaging in nonpartisan analysis, study, or research and (2) the results of the work are made available to the general public, a segment of the public, or to governmental bodies, officials, or employees.[16]

The phrase *nonpartisan analysis, study, or research* means an independent and objective exposition or study of a particular subject matter. To be nonpartisan, or impartial, the activity must be considered educational.[17] The report can advance a particular position or viewpoint if there is a sufficiently full and fair exposition of the pertinent facts to enable an individual or the public to form an independent opinion or conclusion. A communiqué could say that oil tankers should have double hulls to lessen the possibility of oil spills so long as the information forming the basis for the viewpoint is unbiased. Mere opinion, unsupported by pertinent facts, is not nonpartisan. The regulations contain 12 examples that can be studied.[18]

The *making available test* is satisfied when the results of the nonpartisan research or study are distributed in articles and reports, conferences, meetings, discussion, press releases, and other public forums.[19] The communications cannot be directed solely toward those who are interested in one side of the particular issue. Additionally, subsequent use of the research in grassroots lobbying by a grantee or other organization permitted to lobby may result in a taxable expenditure for the foundation that finances the study. The somewhat complicated rules distinguishing research materials from advocacy communications look to the primary purpose for which the study was conducted to determine whether the research was intended to influence legislation.[20]

A broadcast or publication series must meet the same standards as printed matter. One of the presentations can contain biased information if another part

[15] During 2003, the Council on Foundations and many individual private foundations opposed legislation containing such a proposal.

[16] IRC §4945(e); Reg. §53.4945-2(d)(1)(i).

[17] See discussion in Section 5.1.

[18] Reg. §53.4945-2(d)(1)(vii); see also Section 5.1 for definition of educational.

[19] In Priv. Ltr. Rul. 8548084, conferences to discuss public policy as it affects economic growth were sanctioned.

[20] Reg. §56.4911-2(b)(2)(v).

EXHIBIT 17.1

Request for IRS Approval of Individual Grant Program

Internal Revenue Service Center
Exempt Organization Group
P.O. Box 192
Covington, KY 91012-0192

RE: Sample Foundation
EIN #44-4444444
Request for Approval of Scholarships

Dear IRS:

From 1982 to 2002, the Sample Foundation operated a medical research facility and was classified as a public charity pursuant to Internal Revenue Code (IRC) §509(a)(1). During that time a scholarship fund was established in the memory of Dr. XYZ, one of the founders of Sample. For the past 20 years, scholarship grants have been paid annually. As of MMMM, 20XX, Sample discontinued the research facility and was reclassified as a private foundation. Your approval for the scholarship program is hereby sought.

The XYZ Scholarship will further Sample's educational purposes by enabling deserving men and women to complete a medical-related education in the graduate schools of their choice, so that they will be able to serve honorably and effectively in their chosen medical field.

The scholarship will be a "grant" within the meaning of IRC §4945(d)(3) and will satisfy the requirements of IRC §4945(g) in all respects.

The grant will be awarded on an objective and nondiscriminatory basis. The grant will be excluded from gross income under IRC §117(a), to the extent that it is used for tuition, books, and equipment required for educational courses. The purpose of the grant is to promote medical-related education for graduate degree candidates, and the recipient of the grant will be selected from the population of medical school graduate students.

As provided by Internal Revenue Service Publication 578, Chapter VI, the grant-making procedures will be as follows:

Grantee class. Any graduate college student seeking a degree in medical-related education may be considered for the scholarship.

Selection criteria. The selection criteria for the scholarship will include, but not be limited to, the student's demonstrated academic ability and desire, character, good citizenship, and economic necessity. A recipient cannot be related to a member of the committee or to any "disqualified persons" in relation to Sample.

Selection committee. The selection committee will be composed of members of the board of directors of Sample. Members of the selection committee will not be in a position to receive private benefit, directly or indirectly, if certain potential grantees are selected over others.

Progress reports. The scholarships will be about $5,000 per semester and can be renewed annually for a maximum of three years, provided that the student is not on academic or disciplinary probation and is making satisfactory progress toward completion of a medical-related degree. A student need not have an "A" average, but should be of a caliber to indicate an ability to profit from and be intellectually equal to work on a graduate level. Progress reports will be obtained and verified with the educational institution each semester. Upon completion of the grantee's study, a final report will be collected from the grantee.

Report follow-up. If no report is filed by the student, or if reports indicate that the funds are not being used in furtherance of the scholarship purpose, a member of the board of directors will investigate the grant. While conducting this investigation, Sample will withhold further payments from the grantee and will take reasonable steps to recover grant funds until it has determined that the funds are being used for their intended exempt purpose.

Record keeping. The foundation will retain all records submitted by the grantees and their educational institutions. Sample will obtain and maintain in its file evidence that no recipient is related to the foundation or to any members of the selection committee.

EXHIBIT 17.1 *(CONTINUED)*

Request for IRS Approval of Individual Grant Program

Sample trusts that the above criteria and purpose for its educational scholarship satisfy the requirements of IRC §4945 and respectfully requests your approval of its procedures.

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the request are true, correct, and complete.

Date	Sample Officer

of the series (broadcast within six months of the initial viewing) contains contrary information or the other side of the argument. If the PF selects the time for presentation of information to coincide with a specific legislative proposal, the expenses of preparing and distributing that part of the study may be treated as lobbying and result in a taxable expenditure.[21]

The foundation's communications, either directly with members of the general public or with the legislators themselves, may not

- Mention or refer to the merits of or take a position on specific legislation
- Recommend that the reader or listener take any steps to contact legislators, employees of legislators, or government officials or employees involved in legislation, or contain a *call to action*[22]

(c) Grants to Public Charities That Lobby

As a general rule, a PF can make a grant to a public charity that conducts legislative lobbying, regardless of whether the grant recipient has made the §501(h) election. It is very important to note, however, that the foundation's money cannot be earmarked for lobbying or electioneering. There must be no agreement, oral or written, that the granting PF can direct the manner in which the funds are expended.[23] Also, the PF's grant cannot be more than the amount needed to fund the recipient organization's budget for nonlobbying projects. If, after a grant satisfying these rules is paid, the grant recipient loses its exempt status due to excessive lobbying, the money paid is not a taxable expenditure only if

- The grant was not earmarked for lobbying.
- The recipient had a valid determination of its public status and notice of the revocation was not published when the grant was made.
- The foundation does not control the public charity.[24]

[21] Reg. §53.4945-2(d)(1)(ii). "Private Foundation Grants to Public Charities Engaged in Advocacy on Environmental Issues," *The Exempt Organization Tax Review*, December 1999, vol. 26, no. 3, pp. 401–405.
[22] Supra note 3.
[23] Reg. §53.4945-2(a)(5) and (6).
[24] Reg. §53.4945-2(a)(7).

A foundation may want to protect itself from any question that its grant pays for lobbying by specifically requiring that its public charity grantees agree not to do so. For grantees significantly involved in public affairs, the prudent foundation should retain, and is entitled to rely on, financial information supplied by a prospective grantee that reflects the portion of the public charities budget spent on lobbying.[25] A foundation should also document its efforts to ensure its funds are not spent on lobbying with the Grant Approval Checklist found in Exhibit 17.2. As additional evidence that its funds will not be spent for lobbying, the foundation can request a signature on the grant agreement shown in Exhibit 17.4 or a grant payment transmittal letter shown in Exhibit 17.3. Such precautions are not, however, required.

The absolute prohibition against the foundation itself conducting lobbying or electioneering does not extend to conduct of its officials acting on their own behalf. Even though such persons are closely identified with the foundation, their personal actions are not constrained by these rules. The guidelines for determining when a minister represents him- or herself rather than the church should be studied by foundation officials active in public affairs.[26]

(d) Summary of Permissible Activity

To summarize this important constraint, a private foundation and its managers on its behalf can participate in efforts that involve matters of public policy. Such activities do not constitute legislative intervention in the following situations:

- Self-defense (or germane) lobbying
- Technical assistance or expert testimony given upon request
- Grants (not earmarked for lobbying) to public charities that lobby
- Nonpartisan analysis, study, or research
- Programs involving topics that are the subject of legislation
- Direct communication with government officials, including legislators, and also with the general public, without reference to and not in support of specific legislation
- Efforts to influence regulations or other administrative rules clarifying and interpreting existing laws
- Lobbying efforts of managers acting on their own behalf

17.2 VOTER REGISTRATION DRIVES

All charitable §501(c)(3) organizations, including foundations, are prohibited from participating or intervening in elections of public officials with the intent to influence the outcome. The phrase *participation or intervention* in a political campaign is defined and explained in Chapter 23. Certain educational efforts in connection with the electoral process may, however, be permitted. What a foundation is specifically forbidden to do is to attempt to influence the outcome of any specific pub-

[25] Reg. §53.4945-2(a)(6)(iii).
[26] IRS Publication 1828,Tax Guide for Churches and Religious Organizations.

lic election, or to carry on, directly or indirectly, any voter registration drive.[27] In the South during the early 1960s, certain foundations financed voter drives aimed specifically at registering blacks to vote, in connection with the foundations' effort to eliminate discrimination. Partly as a result, very specific rules govern a PF's participation in such efforts. A foundation is permitted to make a grant to another organization, including another PF, that itself conducts a voter registration drive if the recipient organization meets the following requirements:

- The organization is a charitable one exempt under IRC §501(c)(3).
- Activities of the organization are nonpartisan, are not confined to one specific election period, and are carried on in five or more states.
- At least 85 percent of the organization's income is spent directly on the active conduct of its charitable purposes.
- At least 85 percent of its support (other than gross investment income as defined in IRC §509(e)) comes from other tax-exempts, the general public, and governmental units, and not more than 25 percent comes from a single organization.
- Contributions for voter registration drives cannot be earmarked for particular states or political subdivisions.[28]

An advance ruling for approval of the foundation's procedures for conducting a voter registration drive can be requested.[29]

17.3 GRANTS TO INDIVIDUALS

A private foundation may make grants to individuals for travel, study, or other similar purposes, but may do so only under the terms of a written plan that has been preapproved by the Internal Revenue Service (IRS).[30] A taxable expenditure results if such individual grants are not paid pursuant to an approved plan. Individual grants also cannot be earmarked to be used for political, legislative, or other noncharitable activities.[31] Grants to individuals in need for shelter and food, no-strings-attached awards for achievement, and certain other types of grants to individuals may not require a preapproved plan.

A grant to an individual for travel or study, or grants for similar purposes, must also be one of the following:

- A grant constituting a scholarship or fellowship grant that would be subject to the provision of IRC §117(a) as it was in effect prior to the Tax Reform Act of 1986 to be used at an educational institution qualifying as a school[32]

[27] IRC §4945(d)(2).
[28] Reg. §53.4945-3(b)(1).
[29] Reg. §53.4945-3(b)(4).
[30] Reg. §53.4945-4(a)(5).
[31] IRC §4945(d)(3).
[32] IRC §170(b)(1)(A)(ii), as discussed in Section 5.1(a).

- A prize or award[33] paid to a recipient selected from the general public
- A grant to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee[34]

(a) Meaning of "Travel, Study or Other Purposes"

Only grants paid to individuals for the three aforementioned purposes are subject to the prior plan approval rules. The concepts are well illustrated in three scenarios.[35] In the first, the grant is not subject to IRS approval, but in the second and third, approval is required.

Scenario 1. A PF organized to promote the art of journalism makes awards to persons whose work represents the best examples of investigative reporting on matters concerning the government. Potential recipients are nominated; they do not apply for the award.[36] The awards are granted in recognition of past achievement and are not intended to finance any specific activities of the recipients nor to impose any conditions on the manner in which the award is expended by the recipient. Therefore, since the payments are not to finance study, travel, or a similar purpose, the awards project was not subject to prior approval.

Scenario 2. Assume instead that the annual award recipients are required to take a three-month summer tour to study government at educational institutions. These awards are subject to prior approval because the payment is required to be used for study and travel.

Scenario 3. The facts are the same as in Scenario 1, except that the award must be used to pursue study at an educational institution and qualifies as a scholarship. Again, prior approval is required. A similar conclusion was reached in a ruling concerning grants to science fair winners that required them to use the prizes for their education. The program was a scholarship plan requiring approval.[37]

Other Purposes. The meaning of grants for other similar purposes can be elusive as seen in the preceding scenarios. The regulations say that student loans and program-related investments do constitute such grants.[38] When the payment is given with the expectation or requirement that the recipient perform specific activities not directly of benefit to the foundation, an *other purpose* grant requiring preapproval occurs. Research grants and payments to allow recipients to compose music or to choreograph a ballet are examples of awards for other purposes when the recipient must perform to earn the award.[39]

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[33] Defined under IRC §74(b).
[34] IRC §4945(g).
[35] Rev. Rul. 77-380, 1977-2 C.B. 419.
[36] Thus the IRC §74 exclusion may apply.
[37] Rev. Rul. 76-461, 1976-2 C.B. 371.
[38] Reg. §53.4945-4(a)(2).
[39] Forms 1099 must be issued to report such awards as miscellaneous taxable income; see Section 25.1(c).

A payment to an indigent individual for the purchase of food or clothing is instead not paid for an "other purpose."[40] Grants and interest-free loans made to persons who incur extraordinary medical expenses or funeral or burial costs or who suffer financial hardship due to medical emergencies, natural disasters, or violent crimes are not grants for other purposes and do not require preapproval. Such grants are awards to relieve suffering, not to finance study, travel, or similar purpose as discussed later.

No-Strings-Attached Awards for Achievement. Preapproval is not required for a program to award grants to individuals in recognition of past achievement with no conditions imposed on the manner in which the awards may be expended by the recipients (no strings attached). A grant paid without intention to finance or specify the future activities of the individual, as illustrated in Scenario 1, is not an *other purpose* grant. Awards paid to winners of a craft school competition on an unconditional and unrestricted basis were deemed not to be grants for this purpose.[41] Grants in recognition of literary achievement not given to finance future activity, not imposing any future condition on the recipient, and not paid for travel, study, or other purpose were ruled not to be grants.[42]

The criteria for choosing recipients of such awards should be designed to achieve and relate to a charitable purpose. Although the *objective and nondiscriminatory* standard does not technically apply, it's suitable that the award criteria evidence an intention to benefit a reasonably open class of potential awardees. Publicity making the public aware of the awards evidence impartiality. Certainly the criteria should prohibit any favoritism toward persons related to the foundation creators and managers. The Nobel Peace Prize or the MacArthur Lifetime Achievement Awards are good examples of prizes that serve to acknowledge persons who work to advance science, education, culture, health, and other charitable pursuits that benefit all. The awards honor past achievements and do not require that the monetary award be expended for a particular purpose. A foundation making such awards should maintain records to document the criteria for its choices, the charitable purposes awards may accomplish, and evidence of lack of relationship between the recipient and the foundation's disqualified persons.

A Model Plan. There are plenty of private letter rulings seeking approval for scholarship plans that contain selection criteria based on scholastic performance and leadership potential. Fewer in number are rulings that seek approval for fellowships and other similar purposes. The following criteria were approved by the IRS for a foundation granting prizes and awards to achieve a specific result, produce a report, or improve or enhance literary, artistic, musical, scientific, or other skill or capacity:[43]

[40] Reg. §53.4945-4(a)(3)(i).
[41] Rev. Rul. 76-460, 1976-2 C.B. 371.
[42] Rev. Rul. 75-393, 1975-2 C.B. 451 and Priv. Ltr. Rul. 9151040.
[43] Priv. Ltr. Rul. 200009053.

- Potential benefit to the proposed activities to the community and specific population to be served
- Capacity of the organization or individual to achieve the result
- Adequacy of proposed financial and time budgets for achieving the desired result
- Evidence of cooperation and coordination with other organizations and individuals working in the same field
- Likelihood of ongoing support from other sources for the program
- Other factors indicating the program will accomplish the foundation's charitable purposes

Importantly, the ruling also confirmed the distinctions between grants for future performance and those for past accomplishments. Prizes and awards the foundation proposed to present for past achievement were not subject to preapproval.

(b) Compensatory Payments

Payments for personal services, such as salaries, consultant fees, and reimbursement of travel and other expenses incurred on behalf of the foundation, for work performed on the foundation's own project(s), are not grants requiring a preapproved plan. A foundation can freely hire persons to assist it in planning, evaluating, and developing projects and program activity by consulting, advising, and participating in conferences organized by the foundation.[44] Persons hired to develop model curricula and educational materials, for example, are not grant recipients.[45]

In 1986, Congress gutted the tax-free treatment of scholarships, fellowships, and prizes. As a result, all payments other than those paid for tuition, books, and fees are taxable to grant recipients. Certain scholarships and, particularly, teaching fellowships are taxable for another reason:— the fact that the recipient is expected to render services in return for receiving the grant. Where there is an exchange of services for pay, the grant is made primarily for the benefit of the granting foundation, and the approval rules do not apply. Scholarships paid by one foundation formed to aid worthy college students planning to teach in state public schools were found to have strings attached—services to be rendered for the state. As a condition of the grant, recipients had to indicate they were willing to teach for two years in state public schools after receiving their degrees. Even though the obligation carried no financial guarantee and was only a moral obligation of the student, the IRS found that such scholarships were not described in IRC §177(a) and, therefore, that prior approval was not required.[46] Essentially, the grants were paid in exchange for future services.

(c) Food, Shelter, and Aid for the Poor and Distressed

Programs to make grants-in-aid to individuals who lack the resources to satisfy their basic human needs do not require advance IRS approval. Few foundations

[44] Reg. §53.4945-4(a)(2).
[45] Rev. Rul. 74-125, 1974-1 C.B. 327.
[46] Rev. Rul. 77-44, 1977-1, C.B. 118.

have made such hardship grants in the past, however, due to a lack of guidance. The regulations contain only one example of persons deserving of such support: buying furniture for a poor family. No income or asset standards for measuring *poor* to determine financial need are provided. A foundation must decide at what level of financial resource a family ceases to be poor. There has been no guidance regarding information that should be obtained and maintained to document the worthiness of recipients.

In response to the outpouring of financial support in aid to the victims of the September 11 World Trade Center disaster, the IRS issued Publication 3833, *entitled Disaster Relief: Providing Assistance Through Charitable Organizations*, applicable to both private and public charities. As described later, this useful guidance makes a distinction between victims of a disaster in immediate need and those needing longer-term aid. The publication states that "providing aid to relieve human suffering that may be caused by a natural or civil disaster to relieve an emergency hardship is charity in its most basic form." The use of existing organizations, such as churches, was encouraged by saying they "are frequently able to administer relief programs more efficiently and can offer assistance over a long period of time." Seemingly in response to skeptics questioning what would happen to the generous support for September 11 relief efforts, the publication reminds readers that the assets of a charitable organization must only be spent on and are permanently dedicated to accomplishing its mission.

A *needy and distressed* test must be in place for disaster relief and emergency hardship organizations. A set of objective criteria by which distributions to financially or otherwise distressed individuals is described. Adequate records to support the basis upon which assistance is provided must also be maintained. The publication distinguishes between short-term and long-term assistance and says the type of information needed to support assistance may vary depending on the circumstances:

> Persons do not have to be totally destitute to be needy; they may merely lack the resources to obtain basic necessities. Under established rules, charitable funds cannot be distributed to individuals merely because they are victims of a disaster. Therefore, an organization's decision about how its funds will be distributed must be based on an objective evaluation of the victim's needs at the time the grant is made. The scope of the assessment required to support the need for assistance may vary depending upon the circumstances.

The publication makes it clear that a private foundation can help victims in a variety of ways, including aid to individuals and businesses. Aid may be provided in the form of funds, services, or goods to ensure that persons have basic necessities such as food, clothing, and shelter. The type of aid that is appropriate depends on the individual's needs and resources. A program to distribute short-term emergency assistance requires far less documentation, in the way of victims establishing that they need relief assistance, than the distribution of long-term aid. In the face of an immediate disaster, "providing a drug rescue and telephone crisis center or recovery to a person lost at sea or trapped by a snow storm—would not require a showing of financial need, since the individual requiring these services is distressed irrespective of the individual's financial condition." However, "they may not require long-term assistance if they have adequate financial resources." The IRS bottom line for this test is that "persons who are needy and/or distressed are appropriate recipients of charity."[47]

Adequate standards for providing long-term aid to the needy still do not exist. At what income level a person or family is deserving and the type of hardships a foundation should address are not specified. A foundation can make such grants-in-aid but has a burden of proving that the recipients are chosen to accomplish a charitable purpose in a nondiscriminatory fashion. The criteria for awarding such grants for food, shelter, and medical care should be designed to award funds only to those who are indeed qualified for charitable assistance or persons also referred to as members of a charitable class. To document the charitable nature of the program, a written policy, including an application form, should be used to describe the basis for the decision to grant aid. Facts such as income levels, cause of the hardship, recommendations of a government agency, or referrals from a church are among the factors that might be used to make the choice. See Appendix 17 - 1 for application examples.

The need to establish criteria to evidence the charitable nature of such programs was also indicated in the IRS refusal to approve a program to grant funds to ministers to pay outstanding educational loan balances related to studying for their ministry.[48] It is important to note that the proposed grant was not one requiring prior IRS approval because the ministers were not required to perform any specific acts. The factors the IRS found lacking included these:

- The foundation did not request that the ministers establish that the funds would be used for charitable purposes. (With the right words in their grant documents, it could have been asserted that the program served religious purposes.)
- Grantee ministers were not required to provide any follow-up reports or accounting of the fashion in which they used the grant. (In connection with awards made in honor of achievement, no follow-up reporting is required.)
- Grantees were not required to evidence financial need to qualify for the grant. (Since the grants were not awarded on the basis of achievement, this factor should have been present.)

(d) Designing an Individual Grant Program

Once a foundation chooses to make grants subject to the approval process, it must adopt a suitable plan. The primary criterion for approval of a plan for making individual grants is that the grants must be awarded on an *objective and nondiscriminatory basis.* The plan must contain the following provisions[49]:

- An *objective and nondiscriminatory* method of choice, consistent with the PF's exempt status and the purpose of the grant, is used.

[47] Disaster relief plans of a company foundation, in the IRS view, give impermissible private benefit to the company, as discussed in Section 17.3(e).
[48] Priv. Ltr. Rul. 9927047.
[49] IRC §4945(g); Reg. §§53.4945-4(b) and (c).

- The group from which grantees are selected is sufficiently broad so as to constitute a charitable class.[50] The size of the group may be small if the purpose of the grant so warrants, such as research fellows in a specialized field.
- Criteria used in selecting the recipients include (but are not limited to) academic performance, results of tests designed to measure ability and aptitude motivation, recommendations from instructors, financial need, and conclusions a selection committee might draw from a personal interview as to an individual's potential ability and personal character.
- Selection committee members are not in a position to derive a private benefit, directly or indirectly, if one person or another is chosen. A selection committee made up of persons unrelated to foundation officials could be used to evidence this requirement.[51]
- Grants are awarded for study at an academic institution, or as fellowships, prizes, or awards for study or research involving a literary, artistic, musical, scientific, or teaching purpose.
- Procedures to obtain reports are provided for scholarships, fellowships, and research or study grants.

Class of Potential Grantees. The second item in the preceding list requires the group from which the grantees are chosen to be sufficiently broad. A group including all students in a city or all valedictorians in a state clearly qualifies. The regulations sanction a plan to grant 20 annual scholarships to members of a certain ethnic minority living within a state.[52] However, a group of girls and boys with at least one-quarter Finnish blood living in two particular towns was found to be a discriminatory group and not sufficiently broad.[53] Likewise, a plan that gave priority to family members and relatives of a disqualified person was found to be discriminatory.[54] Although self-dealing does not technically occur if a grant is made to a niece or nephew of the creator,[55] awards to such relatives could be considered to give private inurement to the creator. A program to award scholarships at two named colleges to members of a particular 600-person family group (surname specified) was not a broad enough group.[56]

Scholarships and Fellowships. A report of the grantee's courses taken and grades earned in each academic period must be collected at least once annually and verified by the educational institution. If scholarship funds are paid directly

[50] Defined in Section 2.2(a).
[51] Conceivably, relatives meeting criteria used for all recipients could be chosen by an independent selection committee. See Priv. Ltr. Rul. 200332018 involving a §509(a)(3) organization's scholarship plan and impact of recusal of related parties.
[52] Reg. §53.4945-4(b)(5), Example 2.
[53] Priv. Ltr. Rul. 7851096.
[54] Even though they met the criteria for awards in Rul. 85-175, 1985-2 C.B. 276.
[55] See Section 12.2(c) and §4941(d)(1)(E).
[56] Priv. Ltr. Rul. 9631004; see also discussion of charitable class in Section 2.2(a).

to the school and the school agrees to monitor the student's ongoing qualification, such reports are not necessary.[57] For grantees whose work does not involve classes but only the preparation of research papers or projects, such as a doctoral thesis, the foundation should receive an annual report approved by the faculty members supervising the grantee or other school official. Upon completion of a grantee's study, a final report must also be obtained.

Investigation of Diversions. Procedures must be established to investigate when no reports are filed or when reports indicate that funds are being diverted. The foundation will not be treated as making a taxable expenditure if the recipient has not previously misused funds and if the PF takes the steps outlined later in this chapter during its investigation. Additional grant funds must be held until delinquent reports are received, and reasonable steps to recover the funds should be taken.[58]

Research or Study Grants. At least annually, a report of progress and use of funds is due. A final report describing the grantee's accomplishments and funds expended with respect to the grant must also be made.

- During the investigation, the PF must withhold additional payments until it receives the grantee's assurances that future diversions will not occur, and must require the grantee to take extraordinary precautions to prevent future diversions from occurring.
- The PF must take reasonable steps to recover the funds.
- If a grantee was reprieved after an initial investigation and the PF reinstituted the grant only to have the funds diverted for a second time, a taxable expenditure will not occur if the same steps are repeated and the diverted funds are recovered.[59]

Record Keeping. A foundation making individual grants must maintain and keep available for IRS examination documentation that the recipients are chosen in a nondiscriminatory manner and that proper follow-up is accomplished. The regulations do not specify a required time period.

The following records must be kept:

- Information used to evaluate the qualification of potential grantees
- Reports of any grantee/director relationships
- Specification of amount and purpose of each grant
- Grade reports or other progress reports approved by a faculty member, which must be received annually

Income Tax Reporting. A foundation's grant to an individual does not necessarily represent taxable income to the grant recipient. In a circumstance in which

[57] Reg. §53.4945-4(c)(5).
[58] Reg. §53.4945-4(c)(4).
[59] Reg. §53.4945-4(c)(5)(ii).

the recipient is required to perform services for the foundation, Form 1099 may need to be filed to report the grant payment.[60]

(e) Company Scholarship Plans

The regulations and countless rulings have approved scholarship plans established by a company's foundation for children of the company's employees.[61] The issue with such plans is whether they discriminate in favor of the corporate executives or shareholders and thus represent a means of paying additional compensation. Specific guidelines exist and should be carefully studied prior to application for approval of such a plan.[62] Similar rules apply to a company foundation's educational loan program.[63] The primary criteria are as follows:

- The scholarship plan must not be used by the employer, the PF, or the organizer thereof, to recruit employees or to induce continued employment.
- The selection committee must be wholly made up of totally independent persons, not including former employees, preferably including persons knowledgeable about education.
- Identifiable minimum requirements for grant eligibility must be established and eligibility should not depend on employment-related performance, although up to three years of service for the parent can be required.
- Employees, or children of employees, must meet the minimum standards for admission to an educational institution[64] for which the grants are available and are reasonably expected to attend such an institution.
- Selection criteria must be based on substantial objective standards such as prior academic performance, tests, recommendations, financial need, and personal interviews.
- A grant may not be terminated because the recipient or parent terminates employment. If the grant award is subject to annual review to continue support for a subsequent year, the recipient cannot be ineligible for renewal because the individual or his or her parent is no longer employed.
- The courses of study for which grants are available must not be limited to those of particular benefit to the employer.
- The terms of the grant and course of study must allow recipients to obtain an education in their individual capacities solely for their personal benefit

[60] See Section 25.1(c).
[61] Reg. §53.4945-4(b)(5), example 1; Priv. Ltr. Rul. 9115061.
[62] Rev. Rul. 76-47, 1976-2 C.B. 670, clarified by Rev. Proc. 81-65, 1981-2 C.B. 690, and amplified by Rev. Proc. 77-32, 1977-2 C.B. 541; see also Rev. Proc. 85-51, 1985-2 C.B. 717.
[63] Rev. Proc. 80-39, 1980-2 C.B. 772.
[64] As defined in IRC §151(e)(4).

and must not include any commitments, understandings, or obligations of future employment.

- In its original ruling on company plans, the IRS said no more than 10 percent of the eligible persons and no more than 25 percent of the eligible persons who submitted applications and were considered by the selection committee can be awarded grants.[65]

Essentially, the facts and circumstances should not suggest that the awards represent an additional source of compensation to a significant number of employees and their children who routinely receive the scholarships. Additionally, the plan must be made known, or publicized, to all eligible employees.

Due to the self-dealing rules, no grants can be paid to children of disqualified persons. The plan must avoid a disproportionate amount of grants to executives' children. Application for approval is the same as for other scholarship plans, although satisfaction of the eight tests just listed must be outlined.

No guidelines similar to those imposed on company scholarship plans have been promulgated by the IRS for employee disaster relief and hardship programs. Although it had originally approved of the plan, the IRS reversed itself in privately ruling that a company foundation disaster and emergency relief program was not a charitable activity.[66] Because the plan promoted stable and loyal employees, the foundation payments provided impermissible private inurement to its sponsoring company in the eyes of the IRS. Additionally, the payments were taxable expenditures and could not be classified as qualifying distributions because they were not payments made for a charitable purpose. Finally, the payments constituted acts of self-dealing. Given those circumstances, the foundation had not been operating as a charitable organization and, though the ruling was silent on the matter, could have been revoked. The sanctions for the taxable expenditures, failure to make adequate distributions, and self-dealing were not imposed because the foundation had relied on the prior IRS ruling.

In the first published ruling on this subject in some years, the IRS permitted a company foundation plan to be amended to include educational grants to employees and children of employees who are victims of a qualified disaster.[67]

(f) Seeking Approval

An application for approval of a scholarship plan is a ruling request and is submitted to the IRS Service Center in Cincinnati, Ohio.[68] The approval process is intended to review the foundation's standards, procedures, and follow-up designed to meet the code's requirements for the PF's individual grant programs.[69] The PF submits its proposed procedures for awarding grants (Exhibit 17.1), including the methods of meeting the selection process requirements.

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65 Rev. Proc. 94-78, 1994-52 I.R.B. 38.

66 Priv. Ltr. Rul. 199914040 revoking Priv. Ltr. Rul. 9516047.

67 Rev. Rul. 2003-32, 2003-14 C.B. 689.

68 The procedures for issuing rulings for exempt organizations are updated by the IRS in a revenue procedure issued each spring. The ruling, effective as of publication date, was Rev. Proc. 2004-8, IRB 1,240.

69 Reg. §53.4945-4(d)(1); standards are outlined in Section 17.3(d).

If within 45 days after submission of the plan, no notification is received that the procedures are unacceptable, the PF can consider the plan approved; silence signifies approval. Written IRS approval is customarily sent to successful applicants, but usually well beyond 45 days. A company foundation was painfully reminded of the importance of requesting approval for a company's scholarship program and also of the need to comply with the participation requirements of Rev. Rul. 76-47. Scholarship payments made prior to the date on which it sought IRS approval were taxable expenditures not only because of the lack of approval but also because the company had insufficient data to prove the plan was objective and nondiscriminatory.[70] On the other hand, payments made after the 45 days have passed and prior to receipt of written approval should not result in taxable expenditures. Even if the IRS denies approval or suggests modifications to the plan submitted, the foundation is protected by the assumed approval date.[71]

The user fee for making application for approval of an individual grant program in 2003 was said to be $2,100 ($600 for organizations with annual gross receipts less than $150,000).[72] In recent practice, this fee is not required. The IRS considers approval of scholarship programs merely a modification of the organization's exempt purposes that requires scrutiny to ensure the foundation continues to serve charitable purposes.[73] Newly created foundations can seek approval for their plans in connection with filing Form 1023 and need not make a separate application.

(g) Individual Grant Intermediaries

A foundation wishing to avoid the administrative burden and cost of applying for approval and disbursing scholarships directly can alternatively fund a grant program at an independent public charity. The foundation may be involved in the process. As long as the foundation has no control over the choice of recipients, it is not considered to have made the grants directly to the individuals.[74] There must be no agreement, oral or written, that the PF can dictate the selection of particular individuals. No earmarking is permitted, only suggestions.

The parameters of the grant, such as the study discipline—medicine or law, for example—or qualifications, such as grades or civic achievement, can be stipulated by the foundation, though the class of grantees should be relatively broad. Grants to fund scholarships for children of employees may be considered grants by the company foundation itself, not by the college administering the plan.[75] Actually suggesting the individual grantee is permitted, as long as there is an objective manifestation of the public charity's control over the selection process. Maintaining the right to veto a potential recipient is de facto control.[76]

[70] Priv. Ltr. Rul. 9825004.
[71] Rev. Rul. 81-46. 1981-1 C.B. 514.
[72] Rev. Proc. 93-23, 1993-1 C.B. 538.
[73] See discussion of when to report changes to the IRS in Section 18.3.
[74] Reg. §53.4945-4(a)(4).
[75] Rev. Rul. 81-217, 1981-2 C.B. 217.
[76] Priv. Ltr. Rul. 8542004.

Likewise, a research grant disbursed by a college was found to be a direct grant when the funding was contingent on supervision by the professor designated by the PF with reserved rights to patents, inventions, and publications arising from the research, and the PF retained authority to approve the professor's project and any of his scientific work.[77] The regulations contain useful examples for further study.[78]

17.4 GRANTS TO PUBLIC CHARITIES

Most private foundations make grants to public charities or those grant recipients specifically excluded from the taxable expenditure list in IRC §4945(d)(4)(A). This is true partly because so much charitable work is performed by those organizations, and private foundations have traditionally used their endowments to fund such institutions. The tax law favors private foundation grants to public charities by making their administration simple and by permitting support of a public charity that conducts lobbying and individual grant programs.

A foundation is, however, permitted to make a grant to any type of entity, exempt or nonexempt, if it properly documents its purposes in making the grant and ensures the transaction with expenditure responsibility agreements.[79] The purpose of these rules is to see that PF funds are used to benefit the public, not the private interests of their creators. Public charities commonly serve a broad constituency that monitors their responsiveness to public needs and use of their funds for charitable purposes.

The responsibility to ensure a private foundation's funds are expended for charitable purposes still applies when the foundation makes a grant to a public charity. Completion of the checklist in Exhibit 17.2 and use of one of the letters in Exhibits 17.3 and 17.4 should enable a private foundation to perform the proper oversight. The checklist suggests that the charitable nature of the grant be well described in the grant request or other information. Many foundations now publish their grant applications on a Web site to describe these requirements.

The checklist also documents the foundation's intention that the grant not be used for a prohibited purpose. The letters can also be used to ask that the grantee overtly verify its public status and agree to use the moneys only for the charitable purposes for which they were granted. A discussion of the consequences of a PF grant to a public charity that conducts lobbying activity can be found in Section 17.1(c), and control issues involved in payment of scholarship grants to intermediary organizations are discussed in Section 17.4(b). The checklist and letters should become a part of the foundation's permanent file for each grant paid.

[77] Rev. Rul. 73-564, 1973-2 C.B. 28.

[78] Reg. §53.4945-4(a)(4)(iv).

[79] Discussed next in Section 17.6.

EXHIBIT 17.2

Grant Approval Checklist

This checklist should be complete by a private foundation to obtain documentation before it issues a check for a grant.

1. Obtain the grant proposal indicating the exempt purpose of the grant. If the PF is unilaterally giving a grant to an established for charity for an exempt project, a transmittal letter stating that it is for general support will suffice. A grant agreement and completion of this checklist is recommended.
2. Read the proposal to ensure that the grant will not be expended for
   - A political campaign or influencing voters
   - Influencing legislation at the national, state, or local level
   - Individual grants (unless the recipient's choice is totally under the control of the recipient organization)
   - A grant to another private foundation, unless there is an *expenditure responsibility* contract (Section 17.X)
   - A commercial venture (except for related projects and unless there is an expenditure responsibility agreement (Section 17.X)
3. Verify public charity status:
   - Obtain a determination letter stating that the recipient is exempt under IRC §501(c)(3) and is publicly supported under IRC §509(a)(1), (2), or (3), or that it is an exempt operating foundation.
   - Find the recipient's public status in IRS Publication 78, *Cumulative List of Organizations Described in IRC §170*, either the printed version or on www.irs.ustreas.gov, and check additions and deletions announced in the *Internal Revenue Bulletin* since its latest update.
   - Use the Charity Check System on www.Guidestar.org.
   - Obtain proof that the organization is a church or governmental unit.
4. Ascertain the possibility that this grant will cause the recipient to lose its public status (see Rev. Proc. 89-23 and Section 9.4(a)).
5. Request a grant agreement from the recipient if there is any question about its status or the exempt nature of its project.

(a) Definition of Public Charity

A public charity is a nonprofit organization that is qualified as an exempt organization under IRC §501(c)(3)[80] and is further classified as public by IRC §509(a)(1), (2), and (3).[81] The definition is a bit convoluted because it is expressed negatively in the Tax Code. A charitable organization is treated as a private foundation unless it is described in one of the following three categories:

[80] See Chapter 2.
[81] See Chapter 11.

1. §509(a)(1) public charities are those organizations described in IRC §170(b)(1)(A)(I)-(vi), including churches, schools, hospitals, medical research organizations, branches of the government, states, cities and municipalities, and *donative* charities that receive their support from the many donors, such as a United Way agency, a community foundation, or the American Red Cross.
2. §509(a)(2) public charities are most often *service-providing* nonprofits that derive their revenues from fees and charges for providing exempt purpose services, such as a performing arts organization, think tank, or day care center.
3. §509(a)(3) *supporting organizations* are those that exist to benefit one or more other public charity.

An exempt operating foundation,[82] an instrumentality of a U.S. political subdivision,[83] and an instrumentality of a foreign government[84] are treated as public charities for this purpose as long as the grant is made for charitable purposes.

EXHIBIT 17.3

Grant Payment Transmittal

This letter conveys the grant payment check for repeating grant recipients.

GRANTEE ORGANIZATION
ADDRESS

DEAR GRANT RECIPIENT:

We are happy to enclose our check for $_____ in payment of a grant for [name] project as described in your request dated [date].

As a private foundation, we must document that our grant is expended for a charitable or educational purpose. We must ask that you use our funds exclusively to carry out the project described in your request. You must not use any of our funds to influence legislation, to influence the outcome of any election, or to carry on any voter registration drive.

Please verify that your organization continues to be exempt under Internal Revenue Code §501(c)(3) and is still classified as a public charity pursuant to IRC §509(a)(1), (2), or (3). Kindly send us a copy of your most recent Internal Revenue Service tax determination letter, your financial statements, Form 990, and any annual report for the year in which our grant funds are expended.

Finally, we must ask that any funds not expended for the purposes for which the grant is being made be returned to us. Please indicate your agreement with these conditions by returning a signed copy of this letter.

Thank you.

____
for Sample Foundation

Acknowledged by: ________________

Date: ________________

[82] IRC §4940(d)(2); see Section 13.7.
[83] Rev. Rul. 81-125, 1981-1 C.B. 515; see Chapter 10.
[84] Reg. §53.4945-5(a)(4).

EXHIBIT 17.4

Grant Agreement

This letter requests tax status information before a grant is paid.

GRANTEE ORGANIZATION
ADDRESS

DEAR GRANT RECIPIENT:

As a private foundation, Sample Foundation must ascertain that your organization is exempt from income tax under Internal Revenue Code §501(c)(3) and is classified as a public charity under IRC §509(a)(1), (2), or (3).

According to information furnished to us with the proposal, your organization is so qualified. Please inform us only if there has been a change in your tax status since then.

In addition, we must be assured that our grant will be expended for an educational, scientific, literary, or other charitable purpose. We ask that you use our funds exclusively to carry out the project described in the application. Also, we ask you not to use any of our funds to influence legislation, to influence the outcome of any election, or to carry on any voter registration drive.

Finally, we ask that any funds not expended for the purposes for which the grant is being made be returned to us.

Please signify your agreement with these conditions by returning a signed copy of this letter to us.

Thank you.

____
for Sample Foundation

Acknowledged by: __________________

Date: __________________

(b) Proof of Public Status

A grant-making private foundation must establish a system for documenting the tax character of its grant recipients. Factors 3 through 5 in Exhibit 17.2 address the question of the foundation's verification of each grantee's tax status. The effort to document tax status begins for most foundations when they ask that a copy of the IRS determination letter accompany grant requests. The date on the letter is often many years in the past. The tax regulations say that a private foundation may rely on the IRS determination letter until notice of its revocation is published in the weekly *Internal Revenue Bulletin* or otherwise made public.[85] Therefore, a foundation cannot simply accept the determination letter as proof of current qualification as a public charity. The bulletins are available on the IRS Web site, but are not searchable by a particular organization's name. Instead, a foundation can best verify an organization's listing in Publication 78, the IRS master list of qualifying 501(c)(3)s that notes public or private classification of each entity.[86] Using the IRS Web site for this purpose requires the following two steps:

[85] Reg. §§1.170A-9(e)(4)(v)(b) and 1.509(a)-3(c)(1)(iii)(a).

[86] The printed version of Publication 78 can be ordered from the IRS Reading Room, 1111 Constitution Avenue, Washington, D.C., but will be up to three months out of date.

1. Step # 1. Go to http://www.irs.gov/chares. This list is updated every three months so step # 2 is required.
2. Step # 2 Back up and open the practitioner's page and find the Internal Revenue Bulletins for the past three months. Check each week to see if the organization's public status has been revoked.

Charities are coded in Publication 78 using the following designations:

1. A public charity with 50 percent deductibility
2. A fraternal organization eligible to receive deductible contributions
3. A private operating foundation with 50 percent deductibility limitation
4. A private foundation with 30 percent deductibility limitation
5. A charitable organization whose status as a public charity has not been determined
6. An organization described in §170(c)(1) other than a charity (governmental unit)
7. An organization receiving contributions for use of a governmental unit
8. A foreign-addressed organization

These categories evidence the fact that this listing is intended for use in evaluating organizations eligible to receive tax-deductible donations under §170. Its value to a private foundation is the fact that only organizations listed in category 1 or 6 qualify under the *unless* clause of §4945(d)(4). In other words, grants paid to organizations listed in categories 1 and 6 do not require expenditure responsibility.[87]

Searching Publication 78 on the IRS Web site is not always easy. Because the database contains over 300,000 names, searching for an organization with a commonly used word in its name, such as *institute* or *charitable,* can result in a large number of responses, particularly if it is located in a major city. For a successful search, it is therefore important to use the unique portion of an organization's name and sometimes to omit the location. Some organizations make a search impossible when they function under a different name than that listed on their IRS file. There seem to be somewhat random reasons why organizations are not listed. Often, modest organizations that do not file Form 990 are not included. Although not always the case, name and address corrections reported on Forms 990 are not necessarily entered into the master database. When an organization cannot be found in Publication 78, a toll-free call to 1-877-829-5500 can reach a human being in the Cincinnati determination group who may furnish current information about an organization's status.

Alternatively, one can search the Web site of Guidestar.org. This site registers updates from the IRS weekly and may, therefore, be more current than Publication 78. The site displays Forms 990 and 990-PF and, for a fee, a function now called Charity Check can be accessed to verify the public charity status of a grant applicant.

[87] See Section 17.6.

(c) No IRS Exempt Status or Letter

Churches and their integrated auxiliaries and governmental units do not commonly receive recognition of exemption as public charities, although some seek such a letter to aid in fund-raising. When a foundation wishes to support such entities, they must take the other steps to document the grantee's qualification. Many church groups have certification issued by a national or area association of the member parishes and congregations. For example, Catholic churches, schools, and affiliated auxiliaries are listed in a handsome maroon leather-bound national directory of affiliates. For a church with no such proof, the foundation can gather information directly from the church to determine if the church satisfies a majority of the factors in the 14-point test for qualification as a church by using the checklist A17.D in this chapter's appendix.[88]

Verification that a program is a division of the government would involve similar steps. A certificate from the local municipality, school district, county, or other authority would be obtained. A governmental unit is a body that possesses at least three capabilities: the power to assess and collect taxes, police powers to enforce the law, and sovereign powers of eminent domain.[89]

Lastly, members of an affiliated group of organizations centralized under the common supervision and control of a parent organization do not individually obtain a determination letter and are not listed in Publication 78. Therefore, to verify their public charity status, the foundation should request documentation that the entity is indeed a member of a group (most issue a certificate), look up the parent organization on Guidestar or Publication 78, and observe whether the front page of the grantee's Form 990 indicates it is a member of such group.

(d) The Reliance Issue

When the grantee organization is not controlled by the foundation—that is, the PF cannot cause it to act or prevent its acts—the PF need not investigate the effect of its grant on the recipient.[90] When the foundation has a relationship with the grantee organization, and certainly if the PF controls it, the foundation has a responsibility to determine whether its grant will cause the recipient organization to lose its public status. Although IRS procedures clearly state that the granting foundation can rely on a grantee's public charity status until announcement of a change is published in the Internal Revenue Bulletin, many foundations conduct further investigations and withhold grant funding if there is any doubt about an organization's ongoing public status. A particularly difficult time occurs between the date a new organization's advance ruling expires and its receipt of a final determination. Technically, its public charity status is still in effect if it submits Form 8734 within 90 days of the end of the advance period, until the IRS acts on the report. However, the report to evidence final qualification as a public charity cannot be prepared until after the period expires because the calculation includes revenues received through that date. It normally takes several months for the final determination to be issued. To minimize this prob-

[88] See Section 3.2(b).
[89] See Chapter 10.
[90] Rev. Proc. 89-23, 1989-1 C.B. 844.

lem, the report should be filed as quickly as possible; in a dire situation, the IRS can be asked to hasten its consideration with expeditious handling.[91] As suggested, the Cincinnati office devoted to exempt organizations can be contacted for the most recent information.

This situation, in which a private foundation grant causes loss of public status, is referred to as *tipping*. When a public entity undergoes a "substantial and material change," the PF has three choices if it chooses to make a grant:

1. The PF can satisfy itself that it was not responsible for the change by reviewing financial information from the grantee's officers. The grantor is not responsible if its gift in a year is less than 25 percent of the recipient's total gifts for the immediately preceding four years.
2. The PF can ascertain that the grant is an unusual one that will not cause the grantee to lose public status.
3. The PF can exercise expenditure responsibility.[92]

(e) Earmarked Grants

Public charities are free to make grants to individuals, to support a newly created but yet-unrecognized organization, to finance lobbying efforts, and to conduct a host of other projects that might not be permissible for a private foundation. Accordingly, there is a temptation for a PF to funnel or pass money through a public charity for such a project that the PF itself cannot undertake or for which it does not wish to exercise expenditure responsibility. An earmarked grant to a public charity to do something the PF itself is not permitted to do can result in a taxable expenditure.

A foundation grant to an intermediary organization—also called a fiscal agent—may be treated as a grant by the PF to the ultimate grantee if the foundation has control over the regrant.[93] The rules are similar to the rules applicable to designating scholarship recipients.[94] A look-through rule applies when the PF earmarks its grant in an oral or written manner. If the regrant is to another public charity, there is no problem (unless the grant is earmarked for lobbying or for a particular individual). If the regrant is to be made to another PF or for some other purpose described in IRC §4945, a taxable expenditure may occur. When a foundation grants funds to an organization or fiscal agent in this fashion, the grant should be carefully documented.[95]

17.5 GRANTS TO FOREIGN ORGANIZATIONS

A private foundation is entitled to support non-U.S. organizations, but when it does so, it faces enhanced documentation requirements. The IRS has determined

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[91] Call the IRS EO Group in Cincinnati at (877) 829-5500 for current instructions on this process.

[92] Priv. Ltr. Rul. 8542004; Rev. Proc. 81-6, 1981-1 C.B. 620; see Section 17.6.

[93] Reg. §53.4945-5(a)(5); see also "Grant Intermediaries" in Section 17.6.

[94] Discussed in Section 17.3(f).

[95] An excellent resource for this purpose is Gregory L. Colvin, *Fiscal Sponsorships: 6 Ways to Do It Right* (San Francisco: San Francisco Study Center, 1993).

that a U.S. charitable organization can serve beneficiaries in foreign countries without adversely affecting its exempt status.[96] Among the reasons why a private foundation would involve itself in foreign projects is the rule that disallows income deductions for gifts to foreign charities. When the U.S. charity's board (private or public) has control and discretion over the use of the funds raised, the fact that the funds are contributed to the U.S. charity specifically for projects outside the United States does not render contributions nondeductible.[97] There are three alternative ways in which the foreign organization's eligibility to receive a private foundation grant can be evidenced:

1. The foreign organization has IRS recognition of its public charity qualification.
2. The foundation obtains evidence of the foreign organization's equivalency to a public charity (procedure explained below).[98]
3. The foundation exercises expenditure responsibility.[99]

Whichever of the preceding situations applies, a private foundation must obtain information that evidences two very important facts to avoid incurring a taxable expenditure:

1. The foundation must be able to prove that its money is spent to accomplish a charitable purpose.
2. The foundation must be able to prove that the recipient is an uncontrolled entity that does or would qualify as a public charity or it must exercise expenditure responsibility.

These two factors stem from a need to prove the disbursement satisfies both the minimum distribution requirements[100] and the taxable expenditure rules.

(a) U.S. Recognition of Public Status

A grant to a foreign government and any agency or instrumentality thereof is treated as a grant to a public charity. Certain international organizations also qualify as public charities, such as the World Health Organization, the United Nations, the International Bank for Reconstruction and Development, the International Monetary Fund, and others designated by the president.[101]

A foreign organization with over 15 percent of its gross income from U.S. sources is entitled to seek recognition of tax-exempt status by filing Form

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[96] Rev. Ruls. 68-165, 1968-1 C.B. 253, 68-117, 1968-1 C.B. 251, and 71-460, 1971-2 C.B. 231; also Priv. Ltr. Rul. 9629020.
[97] See Section 24.1(b).
[98] Discussed in Section 17.5(b).
[99] Discussed in Section 17.6.
[100] See Section 15.4(a).
[101] Reg. §53.4945-5(a)(4)(iii). The international organizations are designated by executive order under 22 U.S.C. §288.

1023.[102] In doing so, the foreign organization relieves its potential foundation funders of the burden to obtain information necessary to follow either the equivalency or the expenditure responsibility procedures. The tax treaty between Mexico and the United States, adopted in 1994, establishes a protocol under which Mexican charitable organizations can be recognized as public charities for private foundation purposes. The treaty between Canada and the United States provides that Canadian charities are given reciprocal classification under U.S. rules. However, unless the Canadian organization provides proof of its public charity status, it is presumed to be a private charity. Private foundations that are interested in supporting charitable activities in other foreign countries should be alert for similar provisions in income tax treaties impacting the status of such organizations.[103]

IRS recognition for a foreign organization also provides it an exemption from tax on its U.S.-based investment income.[104] It is important to note, however, that a foreign organization that receives recognition as a §501(c)(3) tax-exempt organization does not qualify to receive charitable donations from U.S. taxpayers.[105]

(b) Equivalency Procedure

A foreign charitable organization that does not have an IRS determination of its public charity status but that is substantially equivalent to, and would in fact qualify as, a public charity if it sought approval may also be treated as a public entity. A private foundation is entitled to make a good faith determination of the foreign organization's status. An affidavit from the foreign entity or an opinion of counsel is obtained. The grant agreement with the foreign organization must also contain restrictions requiring that the funding be used for strictly charitable purposes using language stipulated in §4945(d) at the beginning of this chapter.

Facts concerning the operations and support of the grantee that would allow the IRS to determine that the organization would qualify as a public charity must be gathered. Detailed financial information, organizational documents, program activity descriptions, and other information that evidences the foreign charity's ability to qualify as a public charity under the U.S. Tax Code must be obtained.[106] The information must be translated into English and accompanied by a sworn statement of validity from the grantee. Additionally, the foundation must obtain follow-up reports that its grant was, in fact, spent for the purposes for which it was awarded. As a practical matter, these documentation require-

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[102] IRC §4948(b) denies the application of IRC §508 (notice of exemption) for a foreign organization that receives substantially all of its support (other than gross investment income) from sources outside the United States.

[103] Milton Cerny outlined the rules pertaining to nonprofit organizations in the February 1995 issue of the *Exempt Organizations Tax Review*, in an article entitled "The Americas: An Expanding Nonprofit Sector."

[104] See Section 13.5.

[105] IRC §170; see Section 24.1.

[106] Reg. §53.4945-5(a)(5); see Rev. Proc. 92-94, 1992-46 I.R.B. 34 for contents of a "currently qualified" affidavit from the grantee.

ments are often difficult to satisfy. Differences in accounting systems, language, cultural patterns, and reporting systems in their own countries can lead to confusion. Though the foreign grantee may readily agree to fulfill the requirements described in the grant agreement, their understanding of the English terms may lead to an unintended result.

To relieve foundations of the burden of obtaining a legal opinion regarding the public status of each of its foreign grantees, the IRS, in 1992, designed a procedure to allow the foreign organization to prepare evidence of its qualification that can be used by all of its grantors. The procedure is referred to as *simplified* and produces a generic affidavit. The following four factors must be present for a private foundation to follow this procedure to ascertain a foreign organization's equivalency to a public charity.[107]

1. The grant is not a transfer of assets under a liquidation, merger, redemption, recapitalization, or other adjustment.
2. The foreign organization furnishes a currently qualified affidavit containing a specific list of 13 different declarations regarding its ability to meet the organizational and operations tests of IRC §501(c)(3) and its qualification as a public charity under IRC §509.
3. The grantee is not controlled by the grantor foundation.
4. The grantor foundation bases its reasonable judgment and good faith determination of the status under U.S. law of the foreign grantee upon a currently qualified affidavit.

The affidavit must be prepared by the grantee organization in English, including a translation of organizational documents. For an organization whose public status is based on its sources of support, an attested (issued by an accountant) financial statement for the latest complete accounting year must be included. Otherwise, the affidavit is considered current until the facts change.[108]

(c) Expenditure Responsibility Route

Seeking the appropriate information described in the preceding subsection from a foreign organization is not so simple and is often troublesome due to language, currency, and legal differences. Because of these difficulties, a private foundation will sometimes find it more comfortable to treat such foreign grants as expenditure responsibility grants to avoid unexpected results. The paperwork may be reduced and the possibility for a taxable expenditure less.[109] In an effort to gain clarity, the Council on Foundations, in December 1999, asked for the guidance. In response, the 2000 Priority Guidance Plan of the Office of Tax Policy and

[107] Rev. Proc. 92-94, 1992-2 C.B. 507

[108] The Council on Foundations publishes a quarterly journal, *International Grant-making,* that periodically addresses these issues.

[109] Priv. Ltr. Ruls. 8030104 and 8515070 indicate the extent to which some PFs go in ensuring that their grants to foreign organizations meet the expenditure responsibility test.

Internal Revenue Service included the issuance of guidance on private foundations' assistance to foreign entities. The IRS kept this promise with the April 2001 Information Letter addressing the following issues raised by the Council:

1. *Classifying Governmentally Supported Foreign Charities.* Establish that a foreign charity receiving substantial support from its government, as many do, could readily qualify as a public charity without further inquiry into its sources of support as Rev. Proc. 92-94 currently requires.
2. *Choosing Expenditure Responsibility Rather Than the Out-of-Corpus Rules.* Clarify that a private foundation may elect to treat grants to foreign organizations as grants to noncharities, rather than following the special out-of-pocket rules for grants to other private foundations, even if the private foundation has determined that the foreign organization could qualify as a §501(c)(3) equivalent but cannot determine whether it is a public charity equivalent. Although Rev. Proc. 92-94 clearly states that the equivalency procedure is optional, it does not offer clear guidance on what to do if a private foundation begins the procedure and gets as far as establishing §501(c)(3) equivalence but cannot get any further. Private foundations would like written assurance that they can disregard whatever information they have gathered on §501(c)(3) equivalence and make an expenditure responsibility grant to a noncharity rather than a grant meeting the out-of-corpus requirements.
3. *Duration of Expenditure Responsibility for Capital Equipment and Endowment Grants.* Clarify the number of years expenditure responsibility will be required for grants to foreign grantees for capital equipment or endowment.

The IRS did not respond to questions 1 and 3, but the answer to question 2 was a "yes." The IRS responded by saying, "Neither the Internal Revenue Code nor the Regulations require the foundation to determine whether a foreign grantee is described in section 501(c)(3) of the Internal Revenue Code. Therefore, a U.S. private foundation may elect to treat a foreign grantee as not being described in section 501(c)(3)."[110] The information letter quoted all of the relevant statutes and regulations and concluded there is no provision in the statute or regulations that compels the foundation to determine the foreign organization's status. The letter stipulates that a grant from a private foundation to a foreign grantee will be treated as a qualifying distribution for purposes of §4942 of the Code and not a taxable expenditure for purposes of §4945 under each of the following three circumstances:

1. After making a good faith determination that the foreign grantee is described in §501(c)(3) and §509(a) of the Code and the foreign grantee is the equivalent of a public charity, the private foundation makes the grant without exercising expenditure responsibility.[111]

[110] IRS Information Letter to John A. Edie, Esq., then senior vice president and general counsel, Council on Foundations, April 18, 2001.

[111] Presumably, a foundation choosing this alternative would obtain a sworn affidavit and follow the steps of Rev. Proc. 92-94.

2. After making a good faith determination that the foreign grantee is described in §501(c)(3) of the Code and would be classified as a private foundation because it is not described in §509(a), the private foundation exercises expenditure responsibility with respect to the grant as prescribed by §4945(h) and the regulations thereunder, and obtains records verifying that the grantee distributes the full amount of the grant out of corpus by the end of the year following.
3. The private foundation treats the grantee as not being described in §501(c)(3) of the Code and exercises expenditure responsibility with respect to the grant as prescribed in §4945(h) and the regulations thereunder, including the requirement that the grantee maintain the grant funds in a separate fund dedicated for §170(c)(2)(B) purposes, in accordance with §53.4945-6(c) of the regulations.

Due to the difficulties, the aforementioned guidance, and the more recent issues involving terrorist activities, many foundations now choose to exercise expenditure responsibility over grants to foreign organizations.

(d) Future Developments

Readers should be alert for future changes in procedures required to document grants to foreign organizations and to foreign programs. On November 7, 2002, the U.S. Treasury Department issued a voluntary set of best-practice guidelines for U.S.-based charities to follow to reduce the likelihood that charitable funds will be diverted to finance terrorist activities. The guidelines address four areas entitled Governance, Disclosure/Transparency in Governance and Finances, Financial Practice/Accountability, and Anti-Terrorists Financing Procedures.[112] The suggested due diligence steps are detailed and would require much-enhanced documentation, including on-site audits, verification of all of the jurisdictions and sites in which the foreign organization conducts programs, and vetting of public information by Internet-type searches and proof it does not appear on lists of persons linked to terrorism or money laundering.

17.6 EXPENDITURE RESPONSIBILITY GRANTS

To ensure accountability for grants and program-related investments by private foundations, record-keeping requirements are more stringent when a grant is made to one of the following:

- Another private foundation or a private operating foundation
- An organization exempt under a §501(c) category other than (3)
- A nonexempt business for a direct charitable program or a program-related investment[113]

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[112] *Anti-terrorists Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities.*
[113] Reg. §53.4945-6(c).

Grants to such organizations are not prohibited—a foundation is not the "insurer of the activities of grantee."[114] The PF can make the grant "as long as it exerts all reasonable efforts and establishes adequate procedures" to

- See that the grant is spent solely for the charitable purpose for which it is made
- Obtain required reports of that fact with respect to the expenditures and submit information on Form 990-PF

Non-(c)(3) Organizations. As one example of the latitude available, a PF may make a grant to a social club if the grant is specifically dedicated to charitable purposes. A PF made a grant to a social fraternity's §501(c)(2) title-holding organization to build a study room in the chapter house. The facility was to contain exclusively educational equipment and furniture, along with computers linked to the university's mainframe. The university sanctioned the grant by certifying in writing that the room benefits the school by supplementing its resources, alleviating overcrowding in its library and study areas, and providing additional computer terminals. The fraternity agreed to return any grant funds not used for construction of the study space. There was no time period stipulated for this guarantee, but the foundation required that it be able to inspect the room annually.[115]

Another example was an "urban enterprise association" established to operate a recycling facility to provide jobs for a city's unemployed people.[116] The PF's grant, in addition to commercial loans, provided start-up funds for the project. The project's purpose was to train workers and find them permanent employment. A public charity partner planned to turn the facility into a viable self-sustaining business (presumably related), the net income of which would go to the public charity. Note that the regulations permit a grant to be made to a nonexempt business as long as the charitable purposes, or program-relatedness,[117] of the activity are clearly evident and documented. The grantee organization must, however, agree to maintain the grant funds in a separate fund dedicated to the charitable purposes of the grant.[118]

Governmental Unit. A governmental unit does not technically qualify as a §501(c)(3) organization.[119] The general rule stated in this chapter's introduction stipulates that a taxable expenditure does not result in a grant to a publicly supported §501(c)(3) organization as defined in IRC §509(a)(1), (2), or (3). Thus, the literal language of the Code indicates expenditure responsibility should be exercised for a grant to a governmental unit. Clarity is found in the regulations that treat a domestic and foreign government as a public charity.[120] Therefore, expenditure responsibility is not required.

[114] Reg. §53.4945-5(b)(1).
[115] Priv. Ltr. Ruls. 9050030, 9219033, and 9306034.
[116] Priv. Ltr. Rul. 9310044.
[117] Such grants are further discussed in Section 16.3.
[118] Reg. §53.4945-6(c)(2).
[119] See the interesting discussion of this matter in Section 10.2.
[120] Reg. §53.4945-5(a)(4).

Grant Intermediaries. A private foundation grant to a public charity that regrants or supports a secondary grantee presents similar issues to those applicable when a foundation funds an individual grant program at a college and makes suggestions about recipients. The challenge is to identify the grantee—is it the college or the individual?[121] The question arises when the foundation makes a payment to a public charity and the money is regranted to a secondary grantee that is not a public charity.[122] Such a grant is not regarded as a grant to the secondary grantee that requires expenditure responsibility, if the primary grantee has control over the regranting.

The accounting rules describe the requisite power of the primary grantee as a *variance power.* Financial Accounting Standards Board Opinion #136 says, "[W]hen acting as an agent, trustee or intermediary," the reporting entity (primary grantee) does not recognize revenue.[123] The primary grantee must have discretion and control over the funds; there should be no agreement, written or oral, by which the foundation can cause the selection of the secondary grantee. The grant is not regarded as a grant by the PF to the secondary grantee, even though the PF has reason to believe that certain organizations will derive benefits from the grant, if the primary grantee makes the selection completely independently of the PF.[124] In other words, the primary grantee is not an intermediary.

(a) Pregrant Inquiry

To exercise expenditure responsibility, a foundation must take very specific steps. All eight specific requirements listed in Exhibit 17.5 must be followed. The first step in exercising expenditure responsibility is to investigate the grantee organization and its proposed project by gathering the information shown in Exhibit 17.6. A pregrant inquiry is a limited investigation directed at obtaining enough information to give a reasonable person assurance that the grantee will use the grant for the proper purposes.[125] The inquiry should concern itself with matters such as these:

- The identity, prior history, and experience (if any) of the grantee organization and its managers. Is the other organization capable of accomplishing the grant purposes?
- Information about the management, activities, and practices of the grantee organization, obtained either through the PF's prior experience and association with the grantee or from other readily available sources.

The scope of the inquiry is expected to be tailored to the particular grantee's situation, the period over which the grant is to be paid, the nature of the project,

[121] See Section 17.3(g)
[122] See Section 17.4(e).
[123] The answer to the question also influences the calculation of public support test for the primary and secondary grantees, as discussed in Section 11.5(d).
[124] Reg. §53.4945-5(6)(i).
[125] Reg. §53.4945-5(b)(2).

EXHIBIT 17.5

Expenditure Responsibility Control Checklist

SAMPLE FOUNDATION

Do Not Proceed to Next Step Until Answers Are Yes!

		Date	Initial
Step 1.	Pregrant inquiry completed.	________	________
Step 2.	Establish proper terms for grant or program-related investment.	________	________
Step 3.	Expenditure responsibility contract signed.	________	________
Step 4.	Grant timetable prepared.	________	________
Step 5.	Form 990-PF attachment prepared and submitted (Reg. §53.4945-5(d)).	________	________
Step 6.	Delinquent reports or diversions investigated.	________	________
Step 7.	Withhold payments if diversions occur.	________	________
Step 8.	Segregate documents in a manner to ensure that they are saved for four years.	________	________

Approved By: ____________________ Date: ____________________

and the PF's prior experience with the grantee.[126] Two examples of successful inquiries follow[127]:

- A PF is considering a grant to a newly created drug rehabilitation center located in a neighborhood clinic and classified as a §501(c)(4) organization because it is an "action" organization.[128] One of its directors, they are informed, is an ex-convict. The PF determines that he is fully rehabilitated and that the board as a whole is well qualified to conduct the program, since they are members of the community and more likely to be trusted by drug offenders.
- A grant recipient provides medical research fellowships. It has conducted the program for years and receives a large number of other PF grants. Another foundation that supports this recipient informs the PF that it is satisfied that its grants have been used for the purposes for which they were made.

If the grantee has received prior expenditure responsibility grants from the PF and has satisfied all of the reporting requirements, a pregrant inquiry is not necessary. Likewise, for a grant to a split-interest trust that is required by its instrument to make payments to a specified public charity, a less extensive inquiry would be necessary.[129] It is imperative that Exhibit 17.6 be used to monitor the information gathered that forms the basis for the grant decision as a result of the pregrant inquiry.

[126] See Section 17.5 for enhanced inquiries proposed for foreign grants.
[127] Reg. §53.4945-5(b)(2)(ii).
[128] See Section 6.1.
[129] Supra note 127.

EXHIBIT 17.6

Pregrant Inquiry Checklist

SAMPLE FOUNDATION

Name of Proposed Grantee: ____________________

Tax status? 501(c)(3) ________ 501(c)(4) ________ Other ________ (describe)

Category of public charity? 509(a)(1) ______ 509(a)(2) ______ 509(a)(3) ______

Copy of IRS determination letter obtained: ______ yes ______ no

Verified in Pub. 78__ on Guidestar.org ______

Written request with full details: ______ yes ______ get one

Complete financial information submitted: ______ yes ______ no

Form 990 received or reviewed on Guidestar.org ______ yes ______ no

Other sources of support: ____________________

____

Contracts:	Name	Date of meeting/call
	____________________	__________
	____________________	__________
	____________________	__________

References: ____________________

____

Prior grants: ____________________ Date __________

Prior grants: ____________________ Date __________

Reports on time: ______ yes ______ no; if not, why ____________

Reasons grantee is qualified: ____________________

____

____

____

Charitable nature of project/program ____________________

Is project achievable? ____________________

____

Supplemental information (not required, but helpful):

Organizational history	Publications/reports of projects
List of board members	Projects of grantee
Letters of reference	Annual report
Organization budgets	Needs analysis

(b) Grant Terms

An *appropriate* officer, director, or trustee of the grant recipient must sign a written commitment of the sort displayed in Exhibits 17.7 and 17.8 that, in addition to stating the charitable purposes to be accomplished, obligates the grantee to do the following:

- Repay any portion of the amount granted that is not used for the purposes of the grant.

- Submit full and complete annual reports on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant.
- Maintain records of the receipts and expenditures, and make its records available to the grantor at reasonable times.
- Not use any of the funds for electioneering, lobbying, granting to an individual or organization, or other purposes that would result in taxable expenditures if made directly by the private foundation.[130]

The agreement should clearly state the purpose for the grant. When making a grant to an organization that is not a §501(c)(3), the private foundation must require the grantee to establish, and maintain as long as grant funds remain, a separate fund dedicated to the charitable purposes for which the grant is made.

Program-Related Investments. In addition to the previously listed information required, the recipient of program-related investment funds must also agree to do the following:

- Repay the funds not invested in accordance with the agreement, but only to the extent permitted by applicable law concerning distributions to holders of equity interests.
- Submit financial reports of a type ordinarily required by commercial investors under similar circumstances, and a statement that it has complied with the terms of the investment.
- Maintain books and records of a type normally required by commercial investors.[131]

Program-related investments often provide financing for projects of a business nature, such as real estate development or scientific research. Presumably, funds expended by such projects might not necessarily be considered charitable expenditures if the foundation paid the expenses itself. Therefore, the expenditure responsibility agreement for such investments does not have to contain a requirement that the grantee not use the funds to engage in a noncharitable purpose.

Foreign Grants. An agreement with a foreign entity should phrase the restrictions in appropriate terms under foreign law or custom. While not specifically required, an affidavit or opinion of counsel stating that the agreement is valid under the foreign laws is "sufficient."[132] Translation of the agreement into applicable languages may be appropriate. Making the choice to exercise expenditure responsibility rather than seek an equivalency opinion for foreign grantees should be made in view of the latest guidance on this evolving issue.[133]

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130 Reg. §§53.4945-5(b)(3)(i), (ii), (iii), and (iv).
131 Reg. §53.4945-5(b)(4).
132 Reg. §53.4945-5(b)(5).
133 See Section 17.5.

EXHIBIT 17.7

Expenditure Responsibility Agreement—Version 1

SAMPLE FOUNDATION

Name of Grantee Organization
Address

Dear ___________ :

__________ (Name of Grantor) is pleased to inform you that its Board of Directors has approved a grant of $ __________ to the ___________ (Name of Grantee) pursuant to the grant application dated ___________.

Since your organization and ours are private foundations, we must enter into an expenditure responsibility agreement.

Use of Funds

Our grant must be expended for charitable, scientific, literary, or educational purposes as defined under Internal Revenue Code §501(c)(3), and more specifically for ________ (Description of purpose of grant, title if any, or general support of the grantee). ANY FUNDS NO SO EXPENDED MUST BE RETURNED TO ________ (Grantor). Funds may not be used to influence legislation or the outcome of any election, to carry on a voter registration drive, or to make grants to individuals for travel or study.

Annual Report

(Grantee) will provide a narrative and financial report to us by _______ (Date). The narrative portion should include a copy of publications, catalogs, and other materials describing the accomplishments of the program or project. The financial report must be attested to by an outside accountant and must contain details of expenditures, such as salaries, travel, supplies, and the like.

Although grant funds need not be physically separated, records of receipts and expenditures under the grant, as well as copies of the report furnished to us, should be kept available for our inspection until ________ (four years from grant).

Payment Terms

Payments under the grant will be made on the following dates, after receipt of a signed copy of this agreement:

________________________________ ________________________________

________________________________ ________________________________

(Date) (Amount)

Sign and Return

If this agreement meets with your approval, kindly sign it and return one copy to us. On behalf of __________ (Grantor), I extend good wishes for the success of this endeavor.

Acknowledged by:

________________________________ ________________________________

For Sample Foundation For Grantee Organization

________________________________ ________________________________

Date Date

EXHIBIT 17.8

Expenditure Responsibility Agreement—Version 2

SAMPLE FOUNDATION—GRANT AGREEMENT

Grantee: ________________________

Amount of Grant

Grant Payment Dates

	$ ______________________	______	______
	$ ______________________	______	______
	$ ______________________	______	______
	$ ______________________	______	______
Total Grant Awarded	$ ______________________		

Grant Term in Years: ____

Purpose of Grant: ____

____

____

____

and as further described in your grant request dated ______________________

Terms of Grant:

A. Funds granted will be expended only for the purposes for which the grant is being made. You will notify us if there are any changes in your plans. ANY FUNDS NOT SO USED MUST BE RETURNED TO SAMPLE FOUNDATION.

B. A financial report attested to by an independent accountant must be furnished annually by ______ (date), along with a narrative report of accomplishments and any reports, publications, or other materials prepared in connection with the project.

C. Financial records pertaining to the grant must be maintained in accordance with generally accepted accounting principles. Receipts and other documentation in connection with the grant will be maintained for at least four years and be open to our inspection at any time during that period.

D. No funds may be used to

1. Carry on propaganda, or otherwise attempt to influence legislation (as defined by IRC §4945)
2. Influence the outcome of any specific public election, or carry on, directly or indirectly, any voter registrative drive (as defined in IRC §4945)
3. Make an individual grant or regrant funds to another organization unless the requirements of IRC §4945 are met
4. Advance any purpose other than one specified in IRC §170(c)(2)(B)

E. If Sample Foundation becomes aware that the funds are not being used for the purposes described above, we reserve the right to ask to be reimbursed for the amounts so diverted, and will withhold any future grant payments.

Acknowledged by:

______________________	______________________
For Sample Foundation	For Grantee Organization
______________________	______________________
Date	Date

(c) Grantee Reports

A private foundation that makes an expenditure responsibility grant is not held responsible for the actual accomplishment of the purposes of such a grant, but is required to follow the steps listed in Exhibit 17.5 to document its efforts to monitor its written requirement that the funds are expended for charitable purposes.[134] Details must be provided for each grant upon which any amount or any report is outstanding at any time during the taxable year in the foundation's annual Form 990-PF, as illustrated in Exhibit 17.10.

In monitoring such grants, the foundation may rely on reports and records furnished by grantees and statements of grantee officials. The grantor need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability[135] The grantee should report on the use of the grant funds, reflecting the nature of the expenditures—salaries, travel, supplies, and so on. For a general support grant, an annual financial report or Form 990-PF (or 990) may be sufficient. In addition to financial information, the report should state that the grantee is in compliance with the terms of the grant and describe the progress made by the grantee toward achieving the purposes for which the grant was made. The reports are to be made at the end of the grantee's fiscal year for each year the grant is outstanding and should be received within a reasonable time after the close of the year. For multiyear grants, a final report summarizing all expenditures should be submitted.[136]

Endowment Grants. A grant of endowment funds or funds for the purchase of capital equipment or other capital purposes must be monitored for the year of the grant and for the two following years. The use of the principal and income (if any) from the grant funds is to be reported.[137] Such grants are generally outstanding for 990-PF purposes for three years. Only if it is reasonably apparent before the end of the second succeeding year that the funds have been used for the purpose granted can the reports be suspended.

Program-Related Investments. A grantee report must be received for each year during which the investment is in existence. The Charles Stewart Mott Foundation found out the hard way that program-related investments must be reported for the life of the loan or as long as the investment is held (in its case, 12 years).[138] The Mott Foundation had relied upon the three-year endowment reporting requirement.

Private Foundation Successor Organizations. A private foundation that distributes part of its assets to another private foundation that is not controlled by same persons in a termination distribution[139] has a duty to exercise expenditures

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[134] Thereby do not result in a taxable expenditure.
[135] Reg. §§53.4945-5(c)(1) and (4).
[136] Reg. §53.4945-5(c)(1).
[137] Reg. §53.4945-5(c)(2).
[138] *Charles Stewart Mott Foundation v. U.S.*, 91-2 USTC ¶50,340 (6th Cir. 1991).
[139] See Section 12.4(c).

EXHIBIT 17.9

Report to IRS on Form 990-PF

SAMPLE FOUNDATION **EIN #444444444**

Attachment to Form 990-PF

Part VII-A, Question 5c on page 5

EXPENDITURE RESPONSIBILITY STATEMENT
FOR THE YEAR 20XX

Pursuant to IRC Regulation §53.4945-5(d)(2), the SAMPLE FOUNDATION provides the following information:

(i) Grantee:	The Anna Jane Smith Memorial Library 1444 Smith Terrace Anytown, USA 44444
(ii) Amount of Grants:	December 28, 20xx $100,000 (endowment) December 23, 20xx $10,000 (general support)
(iii) Purpose of Grants:	Endowment or general support for the Anna Jane Smith Memorial Library, an education foundation operating a library free and open to the general public in Anytown, in amounts listed above.
(iv) and (vi) Reports:	The Anna Jane Smith Memorial Library submitted full and complete reports of its expenditure of December 2001 operating support grant on November 21, 20xx. The Anna Jane Smith Memorial Library also submitted a report on the 2001 endowment grant on November 21, 20xx. The endowment report reflected that the grant was properly added to the Library's endowment, the income from which is devoted exclusively to its educational programs.
(v) Diversions:	To the knowledge of the grantor, no funds have been diverted to any activity other than the activity for which the grant was originally made.
(vii) Verification:	The grantor has no reason to doubt the accuracy or reliability of the report from the grantee; therefore, no independent verification of the report was made.

responsibility indefinitely until all of its assets are distributed.[140] The responsibility ceases when the foundation gives away all of its assets.

Grantee Accounting Records. A private foundation grantee classified as a charity under §501(c)(3) need not segregate funds or maintain separate bank accounts or books for the grant unless the grantor foundation requires it to do so. If the funds are not specifically segregated, grants received within a year are deemed to be expended before grants received in a succeeding year. Expenditures made during the year are allocated among all such grants.

A grantee that is not a §501(c)(3) organization, however, must segregate and maintain, so long as grant funds remain unexpended, the grant in a separate fund dedicated to the charitable purposes of the grant.[141] For all grantees, records evidencing the manner in which the funds are expended must be maintained for at least four years after completion of the use of the funds.

[140] Reg. §§53.4945-5(b)(7) and 1.507-3(a)(7) and (8).
[141] Reg. §53.4945-6(c).

(d) Reporting to the IRS

For each year during which a private foundation has an "outstanding" expenditure responsibility grant, information about each grant must be submitted as an attachment to Form 990-PF. The report is due in the year the grant is made and for as many years as the grant is outstanding and monitoring is required.[142] An example of the report required to be attached to Form 990-PF can be found in Exhibit 17.10. No specific form is provided, but the regulations specify that the following data must be submitted:

- Name and address of grantee
- Date and amount of the grant
- Purpose of the grant
- Amounts expended by grantee based upon the most recent report
- Whether (to the knowledge of the grantor) the grantee has diverted any portion of the funds, or income therefrom in the case of an endowment, from the intended purpose
- Dates of any reports received from the grantee
- Dates and results of any verification of grantee reports undertaken because the PF doubted their accuracy or reliability[143]

The IRS has strictly enforced the expenditure responsibility reporting requirement. Before 1984, reporting the information on an amended return did not correct the taxable expenditure.[144] Stiff penalties were upheld against a group of three commonly controlled organizations in the Hans S. Mannheimer Charitable Trust.[145] Their Form 990-PF contained no report. Under the pre-1984 rules, the foundation unsuccessfully argued that all of its internal documents, meeting transcriptions, and actual observations of the activities amounted to the exercise of expenditure responsibility. Despite the facts and the foundation's argument that its failure to report was due to unintentional oversight, the penalty assessment was upheld. Effective beginning in 1984, a mistake of this sort might be corrected without a penalty.[146]

The foundation must retain supporting documentation for information reported in its Form 990-PF at its principal office: a copy of the agreement for each expenditure responsibility grant, all reports received from grantees, and documentation for any investigation the foundation conducted either during the pregrant inquiry period or regarding potential diversion of the funds.

[142] Described in Section 17.6(c).
[143] Reg. §53.4945-5(d)(2).
[144] Rev. Rul. 77-213, 1977-1 C.B. 357.
[145] *Hans S. Mannheimer Charitable Trust v. Commissioner*, 93 T.C. 5 (1989).
[146] See Section 17.8; see Exhibit 17.11.

Exhibit 17.10

Grantee Reports

The Anna Jane Smith Memorial Library
1444 Smith Terrace
Anytown, USA 44444

Ms. Jane Sample, Treasurer
SAMPLE FOUNDATION
101 First Main Plaza
Anytown, USA 44444

RE: Annual Report #1 of grant funds expended under Expenditure Responsibility Agreement

Dear Ms. Sample:

On behalf of the Anna Jane Smith Memorial Library, I want to again say how grateful our library is for the significant support we receive from your foundation. The minds of Anytown's children are challenged and expanded by the enrichment your funds allow. The specific purpose of this letter is to report in accordance with our expenditure responsibility agreement dated December 23, 20xx.

Your annual support gift of $200,000 was expended during our fiscal year ending June 30, 20xx, for the library's educational programs. As reflected in our audited financial statements furnished to you with our endowment grant report, total expenditures this year were $429,000. We spent $204,000 on lending library activities, $56,000 for purchasing new books and publications, $72,000 for a school outreach program, and $97,000 on administration and fund-raising. Your annual gift and others from our community defrayed all but $92,000 of the total expenditures, meaning that we were able to set aside $24,000 as a reserve for the future.

Additionally, as required by our agreement, all of the income earned on your endowment gift was either currently expended for the library's educational programs or reserved to be spent for such purpose in the future. No portion of the gift was expended for a noncharitable purpose; particularly, no amounts were expended to carry on propaganda or otherwise to attempt to influence legislation, to attempt to influence an election, or to make a grant to an individual. We maintain detailed documentation evidencing the nature of our expenditures and would welcome your inspection of the records if you so desire.

Thank you again for your financial support. If any additional information is required, please let us know.

November 21, 20xx

Mary Kay Anderson
Chief Financial Officer

EXHIBIT 17.10 *(CONTINUED)*

Grantee Reports

The Anna Jane Smith Memorial Library
1444 Smith Terrace
Anytown, USA 44444

Ms. Jane Sample, Treasurer
SAMPLE FOUNDATION
101 First Main Plaza
Anytown, USA 44444

RE: Annual Report #2 under
Endowment Expenditure
Responsibility Agreement
Dear Ms. Sample:

Dear Ms. Sample:

On behalf of the Anna Jane Smith Memorial Library, I want to first say how grateful our library is for the significant support we receive from your foundation. The minds of Anytown's children are challenged and expanded by the enrichment your funds allow. The purpose of this letter is to again report in accordance with our expenditure responsibility agreement dated December 28, 20xx.

Your generous endowment gift of $100,000 was added to the Anna Jane Smith Memorial Library Endowment Fund to be conserved and prudently invested so as to produce income to support our educational programs. The balance of the endowment as of June 30, 20xx, was $920,000. During our fiscal year then ended, current income of $119,000 was realized on the endowment. Out of this income, $92,000 was expended for library operations and $24,000 was set aside in the temporarily restricted funds to ensure support of operations in any future years in which current yield might be lower. A copy of our audited financial statements is enclosed for a full report of our financial activity.

As required by our agreement, all of the income earned on your endowment gift was either currently expended for the library's educational programs or reserved to be spent for such charitable purposes in the future. None of the endowment fund or its income was expended for a noncharitable purpose; particularly, no amounts were expended to carry on propaganda or otherwise to attempt to influence legislation, to attempt to influence an election, or to make a grant to an individual. We maintain documentation evidencing the nature of our expenditures and welcome your inspection of the records, if you so desire.

Thank you again for your financial support. If any additional information is required, please let us know.

November 21, 20xx

Mary Kay Anderson
Chief Financial Officer

(e) Grant Diversions

Rules similar to those governing scholarship fund diversions apply to expenditure responsibility grant fund diversions. The grant is not considered to be a taxable expenditure even though the grantor foundation finds that any or all of the funds were used for improper purposes if the grantor PF does the following:

- Takes all reasonable and appropriate steps either to get the funds back or to cause the grantee to use other funds to satisfy the grant terms
- Withholds, as soon as it discovers the problem, any further payments to the grantee until it receives the grantee's assurance that future diversions will not occur, and requires the grantee to take extraordinary precautions to prevent future diversion from occurring[147]

If a grantee fails to make reports, a taxable expenditure will result unless the PF

- Originally made the grant following the appropriate procedures[148]
- Complied with all reporting requirements
- Makes a reasonable effort to obtain the required report
- Withholds any future payments on the specific grant and on any other grants to the same grantee[149]

If the grantor foundation is treated as having made a taxable expenditure because it failed to take any of the required steps in the preceding list, the penalty will be imposed on the initial grant. If additional funds are granted after it discovers the problem, the penalty is imposed on all payments.

17.7 NONCHARITABLE EXPENDITURES

The term *taxable expenditure* includes any amount paid or incurred for a noncharitable purpose.[150] The IRS has provided a list of expenditures that will not be classified as noncharitable, even though they are neither grants nor project expenditures. The list includes the following:

- Payments to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of charitable pursuits
- Payment of taxes
- Expenses deductible against unrelated business income
- Payments constituting a qualifying distribution under IRC §4942 or a deduction against investment income under IRC §4940
- Reasonable expenses to evaluate, acquire, notify, and dispose of a program-related investment

[147] Reg. §53.4945-5(e)(1)(iii).
[148] Listed at the beginning of Section 17.6.
[149] Reg. §53.4945-5(e)(2).
[150] IRC §4945(d)(5).

- Business expenses by the recipient of a program-related investment[151]
- Return of contingent contributions[152]

Conversely, the following expenses are taxable expenditures:

- Unreasonable administrative costs, including consulting fees
- Payment of unreasonable compensation[153]
- Payment of legal costs and settlement amounts to defend officers and directors in an unsuccessful state mismanagement action[154]
- Payments to a cemetery company eligible to receive charitable contributions under IRC §170(c)(5)[155] (because they are not technically a public charity under IRC §509(a)(1))

In a reversal of its approval of a company foundation employee relief program, the IRS provided a comprehensive review of the private foundation sanctions that can result when a foundation is found to have made a noncharitable expenditure. A careful discussion of the interaction between §§4941, 4942, and 4945 can be found in the ruling.[156]

17.8 EXCISE TAXES PAYABLE

An excise tax of 10 percent of the amount of any taxable expenditure is imposed on the private foundation making such an expenditure. A 2½ percent tax is payable by any foundation manager who willfully agreed to the expenditure, knowing that it was such an expenditure, up to a maximum of $5,000. These taxes may possibly be abated as discussed at the end of this section.

To be subject to the tax, the manager must intentionally agree to the expenditure, knowing that it is taxable. Knowing does not necessarily mean having reason to know. Such manager must have agreed to make the expenditure willfully and without reasonable cause, such as reliance on the written advice of outside or inside counsel. Only those managers in a position to decide what expenditures are paid and approve such disbursements are subject to the tax.[157]

If the taxable expenditure is not corrected before the date of mailing a notice of deficiency or the date on which the initial tax is assessed, known as the *taxable period*, an additional tax of 100 percent of the expenditure is imposed on the foundation.[158] The knowing managers are jointly and severally liable for an additional tax of 50 percent, up to a maximum of $10,000.

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[151] Reg. §53.4945-6(b).
[152] *Underwood v. U.S.*, 461 F. Supp. 1382 (N.D. Tex. 1978).
[153] *Kermit Fisher Foundation v. Commissioner*, T.C. Memo 1990-300.
[154] Rev. Rul. 82-223, 1982-2 C.B. 301.
[155] Rev. Rul. 80-97, 1980-1 C.B. 257.
[156] Priv. Ltr. Rul. 199914040; more fully discussed in Section 17.3(d).
[157] Reg. §53.4945-6(b); see Section 16.4(c) for further discussion of these terms.
[158] IRC §4945(i)(2).

EXHIBIT 17.11

Sample Attachment to Form 4720

SAMPLE FOUNDATION **EIN #44-4444444**

Attachment to Form 4720

For Calendar Year 2004

STATEMENT regarding CORRECTION OF TAXABLE EXPENDITURE

In submitting its Form 990-PF for the calendar year ending December 31, 2003, the SAMPLE FOUNDATION (Sample) inadvertently failed to submit information regarding an expenditure responsibility grant. This failure is corrected in this return by making a complete report of the seven required items properly included as an attachment to Part VII-B, Statement Regarding Activities for which Form 4720 may be Required, of this year's Form 990-PF.

Sample, during 2001, made an endowment grant to ABC FOUNDATION (ABC), a private foundation. The required expenditure responsibility agreement was executed in a timely fashion and the grant information reported in Sample's 2001 Form 990-PF. Additionally, ABC reported that the endowment and its income were dedicated to charitable purposes as its agreement with Sample required. Sample duly submitted the seven points of information on its 2002 Form 990-PF. ABC further made a second year's report for the 2002 fiscal year.

A taxable expenditure occurred, however, when Sample failed to include a statement of the required information on its 2003 Form 990-PF. Sample had made expenditure responsibility grants in past years, but had not previously made an endowment grant that required multiple year reporting. Sample's controller who prepared the return failed to include the report because he was following the pattern established for nonendowment grants. Sample's grant department had engaged outside counselors to prepare the agreement regarding the grant. They were advised Sample needed to receive and submit to the IRS two years of monitoring reports and also to report the grant in the year in which it was made. The controller was not furnished a copy of the counselors' letter describing this requirement.

Pursuant to Internal Revenue Code §4962, Sample respectfully requests that the first-tier §4945 penalty for failure to report, or initial tax of $15,000, be abated because the failure was due to reasonable causes and without willful neglect. The mistake was discovered by Sample's executive director when she was reviewing the 2004 Form 990-PF prior to submitting it to me for signature. The inclusion of the proper report in this 2004 return effectively corrects the failure to report. Therefore, Sample submits it is entitled to an abatement of the tax because it meets the requirements of §4962 and the instructions to Form 4720.

I swear that this information is true and correct and that the foundation's failure to make the third year's report of ABC's endowment grant was inadvertent, accidental, and without intention or knowledge on my part or on the part of any of Sample's other officers.

____

A. B. Sample, President

Correcting the taxable expenditure is accomplished when the PF takes whatever corrective steps the IRS recommends, including the following[159]:

- Requiring that any unpaid funds due the grantee be withheld
- Requiring that no further grants be made to the grantee

[159] Reg. §53.4945-1(d).

- Requiring additional, possibly quarterly, reports to be made
- Improving methods of exercising expenditure responsibility
- Improving methods of selecting recipients of individual grants

If the taxable expenditure was caused by inadequate reporting by grantees, receipt of the appropriate reports is a correction. For failure to obtain advance approval for a scholarship or fellowship grant program, obtaining such advance approval for grant-making procedures is a correction.

The IRS has the discretionary authority to abate the first- and second-tier tax where the PF establishes that the violation was due to reasonable cause, not due to willful neglect, and a timely correction is made. Exhibit 17.11 contains a suggested letter to attach to Form 4720 to seek abatement of the penalty tax. The letter admits the expenditure responsibility steps were not properly followed, but informs the IRS that the foundation took steps to make the required corrections and may be entitled to forgiveness for the violation. The rules for excusing the foundation and its managers and the possible abatement of the tax are the same as those outlined in Section 16.4(c).

APPENDIX 17–1

Examples of Emergency and Hardship Grant Applications

Exhibits A17-1.A, A17-1.B, and A17-1.C are examples of emergency and hardship assistance grant applications. As a consultant to Foundation Source, an on-line private foundation administrative service company, I have assisted their Sr. Vice President for Legal Affairs, Jeff Haskell, to develop checklists and guidance for their web-based foundations. They have graciously agreed to allow inclusion of these examples that were developed with the approval of the IRS.

Exhibit A17-1.D is a Church Substantiation Form created by Foundation Source.[160]

[160] An on-line private foundation administrative resource.

EXHIBIT A17-1.A

SHORT-TERM EMERGENCY ASSISTANCE APPLICATION

Purpose	Up to $1,000 per year for individuals and families who require assistance due to disaster or emergency hardship, such as a flood, fire, tornado, violent crime, physical abuse or trauma. ▶ Food, clothing, shelter ▶ Medical treatment, professional counseling
Who qualifies for assistance?	▶ Individuals and families temporarily unable to be self-sufficient as a result of a sudden and severe personal or family crisis. ▶ Persons in need of counseling because of trauma experienced as a result of a disaster, crime or hardship.
How to apply	▶ Sections 1 - 4 are filled out by the person applying for emergency assistance. ▶ Then return this application to the person who gave it to you. ▶ Section 5 will be completed by the foundation considering assistance.

Section 1 - General Information

Last Name ____________ First Name ____________ Middle Initial ______

Home Address ______________________ Apartment No. ______

City ____________ State ______ Zip ______ Phone ____________

Section 2 - Information About Your Household

List the name, age, relationship and social security number of each person living in your household, including yourself, as reported on your tax return.

	Name	Age	Social Security Number
1	**Your name**	**Age**	**Social Security Number**
2	**Name of 2nd person in your household**	**Age**	**Social Security Number**
	Relationship to you		
3	**Name of 3rd person in your household**	**Age**	**Social Security Number**
	Relationship to you		
4	**Name of 4th person in your household**	**Age**	**Social Security Number**
	Relationship to you		
5	**Name of 5th person in your household**	**Age**	**Social Security Number**
	Relationship to you		
6	**Name of 6th person in your household**	**Age**	**Social Security Number**
	Relationship to you		
7	**Name of 7th person in your household**	**Age**	**Social Security Number**
	Relationship to you		

EXHIBIT A17-1.A *(CONTINUED)*

Section 3 - Information About the Emergency **- Page 2 -**

Approximate Date Emergency Occurred ______________________________

Briefly describe the nature of the emergency hardship and the circumstances supporting your request for assistance:

____

____

____

____

____

____

____

____

Section 4 - Applicant's Declaration

I affirm that all the information I have given above in order to qualify for emergency assistance is complete, correct and true to the best of my knowledge. I understand that I may be denied assistance if any of the above is false, and that I may be required to repay any assistance that I get based on false or incomplete information.

Upon request, I agree to provide the granting Foundation or its Administrator with evidence of the information I have given on this application. I understand that this application becomes the property of the granting Foundation when submitted.

SIGN HERE ➤ ______________________________ **DATE** ➤ ____________________

Stop here - you have completed your part of this application.

Return this completed application to the person who gave it to you.

EXHIBIT A17-1.A *(CONTINUED)*

Section 5 - Foundation President's Approval

What factors influenced you to provide emergency assistance to this particular individual and/or household?

Please check all boxes that apply

☐ This individual has no "safety net," such as nearby family or friends, who can offer assistance.

☐ This individual has a large number of dependents.

☐ This individual (or a member of the household) is gravely ill and requires medical attention.

☐ This individual (or a member of the household) is physically disabled or handicapped.

☐ This individual (or a member of the household) is emotionally traumatized/ psychologically fragile.

☐ This individual (or a member of the household) is of advanced age.

Briefly describe any other factors that influenced your decision to provide emergency assistance:

____

____

Who referred this applicant to your attention for emergency assistance?

Amount of Emergency Assistance Grant

You may give an individual

$ ____________

EXHIBIT A17-1.A *(CONTINUED)*

Section 5 - Foundation President's Approval (Continued) **- Page 4 -**

____
Initials of President/Secretary

I agree to deliver to the applicant of this form the grant check provided to me by Foundation Source. I agree to deliver the check promptly upon receipt, and, in any case, not later than December 31st of the year that I receive the check. I understand that Foundation Source relies upon proper delivery on or before this deadline, and that Foundation Source will have no liability whatsoever in the event that such delivery is not made on a timely basis.

____
Initials of President/Secretary

As President/Secretary of the Foundation, I declare that no substantial contributor to the Foundation, nor any of the Foundation's officers and/or directors and members of their respective families or households, will benefit, either directly or indirectly, from the making of this gift. I further declare that the proceeds of this gift will not be used to influence legislation, to finance voter registration drives, or to satisfy the charitable pledges or obligations of any person or organization.

Name of Foundation ____
Please Print

Name of President ____
Please Print

SIGN HERE ➤ ______________________________ **DATE** ➤ ____________________

! **Please return this completed, original application to Foundation Source at 20 Glover Avenue, Norwalk, CT 06850.**

If you have any questions about this application please call Foundation Source Customer Service at (800) 839-1754.

Exhibit A17-1.B

Hardship Assistance Application
(Lower-Income Households)

Purpose	Up to $5,000 per year for low-income individuals and families who require assistance due to financial, medical or other hardship. ▶ Housing expenses (rent, utilities, basic furnishings, mortgage) ▶ Medical expenses (including prescription drugs and equipment) ▶ Living expenses (food, clothing, day care, housekeeping supplies) ▶ Educational expenses (tuition, supplies, tutoring)
Who qualifies for assistance?	Only one grant per household in any 12-month period. ▶ 1-person households with income **under $----------------** ▶ 2-person households with combined income **under $----------------** ▶ 3- and 4-person households with combined income **under $----------------** ▶ 5- or more person households with combined income **under $----------------** **AND** ▶ In addition to the income qualifications above, household net worth must be **under $----------------**. (The total value of savings, house and other assets, less credit card debt, mortgage and other loans.)
How to apply	▶ Sections 1 - 5 are filled out by the person applying for hardship assistance. ▶ Section 6 must be filled out by a professional who is familiar with the applicant's needs. See that section for details. (The application will not be reviewed unless this section is completed.) ▶ Then return this application to the person who gave it to you. ▶ Section 7 will be completed by the foundation considering assistance.

Section 1 - General Information

Last Name ______________________ First Name ______________ Middle Initial ______

Home Address ______________________________________ Apartment No. ______

City ______________ State ________ Zip ________ Phone ______________

Section 2 - Your Household Income

List the name, age, relationship, annual income and social security number of each person, including yourself, living in your household.

1	**Your name**	**Age**	**Social Security Number**	**Annual Income** $
2	**Name of 2nd person in your household** **Relationship to you**	**Age**	**Social Security Number**	**Annual Income** $
3	**Name of 3rd person in your household** **Relationship to you**	**Age**	**Social Security Number**	**Annual Income** $

EXHIBIT A17.B *(CONTINUED)*

Section 2 - Your Household Income (Continued) **- Page 2 -**

4	Name of 4th person in your household	Age	Social Security Number	Annual Income
	Relationship to you			$
5	Name of 5th person in your household	Age	Social Security Number	Annual Income
	Relationship to you			$
6	Name of 6th person in your household	Age	Social Security Number	Annual Income
	Relationship to you			$
			TOTAL ANNUAL INCOME ▶	$

Section 3 - Your Household Net Worth

ASSETS	LOANS/DEBTS
Savings $	Credit card debt $
IRA(s) $	Car loans $
Value of a house that you own $	Mortgage $
Other assets (cars, etc.) $	Other loans (student loans, etc.) $
Total assets $	Total loans/debts $
NET WORTH (TOTAL ASSETS - TOTAL LOANS/DEBTS) ▶	$

Section 4 - How the Money Will Be Used

4A . MEDICAL EXPENSES

If you check any of the boxes in this section, you must have a doctor or health care provider complete Section 6A to confirm your medical condition.

MEDICAL

- ☐ Medical Equipment/Hardware
- ☐ Medical Visit/Procedures
- ☐ Dental Visit/Procedures
- ☐ Prescription Drugs
- ☐ Home Health Care (Aide/Nurse)
- ☐ Therapy (Occupational/Physical/Speech)
- ☐ Psychiatric Care/Counseling
- ☐ Substance Abuse Rehabilitation/Counseling
- ☐ Health Insurance

4B . NON-MEDICAL EXPENSES

If you check any of the boxes in this section, you must have a clergyman, social worker, school representative, government ager or an official from a social assistance program or public charity complete Section 6B to confirm your need for hardship assistance

LIVING

- ☐ Day Care Assistance
- ☐ Food
- ☐ Clothing
- ☐ Housekeeping Supplies
- ☐ Personal Care Products & Services

EDUCATIONAL

- ☐ Tuition Assistance
- ☐ School Supplies
- ☐ Vocational Job Counseling/Training
- ☐ Tutoring Fees

HOUSING

- ☐ Rent/Mortgage
- ☐ Basic Furnishings
- ☐ Utilities

EXHIBIT A17-1.B *(CONTINUED)*

Section 4 - How the Money Will Be Used (Continued) **- Page 3 -**

Briefly describe the circumstances supporting your request for hardship assistance:

Section 5 - Applicant's Declaration

Initials of Applicant

I affirm that I qualify for hardship assistance based on the income and assets criteria specified above and, further, I affirm that my current income and asset levels require these additional funds to mee the needs described in Section 4.

I affirm that all the information I have given above in order to qualify for hardship assistance is complete, correct and true to the best of m knowledge. I understand that I may be denied assistance if any of the above is false, and that I may be required to repay any assistanc that I get based on false or incomplete information.

Upon request, I agree to provide the granting Foundation or its Administrator with evidence of the information I have given on th application. I understand that this application becomes the property of the granting Foundation when submitted.

SIGN HERE ➤ ____________________ **DATE** ➤ ____________

Stop here - you have completed your part of this application.

If you sought assistance for medical expenses, make certain that Section 6A is completed by the treating physician o health care provider. If you sought assistance for non-medical expenses, make certain that Section 6B is completed by a clergyman, social worker, government agent or an official from a social assistance program or public charity that is familiar with your needs. This application will be <u>rejected</u> if the required referral is not completed and signed.

Return this completed application to the person who gave it to you.

EXHIBIT A17-1.B *(CONTINUED)*

Section 6A - Medical Expenses Referral Form **- Page 4 -**

! **This referral form must be completed and signed by the physician or health care provider treating the applicant and/or a member of the applicant's household.**

The patient has requested financial assistance from a private foundation. In order for the patient to qualify for assistance, we need to verify the patient's medical condition. Please return this completed form to the patient.

Patient's name ______________________

Health care provider's name ______________________

Area of speciality & title ______________________

Facility's name (if applicable) ______________________

Address ______________________

City, state and zip ______________________

Phone ______________________

How long have you been treating the patient? ______________ Date of last examination ______________

How many contacts have you had with the patient in the last six months? ______________

Describe the patient's significant medical problems:

____

____

____

Describe treatment and response:

____

____

____

Additional comments:

____

____

I affirm that all the information I have given above in order to assist the named applicant qualify for hardship assistance is complete correct and true to the best of my knowledge.

SIGN HERE ➤ ______________________ **DATE** ➤ ______________

Health Care Provider's Signature

EXHIBIT A17-1.B *(CONTINUED)*

Section 6B - Non-Medical Expenses Referral Form **- Page 5 -**

! This referral form must be completed by a clergyman, social worker, school representative, government agent or an official from a social assistance program or a public charity familiar with the needs of the applicant and/or members of the applicant's household.

The applicant has requested financial assistance from a private foundation. In order for the applicant to qualify for assistance, we need to verify the extraordinary circumstances supporting the applicant's claim. Please return this completed form to the applicant.

Applicant's name ____

Referring person's name ____

Define your relationship with applicant:

Please check the box that applies

☐ Clergyman

Your title ____________________

☐ Social worker

Your title ____________________

☐ School representative

Your title ____________________

☐ Government agent

Your title ____________________

☐ Official from a social assistance program or a public charity

Your title ____________________

Your organization's name (if applicable) ________________________ Phone ________________

Address ____

City, state and zip ____

How long have you known the applicant and/or the members of his or her household? __________

How many contacts have you had with the applicant and/or members of his or her household in the last six months? __________

Based on you familiarity with the applicant's circumstances, what key factors support the applicant's claim for hardship assistance?

____

____

____

____

____

I affirm that all the information I have given above in order to assist the named applicant qualify for hardship assistance is complete, correct and true to the best of my knowledge.

SIGN HERE ➤ ____________________________ **DATE** ➤ ________________

Referring Person's Signature

EXHIBIT A17-1.B *(CONTINUED)*

Section 7 - Foundation President's Approval **- Page 6 -**

What factors influenced you to provide hardship assistance to this particular individual and/or household?

Please check all boxes that apply

☐ This individual has no "safety net," such as nearby family or friends, who can offer assistance.

☐ This individual has a large number of dependents.

☐ This individual (or a member of the household) is gravely ill and requires medical attention.

☐ This individual (or a member of the household) is physically disabled or handicapped.

☐ This individual (or a member of the household) is emotionally traumatized/ psychologically fragile.

☐ This individual (or a member of the household) is of advanced age.

Briefly describe any other factors that influenced your decision to provide hardship assistance:

____

____

How did this applicant's needs came to your attention?

Please check all boxes that apply

☐ Through a clergyman or religious institution

☐ Through a social worker or government agency

☐ Through a social assistance program

☐ Through a public/community charity

☐ Through other means (briefly describe) ______________________

Amount of Hardship Grant

You may give an individual or household a maximum of $5,000 in any 12-month period. You may deliver the grant in a single lump sum, or smaller periodic installments. Please indicate below the total amount of assistance you would like to approve for the applicant for the next 12 months as well as the amount of the initial grant. The initial grant can be anything between $0 and the total grant approved, up to the $5,000 maximum.

Total Grant Approved $ ______________ **Initial Grant Amount** $ ______________

Once the applicant's eligibility for assistance has been confirmed, we will create an account for the applicant within your foundation. Any initial grant will be processed immediately and sent to you for delivery to the applicant. Subsequent grants to the applicant can be initiated from your foundation web site or by calling Foundation Source Customer Service at 800-839-1754. Over the next 12 months, you may make grants to the applicant as often as you wish until it has been entirely depleted.

____
Initials of President/Secretary

I agree to deliver to the applicant of this form the grant check provided to me by Foundation Source. I agree to deliver the check promptly upon receipt, and, in any case, not later than December 31st of the year that I receive the check. I understand that Foundation Source relies upon proper delivery on or before this deadline, and that Foundation Source will have no liability whatsoever in the event that such delivery is not made on a timely basis.

____
Initials of President/Secretary

As President/Secretary of the Foundation, I declare that no substantial contributor to the Foundation, nor any of the Foundation's officers and/or directors and members of their respective families or households, will benefit, either directly or indirectly, from the making of this gift. I further declare that the proceeds of this gift will not be used to influence legislation, to finance voter registration drives, or to satisfy the charitable pledges or obligations of any person or organization.

Name of Foundation ______________________________
Please Print

Name of President ______________________________
Please Print

SIGN HERE ➤ ______________________ **DATE** ➤ ______________

! **Please return this completed, original application to Foundation Source at 20 Glover Avenue, Norwalk, CT 06850.**

If you have any questions about this application please call Foundation Source Customer Service at (800) 839-1754.

EXHIBIT A17-1.C

HARDSHIP ASSISTANCE APPLICATION
(Moderate-Income Households)

Purpose	Up to $5,000 per year for moderate-income individuals and families who require assistance due to job loss, temporary displacement or extraordinary medical need. ▶ Job loss-related expenses (loss of income, job counseling) ▶ Housing expenses (rent, mortgage) ▶ Medical expenses (including COBRA payments, prescription drugs and equipment)
Who qualifies for assistance?	Only one grant per household in any 12-month period. ▶ 1-person households with income **under $**---------------- ▶ 2-person households with combined income **under $**---------------- ▶ 3- and 4-person households with combined income **under $**---------------- ▶ 5- or more person households with combined income **under $**---------------- **AND** ▶ In addition to the income qualifications above, household net worth must be **under $**----------------. (The total value of savings, house and other assets, less credit card debt, mortgage and other loans.)
How to apply	▶ Sections 1 - 6 are filled out by the person applying for hardship assistance. ▶ Section 7 must be filled out by a professional who is familiar with the applicant's needs. See that section for details. (The application will not be reviewed unless this section is completed.) ▶ Then return this application to the person who gave it to you. ▶ Section 8 will be completed by the foundation considering assistance.

Section 1 - General Information

Last Name ______________________ First Name ______________ Middle Initial ______

Home Address ____ Apartment No. ______

City ________________ State ________ Zip ________ Phone ______________

Section 2 - Your Household Income

List the name, age, relationship, annual income and social security number of each person, including yourself, living in your household.

1	**Your name**	**Age**	**Social Security Number**	**Annual Income** $
2	**Name of 2nd person in your household**	**Age**	**Social Security Number**	**Annual Income** $
	Relationship to you			
3	**Name of 3rd person in your household**	**Age**	**Social Security Number**	**Annual Income** $
	Relationship to you			

EXHIBIT A17-1.C (CONTINUED)

Section 2 - Your Household Income (Continued)					- Page 2
4	Name of 4th person in your household	Age	Social Security Number	Annual Income	
	Relationship to you			$	
5	Name of 5th person in your household	Age	Social Security Number	Annual Income	
	Relationship to you			$	
6	Name of 6th person in your household	Age	Social Security Number	Annual Income	
	Relationship to you			$	
			TOTAL ANNUAL INCOME ▶	$	

Section 3 - Your Household Net Worth

ASSETS	LOANS/DEBTS
Savings $	Credit card debt $
IRA(s) $	Car loans $
Value of a house that you own $	Mortgage $
Other assets (cars, etc.) $	Other loans (student loans, etc.) $
Total assets $	Total loans/debts $
NET WORTH (TOTAL ASSETS - TOTAL LOANS/DEBTS) ▶	$

Section 4 - Your Monthly Household Expenses

TOTAL MONTHLY HOUSEHOLD LIVING EXPENSES	
Housing and utilities* $	
Food, clothing and miscellaneous** $	
Transportation*** $	
Health care $	
Child/dependant care $	
Tuition and related educational expenses $	
Credit card payments $	
Other debts/loans (student loans, etc.) $	
Court ordered payments $	
Other expenses $	
TOTAL MONTHLY HOUSEHOLD LIVING EXPENSES ▶	

List here your household's monthly expenses. Do not include charitable or voluntary retirement contributions.

***Housing and utilities**. This is the total of your rent or mortgage payment. Add the average monthly household expenses for property taxes, home owner's or renter's insurance, maintenance, dues, fees and utilities.

Utilities include gas, electricity, water, fuel, oil, other fuels, trash collection and telephone.

****Food, clothing and miscellaneous**. This is the total of clothing, food, housekeeping supplies and personal care products for all household members for one month.

*****Transportation**. This is the total of lease or purchase payments, vehicle insurance, registration fees, normal maintenance, fuel, public transportation, parking and tolls for one month.

EXHIBIT A17-1.C *(CONTINUED)*

Section 5 - How the Money Will Be Used **- Page 3 -**

5A . MEDICAL EXPENSES

If you check any of the boxes in this section, you must have a doctor or health care provider complete Section 7A to confirm your medical condition.

MEDICAL

- ☐ Medical Equipment/Hardware
- ☐ Medical Visit/Procedures
- ☐ Dental Visit/Procedures
- ☐ Prescription Drugs
- ☐ Home Health Care (Aide/Nurse)
- ☐ Therapy (Occupational/Physical/Speech)
- ☐ Psychiatric Care/Counseling
- ☐ Substance Abuse Rehabilitation/Counseling

5B . NON-MEDICAL EXPENSES

If you check any of the boxes in this section, you must have a clergyman, social worker, government agent or an official from a social assistance program or public charity complete Section 7B to confirm your need for hardship assistance .

NON-MEDICAL

- ☐ Rent/Mortgage
- ☐ Health Insurance Premiums (COBRA Payments)
- ☐ Vocational Job Counseling/Training

Briefly describe the circumstances supporting your request for hardship assistance:

____

Section 6 - Applicant's Declaration

____
Initials of Applicant

I affirm that I qualify for hardship assistance based on the income and assets criteria specified above and, further, I affirm that my current income and asset levels require these additional funds to meet the needs described in Section 5.

I affirm that all the information I have given above in order to qualify for hardship assistance is complete, correct and true to the best of my knowledge. I understand that I may be denied assistance if any of the above is false, and that I may be required to repay any assistance that I get based on false or incomplete information.

Upon request, I agree to provide the granting Foundation or its Administrator with evidence of the information I have given on this application. I understand that this application becomes the property of the granting Foundation when submitted.

SIGN HERE ➤ ______________________________ **DATE** ➤ ________________

! **Stop here - you have completed your part of this application.**

If you sought assistance for medical expenses, make certain that Section 7A is completed by the treating physician or health care provider. If you sought assistance for non-medical expenses, make certain that Section 7B is completed by a clergyman, social worker, government agent or an official from a social assistance program or public charity that is familiar with your needs. This application will be rejected if the required referral is not completed and signed.

Return this completed application to the person who gave it to you.

EXHIBIT A17-1.C *(CONTINUED)*

Section 7A - Medical Expenses Referral Form **- Page 4 -**

This referral form must be completed and signed by the physician or health care provider treating the applicant and/or a member of the applicant's household.

The patient has requested financial assistance from a private foundation. In order for the patient to qualify for assistance, we need to verify the patient's medical condition. Please return this completed form to the patient.

Patient's name ______________________________

Health care provider's name ______________________________

Area of speciality & title ______________________________

Facility's name (if applicable) ______________________________

Address ______________________________

City, state and zip ______________________________

Phone ______________________________

How long have you been treating the patient? ______________ Date of last examination ______________

How many contacts have you had with the patient in the last six months? ______________

Describe the patient's significant medical problems:

____

____

____

Describe treatment and response:

____

____

____

Additional comments:

____

____

I affirm that all the information I have given above in order to assist the named applicant qualify for hardship assistance is complete correct and true to the best of my knowledge.

SIGN HERE ➤ ______________________________ **DATE** ➤ ______________

Health Care Provider's Signature

EXHIBIT A17-1.C *(CONTINUED)*

Section 7B - Non-Medical Expenses Referral Form **- Page 5 -**

! This referral form must be completed by a clergyman, social worker, government agent or an official from a social assistance program or a public charity familiar with the needs of the applicant and/or members of the applicant's household.

The applicant has requested financial assistance from a private foundation. In order for the applicant to qualify for assistance, we need to verify the extraordinary circumstances supporting the applicant's claim. Please return this completed form to the applicant.

Applicant's name ______________________________

Referring person's name ______________________________

Define your relationship with applicant:

Please check the box that applies

☐ Clergyman

Your title ______________

☐ Social worker

Your title ______________

☐ Government agent

Your title ______________

☐ Official from a social assistance program or a public charity

Your title ______________

Your organization's name (if applicable) ______________ Phone ______________

Address ______________________________

City, state and zip ______________________________

How long have you known the applicant and/or the members of his or her household? __________

How many contacts have you had with the applicant and/or members of his or her household in the last six months? __________

Based on you familiarity with the applicant's circumstances, what key factors support the applicant's claim for hardship assistance?

____

____

____

____

____

____

I affirm that all the information I have given above in order to assist the named applicant qualify for hardship assistance is complete, correct and true to the best of my knowledge.

SIGN HERE ➤ ______________________________ **DATE** ➤ ______________

Referring Person's Signature

EXHIBIT A17-1.C *(CONTINUED)*

Section 8 - Foundation President's Approval **- Page 6 -**

What factors influenced you to provide hardship assistance to this particular individual and/or household?

Please check all boxes that apply

☐ This individual has no "safety net," such as nearby family or friends, who can offer assistance.

☐ This individual has a large number of dependents.

☐ This individual (or a member of the household) is gravely ill and requires medical attention.

☐ This individual (or a member of the household) is physically disabled or handicapped.

☐ This individual (or a member of the household) is emotionally traumatized/ psychologically fragile.

☐ This individual (or a member of the household) is of advanced age.

Briefly describe any other factors that influenced your decision to provide hardship assistance:

____

____

How did this applicant's needs came to your attention?

Please check all boxes that apply

☐ Through a clergyman or religious institution ☐ Through a social worker or government agency

☐ Through a social assistance program ☐ Through a public/community charity

☐ Through other means (briefly describe) ____________________

Amount of Hardship Grant

You may give an individual or household a maximum of $5,000 in any 12-month period. You may deliver the grant in a single lump sum, or smaller periodic installments. Please indicate below the total amount of assistance you would like to approve for the applicant for the next 12 months as well as the amount of the initial grant. The initial grant can be anything between $0 and the total grant approved, up to the $5,000 maximum.

Total Grant Approved **$** \_\_\_\_\_\_\_\_\_\_ **Initial Grant Amount** **$** __________

Once the applicant's eligibility for assistance has been confirmed, we will create an account for the applicant within your foundation. Any initial grant will be processed immediately and sent to you for delivery to the applicant. Subsequent grants to the applicant can be initiated from your foundation web site or by calling Foundation Source Customer Service at 800-839-1754. Over the next 12 months, you may make grants to the applicant as often as you wish until it has been entirely depleted.

____
Initials of President/Secretary

I agree to deliver to the applicant of this form the grant check provided to me by Foundation Source. I agree to deliver the check promptly upon receipt, and, in any case, not later than December 31st of the year that I receive the check. I understand that Foundation Source relies upon proper delivery on or before this deadline, and that Foundation Source will have no liability whatsoever in the event that such delivery is not made on a timely basis.

____
Initials of President/Secretary

As President/Secretary of the Foundation, I declare that no substantial contributor to the Foundation, nor any of the Foundation's officers and/or directors and members of their respective families or households, will benefit, either directly or indirectly, from the making of this gift. I further declare that the proceeds of this gift will not be used to influence legislation, to finance voter registration drives, or to satisfy the charitable pledges or obligations of any person or organization.

Name of Foundation ____________________
Please Print

Name of President ____________________
Please Print

SIGN HERE ➤ ____________________ **DATE** ➤ __________

! **Please return this completed, original application to Foundation Source at 20 Glover Avenue, Norwalk, CT 06850.**
If you have any questions about this application please call Foundation Source Customer Service at (800) 839-1754.

EXHIBIT A17-1.D

FOUNDATION Source®

The Silent Partner Behind America's Foundations

CHURCH* SUBSTANTIATION FORM

1a. Full name of organization:

____

1b. Mailing address:

____

____

1c. Web site address (if applicable):

____

2. Employer identification number (EIN):

____

3. Name and telephone number of person to be contacted if additional information is needed:

____

4. Date incorporated or formed:

____

5. Check the box for the type of organization:

☐ Corporation ☐ Trust ☐ Association

6. Provide a brief history of the organization, including the reasons for its formation:

____

____

____

____

____

* For purposes of this form, the term "church" generally means a body of people, a congregation, that shares a common belief system, regularly worships together, and engages in sacerdotal functions or rituals (communion, bar-mitzvah, wedding, funeral, etc.). Under this definition, a synagogue or a mosque could constitute a church.

Church Substantiation Form

7. Does the organization have a written creed or statement of faith[1]?

☐Yes ☐No

If "Yes," please briefly describe:

____

____

8. Does the organization have a formal code of doctrine and discipline[2] for its members?

☐Yes ☐No

If "Yes," please briefly describe:

____

____

9. Describe the form of worship and <u>attach a schedule[3]</u> of worship services:

____

____

____

10a. How many active members are currently enrolled in the church?

____

10b. What is the average attendance at the worship services?

____

11. In addition to worship services, what other religious services (such as baptisms, bar-mitzvahs, weddings, funerals, etc.) does the organization conduct?

____

____

[1] For example, the New Testament, the Old Testament and the Qur'an all represent written creeds or statements of faith.
[2] For example, Catechism, Talmudic Law ("Halacha"), and Hadith all represent formal codes of doctrine and discipline for the adherents of Catholicism, Judaism and Islam, respectively.
[3] For example, a weekly or monthly bulletin announcing events pertaining to the congregation, such as births, baptisms, bar-mitzvahs, engagements, funeral services, etc., as well as the times of worship services, sermons, and special events.

EXHIBIT A17.D *(CONTINUED)*

Church Substantiation Form

12. Does the organization have a school for the religious instruction of the young?

☐Yes ☐No

13. Were the current deacons, minister, rabbi and/or pastor formally ordained after a prescribed course of study?

☐Yes ☐No

14. Does the organization have an established place of worship?

☐Yes ☐No

If "Yes," please provide the address and a description of the facility:

____

____

____

If the organization has no regular place of worship, state where the services are held and how the site is selected:

____

____

____

SIGN HERE: ______________________________

PRINT NAME: ______________________________

DATE: ______________________________

PRINT TITLE/AUTHORITY OF SIGNER: ____________________

PART THREE

Obtaining and Maintaining Tax-Exempt Status

CHAPTER EIGHTEEN

IRS Filings, Procedures, and Policies

The Internal Revenue Service (IRS) is an important player throughout the life of an exempt organization (EO). Eligibility to receive tax-deductible donations and member dues, the privilege of receiving tax-free income, and other special advantages granted by federal, state, and local governments give significant economic value to exempt organizations. Tax-exempt status typically begins with recognition of qualification by the IRS and continues with the annual filing and potential scrutiny of the Forms 990, making it important to understand how that division of the IRS functions.

As a result of the Internal Revenue Service Restructuring and Reform Act of 1998, a Tax-Exempt and Government Entities (TE/GE) Division was created to serve exempt organizations, employee plans, and government taxpayers. This division is expected to enhance accountability, technical excellence, and interactive customer service. The intention was to simplify the IRS hierarchy and eliminate regions and districts and their directors and assistant commissioner positions.[1] Since that time, exempt organization matters are handled by the following centralized offices:

- Cincinnati, Ohio, office responsible for determination of exempt status by handling Forms 1023 and 1024 and subsequent issues involving changes in exempt status
- Ogden, Utah, office responsible for processing Forms 990 filed annually
- Dallas, Texas, office responsible for examinations
- Washington, D.C., office responsible for technical guidance, training, and overall supervision of the exempt organization matters

One of the causes of the reorganization was the significant cuts in IRS funding during the 1990s while the number of exempt organizations doubled. Positions of departing personnel were unfilled due to a hiring freeze, placing burdens on those remaining. Personnel in the IRS Exempt Organization group are nonetheless well trained, cooperative, and knowledgeable. Their attitude is normally supportive. They assume EOs operate in good faith as they are supposed to—to benefit the public or their members. Their customary approach is to be helpful and to explain, the publications and handbooks are well written, and they offer good telephone assistance, as a rule. Increasingly IRS guidance, publications, forms, and plans are available on the its Web site.[2]

As a part of the reorganization, an Advisory Committee on Tax-Exempt and Government Entities (ACT) was established to make recommendations on ways to improve tax administration, policies, and procedures for TE/GE Division. ACT membership includes a broad cross section of exempt organization representatives plus lawyers, state and tribal government representatives, and university and church officials. ACT, under the initial leadership of Victoria Bjorklund,[3] designed two charts for the IRS Web site linked to information and documents needed to comply with the tax law and entitled "Life Cycle of a Public Charity" and "Life Cycle of a Private Foundation."[4] The charts resemble a subway map and have lines linking the initial application process with annual filing issues with IRS communications. During the coming years, readers should see very positive results from the

[1] Report of consultants, Booz-Allen & Hamilton, in Exempt Organization Tax Review, vol.21, no.2, August 1998, pp. 179–184.

[2] www.irs.gov/charities&nonprofits.

[3] Tax attorney with Simpson, Thacher & Bartlett, New York.

[4] See reports of the ACT at www.irs.gov/charities&nonprofits.

cooperation between exempt organizations and the IRS. At the 2003 public meeting of ACT, TE/GE commissioner Evelyn Petschek committed the IRS to "considering all of the proposals and keeping the dialogue open." The 2003 report recommended the development of a fully interactive and electronically filable Form 1023, combination of the two public support tests, and revision of the advance ruling response system.

18.1 IRS DETERMINATION PROCESS

Evidence of the IRS's intention to work with representatives of exempt organizations was seen in the IRS project to redesign its determination process. During 2002 and 2003, the IRS, ACT, American Bar Association, American Institute of Certified Public Accountants, and other interested organizations actively worked together to redesign the process. Readers should be alert for release of a new Form 1023, expected to reflect a question-and-answer format. Due to the increase in the number of applications and caps on its operating budgets in the past decade or so, the IRS has devoted too large a portion of its personnel to the advance approval process. Thus, the goal is to simplify and streamline the process to free up IRS personnel to devote more time to examinations.

In concert with revised Forms 1023 and 1024, new procedures are being designed for group exemption applications, dissolutions, amendments, nonexempt charitable trusts, advance approval of grant-making requests, termination of private foundation status, and the advance ruling process of public charities. A control system to track applications upon receipt and make them available electronically to agents across the country so that applications can be worked on a first-in, first-out basis is planned. Applications for complicated issues, such as hospital reorganizations or tax-exempt bond issuers, will still be considered in the Washington, D.C., office.[5]

(a) Revised Application for Recognition of Tax-Exempt Status

A nonprofit organization's first association with the Internal Revenue Service usually begins with the filing of an application—either Form 1023 or Form 1024—to request recognition of its qualification as a tax-exempt organization under Internal Revenue Code §501(c). As this edition was being prepared, the revised forms and expanded instructions are in process. The drafts reflect a question-and-answer format designed to be submitted via the Internet. Due to that fact and the already existing girth of this book, the detailed line-by-line suggestions for completing those forms are omitted from this edition. Readers should expect a new book on the subject, accompanied by an online Web site to keep pace with revisions and new developments in a timely fashion.

Forms 1023 and 1024 should be prepared with great care. For many organizations, the highest scrutiny they ever receive occurs during the determination process. The preparation of the forms is a healthy exercise for a new organization's creators. All aspects of the organization's structure, purposes, finances, and rela-

[5] The list of national office cases is announced periodically.

tionships are explored in the process of answering the questions. The gathering of the necessary information provides a good opportunity for strategic planning for the proposed organization and allows the organizers to focus on realizable goals and discard any ill-conceived or potentially nonexempt projects.

In preparing the applications, it is useful to recognize that the terms used to define organizations qualifying for exemption connote different meanings to different persons. What is religious to one may be sacrilegious to another. The IRS specialist responsible for approving or denying an application construes the meaning of a proposed organization's exempt purpose within the context of his or her understanding of the rules. The length of Chapters 2 through 10 indicates the vagaries of the rules and different standards applicable to each type of exempt activity. While the IRS specialists are knowledgeable and cooperative, they may not perceive a proposed organization in the same light as its creators. IRS Publication 557, Tax-Exempt Status for Your Organization, contains sample documents and provides a comprehensive resource for issues the IRS deems important in this regard. Before plunging into the time-consuming process of preparing and submitting the application, the following questions, distilled from the suitability and new organization checklists in Chapter 1, should be evaluated.

- Is there a need to create a new organization, rather than carry out the project through an existing organization?
- What is the best form of organization: nonprofit corporation, trust, or unincorporated association?
- Which category of exemption is appropriate to the goals and purposes of the organization?
- Can the organizational and operational tests be met?[6]
- Might a profit-making organization be preferable? Are the creators or managers willing to forgo potential profits? Will business activity be substantial?[7] Are prospects for raising venture capital better than for getting grants?
- Should more than one EO be created in view of differing purposes or funding sources? A supporting organization?[8] A lobbying branch qualified under IRC §501(c)(4)?[9] A for-profit subsidiary?[10]
- Is a broadly based governing board appropriate? Should the organization be controlled by its membership?

(b) Timely Filing Critical for (c)(3)

Qualification as a charitable organization under §501(c)(3) is not effective until the nonprofit organization properly notifies the IRS of its qualification by filing

[6] See Chapters 2–10.
[7] See Chapter 21.
[8] See Chapter 11.
[9] See Chapter 6.
[10] See Chapter 22.

Form 1023.[11] Additionally, a newly created charitable organization is presumed to be a private foundation unless its properly completed Form 1023 furnishes information reflecting its ability to qualify as a public charity. Organizations that qualify under other subsections of §501(c) are exempt without filing such notice, although the IRS will not accept a Form 990 unless Form 1024 is filed to establish their qualification for exemption.[12]

Due Date. According to the statute and the general instructions to Form 1023, an application for recognition of exemption is due to be filed 15 months after the end of the month the organization is *formed*. Since 1992, an automatic 12-month extension is available simply by checking a box on Form 1023 and filing within 27 months of the organization's formation. A *reasonable action and good faith standard* applies to allow the extension. When the 27 months have passed, the deadline is again extended automatically and without submission of excuses for the delay if the filing is made before the organization is contacted by the IRS and the interests of the government are not prejudiced by the extension. While it seems too good to be true, voluntary filing within any period of time before the IRS discovers the failure is presumed to evidence good faith.[13]

If the IRS discovers that the application is late,[14] all is still not lost. An extension can still be obtained by submitting "reasons specific to your particular organization and situation." The Form 1023 instructions suggest the following information be provided to show good cause for granting an extension:

- Whether the organization consulted an attorney or accountant knowledgeable in tax matters or communicated with a responsible IRS employee (before or after the organization was created) to ascertain the organization's federal filing requirements and, if so, the names and occupations or titles of the persons contacted, the approximate dates, and the substance of the information obtained
- How and when the organization learned about the 15-month deadline for filing Form 1023
- Whether any significant intervening circumstances beyond the organization's control prevented it from submitting the application in a timely fashion or within a reasonable time after it learned of the requirement to file the application within the 15-month period
- Any other information that applicant believes may establish good cause for not filing in a timely way or may otherwise justify granting the relief sought

[11] IRC §508(d)(3)(B).

[12] IRS Information Letter 2000-0260, dated August 31, 2000; this policy is not required by the tax code.

[13] Rev. Proc. 92-85, 1992-2, C.B. 490; see also IRS Publication 557, Tax-Exempt Status for Your Organization.

[14] Because, for example, Forms 1099 are filed to report interest income paid to a nonprofit that files no Form 1120 or 990. Filing Form SS-4 to obtain an identification number for a new nonprofit organization does not register a requirement to file Form 990 or 1120 in the IRS systems. Federal income tax-filing requirements are based instead on the receipt of income.

Effective Date of Exemption. A nonprofit's tax-exempt status is effective retroactively to its *date of organization* if the application is filed in a timely way and accepted by the IRS. Applications not treated as having been filed in a timely way are effective only from the date of filing. A late-filing organization can request tax-exempt status as a (c)(4) organization for the period between formation and the effective (c)(3) exemption date; otherwise, income taxes may be due on income received prior to the effective date of exemption. To prove timely filing, it is preferable that the application be sent by certified mail, return receipt requested; designated commercial delivery services can also be used. The postmark stamped on the envelope or delivery receipt transmitting the application determines the date of filing. Absent such a postmark, the date the application is stamped as received by the IRS is the receipt date.[15] If the application is simply dropped into a postbox and is subsequently lost, the EO has no way to prove that it was sent.

Date Organization Formed. Timely filing is measured from the date the organization is *formed*, or the date it becomes a legal entity.[16] The date of formation is the date on which the organization comes into existence under applicable state law. For a corporation, this normally will be the date the articles of incorporation are approved by the appropriate state official. For unincorporated organizations, it is the date the trust instrument, constitution, or articles of association are adopted.

Incomplete Applications. The regulations take a surprisingly lenient position regarding incomplete applications. "The failure to supply, within the required time, all of the information required to complete the form, is not alone sufficient to deny exemption from the date of organization to the date such complete information is submitted by the organization. If the organization supplies the necessary additional information at the request of the Commissioner within the additional time period allowed by him (her), the original notice will be considered timely."[17]

(c) Organizations That Need Not File

Three types of organizations are excused from filing Form 1023 to achieve tax-exempt status because they are automatically treated as tax exempt.[18] Despite the exception, some such organizations find it desirable to file for a number of reasons. They may need written IRS approval of their exempt status to evidence eligibility to receive tax-deductible donations. Exempt status in some states is dependent upon federal approval. Nonprofit mailing privileges and other benefits of EOs are most readily obtained by organizations that can furnish a federal IRS determination letter.

Churches. The first type of nonprofit organization excused from seeking recognition of its exempt status is churches, including local affiliates and integrated

[15] Rev. Rul. 77-114, 1977-1 C.B. 153.
[16] Rev. Proc. 90-27, 1990-1, CB. 514.
[17] Reg.§1.508-1(a)(2)(ii).
[18] IRC §508(c)(3).

auxiliaries,[19] and conventions or associations of churches. Even though filing is not required, IRS determination may be desirable to remove uncertainty in the case of an unrecognized sect or a branch of a church established outside the United States. Churches are generally granted favorable status; for example, they need not file an annual Form 990 and may receive more liberal local tax exemptions. Employment tax-reporting rules for ministers are also favorable.[20]

Modest Organizations. The second type that does not need to file is an organization with gross revenue normally under $5,000 that is not a private foundation. The term *normally* means that the organization received $7,500 or less in gross receipts in its first taxable year, $12,000 or less during its first two tax years combined, and $15,000 or less total gross receipts for its first three tax years combined. If an organization has gross receipts in excess of these minimal amounts during any year after its formation, it must file Form 1023 within 90 days after the close of that year.[21] Readers should verify whether this threshold has been raised, as has been suggested.

Subordinate Nonprofits. The third type of organization that need not file Form 1023 is the subordinate organization covered by a group exemption, for which the parent annually submits the required information, as explained in the next subsection.

(d) Group Exemptions

To reduce overall compliance efforts, the parent organization of an affiliated group of organizations centralized under its common supervision or control can obtain a *group exemption* letter recognizing tax-exempt status for itself and members of its group.[22] A central organization may be a subordinate itself, such as a state organization that has subordinate units and is itself affiliated with a national organization. Subordinate chapters, posts, or local units of a central organization, such as the Girl Scouts of America or the National Parent-Teacher Association, need not separately seek recognition by filing separate applications if they are covered by the group letter. All of the subordinate EOs in the group must qualify for the same category of exemption (for example, §501(c)(3) for an educational group), although the parent can have a different category from its subordinates. The group may not include private foundations or foreign organizations.

The parent organization files Form 1023 to obtain recognition of its own exemption. Then, it separately applies by letter to the IRS Key District for approval of its group.[23] Subordinates created after issuance of the IRS group determination letter report only to the central EO for recognition of exemption, not to the IRS. Annually, the central organization submits information to update the master list of

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19 Defined in Section 3.2 using a 14-point test.
20 Discussed in Section 25.4.
21 Reg. §1.508-1(a)(3).
22 Rev. Proc. 80-27, 1980-1 C.B. 677.
23 IRS Publication 557, Tax-Exempt Status for Your Organization.

its subordinates with the IRS. The central organization must file its own Form 990. Affiliates may either file their own returns or be included in a group return.

This process is also under revision as this edition is prepared. The author plans to prepare a *1023 Handbook* once the forms and new procedures are finalized.

(e) Determination of Public Charity Status

Since 1969 and until the new system is totally revamped, a prospective §501(c)(3) organization is identified from its inception as either a private or a public charity. Churches, schools, hospitals, and certain other types of charities qualify as public due to their activities, without regard to their support sources[24] and can be given a *definitive* ruling of public status when the Form 1023 is approved. Those organizations classified as public charities for reasons of their sources of support can receive a final determination only after they have completed a tax year of at least eight months. Otherwise, they receive an advance ruling of public charity status. At the end of the advance ruling period, generally after four to five years of existence, Form 8734 is filed to provide public support information to allow the IRS to issue (or not) a final determination of public charity status. Failure to report back can cause the organization to be classified as a private foundation. Since the information provided is essentially identical to that reported on Form 990, Schedule A, Part IV, many have suggested elimination of Form 8734.

It has also been suggested that the two categories of public charities measured by revenue be merged into one. The majority of such charities qualify under §509(a)(1), and many §509(a)(2) organizations can also qualify for the former. The change will be more difficult to implement (than a redesigned form) because it requires a Tax Code change. Again, readers must be alert for an evolution of this important subject.

(f) Reliance on IRS Determination Letter

After a positive determination letter is issued, the exempt organization can rely upon the IRS's approval of its exempt status as long as there are no substantial changes in its purposes, operations, or character. Absent such changes, the IRS can only revoke exemption due to changes in the law or other good causes, and usually can do so only prospectively. Thus, it is very important that Form 1023 accurately portray the proposed operations. Now that the filing deadline is essentially 27 months from the date an EO is established, it may sometimes be useful to delay filing until adequate plans are developed to file an accurate application—if collection of revenues from donors can await the delay.

Contributors, however, cannot necessarily rely upon the IRS's original determination of overall exempt status and qualification for public charity status dated sometime in the past. A critical question for givers and grant makers to publicly supported §501(c)(3)s, particularly private foundations, is whether an organization's status is the same as originally stated in its determination letter. Has a publicly supported organization become a private foundation?

[24] Defined in §170(b)(1)(A)(I)-(v) and §509(a)(3); see Chapter 11.

Checking Current Status. The current IRS status of a nonprofit organization can be found in two different IRS publications. The first place to check on the status of a (c)(3) organization is the IRS master list of exempt organizations, Publication 78, Cumulative List of Organizations Described in IRC §170(c) of the Internal Revenue Code of 1986. This publication lists all organizations currently qualifying under IRC §501(c)(3) and indicates their public or private status. The list is issued annually, with semiannual updates, and includes organizations qualifying according to the IRS master file. The list is available on the IRS Web site at www.irs.gov/charities&nonprofits.

The second place to check is the *Internal Revenue Bulletin*. Revocation of exemption and removal from the list is reported to the general public in this weekly bulletin in a *deletions list*. Until the IRS communicates a deletion, contributors are entitled to rely upon Publication 78 unless the contributor was responsible for or aware of the EO's loss of such status. It is important to remember that the reliance cushion is different for insiders or donors who are in a position to control organizational changes. For them, the change in status is effective retroactively to the time the change occurred. A private foundation making a grant to another organization whose revocation has not been announced can rely upon the determination letter, unless the public charity is controlled by the PF.[25]

Names Missing from Publication 78. Absence from the list does not necessarily mean that the entity has lost its exempt status. The IRS in the past automatically excluded organizations that did not file annual Forms 990. This policy omits a significant group of charities, including churches and their affiliates, state colleges and universities, and those not technically required to file Form 990 because their annual gross revenue is under $25,000. The United States Catholic Conference and some state universities, among others, have specifically sought group exemptions, despite the fact that filing is not required, to ensure their inclusion in Publication 78.

Individuals and organizations must complete a thorough investigation of a proposed grant recipient's tax status and cannot rely totally upon inclusion in or exclusion from Publication 78. The IRS has reinforced its policy that omission from Publication 78 is sufficient notice of loss of exemption. Until a proposed annual postcard registration for all organizations is in effect, the omission of nonfilers will continue and the burden to prove exemption on those organizations' behalf remains.

A call to the IRS EP/EO Group in Cincinnati, Ohio, at (877) 829-5500 may yield an answer. This number reaches a customer service representative who has the ability to look up an organization on the master list. Knowing the federal identification number of the organization makes the process easy. Name searches don't always yield the right answer due to the alphabetizing method or some change in the name since recognition.

An organization that has lost its determination letter or has one evidencing an expired advance ruling period can also call to request verification of its con-

[25] Rev. Proc. 82-39, 1982-17 I.R.B. 18, Reg. §1.170A-9(e)(5); see discussion of this important issue in Section 17.4(b).

tinued exempt status. Suggestions regarding communication with the IRS, when to report back to the IRS, and the consequences to donors and tax-filing status of an organization that loses its exemption are discussed in Section 18.3.

(g) Exemption for State Purposes

Many states allow exemption from some or all income, franchise, licensing fees, property, sales, or other taxes to religious, charitable, and educational organizations and other §501(c) organizations. The process for obtaining such exemptions varies with each state and locality. Each new exempt organization should obtain current information and forms directly from the appropriate state or local authorities. Some municipalities and states also require registration by organizations that plan to solicit donations.

In Texas, by way of example, the state filing schedule starts when a nonprofit charter is filed with the secretary of state. There is no filing or registration for trusts or unincorporated associations. A status report is next filed with the comptroller of public accounts, indicating which category of federal exemption is being sought. No formal application process is required for exemption. State exemption is automatically granted when the exempt organization furnishes a copy of its federal exemption to the comptroller's office. The organization may choose to furnish a copy of its completed Form 1023 and a letter requesting state exemption, if it desires state recognition prior to receiving the federal approval. The effective date of Texas sales and franchise tax exemption is the date of qualification for §501(c) exemption. If the federal exemption process is delayed one year, a franchise tax may be due. That tax is refundable once the exemption is approved.

18.2 ANNUAL FILING OF FORMS 990

The various Forms 990 are designed to accomplish many purposes that go far beyond simply reporting to the IRS. Accurate and complete preparation of the forms should be given top priority by a nonprofit organization. For §501(c)(3) organizations, the forms have entered the electronic age and are accessible for all to see on the Internet at Guidestar.org. Those organizations' public reporting responsibilities have entered another dimension and deserve careful attention. The IRS implemented an optional electronic filing system for 990s for the 2004 filing season that eventually will be mandatory, with the goal of eliminating the paperwork altogether and allowing more effective monitoring of exempts in a statistical and focused fashion.

In essence, and now in fact, Forms 990 are public documents. Yet another reason for a tax-exempt organization to pay careful attention to completion of the Forms 990 is the requirement that copies of the three most recent years' returns[26] be given upon request to those who pay a modest fee. Between 1984 and 1998, an organization had to allow anyone who knocked on its door to look at its Forms 990 and 1023 or 1024 in its office. Beginning in 1999, a copy of the forms has to be furnished.[27] Different response times apply dependent upon whether the request

[26] Public charities are not required to disclose the names and addresses of their donors.
[27] Effective June 8, 1999; Taxpayer Bill of Rights 2, §1313, amending IRC §6104(e).

comes in the mail, with or without payment, or from a person physically knocking on the door.[28] The form can be posted on the organization's website in printable format. Penalties can be imposed for refusal to follow the disclosure requirements.

Forms 990 are also used for a variety of state and local purposes. In many states, an exempt organization satisfies its annual filing requirement by furnishing a copy of Form 990 to the appropriate state authority. Many grant-making foundations request a copy of Form 990 in addition to or in lieu of audited financial statements, to verify an organization's fiscal activity. The state open-records standards may also require that financial reports and records be open to the public.

Form 990 provides a wealth of information. An organization's basic financial information—revenues, expenses, assets, and liabilities—is classified into meaningful categories to allow the IRS to evaluate the nonprofit's ongoing qualification for federal tax exemption §501(c). The returns are also used by funders, states, and other persons to evaluate the scope and type of a nonprofit's activity. Information pertaining to the accomplishment of the organization's mission is presented—how many persons are served, papers researched, reports completed, students enrolled, and the like. Extensive details are reported for grants paid to support other organizations and disbursed as aid to the poor, sick, students, and others in need. Compensation for services, sales of assets, or loans to or from persons who run and control the organization are reported. The program accomplishment reports should particularly be prepared with a view to presenting the organization to funders and other supporters. Some use the information to compare nonprofit organizations statistically.

The returns also include a list of questions that fish for failures to comply with the federal (and, to some extent, state) requirements for donor and member disclosures, political and lobbying activity, transactions with nonexempt organizations, insider transactions, and more. In sum, the returns are designed to show that a nonprofit organization is entitled to maintain its tax-exempt status and also to provide a wealth of other information of interest to funders, constituents, and regulators.

It is extremely important to remember that tax-exempt organizations are taxpayers. Though certain types of revenues they collect may not be subject to income tax under §501(c), they are subject to all of the sections contained in the Internal Revenue Code and the tax rules imposed by the states in which they operate. Many of the problems nonprofits bring to the author to solve stem from lack of awareness of this fact, ranging from federal payroll taxes, gift and estate taxes, and deductibility rules impacting persons who provide it revenues into other federal issues, such as labor laws and employee retirement plans (ERISA rules).

Lastly, representatives of federally tax-exempt organizations must also inform themselves of the wide variety of state and local tax compliance and filing requirements that are beyond the scope of this book. Due to the increasing globalization of activity fostered by the Internet, readers must pay close attention for new developments in this regard. Professional help should be sought; CPA and bar association referral services should be able to recommend persons with nonprofit organization experience. For those organizations that cannot

[28] Consult the IRS Form 990 instructions for details.

afford to pay, a nonprofit management assistance program can be found. Many civic-minded CPAs, lawyers, and businesspeople donate their time through local bar and CPA societies, the United Way, retired executives, and other volunteer organizations.

(a) Filing Forms 990

The annual Forms 990 are submitted to a processing center devoted exclusively to exempt return filings located in the Ogden, Utah, IRS Service Center. The forms have evolved slowly over the years through cooperative efforts between the IRS, nonprofit organizations, the American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), and state officials. Current page 6 of Form 990, added by Congressional mandate, reveals the related and unrelated nature of an organization's revenues. Parts IV-A and B were added in response to a request from state officials to provide a reconciliation of the Form 990 to audited financial statements. The initial electronic version of the form has no major changes, but readers should expect change.[29] For example, the author has suggested for some years a redesign of Schedule A to contain one summary page that prompts attachment of detailed schedules only by those public charities to which they apply.

It is advisable that tax return preparers review the Form 1023 or 1024 and any IRS correspondence pertaining to a nonprofit's qualification for tax exemption. For many reasons, it is important to know why the IRS granted exempt status. The Forms 990, 990-EZ, and 990-PF ask each year, "Did the organization engage in any activity not previously reported to the IRS?" To identify revenues as related or unrelated to the nonprofit's mission necessitates an understanding of an entity's exempt functions. The starting point for evaluating whether a proposed program might in any way endanger the organization's exempt status is the rationale for their original qualification.

(b) Who Files What

The numerous categories of organizations exempt from income tax are reflected in the different types of returns to be filed. Not all organizations are required to file annual reports with the Internal Revenue Service. Churches and their affiliated organizations, in a manner similar to the Form 1023 rules for churches and divisions of states, or municipalities, do not file Forms 990, except possibly 990-T. Modest-sized organizations may also be excused from filing. The different types of exempt organization annual reports and their basic requirements are as follows:

- *No Form Filed.* Organizations with gross annual receipts *normally* under \$25,000,[30] churches and certain of their affiliates, and other types of organizations listed below need not file; but see why to file below.

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[29] Consult companion website to Jody Blazek, *IRS Form 990 Tax Preparation Guide For Nonprofits*, (Wiley: Hoboken, 2004). For latest developments.

[30] Less than \$37,500 in its first year of existence and an average of less than \$30,000 in each of its first two years.

- *Form 990-EZ.* All exempt organizations, except for private foundations, whose gross annual receipts equal between $25,000 and $100,000 and whose total assets are normally less than $250,000 file Form 990-EZ.[31]
- *Form 990*. All exempt organizations, including certain political organizations but not including private foundations, whose gross annual receipts are more than $100,000 or that have assets of more than $250,000 must file Form 990. §501(c)(3) organizations that are public charities also file Schedule A.
- *Form 990-PF.* All private foundations (PFs) file Form 990-PF annually, regardless of annual receipts or asset levels (yes, even if the PF has no gross receipts).
- *Form 990-T.* Any organization exempt under §501(a), including churches, state colleges and universities,[32] and §401 pension plans (including individual retirement accounts) with $1,000 or more gross income from an unrelated trade or business must file Form 990-T.
- *Form 990-BL.* Black lung trusts, §501(c)(21), file an annual Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons.
- *Form 4720.* Form 4720 is filed to report excise taxes and to claim abatement of such taxes imposed on §501(c)(3) charities and their insiders for conducting prohibited activities.
- *Form 5500*. One of several Forms 5500 may be due to be filed annually by pension, profit-sharing, and other employee welfare plans. Form 5500-EZ is filed for one-participant pension benefit plans and 5500 C/R is filed for organizations with fewer than 100 participants in their employee plans, among others.
- *Form 5768.* The form is filed to elect or revoke an election by a public charity to measure its permissible lobbying expenditures under §501(h).[33]
- *Forms 941, 1099, W-2, W-3*, and other federal and state compensation reporting forms are filed to report payments to workers who perform personal services for tax-exempt organizations.[34]

(c) Federal Filing Not Required

The list of organizations not required to file is reproduced each year in the instructions to Form 990. The most recent version should be consulted if there is any question about filing requirements. The instructions for 2003 list the following organizations as being excused from filing:

[31] There is often talk of raising these levels—watch for new developments.
[32] IRC §511(a)(2)(B).
[33] Discussed in Chapter 23.
[34] Penalties are imposed for failure to withhold and pay over federal taxes from employees and to file other types of compensation reports. See checklists and guidance regarding this very important subject in Chapter 25.

- Churches and their affiliates including an interchurch organization of local units of a church, a convention or association of churches, an integrated auxiliary of a church (such as a men's or women's society, religious school, mission society, or youth group) or an internally supported, church-controlled organization[35]
- Church-affiliated organizations that are exclusively engaged in managing funds or maintaining retirement programs and are described in Rev. Proc. 96-11, 1996-1C.B. 577
- Schools below college level affiliated with a church or operated by a religious order
- Mission societies sponsored by or affiliated with one or more churches or church denominations, if more than half of the society's activities are conducted in or directed at persons in foreign countries
- An exclusively religious activity of any religious order
- A state institution whose income is excluded from gross income under §115
- A §501(c)(1) organization that is an instrumentality of the United States and organized under an act of Congress[36]
- Governmental units and their affiliates granted exemption under §501(a)[37]
- Religious and apostolic organizations described in §501(d) that file Form 1065
- A limited liability company (LLC) that elects to be treated as a disregarded entity the transactions of which are reported as the parent's information[38]
- Certain affiliates of political parties and candidates that otherwise submit revenue and expense reports under the election laws[39]

(d) Why File Even If Not Required To

Annual filing of Form 990-EZ may be advisable for organizations whose annual gross receipts are below the $25,000 mark to ensure that the organization remains on the IRS mailing list to receive the forms for annual filing and other announcements issued by the IRS every year or so. Particularly for a volunteer organization that changes its treasurer each year, it is useful to file if the organizational address is that of its treasurer. The amount of the gross receipts is input on Form 990-EZ without completing any other information. Prudence dictates that any §501(c)(3) organization seeking donations file to ensure its name is listed in IRS Publication 78, the master list of qualifying charitable organizations.

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[35] Section 3.2 discusses the criteria applied to define organizations qualifying as churches and their affiliates.

[36] IRC §§6033(a)(2) and (3).

[37] Defined in Rev. Proc. 95-48, 1995-47 I.R.B. 13.

[38] IRC §301.7701; see Section 1.7(d).

[39] See Section 23.3(c).

Omission from the list may cause two problems: disallowance of charitable contribution deduction to donors and unwillingness of private foundations or other donors to grant funds to the organization.

The extended 27-month deadline for submitting applications for recognition of exemption[40] creates a filing dilemma. A new nonprofit organization should file Form 990 or 990-EZ for the first fiscal year closing, even if it has not yet filed Form 1023 or 1024 for recognition of its exempt status. There is a blank to check on Form 990 to indicate "exemption application is pending." A dilemma arises, however, when the new nonprofit has not yet filed its application for exemption. Until exempt status is entered in the master data bank, the IRS expects the yet-to-be-determined exempt status organization to file Form 1120 or 1041. When tax is due, this is an unwelcome burden, even if the tax is ultimately recovered on an amended return. If income tax returns are filed, gross income received in the form of voluntary donations should be treated as nontaxable income because such donations are gifts.[41]

Whether to submit a protective filing for an expectant exempt organization can also be a tough call. Say the new organization is technically not required to file a 990 because its gross revenue in the first year or two is less than $25,000 or it is a church or church affiliate. In such a case, the possibility that exempt status could be denied must be weighed. Filing of Form 990 by a not-yet-recognized organization, in the good faith belief that it qualifies as an exempt organization, starts the period of limitations for collection of income tax.[42] The submission of financial information on a 1023 has been found not to constitute the filing of a return,[43] so penalties for late filing may not be excusable. The time required to appeal an adverse determination can be years, so filing 990s may furnish valuable protection from tax assessments for an organization ultimately found not to be exempt.[44] Such a filing may also provide a "reasonable cause" excuse to reduce or eliminate penalties for failure to file Forms 1120 or 1041 and pay the tax due. [45]

If recognition of exemption is received after the organization has been in existence for more than a year, treatment as a taxable entity may also occur on a state level. In Texas, for example, a new nonprofit corporation must either furnish evidence of the federal exemption or seek exemption within approximately 15 months of its creation or pay a franchise tax. Otherwise, the charter is revoked. If the IRS subsequently issues recognition of exemption retroactive to the date of incorporation, the state tax paid may be refunded.

(e) Filing Deadline

The due date for Forms 990 gives tax practitioners and exempt organizations a reprieve. Forms 990 are due to be filed within 4½ months after the end of the

[40] Discussed in Section 18.1(b).
[41] IRC §102.
[42] Rev. Rul. 60-144, 1960-1 C.B. 636.
[43] *Colombo Club, Inc.*, 71-2 USTC ¶9674, 447 F.2d 1406 (9th Cir. 1971).
[44] Rev. Rul. 69-247, 1969-1 C.B. 303, modifying Rev. Rul. 62-10, 1962-1 C.B. 305 and reflecting the Tax Court decision in *California Thoroughbred Breeders Ass'n.*, 47 T.C. 335, Dec. 28,225 (acq.).
[45] IRC §6662.

organization's fiscal year, rather than the 2½ months allowed for Form 1120 (for-profit corporations) and the 3½ months for Form 1041 (trusts). An extension of time can be requested if the organization has not completed its year-end accounting soon enough for timely filing. For Forms 990-T and 990-PF, an extension of time to file does not extend the time to pay the tax.

The penalty for late filing is $20 a day (up from $10) for organizations with gross receipts under $1 million a year, not to exceed the greater of $10,000 or 5 percent of the annual gross receipts for the year of late filing.[46] The penalty can also be imposed if the form is filed incompletely. The penalty for a large organization (more than $1 million of annual gross receipts) is $100 a day, up to a maximum penalty of $50,000.

(f) Group Returns and Annual Affidavit

The parent organization in *general supervision or control* of a group of subsidiary exempt organizations covered by a group exemption letter may assume the burden of filing a consolidated Form 990 for its subordinate organizations.[47] The parent files its own separate 990. The parent and the subordinate member organizations of the group must each file separate 990-Ts.[48] To be included in a group Form 990, there must be two or more consenting subordinate member organizations with the following attributes:

- Affiliated with the central organization at the time its annual accounting period ends
- Subject to the central organization's general supervision or control
- Exempt from tax under a group exemption letter that is still in effect
- Uses the same accounting period as the central organization

When the parent, or controlling member, of the group takes responsibility for filing a consolidated Form 990, each affiliate member covered by the group exemption must annually give written authority for its inclusion in the group return. A declaration, made under penalty of perjury, that the financial information to be combined into the group Form 990 is true and complete is included. A schedule showing the names, addresses, and employer identification numbers of included local organizations is attached to the group return. An affiliate choosing not to be included in the group return files its own separate return and checks a block on page 1 of Form 990. Each year, 90 days before the end of the fiscal year, the parent organization separately reports a current list of subsidiary organizations to the Ogden, Utah, Service Center.[49]

[46] IRC §6652(c)(1)(A) as amended by the Taxpayer Bill of Rights 2, §1314.
[47] For rules pertaining to inclusion in a group exemption, see Section 18.1(d).
[48] The consolidated return provisions do not apply for Form 990-T filing purposes except for organizations having title-holding companies, described in Chapter 10.
[49] Rev. Proc. 96-40, 1996-32 I.R.B. 8.

(g) Tax Accounting Issues

Good accounting records are the key to successful preparation of federal information returns for a nonprofit organization.[50] The objective is to allocate and attribute revenues and expenses to the proper lines and columns on Form 990. Both for those organizations that want to properly reflect activity costs and those that want to maximize deductions to offset unrelated business income,[51] proper identification of allocable expenses is an important goal. The functional expense display found on page 2 of Form 990 is the same as the reporting prescribed by generally accepted accounting standards. Three types of expenses are reported: program, administrative, and fund-raising. The Better Business Bureau, National Center for Nonprofit Boards, regulatory agencies, and funders generally recommend that an organization's total administrative and fund-raising costs equal about 25 percent of total expenditures. Thus, the desired proportion for spending on programs and mission-related activities is 75 percent. The total for each type of expense is shown on pages 1 and 2 of the form, making it easy for viewers to calculate the ratios.

Documentation and cost accounting records must be designed to capture revenues and costs by function, including joint cost allocations. When expenses are attributable to more than one function, an organization must develop techniques to have verifiable bases upon which expenses may be related to program or supporting service functions. The functional classification of expenses permits the organization to tell the reader of the financial statements not only the nature of its expenses, such as salary, supplies, and occupancy, but also the purpose for which they were made. At a minimum, most 990 filing organizations need to maintain the following documentation.

A *staff salary allocation system* is essential for recording the time employees spend on tasks each day. The possibilities are endless. Each staff member can maintain an individual computer database or fill out a time sheet. The reports should be completed often enough to ensure accuracy, preferably weekly. In some cases, as when personnel perform repetitive tasks, preparing one week's report for each month or one month each year might be sufficient. Percentages of time spent on various functions can then be tabulated and used for accounting allocations.

Office/program space utilization charts to assign occupancy costs can be prepared. All physical building space rented or owned must be allocated according to its usage. Floor plans must be tabulated to arrive at square footage of the space allocable to each activity center. In some cases, the allocation is made by using staff/time ratios, or the converse. For dual-use space, records must reflect the number of hours or days the space is used for each purpose.

Direct program or activity costs should be captured whenever possible. The advantages include reduction of unrelated business income,[52] proof of qualify-

[50] Chapter 6 of Blazek, *Financial Planning for Nonprofit Organizations* (New York: Wiley, 1996) contains a concise outline of basic accounting principles that apply to nonprofits. An extensive treatise on the rules is contained in Gross, Larkin, and McCarty, *Financial and Accounting Guide for Not-for-Profit Organizations,* 6th ed. (Hoboken:Wiley, 2002).

[51] See Section 21.14.

[52] See Section 21.11.

ing distributions for a private foundation,[53] and insurance against an IRS challenge for low program expenditures. A minimal amount of additional time should be required by administrative staff to accumulate costs by programs. A departmental accounting system is imperative. Some vendors will assist by billing according to multiple accounts that allow identification of purchases by department.

Joint project allocations for activities that serve both program and supporting service purposes must be made on a reasonable and fair basis, recognizing the cause-and-effect relationship between the cost incurred and where it is allocated. Four possible methods of allocating include activity-based allocations (identifying departmental costs), equal sharing of costs (e.g., if three projects, divide by three), cost allocated relative to stand-alone cost (e.g., what it would cost if that department had to hire and buy independently), and cost allocated in proportion to cost savings.[54]

Supporting, administrative or other management costs should be allocated to departments to which the work is directly related. The organization's size and the scope of administrative staff involvement in actual programs determine the feasibility of such cost attributions. Staff salaries are most often allocable. Say, for example, the executive director is also the editor of the organization's journal. If a record of time spent is maintained, his or her salary and associated costs could be attributed partly to the publication. When allocating expenses to unrelated business income, an exploitation of the exempt functions rule may apply to limit such an allocation.[55] A computer-based fund accounting system is preferable, in which department codes are automatically recorded as moneys are expended. The cost of the software is easily recouped in staff time saved, improved planning, and possibly tax savings due to a reduction in income and excise taxes.

Tax Accounting Methods. Plainly and simply, the instructions for Forms 990 say that an organization should generally use the same accounting method on the return to figure revenue and expenses as it regularly uses to keep its books and records.[56] So long as the method clearly reflects income, either the cash or the accrual method may be used. For its simplicity, many organizations use the cash method in their early years for filing Form 990 and for reporting to boards and contributors. Under the cash method, only the actual cash received and expended is reported as the financial activity for the year. What is called the *accrual method* reports transactions when a binding obligation to pay or receive occurs. For example, a promise to make a donation is counted under the accrual method when an unconditional pledge is received. Similarly, an expense is recorded when the obligation to pay for the goods and services occurs, not when paid.

Generally accepted accounting principles (GAAP), however, recommend that the accrual method of accounting be used for financial statement reporting; thus, a certified public accountant (CPA) cannot issue a *clean* or *unqualified* opin-

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[53] See Chapter 15.

[54] Dennis P. Tishlian, "Reasonable Joint Cost Allocations in Nonprofits," *Journal of Accountancy*, November 1992, p. 66.

[55] Discussed in Section 21.11.

[56] In accordance with IRC §446(a).

ion on financial statements prepared on a cash receipts and disbursements basis.[57] Maturing organizations commonly face the need to change to the accrual method, in order to secure an audited statement or to satisfy the requirements of its grantors. The procedures for changing tax accounting methods are discussed in the next section.

The net monetary effect of a change of accounting method is reported on line 20 of Part I of Form 990 and Part III of Form 990-PF as a prior-period adjustment. The beginning-of-the-year statement of financial position (balance sheet) is restated to reflect any prior-period adjustments. The cash method of accounting must be used by public charities for purposes of calculating public support percentages under §170(b)(1)(A)(vi) and §509(a)(2) on Schedule A.[58] Private foundations must also tally the §4942 minimum distribution requirements on a cash basis.[59]

18.3 REPORTING ORGANIZATIONAL CHANGES TO THE IRS

As an exempt organization grows and evolves over the years, it faces the question of how to report changes to the IRS. Annually, Forms 990 ask the organization the following questions:

- Did the organization engage in any activity not previously reported to the IRS? If yes, a statement must be attached.
- Were any changes made in the organizing or governing documents but not reported to the IRS? If yes, a conformed copy of the revisions must be attached.

The procedure for reporting changes is to simply furnish the information and leave it up to the IRS to decide whether the change is acceptable. Commonly, no communication—acceptance or rejection—is issued in response to "yes" answers and accompanying attachments to Forms 990.

An organization may also report changes in its organizational documents and/or activities to the Cincinnati, Ohio, Key District Office with a letter requesting that they determine whether the changes have any impact on the organization's exempt status.[60] A response results—the documents and activity descriptions are actually read, and written approval or questions follow. The submission is not a ruling request; no user fee is charged unless a new Form 1023 is required. The decision to report changes with Form 990 attachments rather than in a separate submission to Cincinnati is therefore influenced by the managers' desire for written approval of the organizational change(s). The following subsections discuss various types of changes that might occur, their consequence, and how to report them to the IRS.

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[57] The rules are found in the periodically updated *AICPA Audit and Accounting Guide for Not-For-Profit Organizations*.
[58] Discussed in Chapter 11.
[59] Discussed in Section 15.4.
[60] Internal Revenue Service, P.O. Box 192, Covington, KY 41012-0192 is the mailing address; Internal Revenue Service, 201 West Rivercenter Blvd., Attn: Extracting, Stop 312, Covington, KY 41011is the delivery address; IRS Announcement 97-87, 1997-36, I.R.B. 1.

(a) When to Request a Ruling

In terms of IRS procedures, it is important to distinguish between gaining approval in advance of a change, rather than seeking sanction for a fait accompli. After a change has occurred in the form of organization or a major new activity is undertaken, the organization chooses the best method to inform the IRS, based upon the preceding discussion. Such action is taken when the relevant tax laws are clear and established precedents exist, and there is little or no doubt that the change is acceptable. If there are no published rulings or clear authoritative opinions on the subject, the organization may file a request for advance approval by filing a ruling from the Exempt Organizations Division in the IRS National Office. When significant funds are involved or if disapproval of the change would mean that the organization could lose its exemption, filing of a ruling request may be warranted.

The decision to request a ruling is made in view of the cost and time involved in the process. The IRS issues a series of revenue procedures each spring to update procedures for seeking guidance in the form of private letter rulings, determination letters, and technical advice. A schedule of fees charged and addresses for submitting requests is provided. The most recent pronouncements set the user fee for a letter ruling at $2,570 ($625 for organizations whose gross receipts are under $200,000).[61]

The Ohio Key District Office has responsibility for determining initial qualification for exemption.[62] As a part of that job, the office also makes determinations that fall short of formal ruling requests; no fee is charged. In addition to responding to submission of changes in name, operations, and organizing documents, as discussed previously, the Ohio office also acts upon the following matters[63]:

- Classification of private foundation status
- Recognition of unusual grants[64]
- Advance approval of a PF's grant-making procedures[65]
- Classification as exempt operating foundation or private operating foundation[66]
- Advance approval of voter registration activities[67]

(b) Fiscal or Accounting Year

A change that commonly occurs during the life of an EO is a change in its tax accounting year. Although some commercial, tax-paying businesses must secure advance IRS approval under IRC §446(e) to change their tax year,[68] a streamlined

[61] Rev. Procs. 2004-8, 2004-1 I.R.B. 240; this procedure listing filing fees is updated annually.
[62] Requirements described in Section 18.1.
[63] Rev. Proc. 98-4, 1998-1 IRB 113.
[64] See Section 11.2(h).
[65] See Section 17.3(e).
[66] See Sections 13.7 and 15.5.
[67] See Section 17.1.
[68] IRS Publication 538, Accounting Periods and Methods, can be consulted for more information.

system is available for EOs. The EO simply files a short-period Form 990 (or 990-EZ, 990-PF, or 990-T) in a timely fashion.[69] If a short-period return is filed by the fifteenth day of the fifth month following the end of the new year-end, approval for the change is not required and it is not necessary to submit Form 1128 to Washington.[70]

Say, for example, a calendar-year EO wishes to change its tax year to a fiscal year spanning July 1 to June 30. By November 15, a six-month return is filed to report the financial transactions for the short-period year (the six months ending June 30 of the year of change). If the organization has not changed its year within the past 10 years (counting backward to include the prior short-period return as a full year), the change is automatic. The words *Change of Accounting Period* are simply written across the top of the front page. A private foundation that changes its tax year must prorate certain calculations.[71]

Form 1128, Application to Adopt, Change, or Retain a Tax Year, must be filed in two situations: (1) the organization has changed its year-end within the past 10 years or (2) the return for the short period is not filed in a timely way. When the organization has previously changed its year, the automatic procedure is still followed if the return is filed within 5½ months of the new year-end. In that case, Form 1128 is attached to the short-period return.

When the filing is late, the organization files Form 1128 with the IRS Service Center in Ogden, Utah, to request permission to change its year. If the request is filed within 90 days after the new filing deadline (February 15 in the preceding example), the organization can request that the IRS consider it a timely filing. If possible, the organization should explain that it acted reasonably and in good faith.[72] A filing fee of $155 (as of January 1, 2004)[73] is due. The appropriate Form 990 is not filed using the new tax year until IRS approval is received.

(c) Accounting Method Change

Once an organization adopts either the cash or the accrual method for 990 reporting purposes, Form 3115 is filed to request permission to change the method. Customarily, this situation occurs for an organization that, in its initial years, used the cash method and has now engaged CPAs to issue audited reports of its financial condition.[74] If the change only involves adoption of FASB #116 to report pledges receivable and payable, permission is not required.[75] An organization that wishes to change its overall accounting methods—for example, inventory valuation or calculation of depreciation—must file Form 3115 to request permission for the change. Since an exempt organization is not com-

[69] Rev. Proc. 85-58, 1985-2 C.B. 740
[70] The Form 990 instructions do not say so, but in the author's experience, an application for extension of time to file the short-period return will be approved.
[71] See Sections 15.1 and 15.2(b).
[72] Under Reg. §301.9100-1; affiliated organizations holding a group exemption follow Rev. Proc. 79-3, as updated by Rev. Proc. 2002-39, 2002-22 I.R.B. 1046, to effect a change.
[73] Supra note 61.
[74] Use of the accrual method is required by the FASB, as discussed in Section 18.2(g).
[75] IRS Notice 96-30, I.R.B. 1996-20; still cited in Form 990 instructions.

monly paying tax, it can follow the *simplified change procedures* to seek approval for an accounting method change. To essentially receive automatic approval, Form 3115 is included in a timely filing (including extensions) of Form 990.[76] A copy of the form is filed with the IRS in Washington, D.C. Late applications can be filed, but will be considered only upon a showing of *good cause*[77] and if it can be shown to the satisfaction of the commissioner that granting the extension will not jeopardize the government's interests. Since EOs typically do not pay tax, the possibilities for such approval are good.

A change of accounting method necessitates reporting deferred or accelerated income or expenses that would have been reportable in the past if the new method had been used. Items "necessary to prevent amounts from being duplicated or omitted be taken into account" over a period of years and to mitigate the burden to a tax-paying entity are calculated.[78] In most cases, the change has no tax consequence for an organization filing its Form 990 or 990-PF. The income or expense adjustments are reported in the year of change. When the change impacts the organization's tax liability for unrelated business income, the most current procedures for reporting the change should be studied.

(d) Amended Returns

When a mistake is discovered after Form 990 has been filed, the question arises whether an amended return should be filed or whether the change can simply be reflected in the next year's fund balance section as a prior-period adjustment. There is usually no tax involved, so in accountants' language, the change is not *material.* The extra efforts involved in preparing an amended return may not be necessary.

Amendment is appropriate when correction would cause a change in public charity status or when unrelated business income[79] would increase or decrease, causing an impact on a tax liability. As a rule, for an insignificant correction with no effect on retention of exempt status or tax liability, complete disclosure on the following year's return, along with inclusion of the omitted amounts, is acceptable. Importantly for certain public charities, the correction to revenue should be reported not only in Part I of Form 990, but also in Part IV of Schedule A.

(e) Change in IRC §509(a) Class

IRC §509(a)(1) to (a)(2) or Vice Versa. Exempt organizations recognized under §501(c)(3) that receive revenues from many sources can often qualify as publicly supported under either IRC §509(a)(1) or §509(a)(2). Qualification is based upon percentage levels of revenues calculated using a four-year moving average of financial support received. The calculation is made annually when the organization completes Schedule A of Form 990.[80] The distinctions between the catego-

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76 Rev. Proc. 2002-28, 2002-18 I.R.B. 815.
77 The guidelines for showing good cause are found in IRC §6110; a user fee will be due.
78 IRC §481.
79 Discussed in Chapter 21.
80 See Blazek, *IRS Form 990 Tax Preparation Guide for Nonprofits* (Hoboken:Wiley, 2004).

ries involve the differences in counting revenues as public rather than private.[81] Passage of either test avoids classification as a private foundation, and there is not necessarily an advantage to either category.[82]

Sometimes changes in an organization's sources of support and exempt function revenues cause it to qualify for the other subsection; in some situations, the character of support might change from year to year, further complicating the issue. All too often, the author notes, the (a)(1) blank is checked when the organization's determination letter reflects (a)(2), or vice versa. When a change is indicated or prior Schedule A's have been incorrect, the organization must decide whether to submit the correct information in the currently filed Form 990 filed in Ogden, Utah, or to the Cincinnati office. Currently, the determination letter is only updated in Cincinnati. Sometimes it is a matter of the organization's officials being tolerant of uncertainty. The factors to consider in making the choice include the following:

- The IRS does not issue amended or new determination letters when Form 990, Schedule A, indicates that a change has occurred.
- Private foundations need not exercise expenditure responsibility[83] in making a grant to either category, so a new determination letter is not critical.
- IRS Publication 78 makes no distinction in its labeling of public charities, so the information is not entered into that IRS record.
- The Ohio Key District Office does not charge a user fee for submission of the information.

Ceasing to Qualify as a §509(a)(3) Organization. Failure to maintain qualification under IRC §509(a)(3) as a supporting organization[84] could occur for either of two reasons:

1. The organizational documents are altered in a manner that removes the requisite relationship with one or more public charities and the organization becomes a private foundation supporting grantees of its choice.
2. A sufficient level of public support is obtained to allow the organization to convert to a §509(a)(1) or (2) organization.

In the first case, conversion to a private foundation (PF) requires no IRS approval, though most would favor overt sanction for the change. Preferably, the conversion is timed to occur at the end of the fiscal year. If not, a short-period final Form 990 would be filed at the end of the §509(a)(3) classification. A short-period Form 990-PF would then be filed beginning with the date of the change.

[81] See Section 11.4.
[82] See Section 12.4(c) for misconceptions due to the §507(b)(1)(A) lack of mention of §509(a)(2) organizations.
[83] See Section 17.6.
[84] See Section 11.6.

Required minimum distributions,[85] excise tax on investment income,[86] and other PF sanctions would apply as if the organization were newly created upon the date of conversion. Full disclosure of the changes would be furnished to the IRS in filing both returns.

In the second situation, the organization would continue to file Form 990, and the change would again be fully disclosed with the return for the year the change occurred. The aforementioned dilemma regarding a change from (c)(1) to (c)(2) or vice versa also applies in this situation. No new determination letter is issued in response to the 990 filing. The EO should analyze its need to furnish evidence of its new status to potential supporters. This situation is rather unusual, and prudence dictates reporting to the Ohio Key District Office to ensure approval of the new category of public status.

Ceasing to Qualify as a Public Charity. Lastly, an organization classified as a public charity may become reclassified as a private foundation for one of two reasons:

1. Its sources of support might fall below the requisite amount of public support needed to qualify under IRC §§509(a1) and (2).
2. It ceases to conduct the activity qualifying it as a public charity or changes its governance structure.

As to an EO the public status of which is based upon revenues, the calculation is made at the end of each year and impacts the next succeeding year. Say, for example, the 2003 Form 990 shows an EO's public support fell to 25 percent of its total support (based upon revenues received from 1999 to 2002). Unless the facts and circumstances test applies,[87] or support level rises in 2004, beginning in the year 2005, the EO would be reclassified as a private foundation. Similar to a §509(a)(3) organization converting to private, all of the special rules applicable to private foundations would become applicable on the first day of 2005.

A church, school, or hospital qualifies as a public charity because of the activity it conducts without regard to its sources of revenue. When such an EO ceases to so operate, it potentially becomes a private foundation on the date the change occurs. As the health-care industry reformed itself during the 1990s, the assets of tax-exempt hospitals were purchased by for-profit hospitals. Typically, the proceeds of the asset sale were then invested to produce income to conduct charitable grant-making programs. For up to two years following the sale, it is conceivable for the hospital to reclassify itself as a public charity based upon its sources of support during the time it operated the hospital. Subsequently, it would become a private foundation unless it reformed its organizational structure to qualify as a supporting organization.

[85] See Chapter 15.
[86] See Chapter 13.
[87] See Chapter 11.2.

18.4 WEATHERING AN IRS EXAMINATION

After securing tax exemption from the IRS Key District office and filing Forms 990 annually with the Internal Revenue Service Center, a call may be received from the IRS Exempt Organization Office in the EO's area. The knock on the organization's door comes in the form of a phone call from the IRS agent assigned to the case to the person identified as the contact person on Form 990. As a part of its ongoing efforts to stretch its resources, the IRS in 2003 asks its ACT advisors to assist in revising its examination efforts.

(a) Redesigned Examination Methods

When the number of requests for recognition of exemption jumped during the 1990s, the IRS reassigned examination agents to handle the increased number of Forms 1023. Exams during that time focused on large universities and hospital systems. Other exams were planned by topic—bingo one year and used car donations in another. As a result, there have been very few examinations of modest organizations. To change this fact, the IRS has hired additional agents and announced a new market segment approach in 2002. Some 35 segments were identified,[88] The plan is to randomly select 150 organizations in each segment to examine and thereby provide more comprehensive coverage of the differing types of exempt organizations. The first group of segments examined included social clubs, business leagues, labor unions, social services, religious organizations (not churches), and community trusts. The check sheets designed for these examinations can be viewed on the IRS Web site. Steve Miller, chief of the TE/GE Division of the IRS, says the expected response to problems they identify will not be to perform additional audits, but instead to develop educational materials to "get people back on track."[89] The yearly focus for examinations is announced in the IRS/Treasury Priority Guidance Plan issued each summer.[90]

An Exempt Organization Compliance Unit (EOCU) was established in the Utah office in early 2004 to perform compliance checks. The EOCU will conduct limited-scope examinations focused on noncompliance issues reflected on returns, using correspondence and telephone contacts by revenue agents and examiners. The first project announced by EOCU involved the more than 2,000 entities that reported substantial contributions but showed no fund-raising expenses. An educational letter was sent to those organizations, in advance of their next filing deadline, to explain reporting requirements. Those returns will be monitored to see

[88] Agricultural, amateur athletics, business leagues, cemeteries, child care, churches, colleges and universities, community foundations, cooperatives, credit unions, economic development, educational, employee benefit, fraternal, grant making, health maintenance, homeowners, hospitals, insurance, labor unions, low-income housing, elder housing, political organizations, private foundations, religious, schools, scientific and research, social clubs, social service, social welfare, supporting, title-holding, trusts, tuition plans, and veterans organizations.

[89] Comments made at January 18, 2002, meeting of the ABA Tax Section Exempt Organizations Committee Meeting.

[90] Available on the Internet at www.irs.gov/charities&nonprofits.

whether subsequently filed returns show fund-raising expenses. "Appropriate actions will be taken if reporting requirements have not been met."[91]

A Team Examination Program (TEP) replaced the prior Coordinated Examination Program (CEP) used to examine large, complex organizations. Under TEP, a wider array of organizations will be reviewed. A Data Analysis Unit will develop databases and information to investigate emerging compliance trends to improve identification and selection of noncompliance issues.

(b) How the IRS Examines Returns

The examination procedures are outlined in the IRS *Exempt Organizations Guidelines Handbook*.[92] Before making contact with the EO for a full-scale office examination, IRS agents are directed to perform the following steps:

- *Pre-examination*. Review the returns to identify any large, unusual, or questionable items that should be examined for determining the correct tax liability and exempt status. The balance sheet and revenue sources are to be scrutinized for unidentified unrelated business activity. The return is checked for completeness and to identify any times to be secured in the field.
- *Administrative file*. The organization's IRS administrative file (if available) is checked for possible caveats in an exemption letter, and to familiarize the agent with the reasons for which the EO was originally exempt. Prior examinations, technical advice, and correspondence with the EO are reviewed. If a prior examination recommended some changes in operations, the agent is to be alerted during the current examination to ensure that corrective action was taken.
- *Examination guidelines*. Agents are responsible for developing issues raised in the examination. They are to study the relevant portions of the *Exempt Organizations Handbook* concerning the particular type of EO they are examining, and they are to gather facts to apply the statutes.
- *Preliminary work*. The examination is to be conducted at the EO's place of business with an authorized representative. Before the books and records are reviewed, the agent conducts an initial interview with the principal officer or authorized representative. The agent looks into programs and activities, sources of income, purchases of assets, receipts and payments of loans, noncash transactions, internal controls, and any large or unusual items.
- *On-site tours*. The agent most likely will request a tour of the facilities. During this time, other employees who may be able to provide a more detailed description of operations may be interviewed.
- *Routine Examination*. After the appointment is made, the examiner will send a letter specifically listing the items to be reviewed. The basic list is

[91] FY 2004 Exempt Organizations (EO) Implementing Guidelines, p. 8.
[92] IRM 7(10)69.

organizational documents, minutes of meetings and correspondence, books and records of assets, liabilities, revenues and disbursements, check registers and bank statements including canceled checks, outside auditor's report, copies of other federal tax returns filed, pamphlets, brochures, and other literature, and supplemental information dependent upon the nature of the organization.

The records are sampled by the auditor. All of the board of director meeting minutes are usually read, but not all of the canceled checks are scanned. The breadth of the materials reviewed depends to some extent upon the quality of the accounting workpapers and ledgers, and on the nature of the EO's operations. When accounting records and original source documents can easily be traced to the numbers reported on the Form 990 being examined, the amount of detailed work will be limited, and the examination scope may also be limited.

- *Rollover Audits*. Sometimes the motivation for the audit is another IRS audit, such as a review of a substantial contributor's or a related organization's return. For example, the IRS might examine individual physicians in connection with its CEP examination program of a hospital. In such a case, the organization must ask to be informed about all of the facts and circumstances, and should do everything possible to cooperate with the other taxpayers involved.

(c) Who Handles the Examination?

The first question to ask in connection with the examination is its location. If a professional firm or advisor is involved, the examination might take place in their office, depending upon the sophistication of the EO's accounting staff and the volume of records to be examined. The IRS has the authority to choose the site, though they are cooperative in that regard. Whatever the examination site, the IRS agent customarily visits the physical location in which the EO's programs are conducted.

For an exam conducted in the EO's facilities, a private office should be provided as the examiner's workspace, rather than a nook near the coffee bar or copy machine. Affording some privacy will prevent organization staff from involving themselves in the examination and will minimize any distractions that would waste the examiner's time. Particularly when a paid professional is assisting in the examination, it is useful to limit the scope of the work and make the review as efficient as possible, to save professional fees.

(d) How to Prepare for the Audit

Good judgment is called for in culling through an organization's records to prepare for the auditor's appointment. For example, the auditor will ask to see correspondence files. In the case of a United Way agency in a major city, this cannot possibly mean every single correspondence file. Perhaps the correspondence of the chief financial officer or the executive director would be furnished, with an offer to furnish more correspondence as issues dictate.

Too often, some of the requested records are not in appropriate condition to be examined. The most troublesome records are too often the board minutes. It is important to carefully prepare minutes of the board of directors' meetings. Optimally, such minutes reflect the exempt nature of the organization's overall concerns. If, for example, a commercial-type operation is undertaken because it helps to accomplish exempt purposes, the minutes should reflect that relationship. Why did the organization enter into a joint venture with a theatrical show producer? Was it because the business put up all the working capital so that the organization experienced no financial risk for producing an avant garde opera production? Proving the relatedness of the venture for purposes of avoiding the unrelated business income tax can be facilitated with carefully documented minutes.

For private foundations, public charities, and civic associations, it is extremely important that the minutes of director and committee meetings document the basis on which salaries, fees, and benefits of personnel are approved. What the IRS calls "contemporaneous documentation of process" is required to evidence that an EO is paying reasonable compensation and not excess benefits subject to sanctions or self-dealing penalties.[93]

Nature of Exempt Activities. The agent reviews the EO's publications with an eye to the exempt purpose of programs conducted. The EO representatives should review the criteria outlined in Chapters 2 through 10 alongside the EO's Form 1023 or 1024 for descriptions of activities originally approved by the IRS. Pamphlets, brochures, and other literature are also an open-ended category. In some cases, the volume of such literature is staggering, so choosing those examples that portray the organization in the best light is acceptable.

Unrelated Business Income. The EO's pamphlets and publications will be perused for advertisements and for donor acknowledgments that constitute advertising.[94] Contracts and agreements relating to joint ventures,[95] licensing of intellectual property, affinity cards, exclusive marketing agreements,[96] rentals of property, and other arrangements with exempt and nonexempt entities will be evaluated in this regard. Descriptions of fund-raising activities would also be studied to discern their character as related or unrelated.

Disclosures. For schools, the agent looks for announcements of its nondiscrimination policy.[97] For (c)(4), (5), and (6) organizations, disclosure of nondeductibility as a charitable entity and for lobbying expenditures would be sought.[98] Lastly, fund-raising invitations, member brochures, and other solicitations for donations of (c)(3) organizations will be reviewed for quid pro quo disclosures.[99]

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[93] See Section 14.4 for private foundations and Section 20.9 for public charities and civic leagues.
[94] See Section 21.8(e).
[95] See Chapter 22.
[96] See Sections 21.10(d) and (f).
[97] See Section 5.1.
[98] See Section 6.4.
[99] See Chapter 24.

Obviously, the examiner cannot and will not look at every shred of paper produced by the organization in the entire year(s). Someone knowledgeable about the issues involved in ongoing qualification for exempt status should review the materials and choose those most suitable to be furnished to the auditor. Or such a person should develop guidelines for persons gathering the information, to ensure that the best possible case is presented to the IRS.

(e) Achieving Positive Results

There are three rules for achieving positive results in an IRS examination:

1. *The less said the better.* Only the specific question asked should be answered. No more information than that requested should be provided. One person in the organization should be identified as the lead contact through whom all answers are to be coordinated. If an outside professional is conducting the examination, he or she would be the contact. The examiner should be given specific answers to specific questions. He or she should not be allowed to go through the organization's file cabinets.
2. *Do not answer a question if you are unsure of its import.* Problem issues should be identified ahead of time, and the materials to be furnished to the IRS should be organized for presentation in the most favorable light. New materials, reports, or summaries of information found lacking can be prepared to better reflect the organization's purposes and accomplishments. If one is unsure of the answer to any question, one should say they are unsure and will find out, make a list for further consideration, consult a professional, or simply get better prepared to present the best picture for the organization. Agents commonly prepare an information request for answers to such questions and for data not readily furnished during the first visit.
3. *Expect the best from the EO examiner.* The IRS agents who examine exempt organizations are knowledgeable, experienced, cooperative (usually), and sympathetic with the spirit of the nonprofit community. They perceive their purpose as different from that of income tax examiners. Their examination can often be a positive experience for an organization. It can validate the EO's qualification and can sometimes help the organization staff to understand why, in fact, the organization is exempt. Another very useful aspect is the reminder it serves of the need to document and preserve a clear record of accomplishments, from both a financial and a philosophical standpoint.

(f) The Desired Result: A "No Change"

The desired end product of an examination is a "no change" letter stating that the organization will continue to qualify for exempt status. If the examiner finds no reason to challenge the status of the organization, he or she will normally convey this conclusion to the organization's representative in the field. The examiner then returns to the office to "write up the case." The report is reviewed by the examiner's superiors and, some months later, the organization should receive a letter.

In the event that the IRS examiner finds the organization is not operating in an entirely exempt fashion, several consequences might follow. Changes with no consequences to the basic exempt status could be suggested. A change from §509(a)(2) to 509(a)(1) might result from an analysis of the sources of revenue, but this change often has no adverse consequence. More seriously, the agent could discover failure of the support test for public charity status and could reclassify the EO as a private foundation. Even so, the basic exempt status as a §501(c)(3) organization is not revoked.

If the agent finds unreported or underreported unrelated business income[100] (UBI), the consequences depend upon the amount of the UBI in relation to the EO's total revenues. If the UBI is not considered excessive, the organization's exempt status is not challenged. However, excessive UBI may trigger an exemption challenge. If Form 990-T has not previously been filed, its preparation will be requested and any delinquent income taxes, penalties, and interest will be assessed. Deductions claimed in calculating the taxable unrelated income will be reviewed.

The agent often comments on documentation policies. Are invoices available to evidence all disbursements? What about expense reimbursement reports, particularly for travel and entertainment? Payments for personal services paid to individuals are closely scrutinized to evaluate employee versus independent contractor classifications.[101]

Private schools must prove that they do not operate in a racially discriminatory manner and present proof of publishing notice of the nondiscrimination policy in a widely circulated publication in the community.[102] Additionally, the agent will seek statistical information about the student and teacher population and scholarship grants that might evidence lack of racial balance. Failure to publish the proper notice by a school that does not, in fact, discriminate will probably be forgiven. However, such a failure in a school whose students are all one race may cause the agent to recommend revocation of status.

The most serious challenge, of course, is a revocation of exemption. The reasons for revocation could include violations of any of the restraints and sanctions discussed in this book. The organization has the right to appeal the examiner's report. Specific procedures must be followed, and some policy decisions will affect the outcome. Resisting a proposed revocation of exempt status demands the assistance of a trained professional and is beyond the scope of this book.

18.5 WHEN ORGANIZATION LOSES ITS TAX-EXEMPT STATUS

The National Office of the IRS issued General Counsel Memorandum 39813 in April 1990, which extensively describes the consequences and tax-filing requirements when a public charity's exempt status is retroactively revoked. Such revocation occurs after the IRS has found that an organization has operated to benefit

[100] See Chapter 21.
[101] See Chapter 25.
[102] See Section 5.1(b).

a limited group of insiders, received excessive unrelated business income, engaged in excess lobbying or political activity, or has otherwise failed to serve its charitable or public constituents. The memorandum was reportedly issued to explain the IRS's response to the Tax Court's opinion in *The Synanon Church v. Commissioner.*[103]

Classification of the Organization. For federal income tax purposes, an organization losing its exempt status is treated as a corporation effective on the date of revocation; a charitable trust will be taxed as a trust. Some relief is provided for innocent failures.

Contributions received by a former EO reclassified as a taxable corporation are to be treated as nontaxable gifts[104] during the years the organization considered itself exempt. Contributions received under false pretenses are taxable. If an organization misrepresented itself in its solicitations by stating that it was tax exempt and was devoting the gifts to exempt purposes when the facts indicate otherwise, the gifts can be deemed taxable income. The tax basis for calculating gain or loss resulting from sale or other disposition of donated goods and property is carried over from the donors.

Regarding *deductions* that can be claimed against the retroactively taxed income, the memorandum provides for the deduction of expenses related to the production of business or investment income. To the extent that income is excluded as gifts or contributions to capital, the allocable expenses would not be deductible. Expenditures not otherwise allowable under the normal income tax rules, such as political expenditures or expenses of an activity not entered into for profit motives (such as a hobby), are also not deductible.

Excise taxes could be due and payable by the organization and its officers and directors, if the revocation is due to excess lobbying expenses or political campaign activities[105] or excess benefits paid to disqualified persons.[106]

One major concern when an EO loses its status may be who is liable for the tax on the unfairly sheltered income. Should the individual contributors lose their tax deductions? Should the organization pay the tax due on the funds? The memorandum makes it clear that the official who diverts funds to his or her own use (resulting in individual financial gain) realizes personal ordinary income to the extent of the economic benefit so derived. Innocent and unknowledgeable contributors do not lose their deductions until notice of revocation is published in the *IRS Revenue Bulletin.*

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[103] *The Synanon Church v. Commissioner*, 57 T.C.M. 605 (1989).

[104] IRC §102, or, arguably under IRC §118 or 362(c) as capital received from nonshareholders.

[105] See Chapter 23.

[106] See Chapters 14 and 20.

CHAPTER NINETEEN

Maintaining Exempt Status

Once an organization's tax-exempt status is recognized by the Internal Revenue Service (IRS), applicable states, and other authorities, the task is to maintain such status. This chapter contains checklists that outline compliance requirements and areas of primary concern. The checklists are designed to remind an exempt organization that it is a taxpayer and to allow its managers and professionals to assist exempt organizations in areas of concern deserving annual review. The objective is to ensure an organization's ongoing qualification for exemption.

The sheer number of items on the lists is evidence of the complexity and scope of issues involved in maintaining exempt status. As you first read the opening checklist, do not expect to understand all the terms if you are not a nonprofit organization specialist. Many of the issues are considered in depth in other chapters, and they will hopefully become clear as the materials are studied.

19.1 CHECKLISTS

The checklists can be used yearly to test compliance with a variety of requirements, including the organizational test, the operational test, identification of unrelated business income, payroll tax compliance, public support tests, private foundation sanctions, filing requirements, excise and estimated tax requirements, property contributions, fund-raising event disclosures, public inspection requirements, and group exemption filing requirements.

Exhibits 19.9 through 19.12 address special compliance issues a tax-exempt organization might face. The sections referred to in brackets after the checklist questions are sections in this book where the text pertaining to the issue can be found.

Readers who have used the prior editions of this book will recognize a difference in the Annual Tax Compliance Checklist for 501(c)(3)s; it now comprises two checklists—one designed for completion by the organization/client (Exhibit 19.1) and one to be used by the tax return preparer (Exhibit 19.2). Hopefully this experiment is helpful to users; reader feedback and comments will be welcome. The checklists in this chapter will also be posted on the web site for the *990 Handbook* to allow them to be regularly updated and supplemented. This chapter includes the following checklists:

- Exhibit 19.1, Annual Tax Compliance Checklist for §501(c)(3) Organization—Public Charity
- Exhibit 19.2, §501(c)(3) Public Charity—Return Preparer Checklist
- Exhibit 19.3, Annual Tax Compliance for Tax-Exempt Organizaitons—Short Form
- Exhibit 19.4, Annual Tax Compliance Checklist for NON §501(c)(3) Organizations
- Exhibit 19.5, Annual Tax Compliance Checklist for Private Foundations
- Exhibit 19.6, Annual Tax Compliance Checklist for Private Foundations—Short Form
- Exhibit 19.7, Annual Tax Compliance Checklist for Section 527 Political Organizations
- Exhibit 19.8, Annual Tax Compliance Checklist—Unrelated Business Income
- Exhibit 19.9, An Intermediate Sanction Checklist
- Exhibit 19.10, Checklist for Website Exemption Issues
- Exhibit 19.11, Checklist for Alternative Investments of Tax-Exempt Organizations, including Private Foundations
- Exhibit 19.12, Checklist for Tax & Accounting Issues for Grants

EXHIBIT 19.1

Annual Tax Compliance Checklist for §501(c)(3) Organization
Public Charity

Organization ____

Prepared by ______________ Reviewed with ______________ Date ____________

A. FEDERAL TAX EXEMPTION MATTERS

1. *New organization*: Has Form 1023 been filed within 15 (or 27) months after organizational date? ____________
2. *Young organization* (1-5 yrs): If advanced ruling received, when does form 8734 need to be filed? ____________
3. *All organizations*: Review Form 1023, IRS correspondence, and determination letter for exempt purposes originally represented to IRS to verify category of exemption. Do current activities match original purposes? ____________
4. Has IRS examined or contacted the organization? If so, please forward any correspondence. ____________
5. Does the EO want to change its fiscal year or its accounting method for tax purposes? ____________

B. STATE AND LOCAL TAXES

1. Is the organization doing business or soliciting donations in any other states? ____________
2. Does organization need to file for exemption with any State? ____________
3. Does organization use proper form to claim exemptions it is entitled to? ____________
4. Must the EO collect sales tax on goods or services sold? Are timely returns filed? Is tax deposited on time? ____________
5. Does the organization pay real or personal property tax? ____________
   a. Would use of property qualify it for exemption? ____________
   b. For property classed as exempt, is it devoted to exempt use or has it been converted to commercial use? ____________

C. CHARTER AND BYLAWS

1. Were there any changes to the charter or bylaws this year? If so, forward us a signed copy. ____________
2. Were there substantial changes in exempt activities or mission to report? If so, send description. ____________
3. Review the minutes of director's meetings to see if they reflect exempt purpose of the EO's activities? ____________

EXHIBIT 19.1 *(CONTINUED)*

Annual Tax Compliance Checklist for §501(c)(3) Organization Public Charity

D. PRIVATE INUREMENT OR BENEFIT

1. Does the EO make any payments or provide benefits to persons that control, manage, or fund it? __________
2. Is compensation paid to personnel (both employees and independent contractors) reasonable? __________

   If total comp of >$90,000 per individual is paid, contact us to complete *Intermediate Sanction Checklist*. __________
3. Are loans made to or from officers or directors? If so, gather details and consider reasonableness. __________
4. Does the organization benefit a broad charitable class or a limited number of persons? __________

E. EXEMPT ACTIVITIES

1. Do activities further the purposes for which EO was determined to be exempt? See Form 1023. __________
2. Are files maintained to document or provide an archive of the nature of activities? __________
3. Does the EO have a record retention policy? __________
4. Does the organization lobby? If so, provide report including expenditures. __________
5. Has the organization participated in any political campaigns? Review newsletters for mention of candidates/issues. __________
6. Does EO have unrelated business income? If so, please contact us to complete *UBI Checklist*. __________
7. Does the EO make payments for personal services it receives? If so, __________
   - **a.** Does the EO have a policy for distinguishing between employees and contractors? __________
   - **b.** Are Forms W-9 on file for persons not treated as employees? Are Forms 1099 filed? __________
   - **c.** Must TWC reports and tax be paid (EO has 4 or more employees)? (No federal tax is due!) __________
   - **d.** Are payroll tax reports filed and taxes deposited in a timely fashion? __________
8. Must Forms 5500 be filed for employee benefit plans? Are limitations on maximum employee contributions adhered to? __________ __________
9. Does your organization have a website? If so, please contact us to complete *Website Checklist.* __________

EXHIBIT 19.1 *(CONTINUED)*

Annual Tax Compliance Checklist for §501(c)(3) Organization Public Charity

F. PROPERTY CONTRIBUTIONS

1. Has the organization received gifts of property (other than listed securities)? ________
2. Were there any sales of $5,000+ donated property made within two years from date of gift? ________

G. VALIDITY OF FINANCIAL INFORMATION

1. Has a compilation, review, or audit checklist been completed to insure proper financial reporting and adherence to accounting principles? ________ ________
2. Should an amended return be filed to reflect re-statement of prior year(s)? ________

H. PUBLICLY SUPPORTED ORGANIZATIONS

1. If financial statements are accrual, prepare revenue report on cash basis. ________
2. Does EO maintain a cumulative database of substantial contributors (donate >2% of annual gifts)? ________
3. Is fund raising conducted in a state that requires reports or registration? ________
4. Do fundraising solicitations reflect fair market value (FMV) of benefits offered to donors in return for gifts? ________
5. For +$75 payments, is value of goods & services provided on solicitation or receipts? ________
6. Do donor thank-you letters reflect statement of goods & services were(or were not) provided for >$250 donors? ________
7. Is the method for calculation for FMV of benefits provided to donors reasonable and documented? ________
8. Has EO furnished copies of Forms 990 and 1023 to members of public requesting to see or buy them? ________
9. Are expense allocations and shared expenses with related §501(c)(4), (c)(5), or (c)(6)s documented? ________

EXHIBIT 19.2

501 (c)(3) Public Charity—Return Preparer Checklist

Organization ______________________________

Prepared by________________Reviewed with ________________Date ____________

COMMENTS

A. GENERAL INFORMATION

1. Verify existing engagement letter or request one. ____________
2. Review prior year returns, memos, workpapers and correspondence, planning suggestions and audit results. ____________
3. Review permanent file, IRS determination, and public charity status. ____________
4. Consider need to change fiscal year or accounting method. ____________
5. Review prior year return and carryforward notes. ____________
6. Use Internet Checklist to review organization's website. ____________
7. Does client wish to review a draft of return? ____________
8. Data Request for next year updated

B. DETERMINE APPROPRIATE FORMS TO FILE

1. If gross receipts <$ 100,000 and assets <$250,000, file 990-EZ. ____________
2. If gross receipts < $25,000, consider filing to keep Pub 78 listing. ____________
3. Determine if any state filings/registrations are required.

C. REVENUE – PART I

CONTRIBUTIONS:

1. For government grants, complete checklist to determine proper reporting as contributions versus program service revenue. ____________
2. Inquire if non-cash contributions were received and, if so, is Form 8282 required. ____________
3. Determine that donated services and facilities are excluded in Parts I & II. ____________
4. Determine if all or part of membership fees should be reported on line 3? ____________
5. Verify contribution portion of fundraising receipts included on line 1. ____________
6. Are contributions received from federated fundraising agencies (United Way-type) and/or from closely associated organizations as indirect public support on line 1b? ____________
7. Scrutinize sponsor acknowledgements for quantitative and qualitative information that causes revenue to be an advertisement and UBI. ____________
8. Verify organization provided donor disclosures for: ____________
   a. +$75 *quid pro quo* solicitations ____________
   b. Donations of $250 + (either disclose no or good faith estimate of value of goods and services provided): ____________
9. Update permanent file schedule of cumulative contributions by donor. ____________
10. Check box or complete Schedule B for >2% or $5,000 donors. ____________

EXHIBIT 19.2 *(CONTINUED)*

501 (c)(3) Public Charity—Return Preparer Checklist

COMMENTS

OTHER REVENUES:

11. Prepare Part VII first to detail revenue for lines 2-11. Complete Unrelated Business Income Checklist. Software transfers number to VII. ____________

12. Update (with client) program service (exempt function) income descriptions and coordinate with Part III. ____________

13. Determine that income from program-related investments (housing rentals, student interest, etc.) is reported as program service revenue. ____________

14. Consider proper presentation for sales of inventory-type items. For a hospital, university, or college only, report as program service revenue. ____________

15. Determine that investment income from debt and equity securities is reported separately from investment income from savings and temporary cash investments. ____________

16. Determine that income or loss of an S corporation is reported as UBTI regardless of the source or nature of such income. ____________

17. Determine if affinity programs are being properly reflected as royalty income. ____________

18. Determine that any capital gain dividends are properly reported as gains from investment securities. ____________

19. Update schedule of cost for investments that are carried at market. Separately report mark-to-market adjustments on line 20. ____________

20. Verify required attachments correctly prepared:
Summarize sales of securities (don't list every trade)
Special events (list details for top three events only)
Inventory Sales ____________

21. Gross up expenses netted against revenue for financial reporting purposes. ____________

D. PART II - FUNCTIONAL EXPENSES

1. Separate grants and allocations from special assistance to individuals. Prepare schedule for lines 22 and 23 grouped by charitable purpose. ____________

2. Tie line 25 for compensation of officers and directors to Part V, column C. ____________

3. Ascertain organization's method for allocating costs to functions. If needed, assist to redesign chart of accounts, establish time keeping or other systems to correctly capture costs throughout the next year. ____________

4. Calculate percentage of program service cost (column b) to total expense and consider discussing with organization if less than 75%. ____________

E. PART III - MISSION AND ACCOMPLISHMENTS ____________

1. Ask organization to prepare Part III and encourage descriptions that portray mission and accomplishments with a view to public disclosure. ____________

2. Determine cost of four largest programs and tie total to Part II, column b. ____________

EXHIBIT 19.2 *(CONTINUED)*

501 (c)(3) Public Charity—Return Preparer Checklist

COMMENTS

F. PART IV - BALANCE SHEET

1. Segregate non-interest-bearing from interest-bearing cash and investment accounts. Show overdraft as liability, not negative cash. ______
2. Identify assets held for investment (lines 54-56) versus all other assets. ______
3. Gather detailed information required for notes receivable and payable. ______
4. Group assets to summarize information for line 54-58 attachments. ______
5. Verify SFAS 117 check box for cash vs. accrual method. ______
6. Update property info to prepare detailed schedule. ______
7. Obtain reconciled bank statements for non-audit clients. ______

G. PART V - LIST OF OFFICERS, DIRECTORS, ETC.

1. Review definition of key employee and determine if the organization employs personnel satisfying this definition. ______
2. For persons with total comp > $90,000, complete Intermediate Sanction checklist with that person (if possible). ______
3. Use organization's, not individual's, addresses for persons listed. ______

H. PART VI - OTHER INFORMATION

1. Obtain attachments if answers to Q. 76-77 are "yes." ______
2. If Q 78 answer is "yes," cross check >$1000 in Part VII, column B ______
3. Verify answers to Questions 81 and 83 are "NO!" ______
4. Determine if Excess Benefits have been paid (see item G2). ______
5. Submit name of human being who should get phone calls on line 91. ______
6. If organization owned 50% or greater interest in taxable entity, gather detailed information. ______

I. SCHEDULE A PUBLIC CHARITY SUPPLEMENTAL INFO

1. Be sure client provided compensation info; if not, ask client to review. ______
2. If any answers to Part II are "yes," verify answers with client. ______
3. Match box checked in Part IV to determination letter. ______
4. Be sure cash basis revenues reported; update carryforward schedule. ______
5. For schools, ascertain whether they need to do news notice. ______
6. If EO lobbies and has not elected 501(h), consult with them about electing. ______

EXHIBIT 19.3

Annual Tax Compliance for Tax-Exempt Organizations—Short Form

Organization ______________________________

Prepared by ____________ Reviewed with ______________ Date ________________

ORGANIZATIONAL TEST

- Have all exemptions been applied for in a timely manner? [Ch.18] ________
- Federal final determination received. [Sec. 18.1] ________
- State franchise, income, sales, property tax, or other exemptions in place. ________
- Were there changes in charter, bylaws, or purposes? ________

OPERATIONAL TEST

- Were there transactions with board members, officers, or other insiders? If so did private inurement occur? [Chs. 20 and 22] ________
- Are activities in furtherance of exempt purposes? [Chs. 3–10] ________
- Do new activities need to be reported to IRS? [Sec.18.3] ________
- Are files maintained to document nature of activities? ________
- If EO lobbies, should Form 5768 be filed? [Ch. 23] ________
- Any political activity? [Ch. 23] ________
- Is there excessive unrelated business income? [Ch. 21] ________
- Is payroll tax withholding required? [Ch. 25] ________
- Are exempt disbursements sufficient for commensurate test? [Ch. 2] ________
- Are fund balances excessive? [Ch. 2] ________
- If EO is a (c)(7), complete social club revenue tests. [Ch. 9] ________
- Review web site ____________ (address) with separate checklist ________

FILING REQUIREMENTS

- Is Form 990 required? If so, can and should EZ be filed? [Sec.18.2] ________
- Is Form 990-T required? (Complete UBI checklist.) [Ch. 21] ________
- Are payroll and information returns filed? [Exh. 25.1] ________
- Should extension of time to file be requested? ________
- Has change of accounting method occurred? [Sec. 18.3] ________
- Should tax filing year be changed? [Sec. 18.3] ________
- Is Form 4720 required for excise taxes? ________
- Is Form 8283 or 8282 due for property gifts received? ________
- Do fund solicitations reveal fair market value or nondeductibility of benefits to donors? [Ch. 24] ________
- For non-(c)(3) is nondeductibility conspicuously disclosed? [Ch. 6] ________
- Are Forms 990 and 1023 made available for public inspection? [Ch. 18] ________
- If EO is part of a group, should group exemption be obtained? [Ch.18] ________
- Has there been an IRS examination? Changes to consider? [Sec. 18.3] ________

EXHIBIT 19.4

Annual Tax Compliance Checklist for NON §501(c)(3) Organizations

Organization ______________________________

Prepared by ______________ Reviewed with ________________ Date ____________________

ORGANIZATIONAL ISSUES

FEDERAL TAX EXEMPTION

New organization: Has Form 1024 has been filed? If not, consider need for proof proposed operation qualifies for exemption and proper listing for IRS filing status? [Sec. 18.1] ____________

All organizations: Review Form 1024, IRS correspondence, determination letter for exempt purposes originally represented to IRS to verify category of exemption. Are activities in keeping with expressed purposes. ____________

STATE AND LOCAL TAXES

- Does EO have any State or local filing requirements? ____________
- Is the EO entitled to any State tax exemptions? ____________
- Obtain a copy of any State tax exemption(s) certificates or prepare application for exemption(s). ____________
- Does the organization use the proper form to claim exemptions it is entitled to? ____________
- Must the EO collect sales tax on goods or services sold? Are timely returns filed? Is tax deposited on time? ____________
- Does the organization pay real or personal property tax? ____________
- Would use of property qualify it for exemption? ____________
- For property classed as exempt, is it devoted to exempt use or has it been converted to commercial use? ____________

CHARTER AND BYLAWS

- Were there any changes to the charter or bylaws this year? ____________
- If so, obtain copy for attachment to Form 990. ____________
- Were there any substantial changes in structure or purpose that require reporting to the IRS? ____________
  Change reported on Form 990? [Sec. 18.3]
  New 1024 required? ____________
- Review the minutes of director's meetings. Do they reflect the exempt purpose of the EO's activities? ____________

OPERATIONAL ISSUES

PRIVATE INUREMENT OR BENEFIT

- Does the EO provide benefits to persons that control, manage, or fund it? [Sec. 20.1] ____________
- Have excess benefits been paid to a disqualified person by a (c)(4) organization? [Sec. 20.9] ____________
- Is the compensation paid to directors, officers, and others reasonable? [Sec. 20.2] ____________
- Are loans made to officers or directors? [Sec. 20.5] ____________

EXHIBIT 19.4 *(CONTINUED)*

Annual Tax Compliance Checklist for NON §501(c)(3) Organizations

- Does the organization benefit an identifiable class of exempt constituents? [Chs. 6–10] __________
- Does the organization sell services or goods that don't advance the mission [Sec. 21.5] __________

VALIDITY OF FINANCIAL INFORMATION

- Has a compilation, review, or audit checklist been completed to insure proper financial reporting and adherence to accounting principles? __________

EXEMPT ACTIVITIES

- Do activities further the purposes for which EO was determined to be exempt (as described in Form 1024 or subsequently reported to IRS)? __________
- Are files maintained to document or provide an archive of the nature of activities? For example: copy of program notices, peer review boards, member services, etc? __________
- Does the EO lobby? If so, is it germane to purposes? __________
- Has the organization participated in any political campaigns? Does campaigning further the exempt purpose? [Sec. 23.1] __________
- Should Form 1120POL, 8871, or 8872 be filed? [Sec. 23.3] __________
- Are expense allocations and expenses shared with related 501(c)(3), (4), (5), or (6)s accurately calculated? [Sec. 22.1] __________
- If a social club, can it meet the gross revenue tests? [Sec. 9.4] __________
- Does EO have unrelated business income? [Sec. 21.5] If so, complete Form 990-T and UBI checklist. __________
- Does the EO make payments for personal services. If so, complete *Employee vs. Ind. Contractor Status* [Exh. 25.1]. __________
- Does the EO have a policy for distinguishing between employees and contractors? Are Forms W-9 obtained for all contractors? __________
- Does EO comply with Federal/payroll requirements? [Exh. 25.2] __________
- Are payroll taxes deposited in a timely fashion? __________
- Are Forms 5500 due to be filed for employee benefit plans? __________
- Has the IRS ever examined the organization? Review reports for compliance with any changes. __________
- Should an amended return be filed to reflect restatement of prior year(s)? [Sec. 18.3] __________
- Obtain the organization's web site address. www.____________________
- Complete web site checklist. __________

FILING REQUIREMENTS

- FORM 990EZ: EOs with gross receipts <$ 100,000 and assets <$250,000 [See *990 Handbook*] __________
- FORM 990: EOs with gross receipts >$100,000 or assets >$250,000 file long form __________

EXHIBIT 19.4 *(CONTINUED)*

Annual Tax Compliance Checklist for NON §501(c)(3) Organizations

- If the EO is exempt from filing, consider filing. [Sec. 18.1] Address is kept current and statutory time starts. ____________
- Is the EO a chapter or affiliate of a central organization holding a group exemption? If so, ____________

    Must the chapter file its own 990? ____________

    Will the central EO file a group 990? ____________

    Have changes in address been reported to central? ____________
- Was an extension of time requested? [Form 2758] ____________
- If the return is being filed late, has penalty abatement been requested? ____________
- Does the EO need to change its fiscal year or its accounting method for tax purposes? [Sec. 18.3] ____________

NOTICE OF NONDEDUCTIBILITY

- Fund-raising solicitations must "conspicuously" say payments don't qualify for charitable deduction. [Sec. 6.4] ____________
- For (c)(4),(5), and (6) organizations that lobby, has the portion of member dues attributable to lobbying been calculated? If so, have members been informed of nondeductible amount? [Sec. 6.4] ____________
- Has the EO chosen to pay proxy tax for lobbying expenses? If so, has Form 990-T be filed to pay tax? ____________
- Do accounting records identify lobbying expense? ____________

PUBLIC INSPECTION REQUIREMENTS

- Has the EO furnished Forms 990 and 1024 to persons asking to inspect them? [Sec. 18.2] ____________

EXHIBIT 19.5

Annual Tax Compliance Checklist for Private Foundation (PF)

Private Foundation ____________________

Prepared by ____________ Reviewed with ____________ Date ____________

FEDERAL TAX-EXEMPT STATUS

- Review Form 1023 and determination letter for exempt status and purposes originally represented to the IRS. ______
- Was there any substantial change(s) in the PF's exempt purpose(s) that require reporting to the IRS? [Sec. 18.3] ______
  - Review the minutes of director's meetings. ______
  - Should change be reported on Form 990-PF? ______
  - Is a new 1023 required? ______
  - Has there been a substantial contraction or termination? ______
- Was there a change in the charter or bylaws to be attached? ______
- Should PF consider conversion to a public charity? [Sec. 12.4] ______
- Could PF qualify as a Private Operating Foundation? [Sec. 15.5] ______
- Ask for copies of any IRS notices and reports of IRS exam. Review reports for compliance with any changes ______

STATE AND LOCAL TAXES

- Obtain a copy of State tax exemption(s) letter or prepare application for exemption(s). ______
- Does the organization use the proper form to claim exemption on purchases? ______
- Must the PF collect sales tax on goods or services sold? If so, are timely returns filed? Is tax deposited on time? ______
- Does the organization pay real or personal property tax? ______
  - Would use of property qualify it for exemption? ______
  - For property classed as exempt, is it devoted to exempt use or has it been converted to investment property? ______
- Instruct client to send copy of 990-PF to State Attorney General(s) and determine other state return filing requirements. ______

§ 4941 SELF DEALING

- Secure list of officers/directors; update disqualified persons ("DPs") and substantial contributor record [Ch. 12]. ______
- Did a sale, exchange, or other transactions involving property of any sort occur between the PF and its DPs? [Sec. 14.2] ______
- If so, did the financial transactions involve one of the exceptions? ______
  - Was the payment for reasonable compensation? [Sec. 14.4] ______
  - If so, complete *Comp. Disqualified Person Checklist* [Exh.14.1] ______
- Did the PF reimburse exempt function expenses? [Sec. 14.7] ______

Source: Jody Blazek 2000, *Private Foundations: Tax Law and Compliance,* Bruce R. Hopkins and Jody Blazek (Hoboken: John Wiley & Sons, 1998).

EXHIBIT 19.5 *(CONTINUED)*

Annual Tax Compliance Checklist for Private Foundation (PF)

Was interest free loan being repaid? [Sec. 14.3] ________

If the PF shares people or space, does PF have an Expenditure Documentation Policy? [Exh. 14.2] ________

Did the <$5,000 transaction occur during "normal course" of retail business? [Sec. 14.2(c)] ________

Were benefit tickets accepted for PF grant? [Sec. 14.5(c)] ________

Does the PF pay for memberships? [Sec. 14.5(c)] ________

Does the PF indirectly do business with a DP? [Sec. 14.8] ________

- For property bequeathed to the PF, should distributions from estate be delayed until property sold or divided? [Sec. 14.9] ________

§4942 MANDATORY DISTRIBUTION REQUIREMENT

- Review the following issues to determine if the PF has spent a sufficient amount on its charitable programs? ________
- Evaluate calculation of minimum investment return: [Sec. 15.2] ________

Are methods of valuation consistently applied? ________

Are non-readily marketable asset valuations updated? ________

Are exempt function assets excluded? ________

Is dual-use property properly reasonably allocated? ________

Can >1½% cash reserves be justified? ________

Can discount be applied for non-marketable assets? ________

Has real estate declined in value since last appraisal? ________

- Do all grants reported in Part XV count as qualifying distributions? [Sec. 15.4] ________

Any grants organization controlled by the PF? ________

Any redistributions to be offset against corpus? ________

- Must portion of program expenses be reported in column (c) to offset revenues from exempt activities? ________
- Is Part I, column (d) prepared on a cash basis? [Sec. 15.4] ________
- Should PF seek approval for Set-Aside of funds for program better accomplished with several years of income? ________
- Complete Part XII to determine whether minimum distribution requirements are satisfied? [Sec. 15.6] ________
- Determine if adjustments to "qualifying distributions" are needed for the following: [Sec. 15.3] ________

Sale of exempt assets previously classified as distribution? ________

Amounts not redistributed in a timely manner by another private foundation or controlled organization? ________

Set-asides not used for an approved purpose? ________

- If operating foundation, verify data to complete Part XIII [Sec. 15.5]: ________

Amount spent for active conduct of programs. ________

Value of assets devoted to active programs. ________

Source: Jody Blazek 2000, *Private Foundations: Tax Law and Compliance*, Bruce R. Hopkins and Jody Blazek (Hoboken: John Wiley & Sons, 1998).

EXHIBIT 19.5 *(CONTINUED)*

Annual Tax Compliance Checklist for Private Foundation (PF)

Evaluate character of grants to other organizations to distinguish active program activity. __________

Determine if individual grant program qualifies as an active exempt function activity. __________

- Does PF conduct active programs to report in Part IX? __________

§4943 EXCESS BUSINESS HOLDINGS

- If the PF owns more than 2% of a corporation, partnership, or other business holding, ascertain whether disqualified persons' holdings must be aggregated. [Sec. 16.1] __________
- Calculate permitted stock holdings to identify whether excess business holdings exist. __________
- If the PF has permitted excess business holdings acquired through gift or bequest, evaluate status of planning for timely disposition of excess? __________

§4944 JEOPARDIZING INVESTMENTS

- Review PF's investment listings to evaluate presence of a jeopardizing investment. [Sec. 16.2] __________

  Is the fair market value of assets more than cost basis? __________

  Does the foundation hold properties that produce no income? __________
- If net capital loss reported, review past years of investment returns for trend indicating jeopardizing investments. __________
- Does PF have "alternative investments?" If so, complete Checklist for Alternative Investments.[Exh. 19.11] __________

§4945 TAXABLE EXPENDITURES

- Obtain a list of grants paid during year and determine if PF spent money for any of following: [Answers should be NO] __________

  Organizations not listed as public charities in Publication 78. __________

  Lobbying or a grant to finance lobbying [Sec. 17.1] __________

  Political campaign [Sec. 17.1] __________

  Unapproved individual grant [Sec. 17.3] __________

  Support of noncharitable program [Sec. 17.7] __________
- Are files maintained to evidence charitable nature of the PF's activities? For example: files for grantees, copies of exhibitions, class schedules, articles published? __________
- Do grant files contain a Grants Checklist [Exh. 17.1] and Grant Transmittal Letter [Exh. 17.2 and 17.3] for each grant paid? __________
- Did the PF make an expenditure responsibility grant to another PF or a non-(c)(3) entity? [Sec. 17.6] If so: __________

  Prepare Control Checklist of 7 Steps [Exh. 17.5] __________

  Pregrant inquiry [Exh. 17.6] __________

  Expenditure responsibility agreement [Exh. 9.5 and 9.6] __________

Source: Jody Blazek 2000, *Private Foundations: Tax Law and Compliance,* Bruce R. Hopkins and Jody Blazek (Hoboken: John Wiley & Sons, 1998).

EXHIBIT 19.5 *(CONTINUED)*

Annual Tax Compliance Checklist for Private Foundation (PF)

Report in Form 990-PF [Exh. 12.1] ______

- Is the list of grantees for Part XV designed to reflect the purpose of each grant and summarized to reflect the PF's mission? I.e., does this part paint a clear picture of type of organizations the PF wants to support? [Sec. 12.2(m)] ______

VIOLATIONS OF §4941/4945 SANCTIONS

- Did a violation of §§4941-4945 rules occur? ______
- Verify correct answers given in Part VII-B. A "Yes" indicates Form 4720 may need to be filed. ______
- Coordinate answer to Question 5(c) of Part VII-B with attachment of Expenditure Responsibility Report. ______
- Should a Form 4720 be prepared? [Exh. 12.2] ______

  Has violation been corrected? [Sec. 6.6(c) or Sec. 9.8] ______

  Can the penalty be abated for reasonable cause? ______

§4940 INVESTMENT EXCISE TAX

- Does the PF maintain records to support allocation to identify disbursements directly related to its investments, grant-making and program activity, and management and general expenses? [Sec. 13.3] ______
- Are expense allocations consistent with prior years? ______
- Is the tax basis of assets (donee's basis for gifts received) maintained separately from the book basis? [Sec. 13.2] ______
- Does the PF have substantially appreciated property it could distribute (rather than cash) to grantees to reduce excise tax on capital gain from sale of the property? [Sec. 13.4] ______
- Should the PF make extra qualifying distributions to reduce its excise tax to 1%? [Sec. 13.4] ______
- Might estate income distributions be considered taxable because termination of estate if unreasonably delayed? ______
- Does PF have any nontaxable investment income? [Sec. 13.1] ______
- Does PF have unrelated business income? [Ch. 21] If so: ______

  Complete UBI checklist and prepare Form 990-T? ______

  Is the unrelated income excluded from Part I, column (b)? ______

- Was excise tax paid in a timely fashion? [Sec. 13.6] ______

  Should Form 2210 be attached to Form 990-PF? ______

  Must large corporation method for estimating be used? ______

  Is tax properly paid with federal tax deposit coupons (Form 8109) or must it be paid electronically? ______

FILING REQUIREMENTS

- Has PF followed the public disclosure rules for its past three years of 990-PFs and Form 1023? [Sec. 18.3(a)] ______

Source: Jody Blazek 2000, *Private Foundations: Tax Law and Compliance,* Bruce R. Hopkins and Jody Blazek (Hoboken: John Wiley & Sons, 1998).

EXHIBIT 19.5 *(CONTINUED)*

Annual Tax Compliance Checklist for Private Foundation (PF)

- All PFs and PFs converting to public status must file Form 990-PF regardless of support levels. [Appendix 16.1] __________
- Was an extension(s) of time requested on Form 8868? __________
- If the return is being filed late, has penalty abatement been requested? __________
- If the PF wants to change its fiscal year, set up due date for automatic change for next year? __________
- Does the PF need to file Form 3115 to adopt change in tax accounting method? __________
- Does Part XVI-A, Analysis of Income Producing Activity, indicate PF has unrelated business income? [Sec. 12.2(n] __________
- Has Form 990-T been filed? Investigate application of exceptions and modifications that make unrelated income not taxable. [Sec. 11.1 & 11.2] __________
- Does the EO make payments for personal services? If so, __________

  Determine whether PF has a policy to distinguish between employees and independent contractors. __________

  Does PF comply with Federal and state payroll withholding and reporting requirements? __________

  Are payroll taxes deposited in a timely fashion? __________

  Are Forms 941, 5500, W-2 and other tax reports timely filed? __________

CONTRIBUTIONS RECEIVED

- Has substantial contributor list been updated? __________
- Has the PF received gifts of property (other than listed securities) for which Form 8283 is required? __________
- Must sales of $5,000+ donated property made within two years from date of gift be reported on Form 8282? __________
- Has PF furnished its funders §170 donation acknowledgments indicating no benefits provided? __________

  (Provision of benefits would indicate self-dealing.)

Source: Jody Blazek 2000, *Private Foundations: Tax Law and Compliance*, Bruce R. Hopkins and Jody Blazek (Hoboken: John Wiley & Sons, 1998).

EXHIBIT 19.6

Annual Tax Compliance Checklist for Private Foundation (PF)—Short Form

Organization ____

Prepared by ____________ Reviewed with _______________ Date __________________

If the answer to any of these questions is yes, complete long form checklist.

§4941 SELF DEALING [CH. 14]

- Did PF have financial transactions with disqualified persons? ________
- Did the PF reimburse exempt function expenses? ________
- For property bequeathed to the PF, should distributions from estate be delayed until property sold or divided? ________

§4942 MANDATORY DISTRIBUTION REQUIREMENT [CH. 15]

- Does Part XIII or XIV indicate PF failed to spend a sufficient amount on its charitable programs? ________
- There are returned grants to be added back. ________

§4943 EXCESS BUSINESS HOLDINGS [CH. 16]

- Does PF own more than 2% of corporation, partnership, or other business? ________

§4944 JEOPARDIZING INVESTMENTS [CH. 16]

- Does PF's investment list reflect significant declines in value?

§4945 TAXABLE EXPENDITURES [CH. 17]

- Did the PF spend money on: ________
- Organizations not listed as public chairites in Pub 78 ________
- Lobbying or a grant to finance lobbying ________
- Political campaign ________
- Unapproved individual grant ________
- PF does not maintain grant files with Grants Checklist ________

§4940 INVESTMENT EXCISE TAX [CH. 13]

- PF does not have documentation for expense allocations. ________
- Estimated tax payments not made in timely fashion ________
- Can PF time capital gains to reach the 1% tax rate? ________

OTHER TAX COMPLIANCE ISSUES ________

- PF failed to comply with public disclosure rules for past three years of 990-PFs and Form 1023. [Ch. 18.2] ________
- Part XVI-A, Analysis of Income Producing Activity, indicates PF has unrelated business income. [Ch. 21] ________
- PF makes payments for personal services. [Ch. 25] ________
- PF failed to furnish its funders §170 donation acknowledgments indicating no benefits provided? [Ch. 24] ________
- (Provision of benefits would indicate self-dealing.) ________
- There are change(s) to report to IRS. [Ch.18.3] ________
- PF does not have local and state exemptions in place. ________

Source: Jody Blazek 2000, *Private Foundations: Tax Law and Compliance,* Bruce R. Hopkins and Jody Blazek (Hoboken: John Wiley & Sons, 1998).

EXHIBIT 19.7

Annual Tax Compliance Checklist Section 527 Political Organizations

Organization ______________________________

Prepared by ____________ Reviewed with ______________ Date ______________

FEDERAL TAX EXEMPTION

HAS FORM 8871 BEEN FILED? ______

- If not, is the PO required to report as a political committee to the FEC? ______
- If not, are annual receipts expected to always be less than $25,000? ______

STATE AND LOCAL TAXES

- Does PO have any state or local filing requirements? ______
- Is the PO a state or local candidate committee or a local committee of a political party? ______
- Must the EO collect sales tax on goods or services sold? Are timely returns filed? Is tax deposited on time? ______

CHARTER AND BYLAWS

WERE THERE ANY CHANGES TO THE CHARTER OR BYLAWS THIS YEAR? ______

- If so, obtain copy for attachment to Form 990. ______

EXEMPT ACTIVITIES ______

- Do activities further the purposes for which PO was determined to be exempt? ______
- Are files maintained to document or provide an archive of nature of activities? ______
- Does the PO make payments for personal services? If so, complete *Employee vs. Independent Contractor Status*. ______
- Does the PO have a policy for distinguishing between employees and contractors? Are Forms W-9 obtained for all contractors? ______
- Does PO comply with Federal/payroll requirements? Timely deposits? ______
- Has the IRS ever examined the organization? Review reports for compliance with any changes. ______
- Obtain the organization's web site address. www. ______________

FILING REQUIREMENTS FORM 990

- FORM 990EZ: POs with gross receipts <$ 100,000 and assets <$250,000 ______
- FORM 990: POs with gross receipts >$100,000 or assets >$250,000 ______
- The PO is excepted from filing (<$25,000 in gross annual receipts) ______

FILING REQUIREMENTS FORM 1120POL

- FORM 1120POL: PO must file if taxable income >$100 *OR* gross receipts are >$25,000, without regard to income. ______

EXHIBIT 19.7 *(CONTINUED)*

Annual Tax Compliance Checklist Section 527 Political Organizations

- The PO is excepted from filing because taxable income <$100 *and* gross receipts are <$25,000. __________

FILING REQUIREMENTS FORM 8872

FORM 8872: PO MUST FILE UNLESS EXCEPTED BECAUSE: __________

- The PO is required to report under the FEC Act as a political committee. __________
- The PO anticipates that annual receipts will always be less than $25,000. __________
- The PO is a political committee of a state or local candidate. __________
- The PO is a state or local committee of a political party. __________

NOTICE OF NONDEDUCTIBILITY __________

- Fund-raising solicitations must “conspicuously” say payments don’t qualify for charitable deduction. __________

PUBLIC INSPECTION REQUIREMENTS __________

- Has the PO furnished Forms 990 and 8871 to persons asking to inspect them? __________

EXHIBIT 19.8

Annual Tax Compliance Checklist—Unrelated Business Income

Organization ______________________________

Prepared by ____________ Reviewed with ______________ Date ________________

I. UNRELATED BUSINESS INCOME

1. Does the EO sell goods or services in an activity that does not relate to or further its exempt purposes? [Sec. 21.4 and 21.5] ________

2. Does the "related business" have a commercial taint? If so, complete *Commerciality Test* on Exh. 21.1. ________

3. Are revenues and codes correctly reported on Form 990, Part VII? ________

4. Is the business activity substantial (as measured by gross revenue or staff time devoted to it) in relation to the organization's exempt activity? [Sec. 21.3} ________

5. Does the organization do any of the following?

- **a.** Sell advertisements in its publications? [Sec. 21.8(d) and Exhibit 21-4 for calculation of taxable portion] ________
- **b.** Provide substantial benefits to corporate sponsorships? [Sec. 21.8(e)] ________
- **c.** Rent personal or real property? [Sec. 21.10(c)] ________
- **d.** Earn any income from indebted property, margin accounts, or loans? [Sec. 21.12] ________
- **e.** Receive revenues from Subchapter S corporation or partnership?[21.10g] ________
- **f.** Receive interest, dividends, rents or royalties from >50% subsidiary? ________
- **g.** Sell its mailing list? [Sec. 21.9(h)] ________
- **h.** Operate a bookstore, restaurant, or parking lot for member convenience? If so, are any sales made to unrelated parties causing the fragmentation rule to apply? [Sec. 21.4(c)] ________
- **i.** Furnish or sell services? [Sec. 21.8(b)] ________
- **j.** Carry out any of the above activities through a separate, but controlled, business corporation or partnership? [Sec. 22.4] ________

6. For unrelated revenues, does an exception or modification apply?

- **a.** The activity is not regularly carried on. [Sec. 21.6] ________
- **b.** Substantially all (85 percent) work in carrying out the trade or business is performed by volunteers. [Sec. 21.9(a)] ________
- **c.** The facility is operated for the convenience of persons participating in the organization's activities. [Sec. 21.9(c)] ________
- **d.** Items sold are either donated, educational, or directly related to the exempt function. [Sec. 21.9(b)] ________

EXHIBIT 19.8 *(CONTINUED)*

Annual Tax Compliance Checklist—Unrelated Business Income

- **e.** Items are "low-cost" premiums sold for significantly more than their value. [Sec. 21.9(g)] ______
- **f.** The income is of a passive nature (e.g., dividends, interests, rents, or royalties). [Sec. 21.10] ______

J. FILING ISSUES ______

1. Do accounting records reflect allocation for expenses? [Sec. 18.2(f) and 21.11] ______
   - **a.** Time records for staff. ______
   - **b.** Square footage of spaces used. ______
   - **c.** Allocation of membership dues to publications. ______
2. Has Form 990-T been filed in prior years? ______
3. Is IRS alerted 990-T is required because Form 990, page 5, Part VII, column B contains a number? ______
4. Does the gross income exceed $1,000? If loss realized, 990T required and useful to establish net operating loss carryover or carryback and start statute of limitation time period. ______
5. Should estimated tax payments be made 990-T tax? ______
6. Are federal tax deposit coupons (Forms 8109) available? ______
7. If 990-T is required, complete *Checklist for Preparation of Form 990-T.* [See Blazek, *990 Handbook*] ______

EXHIBIT 19.9

An Intermediate Sanction Checklist

This two-part checklist evaluates the possibility that the intermediate sanctions could apply to penalize the recipient of "excess benefits" and managers of the organization that approved the making of payments. "Yes" answers in the first part indicate the second part should be completed

Organization ______________________________

Prepared by ____________ Reviewed with ______________ Date ________________

Excess benefit occurs when economic benefit provided directly or indirectly to a disqualified person (DP) exceeds value of benefits provided by the DP.

Manager is an officer, director, trustee, or one with similar responsibilities.

Disqualified Person is one with substantial influence over the organization's affairs and their family members and 35% + controlled entities.

PART A. DID AN EXCESS BENEFIT TRANSACTION WITH A DP OCCUR?

- Was compensation in excess of $85,000 paid to an employee? __________
- Was more than the fair market value paid for purchase of goods, services, or other property? __________
- Is there a revenue sharing (incentive pay) agreement? __________

PART B. IF SO, IS THE TRANSACTION PROPERLY DOCUMENTED?

- Comparable data – independent surveys, offers, appraisals, availability of others for job, other evidence of value gathered. __________
- Total terms of agreement documented (all fringes & allowances). __________
- Record of meeting when arrangements approval are kept with who voted yes, no, abstained (conflict), and when __________

Complete rebuttable presumption checklist, if any doubt about excess benefits. __________

Prepared by ____________ *with (client representative)* ____________ *date* __________

Exhibit 19.10

Checklist for Website Exemption Issues

Organization ____

Web Address ____________________ With (client representative)____________________

Prepared by ____________ Reviewed with ______________ Date ________________

1. Print Home page and other representative pages from EO's site to review scope of information presented on site. __________

2. Does the site reflect the EO's mission as described in Part III of Form 990 or Part XV of Form 990-PF? [Sec. 2.2(j)] __________

3. Are goods and services offered for sale on the site? __________

- **a.** Do products or services sold relate to accomplishing exempt purposes? __________
- **b.** Does site link to a commercial site for sale of its goods or services? __________
- **c.** Is revenue produced from "hits" on the linked site or some other site? __________

4. Does the organization solicit contributions and/or memberships on its site? __________

- **a.** If so, is state registration required? __________
- **b.** Are disclosures for quid pro quo transactions provided? [Sec. 24.2] __________
- **c.** Are sponsors recognized with banners on the site? If so, does the information on the site qualify as an acknowledgment? [Sec. 21.8(e)] __________

5. Can the accounting system capture costs related to the site? [Sec. 27.14] __________

6. Can revenues be fragmented by related and unrelated sources? [Sec. 21.4(c)] __________

7. Does the site contain discussion of public affairs? __________

- **a.** If so, is there a "call to action" urging viewers to contact legislators that constitutes grassroots lobbying? [Sec. 23.4] __________
- **b.** Does the information presented regarding issues of public policy (gun control, abortion, etc) present a biased viewpoint? [Sec. 5.1] __________

8. Is the site linked to other sites? If so, follow the link to determine whether: __________

- **a.** Links provide information/resources pertaining to mission? __________
- **b.** Are there links to the organization's sponsors or contributors? __________

  If so, does the link represent advertising for the sponsor? [Sec. 21.8(e)] __________
- **c.** Is there a link to a political party? [Sec. 23.2] __________

9. Review organization's information reported on Guidestar.org and IRS Publication 78. __________

EXHIBIT 19.11

Checklist for Alternative Investments for Tax-Exempt Organizations, Including Private Foundations

This checklist is designed to make tax-exempt organizations aware of the tax issues posed by investments in ventures not taxed as normal corporations. Investors must report the income and corresponding deductions from such entities on Forms 990 and 990-PF and possibly Form 990-T, according to information reported on Form K-1.

Organization ____________________

Prepared by ____________ Reviewed with ____________ Date ____________

FORM OF INVESTMENT ENTITY

- Is the investment entity a partnership or LLC taxed as a partnership (income passes through with same character, i.e., ordinary, dividends, interest, capital gain)? ________
- Is the investment entity a Subchapter S corporation (all income taxed as UBI)? ________
- Is investment entity a corporation taxed itself on the income generated (no UBI)? ________
- Is the entity an offshore company that reports no U.S. taxable income? ________

CHARACTER OF INCOME

- Is the organization's share of distributable income comprised of passive interest, dividends, rents, and royalties?[IRC §512(b) and §4940] ________
- If ordinary taxable income distributed, are there any deductible (allocable) expenses, such as the investment management fees and legal and accounting fees? ________
- Is current income or gains from options, futures, derivatives, currency transactions, and types of alternative investment income taxable? ________
- Does the venture have indebtedness or operate an active business (creates UBI)? ________
- Does the partnership agreement provide UBI protection for exempt partners? ________
- Does the venture operate outside the United States (special rules apply)? ________

FIDUCIARY RESPONSIBILITY/JEOPARDIZING INVESTMENT ________

- Does the organization engage independent investment advisors? ________
- Were the investments purchased under a plan to diversify the organization's investments following the Prudent Investor Rules? [IRC §4943] ________
- What portion of the organization's overall investment assets do the alternative investments comprise? ________
- If purchased by a private foundation, was an opinion of independent counsel that the investments would not be jeopardizing sought? [IRC §4944] ________

EXHIBIT 19.11 *(CONTINUED)*

Checklist for Alternative Investments for Tax-Exempt Organizations, Including Private Foundations

- Is the investment readily marketable? "No" answer means more risk. Does lock-in (cannot withdraw money from venture) mean valuation should be discounted? ____________

TAX BASIS/GAIN ON DISPOSITION

- Does the capital account reported on Form K-1 reflect the organization's actual tax basis? Is a system in place to record annual changes in tax basis? ____________
- Does the venture book increases and decreases in value into the capital accounts? ____________
- Do special allocations of deductions apply? ____________
- Does the investment entity have assets purchased with indebtedness?[IRC §514] ____________
- Will gain on sale be taxable due to acquisition indebtedness? ____________

VALUATION ISSUES

- Does manager provide periodic valuation information for calculation of average values for minimum investment return purposes? [IRC §4942] ____________
- Is the investment marketable? Do the terms of the investment limit sale of withdrawal so that a discount in value is indicated? ____________
- For PF purposes, must the investment be valued monthly or annually? ____________

EXCESS BUSINESS HOLDINGS:

- Does the organization own more than 20% of the venture? What percentage do the organization's insiders own? [IRC §4943] ____________
- Is more than 95% of the income produced by the investment passive? ____________

FORM 990-T

- Must the income be reported and taxed on Form 990-T? ____________
- Does K-1 report information regarding unrelated business character of distributions? ____________
- Must the organization make deposits of estimated income tax? ____________

Complete by________________ Discussed with client_______________ date ____________

EXHIBIT 19.12

Checklist for Tax & Accounting Issues for Grants

Organization ______________________________

Title of Grant ______________________________

The federal tax rules and generally accepted accounting principles ("GAAP") do not always reach the same conclusion. The accounting rules are described in statements of financial accounting standards referred to as "SFAS." This checklist asks a series of questions to identify whether a grant is classified as a donation or as exempt function income. The next questions seek to identify those revenues taxable as unrelated income. Lastly, questions intended to identify who's money is who's, or when the EO does not recognize revenue because it is serving as agent to receive and pass-through the funding to another organization.

DONATIONS: SFAS No. 116 defines a donation as an unconditional, voluntary, and nonreciprocal transfer. "Yes" answers to the next questions indicate a donation:

- Does grant allow organization to carry on programs or activities that further its exempt purposes? [Reg. §1.509(a)-3(g)]. ______
- Programs supported by grant give a direct benefit primarily to general public rather than an economic/physical benefit to grantor. ______
- Activity subsidized or services performed not generally recognized as responsibility of government or other grantor. ______
- EO expresses its goal and develops methodology for program funded. ______
- Government or other grantor does not normally contract with commercial concerns for same services. ______
- Payment terms structured to subsidize efforts of EO. ______
- No return of funding or penalty for failure to perform specific activities. ______
- Timing and methodology of conducting activities under control of EO. ______

FEE FOR SERVICES: SFAS No. 116 says an Exchange Transaction (not a donation) is a transfer of assets in return for an asset or obligation of commensurate value, a reciprocal, or *quid pro quo* transfer. "Yes" answers indicate fees for service revenue:

- Services of particular benefit to and/or delivered directly to grantor. ______
- Recipients of services are defined and determined by funding entity. ______
- Granting organization determines the "how-to." For example, research conducted under protocol furnished by sponsor. ______
- Granting entity also contracts with commercial firms for same services. ______
- Penalties beyond amount of grant can be imposed for failure to perform. ______
- Specific delivery required within specific time frame? ______

UBI QUESTIONS: If answers are "No," complete unrelated business checklist. ______

- Services to grantor are related to EO's exempt purposes, such as healthcare, childcare, education services, housing homeless, and the like? ______
- Research performed for a governmental unit, not a for-profit company? ______
- Research performed for commercial sponsor; results will be made available to the general public? ______

EXHIBIT 19.12 *(CONTINUED)*

Checklist for Tax & Accounting Issues for Grants

- Income is payable as a royalty, or other income excludable from UBI. __________
- Must the income be reported and taxed on Form 990-T? __________
- Do accounting records contain sufficient information to allocate costs to activities conducted with grant funding? __________

AGENCY TRANSACTION: A recipient EO that accepts assets from a donor and agrees to use those assets on behalf of, or transfer assets to another, records a liability, not a donation under SFAS No. 136. If answer below is "Yes," the EO has no income to report:

- EO is acting as an agent or intermediary possessing an obligation to pay the funds over to another organization. __________
- EO seeks funding on behalf of other named organization(s) and has no dominion and control over the disposition of funding. __________
- Conditions imposed by the transferor make the transfer revocable, repayable, or otherwise subject to restrictions on its use. __________
- Resource provider (term used when transferor is not a donor) is related to recipient in a way, such as common control, that causes the transfer to be reciprocal.

Prepared by__________ with (client representative)__________ date __________

CHAPTER TWENTY

Private Inurement and Intermediate Sanctions

Organizations exempt under most categories of Internal Revenue Code (IRC) §501 must meet two separate tests in order to retain exemption. The first test, called the organizational test, ensures that no one owns an exempt organization. No dividends are paid; shareholders exist only in certain membership organizations; and the circumstances under which funds can be returned to the members in the business league, social club, or other category are very limited. When recognizing an organization's exempt status, the Internal Revenue Service (IRS) applies this test to review the charter, bylaws, and other organizational documents.

The second test, though, is an ongoing one. Exempt organizations of all categories must continually operate "exclusively" for their particular exempt purposes, whether that purpose is charitable, agricultural, or for the advancement of a line of business. An exempt organization (EO) must not devote itself to benefiting private individuals. To describe the requirements of tax-exempt status, IRC §501 uses the word *inures* to limit the activities of §501(c)(3), (4), (6), (7), (9), (10), (13), and (19) organizations. These subsections all require that "no part of the net earnings inure to the benefit of any private shareholder or individual."

The last of the six definitions of *inure* found in *Webster's Deluxe Unabridged Dictionary,* second edition, is the one applied for federal tax exemption purposes: "to serve to the use or benefit of, as a gift of land inures to the heirs of a grantee or it inures to their benefit." The IRS 1981 *Continuing Professional Education Text* for EO agents[1] comments that inurement is "likely to arise where the organization transfers financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purpose, or more plainly stated, a private person cannot pocket the organization's funds." Whether private benefit is incidental to overall public benefit or interest turns on the nature and quantum of the activity under consideration and the manner by which the public benefit is derived. The 1983 text asserts that "the forms which inurement can take are limited only by the imagination of the insiders involved."[2] The 2001 text updated this important subject by applying the private benefit standards to fictitious charter schools and housing projects.[3]

Private inurement potentially occurs whenever a person receives funds or property from an exempt organization in return for which he or she gives insufficient consideration—in other words, pays less for something than it is worth or gives less than he or she receives. An organization that devotes too much of its funds to providing private inurement does not qualify for exemption.

To eliminate the possibility of private inurement in a privately funded charity, Congress in 1969 introduced the concept of self-dealing.[4] As a rule, all financial transactions with insiders are absolutely prohibited for private foundations (PFs). The fact that the transaction actually benefits the PF (a bargain sale, for example) does not lift the ban. Neither will the facts that the transaction is at arm's length and for fair market value rescue the transaction from self-dealing sanctions (as these facts would for a public charity). A few limited exceptions, involving compensation for personal services, expense reimbursements, no-interest loans, and no-rent leases, are pointed out in the following sections.[5]

To provide a tool to punish a public charity or civic league that paid excessive amounts to its insiders, Congress in 1996 added intermediate sanctions to the Tax Code.[6] Until that time, the only penalty the IRS could impose on such an organization was revocation of its exempt status. Thus, as the word *intermediate*

[1] Exempt Organizations Continuing Professional Education Technical Instruction Program for 1981, p. 92; Gen. Coun. Memo. 38459.
[2] Exempt Organizations Continuing Professional Education Technical Instruction Program for 1983, p. 50.
[3] Andrew Megosh, Larry Scollick, Mary Jo Salins, and Cheryl Chasin, Chapter H, "Private Benefit under IRC §501(c)(3)," *IRS CPE Text,* 2001, pp. 135–153.
[4] Defined in IRC §4941.
[5] See Chapter 14 for more details.
[6] Discussed in Section 20.9.

implies, sanctions that stop short of revocation can now be imposed when inurement occurs. This new regime for scrutiny of insider transactions does not replace the inurement standards discussed in this chapter but can be thought of as a new construct within which to evaluate the presence of inurement.

20.1 DEFINING INUREMENT

To ensure that it operates to benefit its exempt constituents, an exempt organization must monitor its financial relations with *private shareholders or individuals*, a very broad group. The regulations narrow the group somewhat by saying that it "refers to persons having a personal and private interest in the activities of the organization."[7] While this language does not specifically say so, the "interest" commonly stems from control. Additionally, tax-exempt organizations are required to operate exclusively for exempt purposes—rather than for the private benefit of individuals.

(a) Persons Involved

Expressed most simply, the rule is usually (but not always) applied to insiders, including the following:

- Someone with the ability to decide (e.g., vote) to authorize payments (e.g., a member of the board, a trustee, an executive committee member, or an officer)
- A member of the family of such a person
- A substantial contributor able to influence the organization's actions
- A business controlled or owned by one of the preceding types of insider

The intermediate sanction rules are imposed on insiders called *disqualified persons*, defined as those in a position to exercise substantial influence over the affairs of the organization.[8] Private foundation insiders are also called disqualified persons.[9]

Persons not on the preceding insider list—outsiders—can also receive unacceptable advantage or gain. Persons having a relationship that might produce some private benefit equivalent to inurement include employees, consultants, and exempt function beneficiaries (those persons who participate in the organization's activities and are the intended recipients of its services). The IRS and the courts have not limited their finding of private benefit to members of the board or other persons in direct authority, but instead find the following relationships can embody compensation arrangements that jeopardize exempt status:

- Doctors and the hospitals that need to attract their services[10]
- Ministers whose churches pay them lavishly[11]

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[7] Reg. §1.501(a)(1)-1(c).
[8] See Section 20.9 for a detailed definition for that purpose.
[9] See Section 12.2(c).
[10] Gen. Coun. Memo. 39862.
[11] *Founding Church of Scientology v. U.S.*, 412 F.2d 1197 (Ct.Cl. 1969).

- Fund-raising consultants who receive a large percentage of funds raised[12]

In deciding whether the significant fees paid to the fund-raisers by the United Cancer Council (UCC) violated these rules, the courts struggled with the distinction between insiders and outsiders. The court thought there were insufficient facts to support a finding that the fund-raising counsel, Watson & Hughey (W&H), seized control of the UCC. [13] Although W&H received over 90 percent of the funds raised, they found that private inurement technically did not occur and remanded the case. Because the W&H did not control the UCC and the compensation arrangement was arrived at through arm's-length negotiations, private benefit was not found.[14]

(b) Identifying Inurement

For most exempt organizations, financial transactions involving insiders are not specifically prohibited, but instead are constrained and subject to scrutiny. In each case, the same criteria are applied to evaluate the presence of disqualifying inurement to insiders and their family members. The IRS agents are instructed to examine contracts for supplies and services, loan and lease agreements, and compensation contracts, and to be alert "to the appearance of insiders' names in a context indicating that the individuals are not acting as representatives of the exempt organization."[15] The answer will be based on the facts of each case. The burden of proof is on the exempt organization.

- *Reasonableness*. Is the amount paid reasonable?
- *Documentation.* Is the transaction properly documented?
- *Independent approval*. Is the transaction sanctioned by disinterested persons or by an independent appraiser?
- *State law.* Does the deal violate fiduciary responsibility law or state fund solicitation regulations?

Transactions between related for-profit businesses are subject to reallocation among the parties if the IRS finds they were not conducted at arm's length. The rules to test for fair pricing in intellectual property transactions use 12 factors.[16] These income tax rules on reallocations can be instructive in evaluating possible inurement between an exempt organization and its related parties.

1. Prevailing rates in the same industry or for similar property
2. Offers of competing transferors or bids of competing transferees
3. Terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted

[12] *United Cancer Council, Inc. v. Commissioner,* 100 T.C. 162 (1993).
[13] *United Cancer Council, Inc. v. Commissioner*, 109 T.C. 326 (1993).
[14] *United Cancer Council v. Commissioner*, 83 AFTR2d ¶99,416 (7th Cir. 1999).
[15] Exempt Organizations Examination Guidelines (IRM 7(10-69)), §153.
[16] Reg. §1.482-2(d)(2)(iii).

4. The uniqueness of the property and the period for which it is likely to remain unique
5. The degree and duration of protection afforded to the property under the laws of the relevant countries
6. Value of services rendered by the transferor to the transferee in connection with the transfer
7. Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property
8. Capital investment and start-up expenses required of the transferee
9. Availability of substitutes for the property transferred
10. Arm's-length rates and prices paid by unrelated parties when the property is resold or sublicensed to such parties
11. Cost incurred by the transferor in developing the property
12. Any other fact or circumstance that unrelated parties would have been likely to consider in determining the amount of an arm's-length consideration for the property.

(c) Meaning of Net Earnings

For inurement or private benefit to result, the organization's net earnings must be paid in an impermissible fashion to one or more individuals. The meaning of *net earnings* is not the customary accounting definition—gross revenues less associated expenses.[17] Instead, the term is very broadly construed to mean all assets an exempt organization holds as permanent capital, restricted funds, current or accumulated surpluses, or net profits. An exempt organization is treated as having earned each penny it has accumulated. A prohibited distribution of net earnings or profits is not limited to an arrangement based on some sharing agreement, incentive, or ownership. It can take many forms, including but not limited to those discussed in the following sections of this chapter.

20.2 SALARIES AND OTHER COMPENSATION

Reasonable compensation for personal services rendered can be paid to insiders in the form of salaries, directors' fees, or other payment. The IRS position on compensation is expressed in its training literature.

> The National Office has found that benefit to an exempt organization's employees, so long as it constitutes no more than reasonable compensation for services rendered, is not necessarily incompatible or inconsistent with the accomplishment of the exempt purpose of the employer. Exempt organizations can establish and operate incentive plans that devote a portion of receipts to reasonable compensation of productive employees so long as the benefits derived from the plans generally accrue not only to the employees but also to the charitable employers through, for instance, increased productivity and cost stability, thus aiding rather than detracting from the accomplishment of exempt purpose.[18]

[17] Exempt Organizations Annual Technical Review Institutes for 1983, p. 41.
[18] Ibid. p. 46, n. 2.

The exempt organization must be able to substantiate that the payments are not excessive for the work performed, because the payment of excessive compensation clearly will jeopardize exempt status.[19] When compensation is found to be unreasonably high, the recipient may be treated as having received an excess benefit that must be returned. Not only must the excess be repaid, but penalties may be imposed upon both the recipient and those approving of the payments.[20]

An evaluation of the reasonableness of compensation should also include an analysis of the need for the position. Consideration of the exempt purposes served by the job performed within the context of the organization's programs is expected by the IRS. The board must analyze the needs of an institution and come up with a "methodology for meeting a need and then take appropriate steps using reasonable standards for fair market value and reasonable standards for terms and conditions of arrangements."[21] The types of questions asked to measure the reasonableness of compensation, the answers to which must be maintained, include the following:

- Is the amount of any payment for personal services excessive or unreasonable?[22]
- Are the payments ordinary and necessary to carry out the exempt purposes of the EO? (Apply the same tests used under IRC §162 to judge the reasonableness of business deductions.)[23]
- What are the individual's responsibilities and duties? Is there a written job description, a contract for services, or personnel procedures?
- Is the person qualified for the job through experience, education, or other special expertise?[24] How much time is devoted to the job?
- To evaluate compensation accurately, count not only salary but all benefits,[25] including
    - Salary or fees (current and deferred)
    - Fringe benefits
    - Contributions to pension or profit-sharing plans
    - Housing or automobile allowances
    - Directors' and officers' liability insurance
    - Expense reimbursements
    - Clubs, resort meetings, or other lavish items
    - Compensation to family members

[19] *Birmingham Business College, Inc. v. Commissioner*, 276 F.2d 476 (5th Cir. 1960).
[20] See Sections 20.9 and 14.4.
[21] Remarks of Marcus S. Owens, then director of the IRS Exempt Organization Division, in describing the need for "contemporaneous documentation of process," in discussing the physician recruitment ruling (Rev. Rul. 97-25, discussed in Section 4.6) before the American Bar Association Exempt Organization Committee members on May 9, 1997.
[22] *The Labrenz Foundation, Inc. v. Commissioner*, 33 T.C.M. 1374 (1974).
[23] *Enterprise Railway Equipment Company v. U.S.*, 161 F. Supp. 590 (Ct.Cl. 1958).
[24] *B.H.W. Anesthesia Foundation, Inc. v. Commissioner*, 72 T.C. 681 (1979).
[25] *John Marshall Law School vs. U.S.*, 81-2 T.C. 9514 (Ct.Cl. 1981); Rev. Rul. 73-126, 1973-1 C.B. 220.

- Does the method of calculation imply inurement? Paying a percentage of profits from operations or fund-raising efforts may suggest inurement. The IRS has not always won this one, particularly when the overall pay is reasonable.[26]
- Are adequate accounting records, such as time sheets or diaries, maintained to document the actual time expended on the job?
- How does the individual's salary compare to those of other staff members and to the total organization budget?
- How does the compensation structure compare to those of similar exempt organizations or commercial businesses of similar size?[27] Compare the exempt organization to commercial businesses of similar size, if possible. There is no ruling that says that nonprofit employees or consultants cannot be paid salaries commensurate with those paid by businesses, nor that they need to donate their services.

20.3 FINDING SALARY STATISTICS

Comparative information is critical to evaluating the reasonableness of a salary. The most appropriate comparison is made to similar exempt organizations in the same field of endeavor (for example, health care, academia, music, or college administration). Surveys of compensation in the EO's area of interest can be obtained, and should be retained for IRS scrutiny. A personnel consulting and executive search firm can be engaged to recommend appropriate levels of compensation for the organization. Such independently commissioned surveys satisfy the rebuttable presumption of reasonableness that is required to avoid intermediate sanctions.

Another way to obtain compensation information is to look at Forms 990 for comparable organizations. The forms must be made available upon request at the organization's office and are also available on the Internet.[28] Any amounts paid to officers and directors for compensation, employee benefit plans, and expense accounts are to be reported, along with their titles and average amounts of time devoted to the position each week. For charitable organizations only, Form 990, Schedule A, also reports the same information for the top five employees (other than key employees) receiving over $50,000 a year. Additionally, the top five independent professional contractors paid over $50,000 during the year are listed by name and amount.

The Council on Foundations publishes a biennial Foundation Management Report containing private foundation compensation levels by size of foundation, position, and area of the country. The Society for Nonprofit Organizations annually publishes Compensation for Nonprofit Organizations, a comprehensive survey of salaries and benefits by size of organization, by focus or purpose of the entity (health, education, day care, and so on), and by position (executive direc-

[26] *World Family Corporation v. Commissioner*, 81 T.C. 958 (1983); see Section 20.2(c).
[27] Reg. §1.162-7(b)(3).
[28] www.guidestar.org.

tor, controller, clerical assistant, program manager, and so on). In Houston, Texas, the Management Assistance Program of the United Way of the Texas Gulf Coast compiles a similar annual survey of area compensation.

(a) Avoiding Conflict of Interest

When compensation is paid to directors, officers, or other controlling members of an organization, additional proof of the reasonableness of compensation is required. It is critical that local conflict-of-interest statutes be observed to prove that the payments do not violate fiduciary responsibility concepts. Persons who have significant control over an organization are treated as insiders for this purpose.[29] Most organizations should adopt conflict-of-interest policies to evidence their good faith in securing independent and impartial approval for compensation payments. Such policies should require, at a minimum, that interested parties abstain from approving their own compensation and that there are enough noncompensated members of the board to achieve independent or disinterested approval for the compensation.[30] A compensation committee comprising knowledgeable persons should gather data and make recommendations.

(b) Incentive Compensation

Compensation that is measured by the results of activities—net profits, number of patients served, funds raised, and so on—is subject to enhanced scrutiny. The intermediate sanctions rules have a special section on "transactions in which the amount of economic benefit is determined in whole or in part by the revenues of one or more activities of an organization."[31] One court has said that "there is nothing insidious or evil about a commission-based compensation system," and decided a 6 percent commission for procuring contributions was reasonable, despite the absence of a ceiling on the total commission that could be paid.[32]

In evaluating a "fixed percentage of income" formula, the IRS dissected one hospital's policies and intentions in reviewing the compensation of a radiologist hired to run the radiology department. His compensation was a fixed percentage of the department's gross revenues less bad debts. The IRS found this incentive compensation method to be acceptable because the physician had no control over compensation decisions, either managerial or from a governance position. He was simply an employee. It also noted that the negotiations over compensation were conducted at arm's length.[33] According to the IRS training literature, the following factors are used to find reasonableness in incentive compensation. Not all factors need be present[34]:

- The contingent payments serve a real and discernible business purpose of the organization itself, not the financial need of the employee. The risk of

[29] *United Cancer Council, Inc. v. Commissioner*, 109 T.C. 326.
[30] The rebuttable presumption rules used to evaluate application of the intermediate sanctions should be followed in this regard; see Section 20.9.
[31] See Section 20.9.
[32] *National Foundation, Inc. v. U.S.*, 87-2 USTC ¶9602 (Ct.Cl. 1987).
[33] Rev. Rul. 69-383, 1969-2 C.B. 113.
[34] Exempt Organization Annual Technical Review Institutes for 1983, p. 45.

paying the higher salary due to higher revenues is self-insured by its tie to revenue or profit level.

- Compensation amount is not dependent upon curtailing expenses or skimping on services, but instead is based upon accomplishment of exempt purposes, such as serving more patients, writing more books, or increasing test scores. A plan to pay a percentage of revenues exceeding the budgeted amount has even been sanctioned.[35]
- Actual operating results show that prices for services are comparable to those at similar organizations and are not manipulated to increase the compensation.
- There is a ceiling or maximum amount of compensation, so as to avoid "the possibility of windfall benefit to the employee/professional based upon factors bearing no direct relationship to the level of services provided."[36]

In the health-care context, the IRS, in 1997, updated its guidance regarding incentive compensation packages used to recruit physicians.[37] The IRS suggested 12 questions that should be asked to determine whether incentive payments to staff physicians who serve Medicare beneficiaries result in private inurement.[38] The factors reflect the bullet list at the beginning of this section set in a health-care context that embodies the community benefit standards and other issues unique to the practice of medicine.[39]

A couple of preintermediate sanction cases illustrate the concept. Uncapped compensation equal to a percentage of the tithes and offerings received by People of God Community was found to be excessive and to allow private inurement to its founder and could not continue to qualify for tax exemption.[40] The court stated: "We do not, however, mean to imply that all contingent compensation arrangements made by charitable organizations will preclude tax-exempt status. Such arrangements are a part of business life and must occasionally be paid by a charity to salesmen, publishers, support groups, and even fundraisers." Commissions of up to 20 percent paid to fund-raisers by the World Family Corporation were found to be reasonable in light of all of the circumstances.[41] The court noted that state regulators of charities specifically allow contingent-fee arrangements and permit higher percentages in some instances. Importantly, the commissions were directly contingent upon success in procuring funds and as such were tied to services rendered. In contrast to People of God, World Family did not limit the commissions to particular individuals.

Stock options or employee stock purchase plans are commonly available for employees of for-profit corporations. A nonprofit corporation may wish to offer shares of its for-profit subsidiary to key employees of the subsidiary as incentive

[35] Gen. Coun. Memo. 39674. See also Gen. Coun. Memos. 32453, 36918, 39498, and 39670.
[36] *People of God Community v. Commissioner*, 75 T.C. 127, 132 (1980).
[37] Rev. Rul. 97-25; see Section 4.6.
[38] IRS Information Letter 2002-0021.
[39] Discussed in Section 4.6
[40] *People of God Community v. Commissioner*, 75 T.C. 127 (Tax Court, 1980).
[41] *World Family Corporation v. Commissioner*, 81 T.C. 958 (Tax Court, 1983).

compensation. Encouragement of personnel by issuing a minority interest was found acceptable for an exempt organization.[42] The president of a newly created for-profit subsidiary received 4 percent of the shares as a part of his compensation. The plan was found to be consistent with the charity's purpose of providing the employee an incentive to maximize commercial exploitation of the charity's technology transferred to the subsidiary. The value of the shares would be counted in evaluating the presence of inurement due to unreasonable compensation. To document the amount of compensation at the time of issuance, a comprehensive and preferably independent opinion as to the value of the shares should be obtained.

20.4 HOUSING AND MEALS

An exempt organization may have a good reason to provide housing or meals, or allowances for these purposes, to its officers, directors, or employees. Using the four basic criteria outlined in Section 20.1(b), amounts actually incurred for meals and other travel expenses incurred on exempt organization business can be paid. Questions to ask to ensure that the four criteria are met include the following:

- Is the insider a staff member whose presence is required on the premises of the EO at all hours (a school or home for orphans, for example)?
- Does the housing allowance or provision qualify for income exclusion[43] from insider income because it is furnished for the convenience of the employing EO?
- Is the location of the project remote or temporary? Is the research conducted on an island or in a city away from the EO's and the employee's permanent residence?
- Is the housing lavish or unreasonably expensive?[44]
- Are board meetings held in resort locations?

Documentation is essential to prove both the amount and the nature of each expense, as well as its connection to organization affairs. A diary should be kept of meetings, persons entertained, and the project to which discussions relate. Due to the self-dealing rules, scrutiny can be expected, but a private foundation can reimburse its disqualified persons for "reasonable expenses" incurred in conducting the foundation's affairs.[45] Daily expenses in excess of the federal per diem reimbursement rate would require explanation.

20.5 PURCHASE, LEASE, OR SALE OF PROPERTY OR SERVICES

An exempt organization can buy, lease, or sell property to or from an insider in certain circumstances. The appropriateness of any such transaction depends partly on whether the property is devoted to exempt functions, such as adminis-

[42] Priv. Ltr. Rul. 9311032.
[43] IRC §119.
[44] John Marshall Law School, n. 21.
[45] See Section 14.4.

trative offices, or to production of income, that is, an investment. The standards for reasonable compensation discussed previously may also be applicable to sales of property. The intermediate sanctions apply to property transactions.[46] When a property transaction takes place between an insider and an exempt organization, the following tests must be satisfied:

- Is no more than the current fair market value (FMV) being paid for the property or services which the organization is buying? At least full FMV must be paid for the property being sold or purchased.[47]
  - Is there a readily established market price for the property being purchased or leased?[48]
  - If not, was an appraisal or other independent evidence of its value obtained? Does the appraisal consider a number of different valuation factors, such as income forecast, resale value of underlying property, goodwill, and comparative prices?
  - Was the organization established to promote the insider's business, as was found in cases involving a travel agent,[49] a musical instructor,[50] a doctor who established a hospital,[51] or a minister?[52]
- Are the terms for payment of the purchase price favorable?
  - Is the rate of interest on a mortgage equal to or less than prevailing rates for similar commercial mortgages (if the EO is buying), or more than these rates (if the insider is buying)?
  - If the property is encumbered, can the income generated by the property carry the note and provide a reasonable return? Or does the amount of the debt exceed the value of the property purchased or given?[53]
- Does the purchase, lease, or sale make economic sense?
  - Is the proportion of organization capital devoted to the purchase reasonable in relation to the capital needed to carry out exempt purposes?
  - Will the income yield a rate of return commensurate with the organization's overall financial needs?
  - Does the amount of cash paid down deprive the organization of needed working capital?
  - Is the arrangement beneficial for the organization? The rates or rents should be favorable.[54]
- Does the purchase or sale serve an exempt function?

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[46] See Section 20.9.
[47] *Anclote Psychiatric Center, Inc. v. Commissioner*, T.C. Memo. July 1998.
[48] Priv. Ltr. Ruls. 8234084 and 9130002.
[49] *International Postgraduate Medical Foundation v. Commissioner*, 56 T.C.M. 1140 (1989).
[50] *Horace Heidt Foundation v. U.S.*, 170 F. Supp. 634 (Ct.Cl. 1959).
[51] *Kenner v. Commissioner*, 33 T.C.M. 1239 (1974).
[52] *Church by Mail, Inc. v. Commissioner*, 48 T.C.M. 471 (1984).
[53] Rev. Rul. 76-441, 1967-2 C.B. 147.
[54] *Texas Trade School v. Commissioner*, 30 T.C. 642 (1958), aff'd., 272 F.2d 168 (5th Cir. 1959); *Founding Church of Scientology*, supra note 9.

Although a PF is absolutely prohibited from buying, selling, or leasing anything to or from its disqualified persons for any price—even one dollar—a rent-free lease to the PF is allowed if it serves the organization's objectives. A PF can pay its proportion of occupancy costs, but "sharing arrangements" can present problems.[55]

The Sta-Home Health Agency case indicates how careful an organization and its advisors must be to establish adequate and accurate documentation to evidence the amounts paid in consideration for property transfers.[56] Significant excess benefits were asserted by the IRS and partly sustained by the court in a transfer of assets from three tax-exempt home health-care agencies to for-profit corporations. The valuation placed on nursing home assets was found inadequate by the IRS in assessing millions of dollars of sanctions plus penalties against members of the Caracci family.[57] The IRS also proposed, but the court did not approve, revocation of exemption for the three home health agencies the family had managed since the 1970s before transferring the assets to for-profit corporations.

The opinion contains an extensive consideration of the standards for determining fair market value. The valuation relied upon gave the organizations no value because liabilities exceeded the book value of their assets due to consistent operating losses. This approach, however, placed no value on the extensive intangible assets of the service-providing entities, including its operating licenses, Medicare certifications, patient lists, referral relationships, trained and assembled workforce, proprietary policies and procedures, trade name, and going-concern value. The judges relied on experts that considered sales of comparable home health agencies, the market value of invested capital (MVIC) method, and the guideline merged and acquired company method to decide that the net value of the organizations was instead $5,164,000. Since the tax-exempt organizations received no consideration, the entire value represented excess benefits that had to be returned to the sanctions imposed on the disqualified persons.

As it regarded revocation of the tax-exempt status of the organizations, the court noted that the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case. The single transaction that rendered the organizations dormant was not an adequate basis for determining whether they were functioning as tax-exempt entities. Also, their continued existence would allow them to receive assets to cause correction of the transaction. The court declined to consider abatement of the sanctions, but noted that §§4961(a) and 4963(e)(1) would allow abatement "if the excess benefit transaction giving rise thereto is corrected within 90 days after our decision sustaining the tax becomes final."

20.6 LOANS AND GUARANTEES

An exempt organization should very carefully consider the consequences before lending money to or borrowing from an insider. One court has commented that the very fact that an exempt organization was a source of credit for an insider

[55] See Section 14.7.
[56] *Caracci v. Commissioner*, 118 T.C. No. 25 (May 22, 2002).
[57] The opinion reported significant amounts of compensation and bonuses also paid to the Caraccis.

represented inurement.[58] Loans are subject to the same criteria as leases and sales of property, and many of the same questions apply. Additionally, one should ask the following qeustions:

- Is the EO serving exempt purposes by making the loan?[59]
- Are the rates and terms favorable to the EO?[60]
- Is there substantial market risk inherent in the loan?
- Is there adequate security for the loan?
- Is it a good investment? Is the rate of return good?[61]
- Does a low- or no-interest loan to an employee or director serve a permissible compensatory purpose?

A private foundation is prohibited from borrowing money from or lending money to a disqualified person. A gift of indebted property to a PF is prohibited unless the debt was placed on the property 10 years before the gift.[62] Essentially, the PF's taking over responsibility for the debt is treated as compensation or a loan to the donor.

20.7 FOR-PROFIT TO NONPROFIT AND VICE VERSA

Contributing a business to a nonprofit organization with purely gratuitous motivation does not necessarily result in private inurement or benefit to the donor, but such transactions are closely scrutinized. If such a transfer occurs for tax avoidance purposes, as when the donor retains the right to occupy the property and essentially continues to operate the business for his or her own purposes, the level of private interest prevents tax-exempt status for the new nonprofit organization.[63]

When the conversion is basically a sale to the exempt organization, the purchase must be examined for unreasonable price or terms favorable to the seller.[64] In a sale of a proprietary school to a newly created educational organization, the consideration paid for goodwill was found to be excessive.[65] Payments for intangible earning capacity are not, however, prohibited per se. When an exempt organization intends to operate a facility and will clearly benefit from the goodwill that has been established, the intangible assets contribute to the new organization's exempt functions and can be paid for. The IRS has ruled that the "capitalization of excess earnings" formula is an acceptable manner by which to value such an intangible asset.[66]

The health-care industry during the 1990s provided countless examples of the purchase of a nonprofit provider by a for-profit company and vice versa.

[58] *Lowry Hospital Association v. Commissioner*, 66 T.C. 850 (1976).
[59] *Best Lock Corp. v. Commissioner*, 31 T.C. 1217 (1959).
[60] *Hancock Academy of Savannah, Inc. v. Commissioner*, 69 T.C. 488 (1977).
[61] *Donald G. and Lillian S. Griswold,* 39 T.C. 620 (1962), acq., 1965-1 C.B. 4.
[62] IRC §4941 (d)(2)(A).
[63] Rev. Rul. 69-266, 1969-1 C.B. 151.
[64] Under standards discussed in Section 20.4.
[65] *Hancock Academy of Savannah, Inc.*, supra note 47.
[66] Rev. Rul. 68-609, 1968-2 C.B. 227.

Whether private inurement occurs is a significant question in such situations, to be judged by standards developed by the IRS particularly for the industry.[67] For an excellent discussion of the other circumstances in which a for-profit might convert itself to a nonprofit and the tax consequences to shareholders, refer to the transcript of the May 1995 meeting of the American Bar Association Exempt Organization Committee.[68]

The transfer of substantially all of the assets of a taxable corporation to a tax-exempt organization is essentially treated as a taxable sale of the transferred assets at their fair market value under the so-called General Utilities Doctrine.[69] Thus, the conversion of a taxable entity to a tax-exempt one is treated as a transaction in which gain may be recognized.

Converting a Nonexempt Nonprofit into an Exempt Nonprofit. For a variety of reasons, an entity organized as a nonprofit may not seek approval for tax-exempt status or it may lose its exempt status. Converting such a nonprofit into a tax-exempt entity may require a number of steps. The charter or other organizing documents might have to be revised to include constraints required for the particular category of exemption.[70] If the nonexempt entity has relationships with persons who control it, such entanglements may have to be undone. The second issue is whether the future operations would qualify under the desired category of exemption. Third, the proposed exempt would have to prove that no private inurement resulted from the conversion. If, for example, the entity has incurred debt, the assets should be sufficient to retire the debt. In particular, debt owed to persons controlling the organization would be questioned as to its reasonableness, rate of interest, and why it exists. The IRS might require that the debt be retired prior to the conversion. Other business relationships, such as space rental and management service contracts, are also scrutinized.[71]

20.8 SERVICES RENDERED FOR INDIVIDUALS

When does the rendering of services to members or insiders result in private benefit and evidence that the organization does not operate to benefit the public? When is service revenue classified as unrelated business income?[72] As a general proposition, these questions are of most concern to §501(c)(3) organizations, but all exempt organizations must serve some exempt constituency—be it the poor, the pipefitters, or the social set—in a group sense, not on an individual level. For (c)(3) organizations, the basic question is whether the charitable class is sufficiently broad that the individuals are served as a means of achieving the public purpose. The distinction is best made through examples, although the logic is not necessarily clear. [73]

[67] Discussed in Section 4.6.
[68] May 19, 1995, meeting in Washington, D.C., Panel I, entitled "Conversions To and From Exempt Status," presented by Doug Mancino, LaVerne Woods, and Lauren McNulty and reprinted in *The Exempt Organization Tax Review*, vol. 12, no. 1, July 1995.
[69] Reg. §337(d)-4.
[70] For §501(c)(3)s, see Section 2.1; for (c)(4) through (c)(7) organizations, see Chapters 6–9.
[71] Discussed in Sections 20.2– §20.4.
[72] See Chapter 21.
[73] See discussion of charitable class in Section 2.2.

(a) Services Providing Public Benefit

Certain types of services provide public benefit, even though they are furnished to individuals, because they serve a societal purpose that is considered as charitable. Examples include the following:

- Medical services, including hospitals and health maintenance organizations
- Schools, both private and public
- Cultural providers, such as art galleries and all types of performing arts
- Grants of money, food, housing, or other services to poor people or students

(b) When Private Benefit Is Found

Some services produce more than incidental private benefit to individual recipients and, therefore, cause the activity to be considered nonexempt. Examples of such services include the following:

- A bus service for private school students[74]
- Cooperative art gallery management[75]
- Preferential housing to employees of one of the exempt organization's directors[76]
- A genealogical society for a particular common name[77]
- Financial planning for charitable giving[78]
- Management consulting for small businesses[79]
- Real estate multiple listing services[80]

(c) Membership Perks

Member benefit is an especially confusing aspect of this issue. In the §501(c)(3) and (c)(4) context, a membership composed of contributors can be given preferential treatment in certain circumstances. For example, reduced or free admission, discounts in bookstores, attendance at conferences or receptions, and other benefits directly connected with the exempt organization's mission are permitted when their value is small in relation to the charges.[81] However, services construed to benefit individuals on a personal level unrelated to the exempt activities, such as group insurance plans, are troublesome.

Because (c)(5), (c)(6), and (c)(7) organizations are formed to benefit members, they have wider latitude in providing services. Nevertheless, services still

[74] Rev. Rul. 69-175, 1969-1 C.B. 149.
[75] Rev. Rul. 71-395, 1971-2 C.B. 228.
[76] Rev. Rul. 72-147, 1972-1 C.B. 147.
[77] *The Callaway Family Association, Inc. v. Commissioner*, 71 T.C. 340 (1978).
[78] *Christian Stewardship Assistance, Inc. v. Commissioner*, 70 T.C. 1037 (1978).
[79] *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978).
[80] Rev. Rul. 59-234, 1959-2 C.B. 149.
[81] See Chapter 24.

must be directed toward the particular objectives of the exempt organization. Labor unions also provide a wide range of work-related services, including day care, job training, and placement services germane to their members' gainful employment. A union might incur nonexempt function income and potential unrelated business income tax from its sale of housing, food, or medical products. The IRS *Exempt Organizations Handbook* instructs the specialist to refer any inurement questions concerning a labor union to the national office, due to the lack of published precedents.

Business leagues run afoul of the inurement test more often than unions, and a clearer distinction is possible. Such a league must carry out programs that benefit an industry or locality, and, while incidental individual benefit can result, the overriding purpose must be to serve the industry. For example, the American Institute of Certified Public Accountants can perform peer reviews and administer qualifying tests that maintain the standards of its profession, but running an executive search department to secure job placement for individual members would be an unrelated business. Many examples of individual benefits can be found in Revenue Rulings, such as these:

- Group purchases of supplies or inventory[82]
- A trading stamp program[83]
- Research made available only to members, not to the industry as a whole[84]

20.9 JOINT VENTURES

Private inurement occurs when an exempt organization's assets are placed at unreasonable risk of loss in comparison to the assets of private investors joining it in a venture. Of equal importance is whether the exempt organization receives a share of ownership equivalent to the non-EO investors. As usual, there is also the burden of proving that the transaction serves the exempt purposes of the EO.

The IRS has repeatedly refused to allow §501(c)(3) organizations to be general partners in any venture, in order to prevent them from "taking on an obligation to further the private financial interests of their other partners." Only when the venture is buying exempt function property (not investment property), such as a school building or opera production, has the IRS allowed an exempt organization to be a general partner. The Plumstead Theatre Society[85] won a decision that yielded the following characteristics of a limited investor venture:

- The venture served an exempt purpose: to produce a play.
- The amount invested by and provided for return to the limited partners was reasonable.
- The transaction was at arm's length.
- Plumstead was not obligated to return the invested capital.

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[82] Rev. Rul. 66-338, 1966-2 C.B. 226.
[83] Rev. Rul. 65-244, 1965-2 C.B. 167.
[84] Rev. Rul. 60-106, 1969-1 C.B. 153.
[85] *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980).

- Investors had no control over Plumstead's operations.
- Investors were not officers or directors of Plumstead.

The medical community has been fraught with controversy about private inurement. There have been hundreds of private letter rulings seeking approval of hospital reorganizations involving sales of nonprofit hospitals, purchases of medical practices, for-profit subsidiaries, and other rearrangements of health-care entities. The standards for joint ventures are outlined in Chapter 22, and the particular rules applicable to hospitals can be found in Section 4.6. Private foundations are not only constrained when entering into joint ownership with their disqualified persons, but also face the possibility that a joint venture could be classified as a jeopardizing investment or an excess business holding.[86]

20.10 INTERMEDIATE SANCTIONS

To enforce the existing rule that no private individual unfairly reap benefit from a §501(c)(3) or (4) organization, penalties called *intermediate sanctions* can be imposed.[87] Unlike the sanctions on self-dealing with private foundations,[88] the only recourse available to the IRS before 1996 to punish a public charity paying excessive salaries to its key employees was to revoke its exemption. IRC §4958 imposes a nondeductible excise tax on disqualified persons who receive excess benefits and the managers that approve of the transaction(s). No penalty is assessable against the organization itself.

These sanctions aid in enforcing the requirement that both IRC §501(c)(3) and §(c)(4) organizations must operate exclusively to benefit the exempt class they are formed to serve—the poor, culture seekers, or the sick, for example. Exemption revocation was considered an ineffective sanction because it deprived the public of needed services and did not recover the excessive benefits paid. Excessive salaries may be a relatively minor part of the expenditures of an organization that serves its charitable constituents and should thereby be entitled to retain exempt status. Despite the private inurement, an organization may operate substantially for, and devote most of its assets to, the charitable purposes.[89] IRC §4958 serves to complement, not to alter, the requirements for tax-exempt status. Both revocation and penalties can be invoked in a circumstance in which the level of excess benefits reflects a question of whether the organization as a whole functions as a charity.[90] In approving of these new penalties, Congress said, "[I]n practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would only occur when the organization no longer operates

[86] See Chapter 16.

[87] IRC §4958 added by the Taxpayer Bill of Rights 2, H.R. 2337, §§1311–1314, 104th Cong., 2d Sess. (1996).

[88] See Chapter 14.

[89] The organizational and operational requirements for qualification as a tax-exempt organization are discussed in Chapter 2. These tests require that substantially all, but not 100 percent, of the organization's efforts be charitable.

[90] HR Conf. Rep. 506, 104th Cong., 2d Sess.50, n. 15, not necessarily reflected in §53.4958-7(a), which says transactions that are not subject to the sanctions can jeopardize an organization's exempt status.

as a charitable organization."[91] Indeed, in the first case considering these penalties,[92] the IRS proposed, but the court did not agree, that exempt status should be revoked. The nursing homes that were sold in a transaction the court found yielded excess benefits had indeed operated—prior to the single transaction in question—for exempt purposes. Readers should expect the IRS to continue to take a hard line in this regard.

IRC §4958 requires that the excessive compensation or benefits be repaid and imposes a 25 percent initial, or first-tier, penalty tax (the intermediate sanction) on the disqualified person who receives excess benefits from a §501(c)(3) (other than a private foundation) or (4) organization in a transaction that occurred on or after September 14, 1995.[93]

The statute is brief, but the regulations are thorough. Regulations on most of these significant sanctions were finalized on January 23, 2002, six years after enactment and after several versions and many public comments. Still unproposed are regulations on the subject of revenue sharing—those transactions in which the payments are based on revenues of an activity. Happily, a proposal that the sanctions could be imposed on a newly hired executive, referred to as a *first bite rule*, was not retained. The final regulations also narrowed the definition of disqualified persons. Originally, a person who could exercise authority over a discrete department or division, rather than the whole organization, was treated as a disqualified person. Also eliminated as a factor indicating substantial influence was the fact that the person serves as a key advisor to a disqualified person. The definition of excess benefits paid indirectly to a disqualified person was expanded by the regulations to include amounts paid through an intermediary in addition to a controlled subsidiary. Economic benefit is indirect when (1) the organization provides the funds to the intermediary that are paid over, under an oral or written agreement, or (2) the intermediary lacks a significant business purpose or exempt purpose of its own for engaging in the transfer.[94]

(a) Disqualified Persons

The sanctions are imposed on disqualified persons who receive and those who approve of excess benefits. The definition of those treated as disqualified persons is broader than the definition of the same terms under the private foundation rules. The term is generally used to mean a "person in a position to exercise substantial influence over the affairs of the organization, whether they are an exempt organization manager, officer, director, or trustee."[95] Facts and circumstances that tend to show that a person manages a substantial portion of the activities, assets, income, or expenses or the organization as a whole are to be considered. Members of Groups A through C, discussed in the following subsections, at any time during the five-year period ending with the transaction are considered disqualified persons; persons described in Groups D and E are not.

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[91] HR Conf. Rep. 506, 104th Cong., 2d Sess.50, n. 15.
[92] Carucci case, see discussion accompanying note 56.
[93] Reg. §53.4958-1(c).
[94] Reg. §53.4958-4(a)(2).
[95] IRC §4958(f)(1); Reg. §53.4958-3.

Group A. Persons in control of the organization are treated as disqualified by virtue of the fact that they have voting powers and responsibilities of the sort included in the following list:

- Persons serving on the governing body who are entitled to vote (evidence that one did not participate in a decision may be important)
- Presidents, chief executive officers, or chief operating officers
- Treasurers and chief financial officers
- Persons with material financial interest in a provider-sponsored[96] organization

Ex-officio, advisory, emeritus, or other organizational officials not entitled to vote are treated as disqualified persons unless they are members of Group B. The absence of title, or the actual title, for a person in a position of control is not determinative, if the person actually has or shares responsibility for managing the organization's finances.

Group B. A person not listed in Group A may still be treated as a disqualified person based upon the facts and circumstances of his or her relationship to the organization.[97] The following facts tend to indicate that a person has substantial influence:

- The person founded the organization.
- The person is a substantial contributor.
- The person's compensation is based on revenues derived from activities of the organization that he or she controls.
- The person has authority to control or determine a significant portion of the organization's capital expenditures, operating budget, or compensation for employees (such as a school headmaster).
- The person has managerial authority or serves as a key advisor to a person with managerial authority.
- The person owns a controlling interest in a corporation, partnership, or trust that is a disqualified person.

Group C. A person is a disqualified person with respect to a transaction if the person is a member of the family of the person with substantial influence. Members of the family and related businesses are defined for this purpose as the following "statutory categories of disqualified persons":

- Family members[98] (spouses, ancestors, children, grandchildren, great-grandchildren, and siblings and their spouses)

[96] Reg. §53.4958-3(c)(4).
[97] Reg. §53.4958-3(f).
[98] Determined by reference to IRC §4946(d) except for the inclusion of whole- and half-blood siblings.

- A 35 percent controlled entity, meaning corporations in which disqualified persons own more than 35 percent of the combined voting power and partnerships, trusts, and estates in which disqualified persons own more than 35 percent of the profits or beneficial interest

Group D. Persons deemed not to have substantial influence include the following:

- Another organization tax exempt under (c)(3) or (c)(4) as it regards a (c)(3) organization. A (c)(4) organization can receive excess benefits only from another (c)(4).[99]
- An employee who receives economic benefits in an amount less than that used to define highly compensated employees for pension plan purposes, so long as the person is not a substantial contributor or in a position of control[100]

Governmental units and their affiliates are not subject to the intermediate sanctions, nor are they required to file the annual information return, Form 990. For clarity, the final regulations tie the definition of those governmental entities excluded from the sanctions to the existing procedures that govern return filing exclusion.[101] The excess benefits tax does not apply to a foreign organization that receives substantially all of its support from sources outside the United States.

Group E. Facts tending to indicate that a person does not have control over an organization include the following:

- The person has taken a bona fide vow of poverty as an employee or agent of a religious organization.
- The person is an independent contractor, such as an attorney, accountant, or investment manager, unless such person stands to economically benefit with respect to transactions.
- The direct supervisor of the person is not a disqualified person.
- The person does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization.
- The person receives preferential treatment commensurate with other comparable contributors in a solicitation that is a part of a program designed to attract a substantial number of donors.

(b) Managers

A separate penalty equal to 10 percent of the excess benefits can be imposed on the managers who willingly participated in approving of the transactions. The managers are jointly and severally liable up to a maximum penalty of $10,000. A

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99 Reg. §53.4958-3(d)(2).
100 For 2004, this amount is $90,000. The number is the inflation-adjusted amount above which one is treated as highly compensated for pension plan purposes. Reg. §53.4958-3(d)(3) refers to IRC §414(q)(1)(B)(i).
101 Rev. Proc. 95-48, 1995-47 I.R.B. 13; see Section 10.2 for detailed discussion of definition of governmental units.

manager is any officer, director, or trustee of an organization and those individuals who have and actually exercise power and responsibility similar to those of officers, directors, or trustees. A person is considered a manager if[102]

- The person is specifically designated as an officer under the articles of incorporation, bylaws, or other constitutive document of the organization.
- The person regularly exercises general authority to make administrative or policy decisions on the organization's behalf.

Many disqualified persons are also managers. The distinction rests in the first bullet point in the preceding list that allows a person to be a manager for reason of his or her title, even if the person does not have a vote. A person who is not disqualified because he or she does not control the organization may be subject to sanction if he or she participates in approving the excess benefit transaction. Any person with authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer. A person serving on a committee of the governing body of the organization that invokes the rebuttable presumption of reasonableness based on the committee's actions, is treated as a manager for purposes of the 10 percent tax, regardless of whether the person is an officer, director, or trustee.

(c) Participating and Knowing

A manager is subject to sanction if he or she willingly *participates* in the approval of a transaction, *knowing* that an excess benefit transaction would result. The regulations refer to the definitions of these terms in the rules pertaining to private foundation managers.[103] A manager *knows* if he or she negligently fails to make reasonable attempts to ascertain whether the transaction will result in excess benefits. A manager is excused from the penalty if he or she, after full disclosure of the facts, relies upon the advice of outside or in-house counsel expressed in a reasoned written legal opinion that the transaction is not an excess benefit transaction. A manager may be deemed *willing* if he or she had *reason to know* because of actual knowledge of facts that indicate an impermissible act would occur. Willfulness must be voluntary, conscious, and intentional. Penalties can be forgiven if the participation was due to reasonable cause, particularly if the person exercised fiduciary responsibility on behalf of the organization with ordinary business care and prudence.[104]

(d) Excess Benefit Transaction

An excess benefit transaction is one in which the economic benefit the disqualified person receives, directly or indirectly, exceeds the value of the consideration (work performed or price paid) he or she gives back to the organization, also called *a non–fair market value transaction*.[105] The excess benefit is the difference

[102] Reg. §53.4958-1((d)(2)(i).
[103] See Sections 14.10(c) and 16.4(a).
[104] Reg. §53.4958-a(d)(6).
[105] Reg. §53.4958-4.

between the fair market value, or the reasonable or customary amount, and the higher amount actually paid. Fair market value is defined to be the amount that a willing buyer would pay a willing seller in the marketplace in which the item is normally sold, with neither the buyer nor the seller being under any compulsion to buy or sell.[106] An agreement based on the revenues of an organization's activities must be judged by existing private inurement standards.[107]

The fair market value of property sold or leased by or purchased from the exempt organization is determined following well-established standards previously discussed.[108] Valuations should be sought from qualified and reputable appraisers when the property in question, raw land or an operating business, is difficult to value. The Caracci case illustrated the significance of a complete appraisal.

Excess benefit transactions cause the sanctions to be imposed unless reasonableness is evidenced by certain rebuttal presumptions.[109] The three specific types of excess benefit transactions include the following:

1. A non-FMV transaction occurs between the insider and the exempt organization.
2. Unreasonable compensation (including expense allowances and deferred benefits) is paid by the exempt organization to an insider.
3. A revenue-sharing arrangement based on the organization's income violates the private inurement standards.

Excess benefit transactions can be direct or indirect.[110] A payment of the type previously listed made by an exempt organization's controlled subsidiary to a person who is an insider of the organization is subject to the sanction.

The following types of payments are disregarded for this purpose:

- Reasonable expenses for members of the governing body to attend meetings, not including luxury or spousal travel
- Economic benefit received solely as a member, or volunteer to, an organization of a sort provided to the public in exchange for a membership fee of $75 or less per year
- Benefits received as a member of a charitable class the organization intends to benefit, such as admission to a park or educational information

An *initial contract* exception applies. The sanctions do not apply to any fixed payment made to a person pursuant to a binding, written contract entered into with a person who was not a disqualified person in regard to the organization immediately prior to the time it is executed. *Fixed* means a specified amount of money or a specific formula for calculating compensation for services rendered or property transferred. The formula is considered fixed even if it changes upon the occurrence of some contingency or condition, such as a percentage of the

[106] The standards for determining fair market value are described in Section 20.2 and 24.(b).
[107] See discussion of incentive compensation in Section 20.2(c); regulations for revenue-sharing arrangements have not been issued as this edition was being prepared.
[108] Sections 20.4 and 20.5.
[109] Reg. §53.4958-6.
[110] IRC §4958(b)(1)(A).

revenue generated or the rate of inflation. The compensation will be considered fixed so long as no person exercises discretion over the formula for the fluctuating amount. For the compensation agreement to be treated as fixed, the contract cannot change. A new contract occurs when there is a material change to it, including a renewal or a more than incidental change to any amount payable under the contract.

(e) Proving Reasonableness

In determining when an excess benefit transaction has occurred, one must consider whether the total of all types of compensation paid to an individual is unreasonable. The IRS has developed extensive rules pertaining to definition of and reporting of wages, fringe benefits, fees to independent contractors, and other forms of compensation, or economic benefits, paid by an exempt organization to persons who perform services for it.[111] Form 990, Part V, List of Officers, Directors, and Trustees, reports the names and addresses, positions and time devoted, compensation, employee benefit and deferred compensation plan contributions, and expense account and other allowances paid to each individual officer, director, trustee, or key employee.[112] For the rebuttable presumption to apply, it is important that all forms of compensation—taxable and nontaxable—be reported on Form 990. Premiums for liability insurance coverage for penalties imposed by these rules must be treated as compensation, albeit a nontaxable fringe benefit, to avoid classification as excess benefits themselves.[113]

A *like, like, like* rule is applied to measure the reasonableness of total compensation. Compensation is reasonable if it is in an amount that would ordinarily be paid for like services by like enterprises under like circumstances.[114] Appropriate data to be used to evaluate the reasonableness of compensation paid should be gathered and maintained, including levels paid by similarly situated organizations, both taxable and tax exempt, for functionally comparable positions. The location of the organization may be considered, including the availability of similar specialties in the geographic area. Those organizations that decide to use broad statistical norms can access compensation surveys provided on www.guidestar.org. For a fee, statistics gathered from the Forms 990, categorized by disciplines and size of organizational budget can be studied to glean comparative salary statistics. Salary levels reflected in independent compensation surveys by nationally recognized firms and actual written offers made to the person by similar institutions competing for his or her services are also appropriate data. Sources for comparative compensation statistics have expanded in recent years.

Commercial placement firms perform studies for clients seeking information specific to their organization. For an organization with annual gross receipts of less than $1 million, data on compensation paid by five comparable organizations in the same or similar communities or of similar services is considered appropri-

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111 Standards are discussed in Section 20.2.
112 See Blazek, *Form 990 Handbook* (New York: Wiley), for guidance on completing this part.
113 Reg. §53.4958-4(a)(4); the same rule applies to private foundations, as discussed in Section 14.4(a).
114 Reg. §53.4958-4(b)(1)(ii)(A).

ate data. The conditions existing at the time of the contract or other arrangement for engagement of services are the preferred time to measure reasonableness. If that is not possible, all of the facts and circumstances of the transaction are considered, up to and including the date of the payment.[115] The fact that a court, state, local legislative body, or agency has approved of the compensation is not determinative of reasonableness. Reasonableness is reevaluated when the terms are modified or the contract extended. It is extremely important that suitable documentation be accumulated. Steven T. Miller, Director of Exempt Organizations, suggested the use of the checklist shown in Exhibit 20.1 by officials wanting to ensure full compliance[116] The author's version of the checklist can be found in Exhibit 19.9.

Revenue-Sharing Arrangements. Compensation arrangements based on sharing revenues or profits are addressed separately in proposed regulations, not yet finalized.[117] Whether or not excess benefit occurs when incentive compensation is paid is not necessarily based on the reasonableness of the amount paid. Instead, a proportional standard applies. If, at any point, the arrangement allows a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose, an excess benefit will occur. The intention is to ensure that a fair share of the profits goes to the exempt organization. An incentive arrangement that pays a percentage of the increase in the value of the organization's portfolio is okay. Though the manager exerts a measure of control over the amount of the profits by virtue of choosing the investments purchased and sold, the fruits of his or her choices are shared by the organization. An increase in the manager's income also yields an increase for the organization and does not constitute an excess benefit.

In contrast, a profit-sharing arrangement that allows a gaming activity manager to control all aspects of the operation is said to result in excess benefits. In the proposed regulation example, the manager provides the staff and equipment necessary to conduct the games and has total control over the charges and resulting profit from the activity. The arrangement provides no incentive for the manager to enhance the net profits. These examples of revenue-sharing transactions that result in excess benefits help clarify the meaning of arrangements that provide a fair share of the profits to the exempt organization. An incentive arrangement that pays a percentage of the increase in the value of the organization's portfolio is okay. Though the manager exerts a measure of control over the amount of the profits by virtue of choosing the investments purchased and sold, the fruits of his or her choices are shared by the organization. An increase in the manager's income also yields an increase for the organization and does not constitute an excess benefit.

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115 Examples of such circumstances are provided in Reg.§53.4958-4(b)(iii).
116 Article entitled "Easier Compliance Is Goal of New Intermediate Sanction Regulations," *2001 Tax Notes Today* (January 22, 2001); also see the February 2001 issue of *The Exempt Organization Tax Review* for a host of commentary on this subject.
117 Prop. Reg. §53.4958-5.

EXHIBIT 20.1

Intermediate Sanctions

INTERMEDIATE SANCTIONS

REBUTTABLE PRESUMPTION CHECKLIST

1. Name of disqualified person: ____________________

2. Position under consideration: ____________________

3. Duration of contract (1 yr., 3 yr., etc.): ____________________

4. Proposed compensation:

Salary: ____________________

Bonus: ____________________

Deferred compensation: ____________________

Fringe benefits (list, excluding section 132 fringes):

____________ ____________ ____________

____________ ____________ ____________

Liability insurance premiums: ____________________

Foregone interest on loans: ____________________

Other: ____________________

5. Description of types of comparability data relied upon (association survey, phone inquiries, etc.):

(a) ____________________

(b) ____________________

(c) ____________________

(d) ____________________

6. Sources and amounts of comparability data

Salaries: ____________ ____________ ____________

Bonuses: ____________ ____________ ____________

Deferred compensation: ____________________

Fringe benefits (list, excluding section 132 fringes):

________ ________ ________ ________ ________

________ ________ ________ ________ ________

________ ________ ________ ________ ________

Liability insurance premiums: ____________________

Foregone interest on loans: ____________________

Other: ____________________

7. Office of file where comparability data kept: ____________________

8. Total proposed compensation: ____________________

9. Maximum total compensation per comparability data: ____________________

10. Compensation package approved by authorized body: ____________________

Salary: ____________________

Bonus: ____________________

EXHIBIT 20.1 *(CONTINUED)*

Intermediate Sanctions

Fringe benefits (list, excluding section 132 fringes):

__________ __________ __________ __________ __________

Deferred compensation: ____________________
Liability insurance premiums: ____________________
Foregone interest on loans: ____________________
Other: ____________________

11. Date compensation approved by authorized body: ____________________

12. Members of the authorized body present (indicate with X if voted in favor):

__________ ______ __________ ______
__________ ______ __________ ______
__________ ______ __________ ______
__________ ______ __________ ______

13. Comparability data relied upon by approving body and how data was obtained:

____

14. Names of and actions (if any) by members of authorized body having conflict of interest:

____

15. Date of preparation of this documentation (must be prepared by the latter of next meeting of authorized body, or 60 days after authorized body approved compensation):

____

16. Date of approval of this documentation by Board (must be within reasonable time after preparation of documentation above):

____

Source: Information letter from Steve T. Miller, Director, IRS Exempt Organization Division, May 1, 2001.

In a revenue-sharing transaction the compensation is determined in whole or in part by the revenues from one or more of the organization's activities. Excess benefits in such transactions are to be determined by the facts and circumstances of each situation. The proposed regulations give three examples that should be carefully studied by those considering incentive compensation. A revenue-sharing arrangement can yield excess benefit, without regard to whether the total compensation is reasonable, when it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its mission.[118]

(f) Rebuttable Presumption

Managers and disqualified persons can be excused from the sanctions if a *rebuttable presumption of reasonableness* can be shown. To prove this presumption

[118] Reg. §53.4958-5; these rules are to be applied only when the regulations are finalized.

exists, the compensation arrangement or property transaction must be approved by a board of directors, trustees, or compensation committee to which the following apply:

- It is composed entirely of independent individuals unrelated to and not subject to control by the disqualified person involved (no conflict of interest occurs).
- The amount paid is based upon appropriate data as to comparability of value.
- Adequate documentation of data forming the basis for the approval is accumulated and maintained by parties authorizing the transaction.

Thus, it is not sufficient that the compensated individual excuse him- or herself from participating in the approval process. The rebuttable presumption also does not apply to payments to disqualified persons that are not reported by the organization and the individual as compensation. Contemporaneous documentation of process is extremely important for an organization to maintain in this regard. Not only must the procedures for arriving at the amount of all payments be documented, the organization and the recipient must treat them as compensation, as previously noted. The fact that payments are unreported evidences an intention to make excess benefits even if the unreported payments, when combined with reported amounts, result in reasonable compensation.[119]

(g) Correction

Correction of the transaction occurs when the person repays the excess benefits or otherwise financially restores the organization. The transaction must be corrected or undone to the extent possible[120] by taking whatever steps are needed to place the organization in a financial position no worse than what would have existed had the person dealt with it under the highest fiduciary standards. Restoration must be made in cash or cash equivalents, not a promissory note. The organization may choose to accept a return of property that was involved, subject to restitution of any decline in value of the property, or it may not. An increase in value can be returned to the disqualified person. Conversely, if the property is worth less than its value at the time of original transfer, the difference must be repaid to the organization. Interest must be paid at a rate that equals or exceeds the applicable federal rate, compounded annually, for the period between the month of the transaction and return of the cash or property.

Correction does not require that the contractual agreement under which payments were made be terminated, but the terms must be amended to eliminate the excess benefit element. Unless the excess is corrected, a second-tier tax is imposed on the insider, as described in the following subsection.

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[119] Instructions to 2003 Form 990, Part P, appearing on page 12.
[120] Reg. §53.4958-7.

If the organization does not exist when repayment is due, the restitution must be made to another (c)(3) or (c)(4) tax-exempt organization.[121] Payments cannot be made to an organization with the following characteristics:

- A public charity has been in existence for five years before receiving the correction amount.
- The recipient organization does not agree to follow the recommendations of the disqualified persons in spending the money.
- The person making the correction cannot be a disqualified person in relation to the recipient organization.

To be fair, the amounts paid back to the organization in making a correction should be deductible by the disqualified persons. The regulations do not address the issue because the IRS found the "issue beyond the[ir] scope." To date, no guidance has been issued on this subject.

(h) Paying the §4958 Excise Tax

An excise tax equal to 25 percent of the excess benefit is imposed on the disqualified person. The managers who willfully participated in the excess benefit transaction, knowing that it was such a transaction, unless their action was due to reasonable cause, are liable for a tax equal to 10 percent of the excess benefit, subject to a maximum of $10,000. Managers are jointly and severally liable for the tax. A manager who receives excessive benefits may be liable for both taxes plus return of excess benefits. The penalty is not imposed if the reasonableness is evidenced by the rebuttal presumptions.

The person(s) subject to the excise tax must file Form 4720 to report the transaction and calculate the tax due. Form 990 of the organization must disclose any excise tax imposed during the year by answering a four-part question regarding the sanctions for excess benefits, lobbying, or political expenditures.[122] Transactions under contracts binding before September 14, 1995, and still in effect and not materially modified, are not covered. The amount of tax imposed and the amount of reimbursement of tax paid to disqualified persons are also reported on Form 990.

If the excess is not corrected by repayment to the organization, an additional second-tier tax of 200 percent can be assessed against disqualified person(s) (not the managers). Note that no tax is imposed on the organization.

Any reimbursement of the penalty tax to the disqualified person by an organization is to be treated as yet another excess benefit transaction subject to tax unless the reimbursement is treated as additional compensation during the year it is paid, and the total compensation paid, including the reimbursement, is reasonable.[123] Since January 1, 1997, the requirements must be met before the payment is made.

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[121] Reg. §53.4958-7(e)

[122] IRC §6033(b); for 2003, question 89 requests this information on page 5 of Form 990.

[123] For transactions entered into between September 14, 1995, and December 31, 1996, the parties were entitled to rely upon the rebuttable presumption if, within 90 days of the payment of the excess benefits, the basic requirements for presumption are documented.

Abatement. The tax imposed on a disqualified person by the intermediate sanction rules can be abated if the overpayment(s) were not due to willful disregard for the law and the excessive amounts are repaid. The standards of IRC §§4961 and 4962 are made applicable by the regulations in allowing abatement.[124] Losing exempt status to avoid the tax is not effective because the rules are made applicable to any organization that was exempt from tax at any time during the five-year period ending on the date of the excess benefit transaction.[125] The Wiley Nonprofit Series has a book dedicated exclusively to the important subject.[126]

[124] Reg. §53.4958-1(c)(iv); see Section 15.6(c).
[125] Reg. §53.4958-2.
[126] B.R. Hopkins, *The Law of Intermediate Sanctions* (Hoboken: Wiley, 2003).

CHAPTER TWENTY-ONE

Unrelated Business Income

Exempt organizations receive two types of income: earned and unearned. Unearned income—income for which the organization gives nothing in return—comes from grants and donations. One can think of it as *one-way-street* money. The motivation for giving the money is generosity and/or of a nonprofit character with no expectation of gain on the part of the giver; there is donative intent. In contrast, an organization furnishes services and goods or invests its capital in return for earned income: An opera is seen, classes are attended, or credit counseling is given, for example. The purchasers of the goods and services do intend to receive something in return; they expect the street to be two-way. An investment company holding the organization's money expects to have to pay reasonable return for using the funds, and the organization receives earned income. The important issue this chapter considers is when earned income becomes unrelated business income (UBI) subject to income tax.

The tax on unrelated business income applies to all organizations exempt from tax under §501(c) other than corporations created by an act of Congress and also to the following:

- Tax-exempt employee trusts, described in IRC §401
- Individual retirement accounts
- State and municipal colleges and universities
- Qualified state tuition programs, described in IRC §529
- Education individual retirement accounts, described in IRC §530

The rules that govern when earned income becomes unrelated business income are complex. The concepts of UBI are vague and contain many exceptions that have been carved out by special-interest groups. The House of Representatives Subcommittee on Oversight held hearings and drafted revisions over a four-year period from 1987 to 1990. Though proposals to limit deductions and tax a variety of items were not passed, two very important changes resulted from the studies. The Internal Revenue Service (IRS) was directed to expand the Form 990 to report details of revenue sources that now reveal when an organization should file Form 990-T.[1] For-profit subsidiary payments in the form of rent, interest, royalties, or other expense deductible to the subsidiary are taxed to the tax-exempt parent when ownership is 50 percent or more.[2]

Tax planning of the sort practiced by a good businessperson is in order for organizations receiving UBI. The best method for reducing unrelated business income tax (UBIT) is to keep good records. The accounting system must support the desired allocation of deductions for personnel and facilities with time records, expense usage reports, auto logs, and documentation evidencing the nature of expenses. Minutes of meetings of the board of directors or trustees should reflect discussion of relatedness of any project claimed to accomplish an exempt purpose, if the relatedness of the activity could be questionable. For example, contracts and other documents concerning activities that the organization wants to

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[1] Part VII was added to Form 990 to require the organization to identify its related and unrelated income. See Jody Blazek, *IRS Form 900 Tax Preparation Guide for Nonprofits* (Hoboken: Wiley, 2004).

[2] Section 21.10(e).

prove are related to its exempt purposes should contain appropriate language to reflect the project's exempt purposes. An organization's original purposes can be expanded and redefined to broaden the scope of activities or to justify the proposed activity as related. Such altered or expanded purpose can be reported to the IRS to justify the relatedness of a new activity. If loss of exemption[3] is a strong possibility because of the extent and amount of unrelated business activity planned, a separate for-profit organization[4] can be formed to shield the organization from a possible loss of exemption due to excessive business activity.

21.1 IRS SCRUTINY OF UNRELATED BUSINESS INCOME

Since 1989 with the addition of Part VII to Form 990 and Part XVI-A to Form 990-PF, the IRS has had a tool with which it can scrutinize the UBI issue. Until this Analysis of Revenue-Producing Activities was added to the forms, UBI was not identified in any special way on Form 990. The UBI was simply included with related income of the same character. The congressional representatives and the IRS agreed that there was insufficient information to propose changes to the existing UBI rules. Parts VII and XVI-A separate income into three categories:

1. Unrelated income (identified with a business code from Form 990-T that describes its nature)
2. Unrelated income identified by the specific Internal Revenue Code section by which the income is excluded from UBI
3. Related or exempt function income, along with a description of the relationship of the income-producing activity to the accomplishment of exempt purposes

The IRS's first scrutiny of the new information found a 50 to 60 percent compliance rate with UBIT requirements. It found that a large portion of social clubs were failing to file Form 990-T when it took a look in 1997 and 1998. A significant portion of the private letter rulings issued consider this subject. If it is examined, a tax-exempt organization should expect the IRS to carefully scrutinize the nature and source of earned income to determine related or unrelated character. The 2003–2004 IRS Work Plan promised to contain guidance on the application of these rules to income earned on an organization's Web site.

21.2 HISTORY OF THE UNRELATED BUSINESS INCOME TAX

Before 1950, a tax-exempt organization could conduct any income-producing activity and, in fact, many operated businesses and paid no income tax on the profits. Under a destination of income test, the income earned from a business was tax-free so long as it was expended for exempt activities. In view of its extensive operations, the IRS tried in the late 1940s to tax New York University Law School's profits from its highly successful spaghetti factory.[5] The court

[3] Discussed in Section 21.3.
[4] Discussed in Section 22.4.
[5] *C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3rd Cir. 1951).

decided no tax could be imposed under the then-existing Tax Code since the profits were used to operate the school.

In response to pressure from businesses, Congress established the unrelated business income tax in 1951 with the intention of eliminating the unfair competition charitable businesses represented, but it did not prohibit its receipt. The congressional committee thought that the

> Tax free status of exemption section 501 organizations enables them to use their profits tax free to expand operations, while their competitors can expand only with profits remaining after taxes. The problem . . . is primarily that of unfair competition.[6]

A key question in identifying UBI is, therefore, whether the activity that produces earned income competes with commercial businesses and whether the method of operation is distinguishable from that of a for-profit entity. Another question is, Does the income-producing activity accomplish the organization's exempt purpose? These questions are sometimes difficult to answer. The distinction between for-profits and nonprofits has narrowed over the years as organizations search for creative ways to pay for program services. Consider what the difference between a museum bookstore and a commercial one is, other than the absence of private ownership. Privately owned for-profit theaters operate alongside nonprofit ones. Magazines owned by nonprofits, such as *National Geographic* and *Harper's,* contain advertising and appear indistinguishable from *Traveler* or *Life* magazine. The health-care profession is also full of indistinguishable examples. The Tax Court in one case was of the opinion that "unfair competition plays a relatively insignificant role in the application of the amended unrelated business tax."[7] A circuit court expressed the same sentiment in saying that "competition alone does not determine whether an unrelated trade or business should be taxed." The organization had argued that it was not competing with any taxable business, while the government argued that tax on unrelated business income is not limited to competitive business.[8]

21.3 CONSEQUENCES OF RECEIVING UBI

There are potentially several unpleasant consequences of earning unrelated income.

- *Payment of unrelated income tax*. Unrelated net income is taxed at corporate or trust rates, with estimated tax payments required. Social clubs, homeowner's associations, and political organizations also pay the UBI tax on certain passive investment income in addition to the unrelated business income.
- *Exempt status revocation*. The organization's tax-exempt status could be revoked if the unrelated business activity becomes its primary activity, in which case all income is taxed. IRC §501 requires a nonprofit organization

[6] House of Representatives No. 2319, 81st Cong., 2nd Sess. (1950) at 36-37.

[7] *Smith-Dodd Businessman's Association, Inc. v. Commissioner,* 65 T.C. 620 (1975).

[8] *Clarence LaBelle Post No. 217 v. U.S.,* 580 F.2d 270 (8th Cir. 1978), cert. dismissed, 99 S. Ct. 712.

to be both organized and operated exclusively for an exempt purpose, although exclusively does not mean 100 percent.[9]

- *Excess business holdings*. A private foundation may not operate a business and is limited in the ownership percentage it can hold in a separate business entity.[10]

In evaluating the amount of unrelated business activity that is permissible, not only the amount of gross revenue but other factors may be taken into consideration. Nonrevenue aspects of the activity, such as staff time devoted or value of donated services, are factors that might be determinative. The basic issue is whether the operation of the business subsumes, or is inconsistent with, the organization's exempt activities.

A complex of nonexempt activity caused the IRS to revoke the exemption of the Orange County Agricultural Society.[11] Its UBI averaged between 29 and 34 percent of its gross revenue. Private inurement was also found because the society was doing business with its board of directors. A medical aid plan producing 22 percent of revenue was found to be a primary, nonexempt purpose.[12] On the other hand, the IRS privately ruled that a 50-50 ratio of related to unrelated income was permitted for a daycare center raising funds from travel tours.[13] The revenue ratio was not indicative of the primary exempt activity of caring for children. An organization with unrelated income in excess of 15 to 20 percent of its gross revenue must be prepared to defend its exempt status by showing it focuses on its mission purposes rather than on its business activities. An organization can run a business as a substantial part of its activities, but not as its primary purpose.[14] The presence of a single, nonexempt purpose, if more than insubstantial in nature, will defeat exemption, regardless of the number or importance of the truly exempt purposes.[15]

The possibility of loss of exempt status when a significant portion, if not all, of an organization's income is unrelated business income is a question with no precise answer. Even if all of an organization's income stems from unrelated sources, all of the facts and circumstances must be considered.[16] The most important issue is whether the mission is the primary focus of the organization. What is referred to as the commensurate test is one method of finding an answer.[17] It is important to note that there are very few cases or rulings reaching the conclusion that exempt status should be revoked.

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[9] See Chapter 2.

[10] See Chapter 16 for rules defining impermissible excess business holdings for private foundations.

[11] *Orange County Agricultural Society Inc. v. Commissioner,* 90.1 USTC ¶50.076 (2d Cir. 1990), *aff'g.* 55 T.C.M. 1602 (1988).

[12] *Bethel Conservative Mennonite Church v. Commissioner,* 80 T.C. 362

[13] Priv. Ltr. Rul. 9521004.

[14] Reg. §1.501(c)(3)-1(e)(1).

[15] *Better Business Bureau v. U.S.,* 326 U.S. 279 (Sup. Ct. 1945),

[16] Gen. Coun. Memo. 34682.

[17] See Sections 2.2(d) and (e).

21.4 DEFINITION OF TRADE OR BUSINESS

To have unrelated business income, the nonprofit must first be found to be engaging in a trade or business. *Trade or business* is defined very broadly to include any activity carried on for the production of income from the sale of goods or performance of services.[18] The Tax Court, though, said a trade or business is conducted with "continuity and regularity" and in a "competitive manner similar to commercial businesses."[19] This is an area where the tax rules are very gray. The word *income* does not mean receipts or revenue and also does not necessarily mean net income. IRC §513(c) says: "Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit."

The regulations couch the definition in the context of unfair competition with commercial businesses, saying that "when an activity does not possess the characteristics of a trade or business within the meaning of Section 162," the UBIT will not apply. However, these regulations were written before the IRC §513(c) profit motive language was added to the code. They are the subject of continuing arguments between taxpayers and the IRS, and the confusion has produced two tests: profit motive and commerciality.

(a) Profit Motive Test

Under the profit motive test, an activity conducted simply to produce some revenue without an expectation of producing a profit (similar to the hobby loss rules) is not a business.[20] An insurance program entered into with "dominant hope and intent of realizing a profit and otherwise possessing the character of a trade or business" is unrelated.[21] This test is applied in situations when a nonprofit has more than one unrelated business. Losses from the unprofitable activity or hobby cannot necessarily be offset against profits from other businesses. Likewise, the excess expenses (losses) generated in fundamentally exempt activity, such as an educational publication undertaken without the intention of making a profit, cannot be deducted against the profits from a profit-motivated project.[22] Social clubs have battled with the IRS about this issue.[23]

(b) Commerciality Test

The commerciality test looks to the type of operation: If the activity is carried on in a manner similar to a commercial business, it constitutes a trade or business. This test poses serious problems for the unsuspecting because there are no statu-

[18] Reg. §1.513-1(b).

[19] *National Water Well Association, Inc. v. Commissioner*, 92 T.C. 75 (1985).

[20] *West Virginia State Medical Association*, 89-2 U.S.T.C. §9491 (4th Cir. 1989); 91 T.C. 651 (1988), *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

[21] *U.S. v. American Bar Endowment*, 477 U.S. 105 (Sup. Ct. 1986).

[22] Unless the exploitation rule applies, as discussed in Section 21.11.

[23] Discussed in Section 9.5.

tory or regulatory parameters to follow. A broad range of UBI cases where the scope of sales or service activity was beyond that normally found in the exempt setting have been decided by examining the commercial taint of the activity.[24] Providing consulting services for a fee to other organizations was found not to be an exempt activity. The primary purpose for the activity was determined by reference to the "manner in which the activities are conducted, the commercial hue of those activities, and the existence of and amount of annual or accumulated profits."[25] Because a conference center was operated in a commercial manner on a break-even basis, it was also denied exemption.[26] It organized and sponsored more than 600 educational conferences a year in areas as diverse as civil and human rights, international relations, public policy, the environment, medical education, mental health, and disability. Twenty percent of Airlie's conference events were held for government clients, 50 percent from nonprofit and/or educational clients, and 30 to 40 percent for "other" users, including a large number of weddings and other private events. Only a few of the events were financially subsidized with lower prices. The court said, "as it is clear from the facts that plaintiff engaages in conduct of both a commercial and exempt nature, the question whether it is entitled to tax-exempt status turns largely on whether its activities are conducted primarily for a commercial or for an exempt purpose" and decided the former was true. The fact that Airlie was seeking to recover tax-exempt status previously lost due to private inurement issues may have influenced the case. Exhibit 21.1 highlights characteristics that indicate an organization is operating in a commercial fashion.

(c) Fragmentation Rule

Further evidence of the overreaching scope of the term *trade or business* is found in the fragmentation rule.[27] This rule carves out an activity carried on alongside an exempt one and proves that unrelated business does not lose its identity and taxability when it is earned in a related setting. Take, for example, a museum shop. The shop itself is clearly a trade or business, often established with a profit motive and operated in a commercial manner. Items sold in such shops, however, often include educational items, such as books and reproductions of artworks, that serve an exempt purpose. The fragmentation rule requires that all items sold be analyzed to identify the educational, or related, items the profit from which is not taxable and the unrelated souvenir items that do produce tax-

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[24] *Better Business Bureau v. U.S.,* 326 U.S. 279, 283 (1945); *United States National Water Well Association, Inc. v. Commissioner,* 92 T.C. 7 (1989); *Scripture Press Foundation v. U.S.,* 285 F.2d 800 (Ct.Cl. 1961); *Greater United Navajo Development Enterprises, Inc. v. Commissioner,* 74 T.C. 69 (1980); see also Priv. Ltr. Rul. 9636001 for Christian school's textbook publishing department earning UBI because it was indistinguishable from commercial publishing company. In *Living Faith,* 950 F.2d 365, 69 AFTR2d 92-301 (7th Cir. 1991), a vegetarian restaurant and health food store preparing food according to religious tenets was found to have substantial nonexempt purposes in its advertisements, pricing, and lack of donated funds.

[25] *B.S.W. Group Incorporated v. Commissioner,* 70 T.C. 352 (1978).

[26] *Airlie Foundation v. IRS*, D.D.C. 2003).

[27] IRC §513(c).

EXHIBIT 21.1

Commerciality Test Checklist

"YES" answers to these questions are warnings that signal the EO's exposure to a challenge that the organization operates in a commercial manner and may not be exempt.

	Yes	No
COMPETITIVENESS: Does the exempt organization's activity compete with for-profit businesses conducting the same activity? Is there a counterpart for the activity in the business sector, particularly a *small* business?	☐	☐
PERSONNEL MOTIVATION: Do managers receive generous compensation? Is the activity run by well-paid staff members?	☐	☐
SELLING TECHNIQUES: Are advertising and promotional materials utilized? Are retailing methods, such as mail-order catalog or display systems, similar to a for-profit enterprise used?	☐	☐
PRICING: Is the highest price the market will bear charged for goods and services? There are no scaled or reduced rates available for members of a charitable class.	☐	☐
CUSTOMER PROFILE: Are the organization's services and goods for sale to anyone? Are they available to the general public on a regular basis, rather than only for persons participating in the organization's other exempt activities?	☐	☐
ORGANIZATION'S FOCUS—GOOD WORKS RATIO: Does the organization conduct significant other charitable program activity? Is the income-producing activity its primary focus rather than exempt ones?	☐	☐
CHARACTER OF ORGANIZATION'S SUPPORT: Does very little or none of the organization's support come from voluntary contributions and grants or other unearned sources?	☐	☐

able income. The standards applied to identify museum objects as related or unrelated are well documented in IRS rulings.[28]

21.5 WHAT IS UNRELATED BUSINESS INCOME?

Unrelated business income is defined as the gross income derived from any *unrelated trade or business regularly carried on*, less the *deductions connected* with the carrying on of such trade or business, computed with *modifications and exceptions*.[29] The italicized terms are key to identifying UBI. Exhibit 21.2 shows them graphically. All four prongs of the circle surrounding the circle must be considered to determine what earned income is to be classified as UBI.

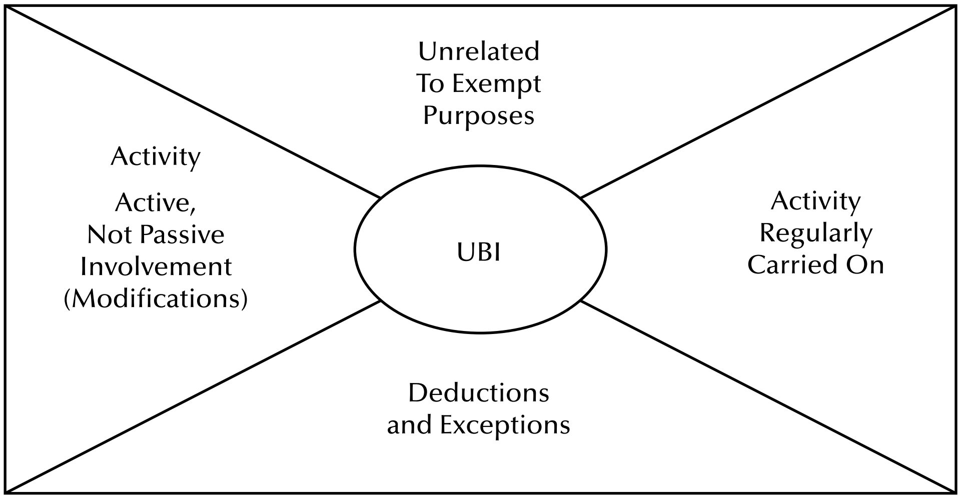
21.6 "REGULARLY CARRIED ON"

A trade or business regularly carried on is considered to compete unfairly with commercial business and is fair game for classification as a taxable business. In determining whether an activity is regularly carried on, one looks at the frequency and continuity of an activity when examined by comparison to commer-

[28] See Section 21.13.
[29] IRC §512(a)(1).

EXHIBIT 21.2

Components of Unrelated Business Income



cial enterprises. The normal time span of comparable commercial activities can also be determinative.[30] Exhibit 21.3 compares regular and irregular activities.

(a) Meaning of Irregular

Intermittent activities may be deemed regularly carried on or to have commercial characteristics unless they are discontinuous or periodic. For example, the revenue from a weekly dance is likely to be classified as UBI; an annual fundraising event would not. By the same token, ads sold for a monthly newsletter would be classed as regular commercial activity; program ads sold for an annual ball would not. Where the planning and sales effort of a special event or athletic tournament are conducted over a span of time throughout the year, the IRS has argued that the activity itself is regularly carried on despite the fact that the event occurs infrequently or even once a year.[31] Congress specifically mentioned income derived from an annual athletic exhibition in stating that the UBI applies only to business regularly carried on.[32] When the IRS proposed taxing broadcast rights, it argued that preparatory time, not the actual playing time, determines regularity. If an event or program takes the entire year to produce, the span of time spent negotiating contracts and otherwise working on the event is considered. Examples of the arguments follow:

- Time spent by volunteers in soliciting advertisements or sponsorships were to be considered in evaluating the time span of the activity.[33]

[30] Reg. §1.513-1(c).
[31] See the NCAA advertising sales discussion of Agency Theory in Section 21.8(h).
[32] S. Rep. 91-552, 91st Cong., 1st Sess. (1969).
[33] Rev. Rul. 75-201, 1975-1 C.B. 164.

EXHIBIT 21.3

Determining Regular Activity

IRREGULAR	REGULAR
Sandwich stand at annual county fair.	Cafe open daily.
Annual golf tournament.	Racetrack operated during racing "season."
Nine-day antique show.	Antique store.
Gala Ball held annually.	Monthly dance.
Program ads for annual fund-raising event.	Advertisements in quarterly magazine.

- An eight-month concert season program was ruled to be comparable to commercial entertainment operations and thereby regularly carried on.[34]
- The National College Athletic Association (NCAA) convinced the court that an independent company's year-round effort to sell ads for the Final Four championship basketball tournament program was not attributable to the NCAA. The three-week duration of the tournament made it irregular and the program income excludable from UBIT even though the activity was an unrelated business.[35]
- Year-round sales effort for ads in a labor organization's yearbook, in IRS eyes, meant the activity is regularly carried on. The facts indicated that the yearbook had relevance to the members throughout the year and "the vast majority of advertisements carry a definitely commercial message."[36]
- One private ruling, however, said it would be difficult to conclude that an annual ball, which occurs only once each year, is regularly carried on.[37]
- Biannual publication of a business league's directory was also ruled to be a regular activity; the every-other-year publication cycle was regular or normal in commercial settings. The IRS opined that "continuity" did not necessarily mean "continuously," but rather having a connection with similar activities in the past that will be carried forward into the future.[38]

Payment made to a statewide farm federation under a nonsponsorship and noncompetition agreement was made in a nonrecurring transaction.[39] Although there was profit motive in making the agreement, no regular trade or business activity occurred when the federation agreed not to compete with the successor to its regional cooperative organization. When the Museum of Flight Foundation

[34] Rev. Rul. 75-200, 1975-1 C.B. 163. See also *Suffolk County Patrolmen's Benevolent Association, Inc. v. Commissioner,* 77 T.C. 1314 (1981), *acq.* 1984-1 C.B. 2. The fact that the solicitors spent 16 weeks organizing the event makes the activity regular in the IRS's eyes.

[35] *National College Athletic Association v. Commissioner,* 914 F.2d 1417 (10th Cir. 1990). The IRS strongly disagrees with this opinion; see Priv. Ltr. Ruls. 9044071 and 9721001.

[36] Rev. Rul. 74-38, 1974-1 C.B. 144; Priv. Ltr. Rul. 9304001.

[37] Priv. Ltr. Rul. 9417003.

[38] Rev. Rul. 73-424, 1973-2 C.B. 190; Priv. Ltr. Rul. 9302035.

[39] *Ohio Farm Bureau Federation, Inc. v. Commissioner,* 106 T.C. 222 (1996).

rented the first Boeing 747 back to the company to use for testing purposes, the IRS contended that the personal property rents paid by Boeing to borrow the plane back for testing purposes was taxable unrelated business income. A court overturned the decision and found that the lease was not a business *regularly carried on* and agreed with the museum that the transaction was a "one-time, completely fortuitous lease of unique equipment.[40]

(b) Seasonal Activity

Activities conducted during a period traditionally identified as seasonal, such as Christmas, if conducted during the season, will be considered regular and the income will not qualify to be excluded from UBIT. Christmas card sales during October or November or Independence Day balloons sold in June/July would be regular sales activity.

21.7 "SUBSTANTIALLY RELATED"

An activity is substantially related only when it has a causal relationship to the achievement of the organization's exempt purpose,[41] that is, the purpose for which the organization was granted exemption based upon its Form 1023 or 1024 and subsequent Form 990 filings. This requirement necessitates an examination of the relationship between the business activities—producing and distributing goods or performing services—that generate the particular income in question and the accomplishment of the organization's exempt purposes.[42]

> Any business the conduct of which is not substantially related (aside from need to make money) to the performance of an organization's charitable, educational, or other purposes or function constituting the basis of its exemption is defined as unrelated.[43]

The size and extent of the activity itself and its contribution to exempt purposes are determinative. The nexus—association, connection, or linkage—between the activity and accomplishment of exempt purposes is examined to find relatedness. The best way to illustrate the concept is with examples.

(a) Examples of Related Activity

Related income-producing activities include the following:

- Admission tickets for performances or lectures
- Student or member tuition or class fees
- Symphony society sale of symphonic musical recordings
- Products made by handicapped workers or vocational trainees[44]

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[40] *Museum of Flight Foundation v. U.S.,* 83 AFTR2d ¶99,474 (D.C. W. Wash. 1999).
[41] IRC §513(a).
[42] Reg. §1.513-1(d).
[43] Reg. §1.513-1(a).
[44] Rev. Ruls. 73-128, 1973-1, C.B. 222 and 76-37, 1976-1 C.B. 148; Priv. Ltr. Ruls. 9152039 and 200225044.

- Hospital room, drug, and other patient charges
- Commercial stores employing developmentally or emotionally disturbed persons[45]
- Agriculture college sale of produce or student work
- Sale of educational materials (see Section 21.13 for museum issues)
- College golf course usage by students and faculty[46]
- Secretarial and telephone answering service training program for indigent and homeless[47]
- Operation of diagnostic health devices, such as CAT scans or magnetic imaging machines, by a hospital or health-care organization[48]
- Sale of online bibliographic data from EO's central databases[49]
- "Public entertainment activities," or agricultural and educational fair or exposition (Section 21.9(d))
- "Qualified conventions and trade shows" (Section 21.9(e))
- Producing tapes of endangered ethnic music[50]
- Birthing center operated as a part of a church in respect of its religious tenets and belief that birth is a sacred and spiritual event[51]

An "interactive virtual library" selling access to both its collections and staff over the Internet, just as if one were visiting the library in person, as well as providing advice based on its expertise in library science to other libraries and businesses, was considered a related activity for a library.[52] Sales of caskets for use in connection with religious burial ceremonies or services of the church of which the monastery is a part furthers its exempt religious purposes, but sales of caskets to members of the general public would be unrelated business activity for the religious group.[53]

(b) Sales of Goods or Merchandise

Many tax-exempt organizations sell physical items that are used in connection with conducting programs. In deciding why and when the sale of such goods is treated as an activity that has a causal relationship to an organization's mission,

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[45] Rev. Rul. 76-94, 1976-1 C.B. 171; Priv. Ltr. Rul. 200225044.

[46] Usage by spouses, alumni, and donors was not considered as related in Priv. Ltr. Rul. 9645004; course developed to provide golf course management to juvenile delinquents was related in Priv. Ltr. Rul. 200151061.

[47] Rev. Ruls. 61-72, 1961-1 C.B. 188 and 79-18, 1979-1 C.B. 194; Priv. Ltr. Rul. 9009038.

[48] Tech. Adv. Memo. 8932004.

[49] Rev. Rul. 81-29, 1981-1 C.B. 329; Priv. Ltr. Rul. 9017028.

[50] Priv. Ltr. Rul. 9210026 citing Rev. Rul. 79-369, 1979-2 C.B. 226.

[51] Priv. Ltr. Rul. 925037, citing Rev. Ruls. 80-114, 79-359, and 71-580.

[52] Priv. Ltr. Rul. 199945062. The library stipulated it would provide that its fee schedule allowed for sliding-scale fees for those who could not afford to pay full fare—a very important factor in proving the services were purveyed in the public interest. Just selling consulting services to business libraries would be considered as unrelated activity.

[53] Priv. Ltr. Rul. 200033049.

EXHIBIT 21.4

Sale of Merchandise

NATURE OF ITEMS SOLD.

- Are the objects actually used by the purchaser to participate in the organization's exempt activities?
- Said another way, ask what is the intended use of the merchandise by the purchaser?
- Are items sold through a Web site or shop open to general public?

METHODOLOGY OF SALES ACTIVITY.

- Does the manner in which the sales activity is conducted evidence commerciality? Use the Exhibit 21.1 checklist to find this answer. For publications, apply tests found in Section 21.15.

MOTIVATION FOR SALES ACTIVITY.

- Was a gift shop established to generate profits or to distribute educational items?
- Does the shop sell both related and unrelated items? Standards discussed in Section 21.13 for museum shops to fragment[1] or identify those objects that qualify as related to exempt purposes and those that do not can be applied.

NONCOMMERCIAL CHARACTER.

- Does one of the exceptions apply evidencing the noncommercial nature of the sales activity?[2]
- Are the shop personnel volunteers?
- Is merchandise donated?
- Is the sales activity irregularly conducted?[3]

1. See Section 21.4(c).
2. See Section 21.9.
3. See Section 21.6.

several factors must be considered. Exhibit 21.4 presents a checklist of issues to consider when the tax-exempt organization sells merchandise.

(c) School Athletic and Entertainment Events

College-sponsored events have traditionally been thought to foster school spirit and advance the educational purposes of the schools. Revenues produced through sales of admission tickets, event programs, refreshments, and similar items have not normally been treated as UBI. Legislative history underlying the UBI provisions states that "athletic activities of schools are substantially related to their educational functions. For example, a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students from other schools."[54]

[54] S. Rep. 2375 and H. Rep. 2319, 81st Cong., 2d Sess. 109 (1950).

Payments for radio and television broadcast rights, however, have been controversial. In 1977, the IRS advised Texas Christian University, Southern Methodist University, University of Southern California, and the Cotton Bowl Athletic Association that revenue derived by the universities from the telecasting and radio broadcasting of athletic events constituted unrelated trade or business income. In 1978, the IRS reversed its position after a challenge by the Cotton Bowl and National College Athletic Association.[55] In 1979, the IRS further expanded its position regarding such events and provided a good outline of the issues[56]:

- Sales of broadcast rights were regularly carried on and the activity was looked at as a profit-motivated trade or business activity, with extensive time expended training the teams and preparing for the game.
- The events were regularly carried on (systematic and consistent, not discontinuous or periodic).
- Games, however, were related to the Cotton Bowl's exempt purpose. Income from sale of the game broadcast was a by-product because it was presented in its original state and provided a simultaneous extension of the exempt function game to the general public.

A long series of IRS proclamations on the subject were issued in following years concerning the sale of broadcast rights by colleges, all of which ruled that such sales produced related income.[57] These arguments eventually led to a Tax Code revision that permits payments in the form of a sponsorship, acknowledged with noncommercial language, to be treated as a contribution.[58]

In 1981, the IRS applied the commerciality test[59] to find the promotion of rock concerts in a "multipurpose college auditorium" a taxable unrelated activity. The college's goal to maximize revenue to the exclusion of other considerations indicated the facility was not operated as an educational program. The nature of the entertainment and the audience were not the criteria used to judge the activity's relatedness; instead, the detrimental fact was the college's selection of events based upon their profitability. The facts outlined in the ruling evidencing the businesslike manner of conduct were as follows[60]:

- During the school year, 45 ticket events were held, 44 percent of which were rock concerts.
- Contemporary professional entertainers comprised 40 percent of the concert season.

[55] Priv. Ltr. Rul. 7851004.
[56] Priv. Ltr. Rul. 7930043.
[57] Priv. Ltr. Ruls. 7851005, 7930043, 7948113; Rev. Ruls. 80-295 and 80-296; and Priv. Ltr. Rul. 8643091.
[58] See Section 21.8(e).
[59] See Section 21.4(b).
[60] Priv. Ltr. Rul. 9147008 citing Rev. Rul. 55-676, 1955-2 C.B. 266, Rev. Rul. 76-42, 1976-2 C.B. 177.

- The facility was managed by a director with more than 30 years' experience in promoting commercial events.
- The school's fine arts department had no involvement in the selection of events to be held at the center and normally did not participate.
- Twenty-six percent of the tickets were sold to nonstudents.
- Tickets were sold through a commercial ticket service.
- Ticket prices for students were not discounted.
- Concerts were generally indistinguishable by price or type of performance from similar events provided by commercial impresarios.
- Compensation to the performers was negotiated and generally the same as compensation paid by for-profit centers.

Spouses and children of students, spouses and dependents of a university's employees, university alumni, and members of a President's Club (big donors and guests) were deemed to be unrelated users of a university's golf course. The IRS ruled that only use by full- and part-time students and employees was substantially related and that there was no causal relationship between the university's educational purposes and use of its golf course by any other persons.[61]

21.8 UNRELATED ACTIVITIES

The types of income that can potentially be treated as unrelated income are numerous, as the following types of income that have been controversial illustrate. The examples do not always follow a logical pattern because courts and the IRS do not always agree, and the IRS has not always been consistent in its rulings. To further complicate the matter, rules applicable to one type of income are not necessarily applied to another type.

(a) Rentals

Rentals of equipment and other personal property (such as computers or telephone systems) to others are specifically listed in IRC §512(b)(3) as a type of unrelated business income. Such a rental is presumed to be undertaken only to collect revenue to cover costs, with no direct connection to the organization's own exempt purposes. Whether rental charges are at, below, or above cost can be determinative in evaluating relatedness. A full fair market value rental arrangement might be considered evidence of lack of exempt purposes, although the taint can be overcome by other reasons for the rental, such as dissemination of specialized educational information. Such rental is said to *exploit* the exempt holding of the property. However, this general rule is not applicable in situations where the rental serves an exempt purpose, such as the following:

- Renting to, or sharing with, another nonprofit or, conceivably, an individual or a for-profit business is related if the rental expressly serves the landlord's exempt purposes. A museum's rental of artworks—which

[61] Priv. Ltr. Rul. 9645004 citing Rev. Rul. 60-143, 1970-1 C.B. 192 (alumni association) and Rev. Rul. 78-98, 1978-1 C.B. 167 (ski facility).

would otherwise be kept in its storage—to other institutions to ensure maximum public viewing of the works serves an exempt, and thereby a related, purpose.

- Rental of computers to its students, to facilitate their learning experience, would be a related activity for a school.

When the practice first became prevalent, the IRS took the position and fought hard to treat the fees for use of an organization's mailing list as unrelated rental income. After several unsuccessful court battles, they conceded that the income was excludable under the passive exception for royalties.[62] Real estate rentals are also excluded from UBI under the passive exceptions, but only if the property is unencumbered and not debt-financed property.[63]

(b) Services

Rendering services by a charitable organization for its exempt constituents—students, patients, the underprivileged, or the parishioners—that accomplish an organization's mission is unquestionably a related activity. Certain types of services are inherently treated as related exempt activities—teaching, healing the sick, feeding the poor, or performing religious rites, for example. Organizations exempt under IRC §501(c)(3) perform services in pursuit of eight specific, but fairly broad, exempt purposes.[64] Services other types of exempt organizations may provide are actually narrower. A business league, labor union, social clubs, and others must perform only services that accomplish the mission and benefit the industry, the union, or the club, not its members as individuals.

Services Provided to an Unrelated Nonprofit. Rendering services, such as billing, technical assistance, or administrative support, to other nonprofits does not serve the exempt purposes of the service provider, however, and is unrelated.[65] The fact that sharing creates efficiencies that allow all the nonprofits involved to save money or improves program administration of the other nonprofits does not necessarily cause the activity to be related. Providing services for a fee below, at, or for cost plus a modest profit may also not serve an exempt purpose and "is not charitable because of the absence of a donative intention."[66] Only where the services themselves represent substantive programs better accomplished by selling the services to other organizations is the revenue considered related.

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[62] Discussed in Section 21.10(d).

[63] IRC §512(b)(3); see Section 21.12.

[64] Religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international amateur sports competition, and preventing cruelty to children or animals. These purposes are discussed in Chapters 3–5.

[65] Rev. Rul. 72-369, 1972-2, C.B. 245.

[66] Chapter H, "IRC Section 501(c)(3) Substantially Below Cost," *IRS CPE Text,* 1986, but see Rev. Rul. 71-529, 1971-2 C.B. 234 program funded by charitable grants to provide low-cost endowment management to colleges and universities was exempt.

- The Tax Court sanctioned the sharing of computer database technology for a group of libraries based upon the concept that if an activity was a necessary component part of the operation of one library, it served an exempt purpose to provide the service to other exempt organizations.[67] A regional computer network to collect and disseminate scientific and educational information for member educational organizations posed a similar case.[68]
- Assistance in management of endowment funds by participating colleges and universities for a charge substantially below cost was an exempt purpose.[69]
- Training courses furnished by a university to a business were sanctioned.[70]
- An HMO service provider created to provide management consulting to other exempt HMOs was not itself exempt.[71] Similarly, the exempt status of an organization providing management and administrative services to rural hospitals was revoked despite the fact that it had been a tax-exempt organization since 1956.[72]
- Internet service providers are considered to sell business services and are not qualified for tax exemption.[73]

Services Provided to an Affiliated Organization. Although providing business services to an unaffiliated organization is usually treated as an unrelated activity, such services provided to an affiliated exempt entity may be related.[74] When services rendered by one member of a related group of organizations to others in the group are essential to the exempt functioning of the group, the services are considered to accomplish an exempt purpose. A wide range of services, including campus security, telephone and mail service, a central steam plant, financial services, an auditorium, a faculty house used for meals and meetings, a medical center, a library, and an interfaith fellowship center, provided by a graduate school to its related "small colleges arranged around a library," were related to accomplishment of its exempt purposes.[75] Though each entity was legally separate, the graduate school's board of fellows includes the presidents and board chairs of each member of the group; matters concerning central programs and service are subject to a two-thirds vote. The constitution and the college's bylaws provide for a council made up of the presidents of each college in the group to

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[67] *Council for Bibliographic & Information Technology,* T.C.M. 1992-364 (Tax Ct. 1992). See also Tech. Adv. Memo. 9032005 in which a §501(c)(6) tourist and convention bureau provided related services to businesses planning conventions but received taxable commissions from hotel referrals.

[68] Rev. Rul. 74-614, 1974-2 C.B. 164.

[69] Rev. Rul. 71-529, 1971-2 C.B. 234.

[70] Priv. Ltr. Rul. 9137002 citing Rev. Rul. 68-504, 1968-2 C.B. 211.

[71] Priv. Ltr. Rul. 9232003.

[72] Priv. Ltr. Rul. 9822004; similarly in Priv. Ltr. Rul. 200318037, administrative services provided to a related joint venture were found to produce unrelated income, but in Priv. Ltr. Ruls. 200325004 and 200151045, health-care services were found to be related to exempt purposes.

[73] Discussed in Section 5.1(i).

[74] Rev. Rul. 72-529; *B.S.W. Group, Inc. v. Commissioner,* 70 T.C. 352 (1978).

[75] Priv. Ltr. Rul. 9849027.

provide policy guidelines on the administration and development of common programs and facilities.

One ruling considered a hospital support organization created to purchase and operate a computer system for the medical faculty group practice[76] and a motel located a short distance from the medical center.[77] The doctors using the computers taught medical students, supervised interns and residents, and served private patients. The motel operation was operated as a *convenience*[78] to the patients of the related hospital.

Affiliate organizations for this purpose are usually referred to as being an integral part[79]of a group or system. Integrated health-care delivery systems have led the way in clarifying this issue.[80] Services rendered to the for-profit organizations in such a group may, however, be treated as unrelated activity.

Cooperative Efforts. When an organization is created to serve a consortium of organizations with a common building or pooled investment funds, the IRS has generally allowed its exemption when the new organization itself is partly supported by independent donations. When services are program related, the cooperative performance of charitable or educational functions has generally been acceptable to the IRS.[81]

- Certain cooperative service organizations are specifically exempt. IRC §501(e) grants exempt status to cooperative hospital organizations formed to provide on a group basis specified services including data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services. Note that laundry is not on the list.
- Cooperative service organizations established to "hold, commingle, and collectively invest" stocks and securities of educational institutions are also provided a special exempt category under IRC §501(f).
- IRC §513(e) allows a special exclusion from UBI for the income earned by a hospital providing the types of services listed in IRC §501(e) to another hospital that has facilities to serve fewer than 100 patients, provided the price for such services is rendered at cost plus a "reasonable amount of return on the capital goods used" in providing the service.

Member Services. Services furnished to members must also accomplish an exempt purpose to be treated as related. Services provided by churches, schools, hospitals, and most other charitable organizations are ordinarily treated as related. Classification of member services by business leagues, labor unions, and other non-(c)(3) organizations is not always clear. The question is whether the service yields private inurement to the individual member or to the profession

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[76] See Section 4.6(c); medical faculty practice groups can qualify as exempt organizations.
[77] Priv. Ltr. Rul. 9847002; see also Priv. Ltr. Ruls. 9811001, 9711002, and 9641011.
[78] See Section 21.9(c).
[79] See Section 2.2(h).
[80] See Section 4.6(d).
[81] See Priv. Ltr. Rul. 9237034.

as a whole and therefore to the general public. Excessive unrelated member services can imperil an association's exempt status. Chapters 7 and 8 have extensive consideration of this issue.

The fact that the services provided to the member cooperatives were "not directly proportional to the amount of the fees paid" indicated that individual economic benefits were not directly tied to the payments. Educational programs to promote farm cooperatives, information regarding economic and social conditions for farmers and farm products, and other services were found by the Tax Court to be conducted by a statewide federation of local county farm bureaus for exempt purposes.[82] Regarding a payment under a noncompete agreement, the revenue was found not to stem from the performance of services or the sale of goods so as to produce unrelated business income.

(c) Licensing Use of the Organization's Name

Licensing the use of an organization's name normally is accomplished by a contract permitting use of the organization's intangible property—its name—with the compensation constituting royalty income that is excluded from UBI.[83] Such arrangements can constitute commercial exploitation of an exempt asset if the nonprofit agrees to endorse products, distribute materials on behalf of the list renter, and perform other services associated with use of its intangible property.[84] The IRS began in 1981 to propose that the sale of names and mailing lists in connection with insurance programs and other commercial marketing plans resulted in unrelated business income.[85] The IRS argued that the extensive involvement of the exempt organization in servicing the membership lists alone made such activity an active business. Later the Tax Court forced them to admit that the licensing of the organization's name and logo alone produces passive royalty income. Endorsements and promotion by the organization in its publications and member/donor correspondence, however, were the performance of valuable services that produced unrelated income.[86] An agreement that contains a requirement that promotional or other services be performed by the organization should be bifurcated to separate the consideration for the royalty and mailing list aspects of the contract.

(d) Advertising

Sale of advertising in an otherwise exempt publication is almost always considered unrelated business income. Advertisements are said to promote the interests of the individual advertiser or company and cannot therefore be related to the charitable purposes of the organization. The corporate sponsorship rules adopted in 1997 bifurcated the rules for advertising. The language and business logo displays permitted for ads placed in a special-event catalog, in a bowl game program,

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[82] *Ohio Farm Bureau Federation, Inc. v. Commissioner,* 106 T.C. 222 (1996).

[83] Under modifications discussed in Section 21.10(d).

[84] In Priv. Ltr. Rul. 9705001 a business league earned royalty income from licensing its name without its mailing list or other services.

[85] Rev. Rul. 81-178, 1981-2 C.B. 135.

[86] The court cases are chronicled in Section 21.10(d).

or on a nonprofit television or radio station program are much more favorable than the information that can be displayed in periodicals.[87] When the sponsorship standards for quantitative and qualitative data do not apply, what constitutes an advertisement will be a display similar to those found in newspapers and magazines and on radio and television. Except for addressing the question of expense allocations, the regulations contain no mention of periodical advertisements. Most of the guidance available on this subject predates the sponsorship bifurcation. The definitions for *advertisement* and *periodical* found in the sponsorship regulations quoted in the next section are said to apply only for that purpose. Readers, however, will find those definitions useful in identifying the character of ads contained in periodicals and should be alert for new developments.

An advertisement contains quantitative and qualitative information that promotes the sale of the sponsor's product or engagement of its services. The following examples are indicative of IRS thinking:

- The American College of Physicians was unsuccessful in arguing that the drug company ads in its health journal published for physicians educated the doctors. The college said the ads provided the reader with a comprehensive and systematic presentation of goods and services needed in the profession and informed physicians about new drug discoveries, but the court disagreed.[88]
- A college newspaper training program for journalism students enrolled in an advertising course produced related income.[89]
- Sponsors listed without typical advertising copy may be considered contributors, not advertisers. Different sizes of acknowledgments indicating different amounts of money donated do not cause the ad to be classified as commercial.[90]
- Advertising revenues received by a police troopers' labor union from sale of business listings and ads in its annual publication were found to be unrelated business income.[91] The firm hired to sell the ads and produce the Constabulary was acting on the union's behalf and under its control in an agency relationship[92] similar to that found in the NCAA case.

Despite classification of ad revenues as UBI, the formula for calculating the taxable UBI often results in little, if any, taxable income. Using the exploitation method,[93] the cost of the publication in which the ads appear, net of any revenue

[87] Reg. §1.513-4, discussed in next section.

[88] *American College of Physicians v. U. S.*, 457 U.S. 836 (1986); ads complementing the text concerning developments in manufacturing technology were held to similarly produce unrelated income in Priv. Ltr. Rul. 9724006.

[89] Reg. §1.513-1(d)(4)(iv), Example 5.

[90] *Fraternal Order of Police, Illinois State Troopers Lodge No. 41 v. Commissioner,* 833 F.2d 717 (7th Cir. 1987), aff'g. 87 T.C. 747 (1986); Priv. Ltr. Rul. 8640007.

[91] *State Police Ass'n. of Massachusetts v. Commissioner,* T.C.M. 1996-407 (Sept. 1996), cert. denied, 123 F.3d 1 (1st Cir. 1997).

[92] Discussed in Section 21.8(h).

[93] See Section 21.15(b), and Exhibit 12.5 for calculation method.

EXHIBIT 21.5

Calculating the Taxable Portion of Advertising Revenue

BASIC FORMULA: A – B – (C – D) = TAXABLE INCOME

A = GROSS SALES OF ADVERTISING

B = DIRECT COSTS OF ADVERTISING

Occupancy, supplies, and other administrative expenses	$ ______
Commissions or salary costs for ad salespersons	$ ______
Clerical or management salary cost directly allocable	$ ______
Artwork, photography, color separations, etc.	$ ______
Portion of printing, typesetting, mailing, and other direct publication costs allocable in the ratio of total lineage in the publication to ad lineage	$ ______
Total direct cost of ads	$ ______

C = READERSHIP COSTS

Occupancy, supplies, and other administrative expense	$ ______
Editors, writers, and salary for editorial content	$ ______
Travel, photos, other direct editorial expenses	$ ______
Portion of printing, typesetting, mailing, and other direct publication costs allocable in ratio of total lineage in publication to editorial lineage (in general, all direct publication costs not allocable to advertising lineage)	$ ______
Total readership costs	$ ______

D = READERSHIP (OR CIRCULATION) REVENUES:

If publication sold to all for a fixed price, then readership revenue equals total subscription sales.	$ ______
or	
If 20% of total circulation is from paid nonmember subscriptions, then price charged to nonmembers times number of issues circulated to members plus nonmember revenue equals readership revenues.	$ ______
or	
If members receiving publication pay a higher membership fee, readership revenue equals excess dues times number of members receiving publication, plus nonmember revenue.	$ ______
or	
If more than 80% of issues distributed to members free, readership revenue is the membership receipts times the ratio of publication costs over the total exempt activities cost including the publication costs.	$ ______

associated with its distribution, are deductible against the net advertising revenue. This formula sometimes yields surprising results that permit ad sale programs to escape tax. See Exhibit 21.5 for the calculation worksheet.

(e) Sponsorships

Sponsorships of a wide variety of events—golf tournaments, fun runs, football bowl games, public television, art exhibitions, and so on—are a favorite form of business support for exempt organizations. The appeal of wide public exposure for sponsoring worthy causes and cultural programs has gained extensive popularity. The *Wall Street Journal* ran a series of articles during 1991 discussing the extent of such support and reasons why it made good business sense.

The Cotton Bowl Association's payments from Mobil Oil Company were, in 1991 after a lengthy controversy, treated as UBI.[94] The IRS found that substantial benefit in the form of advertising was given to Mobil. After an outcry from the exempt community, and in the face of proposed legislation to exempt such payment, the IRS issued proposed regulations concerning the character of sponsorship payments in 1993.[95] The proposals were said to reflect an IRS policy decision not to be responsible for hampering an exempt organization's need to raise private support. The regulation intended to distinguish between commercial advertising and benevolent payments.

In 1997, the Congress codified the proposed regulations to delineate between those sponsorship payments that constitute a donation from those that represent payment for an advertisement taxable as UBI. The Tax Code provision reduced the uncertainty of reliance upon a proposed regulation, but significantly narrowed the definition of an acceptable acknowledgment. The code says the term *unrelated trade or business* does not include the activity of soliciting and receiving qualified sponsorship payments.[96]

Qualified Sponsorship Payment. The term *qualified sponsorship payment* means any payment of money, transfer of property, or performance of services by any person engaged in a trade or business with respect to which there is *no arrangement or expectation that the person will receive any substantial return benefit.* In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's exempt purpose.

It is also irrelevant whether the sponsored activity is temporary or permanent. The sponsored activity can be either related or unrelated to the organization's exempt purpose. Qualifying sponsorships can be received in connection with ongoing activities of an extended or indefinite duration and in support of an exempt organization's operations, not just a single event or special series.

When a sponsorship payment is considered unrelated income because return benefits are provided, the payment may still be modified or excluded from tax under another of the many exceptions applicable to unrelated business income, including a once-a-year event or one run by volunteers.[97] Importantly, the entire amount of a qualified scholarship payment is treated as a contribution in calcu-

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[94] Priv. Ltr. Rul. 9147007.

[95] Prop. Reg. §1.513-4, entitled "Certain Sponsorship Not Unrelated Trade or Business."

[96] IRC §513(i)(2)(A) added by the Taxpayer Relief Act of 1997.

[97] Rules discussed in Sections 21.6, 21.9(a), and 21.10(d).

lating the public support test.[98] The following types of sponsorship payments are not qualified and are subject to the unrelated business income tax rules:

- A contingent payment, or any payment that is "contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events." The possibility the event may not occur is not a contingency for this purpose.[99]
- Periodical and trade show payments that "entitle the payor to the use or acknowledgement of the name or logo (or product line) of the payor's trade or business in regularly scheduled and printed materials published by or on behalf of the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization"
- Any payment made in connection with qualified convention or trade show activity

Substantial Return Benefit. A substantial return benefit does not include (1) goods, services, or other benefit of insubstantial value that are disregarded or (2) the use or acknowledgment of the name or logo of the sponsor's trade or business in connection with the activities of the exempt organization. A benefit provided to the payor may include (1) advertising; (2) certain exclusive provider arrangements; [100] (3) providing facilities, services, or other privileges to the sponsor or persons designated by the sponsor; and (4) granting the sponsor an exclusive or nonexclusive right to use an intangible asset, such as a trademark, patent, logo, or designation of the exempt organization.[101]

Use or Acknowledgment. The code only specifically mentions the use or acknowledgment of the sponsor's name and logo. Anyone watching public TV or radio sees and hears not only the sponsor's name and logo, but their address, phone number, and often extensive "value-neutral descriptions" of their business. A typical sponsor announcement says, "Black, Brown & White is a 90-year old plaintiff's law firm with offices around the world serving a broad base of international business clients." The regulations broaden the code definition by saying[102]:

> *Use or acknowledgment* may include exclusive sponsorship arrangements; logos and slogans that do not contain qualitative or comparative descriptions of the payor's product-line or services; a list of the payor's locations, telephone numbers or Internet address; value-neutral descriptions, including displays or visual depictions, of the payor's product-lines or services; and the payor's brand or trade names and product or service listings. Logos or slogans that are an established part of a payor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution, whether for free or remuneration, of a payor's product by the payor or the exempt organization to the general public at a sponsored activity is not considered an

[98] See Chapter 11 for support tests defining public charities.
[99] §1.513-4(e)(2).
[100] See Section 21.8(i).
[101] Reg. §1.513-4(c)(2)(iii).
[102] Reg. §1.513-4(c)(2)(iv).

> inducement to purchase, sell or use the payor's product for purposes of the section. The use of the name or logo (or product lines) of the sponsor in connection with the activities of the exempt organization is not treated as providing a substantial return benefit.

The regulations include the 12 examples to clarify the rules. Permitted acknowledgments include display of the auto manufacturer's latest-model cars; the sponsor's name in promotions and advertisements of an event; naming the event after the sponsor; the sponsor's name and logo on uniforms, goalposts, and drink cups; and display of the sponsor's logo that sounds like an ad (Better Research, Better Health). Items constituting a return benefit include dinners, event tickets, pro-am playing spots, a program advertisement, souvenir flags bearing the team name, a licensing organization's logo, and product endorsements.

Advertising. An advertisement is any message or other programming material that is broadcast or otherwise transmitted, published, displayed, or distributed, and which promotes or markets any trade or business or any service, facility, or product. Advertising includes messages containing *qualitative or comparative* language, price information or other indication of savings or value, or an endorsement or an inducement to purchase, sell, or use any company, service, facility, or product. A single message that contains both advertising and an acknowledgment is advertising. Purchase of broadcast time by the sponsor to be aired during a sponsored event is not treated as an advertisement placed by the organization.

Certain Goods or Services Disregarded. Substantial return benefit does not include goods, services, or other benefits provided to the sponsor or designates that have an aggregate fair market value of no more than 2 percent of the amount of the payment.[103] Token items—bookmarks, calendars, key chains, mugs, posters, or T-shirts—bearing the organization's name or logo that have an aggregate cost within the limit established for low-cost articles can be provided to sponsors. The values of all return benefits are combined to determine whether excess benefits are provided. When the 2 percent limit is exceeded in total, the value of all benefits is unrelated income. Say, for example, a $100,000-a-year sponsor requires the exempt organization to place an advertisement in its program that has a value of $2,000. The ad alone does not exceed the 2 percent limit. If tickets for employees worth $1,000 are also provided, the total of $3,000 would be treated as unrelated income. If a $4,000 dinner is instead provided for the sponsor's executives, $4,000 would represent a substantial return benefit, and only $96,000 of the payment is a qualifying sponsorship.

The *quid pro quo* disclosure rules require that benefits in excess of $75 be valued and reported to corporate sponsors so that even though the benefits are disregarded for sponsorship classification purposes, the donor acknowledgments should report the value of benefits. The fair market value is determined by the willing buyer–willing seller rules.[104]

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[103] The 2000 proposed regulations limited disregarded benefits to the de minimus amount applicable to premiums and benefits of insubstantial benefit used to determine the deductible portion of a donation originally set forth in Rev. Proc. 90-21 (for 2004 this limit is $82). The IRS and Treasury eliminated this lower limit, admitting it was too low for corporations and business donors.

[104] See Section 24.3(a).

Hyperlinks. Happily, a hyperlink to a sponsor's Web site address is deemed an acknowledgment that does not constitute advertising on behalf of the sponsor. A permissible acknowledgment occurs when a symphony orchestra lists its sponsors on its Web site and includes a hyperlink to each sponsor's site. If the link is to a page on which the sponsor displays the organization's endorsement of its products, a valuable benefit is provided to the sponsor, and an advertisement has occurred.[105]

Exclusivity Arrangements. An arrangement for exclusive sponsorship of an exempt organization's activities or representation of a particular trade or business in connection with programs generally does not result in substantial return benefit. However, a sponsorship arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an organization's activity is deemed to be a substantial benefit.[106]

Periodicals. The acknowledgment/advertisement distinction does not apply if the sponsor's thank-you is published in the organization's periodical, either printed or electronic. The term *periodical* means regularly scheduled materials published by or on behalf of the exempt organization that are not related to and primarily distributed in connection with a specific event. Even if the language is limited to the permissible language previously described for a sponsorship, an acknowledgment printed in the monthly newsletter is treated as producing unrelated income. Favorable cost allocation rules allow deduction of a portion of the overall cost of a publication against the revenue received from advertisers.[107] An organization is not allowed to take advantage of these rules unless the exempt organization can clearly establish that the online materials are prepared and distributed in substantially the same manner as traditional periodicals.[108] The definition of *periodical* is "regularly scheduled and printed material published by or on behalf of the organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization."[109]

The IRS said that "most of the materials made available on exempt organization Web sites are clearly prepared in a manner that is distinguishable from the methodology used in the preparation of periodicals."[110] If the content is regularly updated each Monday with articles and features that look like a print magazine, it will appear that the intention is to provide a periodical. Certainly, if the site information replaces an existing magazine and is available only to subscribers or members, it would be difficult to argue that the site was not a periodical.

(f) Insurance

Group insurance programs have been a subject of active litigation between trade unions and business leagues and the IRS, with the IRS prevailing in classifying

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105 §1.513-4(f), Examples 11 and 12.
106 Reg. §1.513-4(c)(2)(vi); see Section 21.8(i).
107 See Sections 21.8(d) and 21.15.
108 Cheryl Chasin, Susan Ruth, and Robert Harper, Chapter I, "Tax Exempt Organizations and World Wide Web Fundraising and Advertising on the Internet," *IRS CPE Text,* 2000.
109 IRC §513(i)(2)(B)(ii).
110 Ibid., note 108.

revenues produced in an internally managed insurance program for members as UBI.[111] Instead of conducting the insurance program directly, creative nonprofits license their membership lists to insurance providers in return for what they hope will be nontaxable royalty income. Similar to the factors considered in affinity card rulings and other mailing list licensing cases, the issue is to what extent the organization renders personal services in connection with the arrangement. It is also important to note in this context that organizations that provide commercial-type insurance cannot qualify for tax-exempt status under §501(m).

The criteria used to evaluate group insurance programs were outlined in a private ruling requested by a business league serving the public health community.[112] The facts leading the IRS to conclude that valuable services were provided, causing the payments to be classified as taxable UBI rather than royalties excluded by §512(b)(2), were as follows:

- The insurance company acted as the league's agent in choosing suitable policies for its members, marketing the program to members, and performing administrative services such as creation of presentation brochures, seeking enrollments, and handling the premium collections.
- The league agreed to endorse the program and allow the insurance agent to use its logo, name, and membership list to promote the program to its members.
- The league retained the right to approve the form and content of mailings to its members, endorse the plan, and advise its members of its availability, and include plan information in new member packets.
- The league's involvement was direct and extensive and represented the rendering of valuable personal services, so that the so-called licensing payments did not qualify as royalty income.

Careful structuring of the contractual arrangements for such plans can allow the revenues to be bifurcated, resulting in some unrelated taxable income and some nontaxable royalty. Such an agreement would separate the requirements and compensation regarding services to be rendered. Terms for payments due for use of the organization's name can be clearly identified as royalty payments made strictly for use of intangible property, without regard to the service requirements. At best, two separate agreements could be reached to prove that the obligation to pay royalties is dissociated from services to be performed.

(g) Real Estate

The tax character of real estate acquired and held primarily for investment purposes may be changed by the manner in which the exempt organization disposes of the property. The question is whether the organization becomes a developer

[111] *Louisiana Credit Union League v. United States,* 693 F.2d 525 (5th Cir. 1982); *Texas Farm Bureau v. United States,* 93-1 U.S.T.C. 50, 257 (C.D. Tex. 1993), rev'd., 95-1 U.S.T.C. 50,297 (5th Cir. June 1, 1995).

[112] Priv. Ltr. Rul. 9316045.

selling land to customers in a business activity. Development projects can be characterized as related (low-income or elderly housing), as a trade or business (subdivision, debt-financed rental, hotel), as an investment (unindebted rental), or sometimes as a combination of all three. The criteria for determining that sales by an exempt organization were business activity follow:[113]

- Purpose for which the property was acquired and also purpose for which it was held
- Proximity of sale to purchase of the property
- Substantiality, frequency, and size of land sales
- Improvements (roads, utilities, sidewalks, and the like) to enhance attractiveness of property
- Activities of owner in improving and selling property
- Nature of sales solicitations and advertisements
- Use of sales brokers

The income tax standards for determining when a sale of property results in a capital gain or loss are instructive in evaluating the character of the land.[114] Essentially, that standard distinguishes between a property held in the *ordinary course of business* and an investment asset. Ordinary (unrelated) income results when the intention to sell is dominant.[115] Thus, the different methods of selling real estate by an exempt organization will have the following results:

- Leasing or selling raw land is a passive investment activity not resulting in unrelated business income.
- Limited preliminary development work, such as obtaining permits and approval prior to the property's sale, may not convert the sale(s) into a business transaction.
- Development of the property, such as installing streets and utilities, prior to the sale converts the property into a business asset and produces UBI.
- Sale of land in many parcels over a period of time indicates a business activity.

Development of an apartment building and parking garage as a part of an urban renewal effort is a related business for an organization whose purpose is to combat community deterioration. The organization operated to assist the city by encouraging revitalization of its downtown area. While the activity would result in UBI if conducted for investment, in this case the activity served the organization's exempt purposes.[116] A Catholic religious order received IRS sanc-

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[113] *Houston Endowment v. U.S.*, 606 F.2d 77 (5th Cir. 1979); *Malat v. Riddell*, 383 U.S. 569 (1966); Priv. Ltr. Ruls. 200119011 and 2002242041.

[114] IRC §1221.

[115] Priv. Ltr. Rul. 9316032; see also Tech. Adv. Memo 200047049 (purchase with intent to sell).

[116] Priv. Ltr. Rul. 9208033 citing Rev. Rul. 70-585, 1970-2 C.B. 115; see also Priv. Ltr. Ruls. 9337027, 9616039, 9619069, and 200119061.

tion for a UBI exclusion of gain earned in a one-time liquidation of vacant land that had been used as part of its exempt facility. The order proposed to convert the land into 751 residential lots. The order obtained the permits, subdivided the land, and made the minimum physical improvements necessary to sell the lots, but an independent broker was to market and sell the lots. The issue was whether the order was selling property "held for sale to customers in the ordinary course of a trade or business." The fact that the order took the steps necessary to prepare the land for sale and maintained control over the development process did not constitute active business activity.[117]

(h) Agency Theory

An agency theory may be applied to look through certain arrangements. To avoid UBI classification for a potentially unrelated activity, an organization might engage an independent party to conduct the activity in return for a royalty or a rental payment. Inherently passive activities for which compensation is paid in the form of rent or royalty are excluded from UBIT, even if the activity is deemed unrelated. The question is, however, whether one must look through the transactions and attribute the activity of the independent party back to the organization, as the National Collegiate Athletic Association (NCAA) case illustrates. In finding the for-profit acts as agent, a myriad of factors, including control over the manner and means of performing the work, the skill required, method of payment, duration of relationship, and similar factors, must be considered. An operating paradigm that permits the tax-exempt organization to exercise significant control over the sales effort, editorial content, or handling of funds indicates the exempt is conducting the activity.[118] The fiscal year 2002 *IRS CPE Text* says the "question of whether an entity or individual is deemed to be an agent of another for tax purposes is at the heart of many controversies."[119] Readers trying to decide whose income is whose to identify either unrelated income or deductible contributions will want to study this text. The article contains an overview of relevant common-law and IRS rulings on the issue and a checklist of factors that indicate an agency relationship. The accounting standards to identify an agency's transactions are outlined in Section 11.5(d).

The NCAA hired an unrelated commercial publishing company to produce its tournament programs. The NCAA gave the publisher a free hand in soliciting the advertisements, designing the copy, and distributing the programs, in return for a percentage of the advertising and direct sales revenues. Because it had little or no involvement in the activity, the NCAA treated the income as a passive and irregularly carried on activity not subject to the unrelated business income tax. There was no argument that selling the program itself produces related income; nor was there any question that the advertising income was unrelated. The tournament lasts only three weeks.

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[117] Priv. Ltr. Rul. 9337027 citing Rev. Rul. 55-449, 1955-2 C.B. 599 (construction and sale of housing for profit not exempt activity); see Section 21.10(b).

[118] *State Police Ass'n. of Massachusetts v. Commission,* supra note 91.

[119] Ward L. Thomas and Leonard J. Henzke, Jr., Chapter C, "Agency: A Critical Factor in Exempt Organizations and UBIT Issues," *IRS CPE Text,* 2002, pp. 127–154.

The issue considered by the Tax Court was whether the NCAA had sufficiently disengaged itself under the contract.[120] Did it sell the right to use its name or did it engage in the ad activity itself? Because the publisher acted as the NCAA's agent, the activity was totally attributable to the NCAA. The Tenth Circuit Court agreed with the Tax Court, but reversed the decision because the activity was irregularly carried on and not in competition with business. The agency theory was not disputed. The IRS disagrees with the appellate decision regarding irregularity.[121]

The Arkansas State Police Association (ASPA) lost its battle to classify revenues from its publication as unrelated business income.[122] The ASPA engaged an independent company to publish its magazine, *The Arkansas Trooper.* The ASPA participated in, and maintained control over, the content and other aspects of the publication. Neither the Tax Court nor the Eighth Circuit agreed with the ASPA's argument that its role was passive, de minimus, and only related to the protection of its name and thereby produced nontaxable royalty income. The court distinguished the affinity card cases[123] by looking at whose business was being promoted by use of the name. The magazine advanced the interests of the ASPA, not the publisher—unlike the affinity card programs that promote the interests of the banks issuing the cards. The court said, "A royalty exists when A uses the name of B to promote A's products." The fact that the agreement was labeled as a royalty and licensing agreement did not make it so. Following the reasoning of the NCAA case, the court decided the agreement imposed a duty on the publisher to perform services on behalf of the ASPA and did not produce payments to the ASPA for the use of its name.

The agency theory was escaped, however, by an organization that turned over the publication of its monthly journal to a commercial company, retaining one-third of the net revenues from subscriptions and reprints. All advertising income, two-thirds of the circulation revenues, and all the risk of publication expenses were borne by the company. Under the circumstances, the company was acting on its own behalf, not as agent for the charity. No advertising revenue was allocated to the charity.[124]

Earnings of an ostensibly independent for-profit subsidiary may also be allocated back to the nonprofit parent using the agency theory. The subsidiary's business is treated as separate only if it is managed at arm's length without the parent taking part in daily operations.[125]

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120 *National Collegiate Athletic Association v. Commissioner,* 90-2 U.S.T.C. §50513 (10th Cir. 1990), rev'g. 92 T.C. No. 27 (1989); see also Priv. Ltr. Rul. 9137002 and 9211004.

121 See also Priv. Ltr. Ruls. 9306030, 9721001, and 9712001.

122 *Arkansas State Police Association Inc. v. Commissioner of Internal Revenue,* No. 01-2255 (8th Cir. Mar. 6, 2002); see similarly *State Police Association of Mass. v. Commissioner,* 125 F.3d 1 (1st Cir. 1997), and *Fraternal Order of Police v. Commissioner,* 833 F.2d 717 (7th Cir. 1987).

123 See Section 21.10(d).

124 Tech. Adv. Memo. 9023003; similar result in Priv. Ltr. Rul. 9137002 and 7926003; contrary result in Priv. Ltr. Ruls. 9309002 and 9306030.

125 The factors necessary to prove that the subsidiary's operation is separate are discussed in detail in Section 22.4.

(i) Exclusive Marketing Agreements/Covenants Not to Compete

The Georgia Institute of Technology renamed its sports arena McDonald's Center. The basketball court floor prominently displays a golden arch, and you can guess what kind of food and drink is exclusively served in the facility. The school received $5.5 million in return for agreeing to such actions. How this revenue is classified for federal tax purposes depends on the following medley of unrelated business income concepts and tax rules applied to the proverbial facts and circumstances:

- Is the activity a regularly carried on trade or business? (Does this answer depend on whether annual renewals occur rather than a one-time payment for a longer period of time?) (Section 21.6)
- Has the school licensed its intangible property right (its goodwill and student body) in return for an excludable royalty? (Section 21.10(d))
- Does the method of acknowledgment constitute a sponsorship payment treated as a contribution? (Section 21.8(e))
- Has the school rented space for food service? (Section 21.10(c))
- Is the school required to perform any services in connection with the agreement? (Section 21.10(d))
- Is the sports arena a student convenience facility provided as part of the academic mission and the school's responsibility to feed the students? (Section 21.9(c))
- Should the payment be fragmented into different parts? (Section 21.4(c))
- Does the outcome depend on the number of nonstudents who patronize the facility? (Section 21.8(e))

The answer for each institution considering an exclusive-use agreement will depend on its particular set of facts and circumstances; such income is not automatically subject to tax.[126] The Supplementary Information to the sponsorship regulations says that an "Exclusive Provider Agreement occurs when the exempt organization agrees to limit distribution of competing products in connection with the payment."[127] The sponsorship regulations deem exclusivity agreements do result in a substantial return benefit.[128] When the exclusivity is necessary for reasons of limited vending space and/or as a result of a competitive bidding process in acquiring the goods, no benefit occurs. Purchase discounts and rebates negotiated with vendors are considered an adjustment to the purchase price and do not constitute gross income to the purchaser. [129] The provision of substantial services in connection with a vendor contract, however, can cause an otherwise

[126] IRS News Notice, August 14, 2001.
[127] Reg. §1.513-4, introductory paragraph 25.
[128] Reg. §1.513-4(c)(2)(vi(B).
[129] Rev. Ruls. 84-41 (1984-1 C.B. 130) and 76-96 (1976-1 C.B. 23); IRS Tax Law Specialist Judith Kendell reiterated this opinion in a July 17, 2002, program sponsored by the American Society of Association Executives in Washington, D.C.; J. Irvine,"Does Exclusivity Create Liability for UBIT?" *Taxation of Exempts,* July/August 2002, pp. 19–27.

nontaxable agreement to result in unrelated income. If Georgia Institute of Technology, in the preceding example, agrees that coaches will make promotional appearances on behalf of McDonald's, the value of those services becomes UBI.

(j) E-commerce and the Internet

The character of revenues received from the sales of goods and services on the Internet is an evolving issue, many aspects of which are yet to be considered by the IRS.[130] While there is no question that the law, regulations, court decisions, and rulings that apply to identify and tax unrelated business can be applied to e-commerce activities, certain unique aspects of the Internet prompt new questions.[131] Some practitioners joke about a one-click rule to suggest that the first click to a linked site may not produce unrelated income, but two clicks might. The following is the author's list of questions that an organization producing revenue from its site should ask, keyed to the portions of this chapter that further discuss the issue.

- *Do the goods and services sold through the site advance the organization's exempt purposes?* This determination is made in reference to the mission and the purposes for which the organization was originally found to be exempt. (Sections 21.7 and 21.8)
- *Does the organization recognize its sponsors or contributors on its Web site?* If so, do the IRC §513(i)(2)(A) rules delineating donor acknowledgments versus advertisements apply to links to business sponsors? Can the one-click rule apply? When does the link represent advertising for the sponsor? (Section 21.8(e)) A simple banner placed on the organization's site containing information allowed under the sponsorship regulations should represent a permitted acknowledgment that is not advertising. Advertising results when the organization's links to the sponsor's site contain promotional material indicating the EO endorses the sponsor's products.
- *What is the character of income received as "referral fees" from online vendors, such as Amazon.com, to their nonprofit associates?* Can such payments be characterized as a royalty? Does the result change if the link is established to allow the site visitor to purchase books published by the organization itself? Creative organizations will compose agreements with commercial distributors that designate such transactions as licensing transactions. Certainly, very little effort on the organization's part is involved, so that arguably the passive "royalty" modification might apply. (Section 21.10(d))
- *What if the site sells both related and unrelated items and/or both donated and purchased goods?* Relatedness would depend on an ability to identify both the purchaser and the type of goods or services sold. An accounting system capable of tabulating revenues from sale of the purchased, unrelated items separately from the related and donated goods (Section 21.9(b))

[130] The 2003–2004 IRS Workplan promised guidance on the issue.
[131] See Section 2.2(j) A checklist for Web site exemption issues can also be found as Exhibit 19.10.

would be needed to allow use of the fragmentation rule to calculate taxable and nontaxable income. (Section 21.4(c)) The same type of tally would be needed if items were sold both to the general public and to patients, employees, or students. (Section 21.9(c))

- *How would revenue from licensing the use of the organization's name and logo on some other site be classified?* What about sale of the list of visitors to the organization's site? The royalty exception that excludes revenues from licensing use of the intangible personal property should apply. (Section 21.10(d))
- *Is there any circumstance in which the irregular exception would apply?* The continual availability of an organization's Web site to anyone with computer access to the Internet will make most activities pertaining to the site regularly carried on. (Section 21.6) Evidence that a sales activity occurred for a limited period of time might change the answer.
- *Could the volunteer labor exception be applied?* The value of the volunteers' time in relation to the overall cost of the site would be computed. Will a Web site business be considered a capital-intensive business? (Section 21.9(a))
- *How are the costs attributable to Web site activity quantified?* All the *ordinary and necessary* expenses of establishing and maintaining the site and handling the revenue-producing activity would be tabulated. Basically, the hardware and software costs (depreciated over three to five years) for computers utilized, Web site design and maintenance fees, access and server fees, cost of personnel involved in maintaining the site, and other direct costs of the activity would be combined. The exploitation rule might apply to allocate a portion of the organization's exempt function costs to the revenue produced. (Section 21.11)

21.9 THE EXCEPTIONS

Despite their literal inclusion in the *unrelated* prong of the UBI rules, certain types of revenue-raising activities are not subject to the unrelated business income tax because they are not considered to constitute a trade or business and do not compete with commercial businesses.[132] Charitable §501(c)(3) organizations qualify for all of the following exceptions. Certain exceptions do not apply to non-501(c)(3) organizations, as noted under the particular exception.

(a) Volunteers

A business in which substantially all of the work is performed without compensation is excluded from UBI when the labor is an income-producing factor. If the business is capital intensive so that the income is primarily attributable to the investment in property and equipment, such as rental real estate, the fact that accounting and other administrative services are provided by volunteers may

[132] IRC §513(a).

not apply.[133] *Substantially* for this purpose means at least 80 to 85 percent of the total work performed, measured normally by the total hours worked. A paid manager or executive, administrative personnel, and other support staff can operate the business if most of the work is performed by volunteers. This rule is the reason the boxes of candy, coupon books, and other items sold by children to raise funds for parent-teacher organizations do not result in unrelated business income to the school or PTA.[134]

In most cases the number of hours worked, rather than relative value of the work, is used to measure the percent test. This means that the value of volunteer time need not necessarily be quantified for comparison to monetary compensation paid. In the case of a group of volunteer singing doctors, the value of the doctors' time was considered. Because the doctors were the stars of the records producing the income, their time was counted by the court at a premium, which offset administrative personnel whose time was compensated modestly.[135] Having 77 percent of its labor donated by volunteers, however, was not enough to allow a bingo operation to avail itself of this exception. The 23 percent compensated workforce ratio was substantial enough to cause an Elks Lodge to pay tax on its bingo profits.[136]

Expense reimbursements, in-kind benefits, and prizes are treated as compensation if they are compensatory in nature. Particularly when the expenses enable the volunteers to work longer hours and serve the convenience of the organization, the payments need not be counted in measuring this exception. However, solicitors for a religious organization that traveled in vans and lived a "very Spartan life" were not unpaid volunteers, as the organization had claimed, because their livelihood was provided by the organization.[137] Similarly, when food, lodging, and other living expenses were furnished to sustain members of a religious group, the members working for the group's service-oriented businesses teams were not treated as volunteers.[138]

The result for members of a religious order was different.[139] Under a *but-for* test it was decided that food, shelter, clothing, and medical care received by brothers in a religious order were paid without regard to whether they worked. The members of the order were under a vow of poverty and were provided necessities by the order without regard to their particular assignment. The court deemed the benefits provided were not compensatory. There was not a connection between the services and benefits because it was not the case that "but for

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[133] Rev. Rul. 78-144, 1978-1 C.B. 168; the IRS found that a long-term net lease of heavy machinery that required the lessee to provide insurance, pay taxes, make repairs, and secure and process leases was a capital-intensive business not qualifying under §513(a)(1) as a trade or business in which substantially all the work is performed without compensation.

[134] Priv. Ltr. Rul. 9704012.

[135] *Greene County Medical Society Foundation v. U.S.,* 345 F. Supp. 900 (W.D. Mo. 1972).

[136] *Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner,* T.C. Memo 1981-546, aff'd. per curiam, 696 F.2d 372 (5th Cir. 1983).

[137] Priv. Ltr. Rul. 9652004.

[138] *Shiloh Youth Revival Centers v. Commissioner,* 88 T.C. 579 (1987).

[139] *St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner,* 85 T.C. 9 (July, 1, 1985).

rendering of services, the payments would not have been made." It was also noted that only 14 out of St. Joseph's 167 members worked on the farm and that the court had no doubt that, if the farm ceased to operate, the farm-working brothers would continue to receive their livelihood. The farm revenue was therefore excluded from UBI.

(b) Donated Goods

The selling of merchandise, substantially all of which is received by the organization as gifts or contributions, is not treated as a taxable activity. Thrift and resale shops selling donated goods are afforded this exception from UBI for donated goods they sell. A shop selling goods on consignment as well as donated goods must distinguish between the two types of goods. Under the fragmentation rules,[140] the consigned goods sales would be separated, or fragmented, from the donated goods and any net profit from those sales included in UBI. Note that consignment sales by volunteer-run resale shops would be excluded under the volunteer exception.

(c) Convenience

For §501(c)(3) organizations only, a cafeteria, bookstore, residence, or similar facility used in the organization's programs and operated for the convenience of members, students, patients, officers, or employees is specifically excepted from UBI.[141] Visitors have been added to the list. This exception is based on the theory that conveniences allow persons to more fully participate in exempt activities. Patients recover faster when family and friends visit or stay with them in the hospital, and the cafeteria facilitates the visits.

When the cafe, shop, dorm, or parking lot is also open to the general public, the revenue produced by public use is unrelated income. Using the fragmentation rule, revenues attributable to qualified visitors must be distinguished from the unrelated revenue received from other customers.[142] For example, meals served to nonmuseum visitors responding to advertisements promoting a museum's restaurant produced unrelated income.[143] No exempt purpose was served by selling the meals because the general public had access to the restaurant without having to pay for or visit the museum's art exhibits. If, instead, the promotion had emphasized the convenience of the restaurant, the result might have been different. A museum café is a related facility if it[144]

- Attracts visitors to the museum by providing in-house dining
- Allows visitors to devote more time to the museum's educational facilities than if they had to seek outside eating facilities

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[140] Discussed in Section 21.4(c).

[141] IRC §513(a)(2) that also provides an exception for work-related clothes and equipment and vending items by a §501(c)(4) local association of employees organized before May 27, 1969.

[142] Discussed in Section 21.4(c).

[143] Priv. Ltr. Rul. 9720002.

[144] Rev. Rul. 74-399 1974-2 C.B.172.

- Enhances the efficient operation of the museum by enabling staff and employees to remain on the premises throughout the day

Parking lot fees paid by participants in an exempt organization's activities are also excluded from UBI under the convenience exception. A lot open to both visitors and nonvisitors is fragmented into its visitor convenience and nonvisitor parts. If the lot is operated by an independent party under a lease arrangement in which the exempt organization performs no services, the nonvisitor revenue can be classified as rental income excludable from UBI by the passive income modifications. If the organization itself operates the lot, the revenue from general public usage is a trade or business.[145]

The IRS Examination Guidelines for Colleges and Universities[146] contains useful criteria for applying the convenience exception for UBI purposes. Most important, the facts and circumstances of each situation are determinative. The items sold to students, officers, and employees in the school bookstores are individually judged. First, the relatedness of an item is evaluated. Books and materials required and recommended for classes, supplies such as notebooks, pencils, and computers (one a year), and athletic gear necessary to participate in physical education programs are listed as items that advance the educational institution's exempt purposes. Materials that "further the intellectual life of the campus community," such as books, tapes, records, and compact discs, are also deemed related. The unstated presumption is that students or staff can spend more time studying (they need not travel to the mall) if they have toiletries, novelty items bearing the institution's insignia, candy, cigarettes, magazines, greeting cards, film, cameras, and small appliances easily available to them. Sales to alumni, parents, and other outsiders are unrelated and not excludable under the convenience exception.

(d) Bingo Games

Bingo games not conducted in violation of any state or local law are excluded from UBI. IRC §513(f) defines bingo as any game of bingo of a type in which usually (1) wagers are placed, (2) winners are determined, and (3) distribution of prizes or other property is made, in the presence of all persons placing wagers in such game. The regulations expand the definition as follows:

> A bingo game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a pre-selected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the pre-selected pattern wins the game. Any other game of chance including but not limited to, keno, dice, cards, and lotteries, is not bingo (and will create UBI).[147]

Pull-tabs and other forms of instant bingo are not bingo in the IRS's opinion and produce UBI despite the fact that such variations of the bingo game are so classified by the state bingo authority. During 1990, the IRS aggressively examined

[145] Gen. Coun. Memo. 39825.

[146] Final version contained in IRS Announcement 94-112.

[147] Reg. §1.513-5; *South End Italian Club, Inc. v. Commissioner,* 87 T.C. 168 (1986).

nonprofits in the Southwest District and assessed tax on any bingo variations not strictly meeting the code and regulation definitions.[148] In calculating the taxable income earned from a pull-tab operation, all of the "ordinary and necessary" business expenses are deductible.[149] That portion of the profits from the pull-tabs that is required to be paid out for or dedicated only to charitable purposes under local law is treated as a business expense. Publication 3079, entitled *Gaming Publication for Tax-Exempt Organizations*, was issued in April 1998 to explain these rules comprehensively.

(e) Entertainment, Conventions, and Trade Shows

Public entertainment is defined as that traditionally conducted at fairs or expositions promoting agricultural and educational purposes (including but not limited to animals or products and equipment) and does not produce UBI for §501(c)(3), (4), or (5) organizations. To constitute a *qualified* show, the event must be held in conjunction with an international, national, state, regional, or local fair, or be in accordance with provisions of state law that permits such a fair.[150]

A convention or trade show is one intended to attract persons in an industry generally (without regard to membership in the sponsoring organization), as well as members of the public, to the show for the purpose of displaying industry products, or stimulating interest in and demand for industry products or services, or educating persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry. Exhibitors are permitted to sell products or services, and the organization can charge for the display space.

An agricultural exhibition group owning the exhibition facilities may generate both taxable and nontaxable income from programs conducted in the facility. The leasing of the facilities during its off-season (10-1/2 months of the year) can produce passive income excluded from UBI. In a unique and interesting ruling, it was determined that free admission for its shareholders (essentially members) was found not to result in private inurement because such admissions constituted only 3 percent of the tickets given away.[151] Commissions and rebates received from concessionaires granted the right to serve food and beverages in the facility did constitute unrelated business income.

(f) Indian Tribes

Income earned by a federally recognized Indian tribe from the conduct of an unincorporated business or a corporation incorporated under the Indian Reorganization Act of 1934 (IRA) is not subject to federal income tax.[152] A corporation formed instead under the laws of the state in which the tribe is located,

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[148] *Julius M. Isreal Lodge of B'nai B'rith No.2113 v. Commissioner,* 78AFTR 2d ¶96-5482 (5th Cir.), aff'g. T.C.M. 1995-439; see also *Women of the Motion Picture Industry, et.al. v. Commissioner,* T.C. Memo. 1997-518.

[149] See Section 21.11.

[150] IRC §513(d)(2).

[151] Priv. Ltr. Rul. 9835001.

[152] Rev. Rul. 94-16, 1994-1 C.B. 19.

however, would be subject to tax even though it is owned and controlled by an Indian tribe or members of a tribe. The basis of this distinction lies in the definition of an Indian tribe. Section 1 of the Internal Revenue Code subjects individuals, trusts, and estates to tax; Section 11 taxes corporations. A tribe is not such a taxable entity; a separately incorporated business would be.[153]

In 1981 the IRS ruled that a properly established Indian tribal corporation (under the IRA) had the same tax status as an Indian tribe as it regarded activities carried on within the boundaries of the reservation.[154] This restriction to on-reservation activity was reconsidered and removed in the 1994 ruling. The ruling says that because an Indian tribe is not a taxable entity, any income earned by it—on or off the reservation—is not taxable. The ruling states that it applies only to federal income taxes. It does not affect the application of other federal taxes, such as employment and excise taxes (including excise taxes on wagering), to Indian tribes or tribal corporations. A draft of an IRS "Guide to Indian Taxation Issues" was reviewed with tribal representatives on March 3, 1994, but not formally issued. The IRS issued procedural and administrative tax regulations under the Indian Tribal Governmental Tax Status Act of 1982.[155]

(g) Low-Cost Articles

For §501(c)(3) and veterans groups, gift premiums distributed with no obligation to purchase in connection with the solicitations of contributions are not treated as a sale of the gift premium. The gift must be part of a fund-raising campaign and must cost (not fair market value) the organization no more than $8.20 (during 2004; indexed annually for inflation). [156] Two important factors must be present:

1. The recipient of the premium must not request or consent to receive the premium.
2. Literature requesting a donation must accompany the premium along with a statement that the recipient may keep the low-cost article regardless of whether a charitable donation is made.

If the donation is less than the current low-cost amount, the fair market value of the premium cannot be disregarded and must reduce the deductible portion of the donor's gift.

A program for distribution of low-cost articles cannot qualify for this exception if it presents unfair competition to nonexempt businesses and is conducted like a commercial enterprise.[157] A religious group's *donation solicitations* in return

[153] Rev. Rul. 67-284, 1967-2 C.B. 55, 58.

[154] Rev. Rul. 81-295, 1981-2 C.B. 15, relying on *Mescalero Apache Tribe v. Jones,* 411 U.S. 145,157 (1973).

[155] Reg. §305.7701-1 defines an Indian tribal government and Reg. §305.7871-1 considers Indian tribal governments treated as states for certain purposes.

[156] Rev. Proc. 90-12 (Feb. 1990), supplemented by Rev. Proc. 92-58, 1992-2 IRB 10; and updated annually for COLA, latest revision. See Section 24.3 for more information about the de minimus rules.

[157] *Hope School v. Commissioner,* 612 F. 2d 298 (CA-7, 1980).

for caps, T-shirts, and similar items at public sporting and entertainment events was found to be conducted in a profit-seeking fashion in competition with for-profit vendors.[158] For this reason as well as its failure to prove it distributed the items with no obligation to purchase, the revenues were treated as unrelated business income.

(h) Mailing Lists

Again, for the organizations eligible to receive charitable donations under §170—primarily §501(c)(3) and veterans organizations—a business involving the exchange or renting of mailing lists between such organizations is excluded from UBI classification. This special treatment was added by Congress in 1986 based upon IRS recommendation.[159] Sale or exchange of mailing lists by such organizations to others and sales by all other types of §501(c) organizations, ostensibly by omission, create UBI. Courts have found, much to the consternation of the IRS, that §513(h) does not overrule the passive royalty income exception that modifies revenues from licensing of mailing lists for all types of tax-exempt organizations.[160]

A program allowing credit card holders to direct the bank's affinity card program to pay rebates to named charities is a charitable giving program. When the cardholder voluntarily designated a specific charity, the bank was acting as an agent so that its transfer of the funds to the charity on behalf of the cardholder qualified as a charitable contribution.[161] The furnishing of the charity's mailing list to the card company did not constitute rental of the list because the revenue stemmed from cardholders' voluntary action.

21.10 INCOME MODIFICATIONS

For §501(c) organizations other than social clubs, voluntary employee benefit associations, supplemental unemployment plans, and veterans groups, specified types of investment income are modified, or excluded, from UBI unless the underlying property is subject to debt. IRC §512(b) excludes "all dividends, interest, royalties, rents, payments with respect to security loans, and annuities, and all deductions connected with such income." Passive income of a sort not specifically listed is not necessarily modified or excluded from UBI.

(a) Dividends and Interest

Dividends and interest paid on amounts invested in savings accounts, certificates of deposit, money market accounts, bonds, loans, preferred or common stocks, and payments in respect to security loans and annuities, net of any allocable deductions, are excluded from UBI.

In 1978, the general exclusion of interest and dividends was expanded to include the words "payments in respect of security loans." Before that time,

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[158] Priv. Ltr. Rul. 9652004.
[159] IRC §513(h).
[160] See Section 21.10(d).
[161] §1.170A-1(b); Priv. Ltr. Rul. 9623035.

there was uncertainty regarding techniques such as strips, interest rate swaps, and currency hedges. It is now recognized that such investments are ordinary and routine and income earned from such transactions in security portfolios is considered as investment income for §512 purposes.[162]

When securities producing dividends and interest are acquired with indebtedness, the income is swept back into UBI by IRC §514. An organization must be careful to use new money to acquire each element of investment in its portfolio. A pension fund owning five-year certificates of deposit (CDs) in 1979 (after interest rates had risen over 5 points) received UBI when it purchased new CDs using its old CDs as collateral. Although the fund escaped an early withdrawal penalty and received a higher rate of interest, the new CD was a debt-financed asset purchase. Thus, the fund's original CD produced *modified* or nontaxable income, and the new higher-rate CD acquired with the loan proceeds was held to be taxable as unrelated debt-financed income.[163] The CD switch, incidentally, was not a permissible "payment in respect of a security loan." Such a loan allows a broker to use an organization's securities in return for a fee, not as a loan against which the securities are used as collateral.

The Omnibus Budget Reduction Act of 1993 amended §512 to provide that gain and loss received from unexercised options on investment assets such as securities and real estate, as well as loan commitment fee forfeitures, are excluded from the UBI.

(b) Capital Gains

Gains from sale, exchange, or other disposition of property are classified as UBI dependent upon the character of the property sold. Generally, the normal income tax rules of IRC §§1221 and 1231 for identifying capital, versus ordinary income, property apply to identify property covered by this exception. Sales of stock in trade or other inventory-type property, or of property held for sale to customers in the ordinary course of trade or business, produce UBI. The level of sales activity, character of the property, and other factors determine whether an asset is a capital asset.[164]

Options/Shorts. Gains on lapse or termination of covered and uncovered options, if written as a part of investment activity, are not taxable.[165] Short-term capital gain from a short sale of publicly traded stock through a broker was ruled not to create UBI. Although a short sale technically creates an obligation for the purchaser to pay for any loss that may occur on covering the short position, this possible loss is not treated as acquisition indebtedness.[166]

Timber. Timber standing on real estate owned by the exempt organization can be treated as a capital asset if the organization retains an economic interest in the

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162 Regs. §1.512(b)-1(a)(1).

163 *Kern County Electrical Pension Fund v. Commissioner,* 96 T.C. No. 41 (June 20, 1991).

164 The income tax standards for distinguishing capital assets are extensive. See Section 21.8(g) for consideration of when an organization becomes a real estate developer.

165 IRC §512(b)(5).

166 Rev. Rul. 95-8, 1995-14 I.R.B. 1; see Section 21.12.

timber.[167] The somewhat complicated rules must be studied for organizations owning such property to ensure proper tax treatment. Percentage depletion may apply, and specific rules for allocating the cost basis of the underlying property between the real estate and the timber are provided.[168]

Social Club Issues. A gain from the sale of real estate used by a social club in regular club activities (its exempt function) is not classed as UBI to the extent the proceeds are reinvested one year before or three years after the date of the sale.[169] An intention to use the replacement land for club activities is insufficient. Because social clubs often own valuable and desirable real estate, particularly country clubs and old-line city clubs, this exception can be valuable. When the property is considered as nonexempt function, the club must treat the revenue as nonmember revenue and also face the possibility of failing the 35/15 test necessary to maintain ongoing exemption.

Harvesting pine trees to preserve the usefulness of a club's property as a wildlife habitat was found to advance the club's exempt purposes. The club, created in 1870, owned a five-square-mile fish and game preserve and historic clubhouse building adjacent to public land areas maintained in a natural state. The club engaged professional foresters to plan timber harvesting to improve the habitat for wild game and to control gypsy moths. Sale of the timber pursuant to the plans did not create unrelated business income.[170]

A Florida club sold a portion of its property to participate in a land price boom and distributed the proceeds to the members. The court said the sale was a violent departure from the club's normal behavior and not merely incidental to the regular functions of the club. Because financial gain was the aim, the court revoked the club's exemption.[171]

Property contiguous to a club and held for possible future expansion, or simply protecting the club from the suburbs, is not exempt function property. Only property in actual, direct, continuous, and regular use for social and recreational purposes qualifies. Accordingly, a golf club was taxed on gain from selling off-road frontage. The land was originally acquired with the expectation that it would be used for club facilities, but in actuality was not.[172]

Use of vacant land containing no physical improvements but used for jogging, picnics, kite-flying contests, and other outdoor activities was found to constitute direct use by club members. The court said, "It is certainly conceivable that joggers derive as much pleasure and recreation from that pastime as golfers

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[167] IRC §613(b).

[168] Reg. §1.613-2; Priv. Ltr. Rul. 9252028 discusses a private foundation's sale of timber and concludes that the timber sale produces capital gain income not subject to the UBIT and further that the arrangement did not represent a "business enterprise" subject to the excess business holdings rules. See Section 16.1.

[169] IRC §512(a)(3)(D), a proposal to extend this time period to 11 years was included in the Charitable Giving Act of 2003; Priv. Ltr. Rul. 9307004.

[170] Priv. Ltr. Rul. 9535051.

[171] *Juniper Hunting Club v. Commissioner,* 28 B.T.A. 525 (1933).

[172] *Framingham Country Club v. United States,* 659 F. Supp. 650 (D.C. Mass. 1987); IRS Priv. Ltr. Rul. 9307003.

do from their rounds on the links."[173] A "buffer tract," containing a steep incline and heavily wooded with thick undergrowth, however, was found not to be used directly in exempt functions. Even though it isolated the club from the surrounding developed area and roads, its physical condition indicated it was not devoted to exempt activity. Proceeds from granting a permanent easement for passage and use produced UBI.[174]

(c) Rentals

Rental income is considered a passive type of investment income that is modified or excluded from UBI, except in the following cases:

- Personal property rentals are taxable unless they are rented incidentally (not more than 10 percent of rent) with real property.
- A fluctuating rental agreement that calculates the rent based on net profits from the property is unrelated income; rent based on gross revenue is not UBI.

The regulations say that "payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property."[175] When substantial services are rendered, such as the rental of a theater complete with staff or rental of a hotel room complete with room service, the rental is not considered passive.[176] Sharecrop arrangements for farmland owned by an organization may or may not be treated as excludable from UBI under the rent exception. The method for calculating the rent and risk borne by the organization is determinative. The issue is whether the exempt is a joint venturer participating in the farming operations. The following factors were considered in two court cases on the subject.[177]

- The organization is not involved in the day-to-day operation of the farm; it simply provides the land and buildings.
- The organization bears no risk of loss from accidents.

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[173] *Atlanta Athletic Club v. Commissioner,* 93-1 U.S.T.C. ¶50,051 (10th Cir.), rev'g. T.C.M. 1991-83, 61 T.C.M. 2011, Dec. 47,195(M).

[174] Tech. Adv. Memo. 9225001; see also Priv. Ltr. Rul. 9630001, in which adjacent land was also found not to qualify as exempt function property.

[175] Reg. §1.512(b)-1(c)(5); see Tech. Adv. Memo. 9853001 that found storage fees earned when fairground facilities were idle were unrelated income.

[176] While agreeing there was some educational benefit from the site, a museum renting its exhibition halls for private receptions provided substantial services to its tenants that caused the usage fees to be unrelated income in Priv. Ltr. Rul. 9702003.

[177] *Trust U/W Emily Oblinger v. Commissioner,* 100 T.C. No. 9 (Feb. 23, 1993); *Harlan E. Moore Charitable Trust v. U.S.,* 812 F. Supp. 130 (C.D. 111. 1993) aff'd., 93-2 U.S.T.C. ¶50,601 (7th Cir.). Similarly, see *Independent Order of Odd Fellows v. U.S.,* No. 4-90-CV-60552 (S.D. Iowa 1993); and *White's Iowa Manual Labor Institute v. Commissioner,* T.C. Memo. 1993-364.

- The organization is not required to contribute to any losses from the operation, but pays only an agreed portion of the operating expenses (in one case, 50 percent).
- The rent is equal to a fixed percentage of the gross sale of the crop or a fixed amount, not a percentage of net profits.[178]

Parking lot rental presents a similar situation. Rental of the bare real estate to another party that operates the lot (where the organization has no relationship or responsibility whatsoever to the parkers) clearly produces passive rental income.[179] If the exempt provides some services to the operator, UBI taint may occur. The regulations speak of "services rendered . . . primarily for the convenience and other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only." Providing maid service, but not trash hauling, in renting a room is the example given.[180] Operation of a parking lot for the benefit of employees and persons participating in an exempt organization's functions, rather than disinterested persons, is a related activity.[181]

Substantial services were provided to corporate and business patrons who rented an educational organization's facilities for receptions in the evenings. The services provided included maintenance and security personnel and liquor service (because the organization held the license). The IRS was not convinced that the rentals served an exempt purpose in finding that the programs were primarily social or business-oriented and included such items as cocktails, dinner-dances, awards presentations, and holiday celebrations. While there was some educational benefit to the attendees of viewing exhibits, they were ancillary to the events' principal purpose.[182] The IRS noted that the holding would be different if the request was for the organization to create an educational event in its space, with the food and services provided only incidentally. The character of rentals of airspace above and the roof of an organization's building for telecommunication towers presents an interesting question. The roof itself is real, not personal, property. The author welcomes opinions about the nature of the airspace, which she understands may depend upon local law.

(d) Royalties

The fact that the term *royalties* is not defined by the code or regulations pertaining to unrelated income has caused significant controversy. The battle focused on licensing of mailing lists, EO logos, and associated issuance of affinity cards. The regulations provide that royalties, whether measured by production or by the gross or taxable income from the property, are modified, or excluded from

[178] IRC §512(b)(3)(A)(ii).
[179] Priv. Ltr. Rul. 9301024; the parking and storage of cars, boats, motor homes, and campers in an agricultural association's fairground facilities for that portion of the year the spaces are not used for its own annual fair was a "mini-storage business."
[180] Reg. §1.512(b)-1(c)(5); see also Section 21.8(b), "Services."
[181] Priv. Ltr. Rul. 9401031; see also the convenience exception discussed supra in Section 21.9(c).
[182] Priv. Ltr. Rul. 9702003.

UBI.[183] In the cases described here, the courts said, and the IRS eventually conceded, that a royalty paid for the use of intangible property rights is excluded from UBI unless substantial services are performed in connection with the arrangement. Participation in an oil and gas working interest in which the organization is responsible for its share of development costs results in business income not modified, or excluded, from UBI.[184]

Initially, the IRS insisted that none of the revenue paid in return for licensing the use of an organization's mailing list was treated as a royalty payment.[185] While agreeing that mailing lists are intangible property, the IRS argued that the activity exploiting the lists was conducted like an active business. The Tax Court in 1993 ruled,[186] and the 9th Circuit Court agreed,[187] that there was no evidence that Congress intended to limit the royalty exception to passively held investment properties. The Tax Court, on remand, decided that the Sierra Club did not render taxable services when it retained quality control rights over its logo used in a bank affinity card program. The payments received for use of its name, logo, and mailing lists constituted royalties from the licensing of its intangible property rights. Characterization of income as a royalty was not lost when the club scrutinized promotional materials to prevent abuse of its logo.[188] The IRS announced in December 1999 that it had instructed its agents to cease attempts to tax revenues from affinity card and mailing list rental cases as a result of its losses in the courts.

From the Sierra Club and other battles concerning the royalty exception, guidelines have emerged.[189] Payments that can be treated as royalty income

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[183] IRC §512(b)(2).

[184] Reg. §1.512(b)-1(b).

[185] Gen. Coun. Memo. 39827; Priv. Ltr. Ruls. 9029047, 8823109, 8747066.

[186] *Sierra Club, Inc. v. Commissioner,* T.C.M. 47751(M) Dec. 49025 (M) (1993). In 1994, the Tax Court (*Sierra Club, Inc. v. Commissioner,* 103 T.C. No. 17) again ruled in favor of the Sierra Club. The sole issue in question was whether the club was in the business of selling financial services that could produce unrelated business income. The court found no intention on the part of the club to form a joint venture to share in a "mutual proprietary interest in net profits," nor did it bear any risk or loss or expense. The fact that the club was required to solicit members and keep records of their names and addresses did not, in the court's eyes, indicate that the club had control over the financial institution's actions for such actions to be imputed to the club. The Tax Court decision in this case, referred to as *Sierra II*; see also *Alumni Ass'n. of Univ. of Or. Inc. v. Commissioner,* T.C. Memo 1996-63; *Oregon State Univ. Alumni Ass'n. Inc. v. Commissioner,* T.C. Memo 1996-34.

[187] *Sierra Club v. Commissioner,* 96-2 U.S.T.C. ¶50,306 (9th Cir. 1996). Another pair of cases are also on appeal to the 9th Circuit, *Alumni Ass'n. of Univ. of Oregon v. Commissioner,* T.C. Memo 1996-63 and *Oregon State University Alumni Ass'n. Inc. v. Commissioner,* T.C. Memo 1996-34. The IRS decided not to appeal another defeat in the *Mississippi State Alumni v. Commissioner* (T.C. Memo. 1997-37) case.

[188] *Sierra Club, Inc. v. Commissioner,* T.C. Memo. 1999-86 citing Rev. Rul. 81-178, 1981-2 C.B. 135-37; see *Disabled American Veterans v. Commissioner,* rev'g. 91-2 U.S.T.C. ¶50,336 (6th Cir. 1991), 94 T.C. 60 (1990) to further explore the type of services that might cause the list rentals to be treated as a trade or business.

[189] The facts of the *Texas Farm Bureau v. U.S.,* 53 F.3d 120 (5th Cir. 1995) case provides a good example of how they lost the battle; see also *Common Cause v. Commissioner,* 112 T.C. No. 23 (June 1999) and *Planned Parenthood Federation of America Inc. v. Commissioner,* T.C. Memo. 1999-206 (June 1999).

excluded from UBIT are distinguishable by the following criteria from those that will be taxable compensation for services rendered:

- Payments are made pursuant to written documents that stipulate the organization is licensing its intangible property.
- The payments are specifically designated as royalties.
- The tax-exempt organization does not participate in marketing the affinity cards, insurance, or other products the commercial company is promoting to the organization's members and supporters.
- When the organization is to participate in the marketing effort, the services to be rendered are clearly defined and compensation for such services set out in the agreement.
- When the organization promotes the program with advertisements in its newsletters or magazines, fees for the ads are separately paid for by the licensee. Net income allocable to the ad revenues is reported as UBI.
- Any retained rights to inspect or manipulate the marketing materials are permitted for reasons of protecting the organization's name and reputation, rather than being required of the organization. If production and design of brochures, letters, and other promotional materials are performed by the organization, compensation for the work should be stipulated.

This issue is of particular interest in the scientific and medical fields, where considerable sums are earned from royalties paid for the use of patented devices and methods. Perhaps because the licensing of intellectual property rights for patents involves complex legal issues and potential for liability, the agreements are very carefully structured. There is usually no question that the EO assigns all responsibility for services performed in developing the patent to the licensee. Thus, the revenue received by the EO is unquestionably passive and eligible to be modified or excluded from UBI.[190] To confuse this issue, IRC §513(h)(1)(B) excludes revenues attributable to the exchange of lists between entities eligible to receive charitable contributions.[191]

(e) Subsidiary Payments

Payments of interest, rents, royalties, or annuities excluded under the general rules are includable in UBI if paid by either a controlled taxable subsidiary or a controlled tax-exempt subsidiary. On August 5, 1997, the percentage of ownership constituting control for this purpose was reduced from 80 percent to 50 percent.[192] The code defines control as follows:

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[190] See Roderick Darling and Marvin Friedlander, Chapter B, "Intellectual Property," *IRS CPE Text*, 1999.

[191] Discussed in Section 21.9(h).

[192] IRC §512(b)(13) as amended by Taxpayer Relief Act of 1997, Check for changes in this percentage by new legislation.

- In the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation
- In the case of a partnership, ownership of more than 50 percent of the profits, interests, or capital interests of the partnership
- In any other case, ownership of more than 50 percent of the beneficial interests in the entity

The inclusion portion of amounts received is essentially that amount of the payment that would have been taxable to the controlled organization as UBI had it not paid the interest, rent, or royalty that could be claimed as a deductible expense. For a nonexempt controlled entity, the taxable amount is equal to that portion of such entity's taxable income that would have been UBIT had it been a tax-exempt entity.

There is some uncertainty regarding the meaning of beneficial interests in a nonprofit entity. Under regulations issued before the 1997 amendment, control of a nonstock organization resulted from interlocking directors. If at least 80 percent (now read as 50) of the directors of one organization are representatives of the second organization or have the right to appoint or control the board of the second, control exists.

The attribution rules of IRC §318 apply for purposes of determining constructive ownership of stock in a corporation. Similar principles shall apply for purposes of determining ownership of interests in any other entity. Before mid-1997, amounts paid by a second-tier subsidiary were nontaxable and not subject to inclusion because this section at that time contained no attribution or indirect ownership requirement that would treat the parent as controlling its subsidiary's subsidiary.[193] Although not a tax issue for the tax-exempt organization itself, a financial issue that arises for an exempt organization owning a subsidiary is the so-called General Utilities doctrine. The transfer of substantially all of the assets of a taxable corporation to a tax-exempt organization (commonly, as its parent) is essentially treated as a taxable sale of the transferred assets at their fair market value.[194] The conversion of a taxable entity to a tax-exempt one is similarly treated as a transaction in which gain must be recognized. Assets the exempt will use to conduct an unrelated business and that are transferred are not taxed at the time of transfer (because they will be taxed when eventually sold).

(f) Research

Research income is not taxable if the research is performed for the United States, its agencies, or a state or political subdivision thereof by any exempt organization.[195] In addition,

- A college, university, or hospital can exclude all research income from private or governmental contractors.[196]

[193] Priv. Ltr. Rul. 9338003.

[194] Reg. §1.337(d)-4; see Mitchell L. Stump, "Final 337 Regulations Bad News for Clubs Wanting to Be 501(c)(7)s," *Exempt Organization Tax Review*, February 1999.

[195] IRC §512(b)(7).

[196] IRC §512(b)(8).

- An exempt organization performing fundamental research, the results of which are freely available to the general public, can also exclude all research income.[197]

See Sections 5.3 for discussion of the distinction between scientific research that is treated as related income and testing that is considered a commercial and unrelated enterprise.

(g) Partnerships and S Corporations

A tax-exempt organization's share of income from a partnership, regardless of whether distributed or paid to the organization, flows through to the nonprofit partner and retains its character as rent, interest, business, or other type of income.[198] If the partnership conducts a trade or business that is unrelated to the organization's exempt purpose, the organization's share of the business income, less associated deductions, must be reported as unrelated business taxable income. The exceptions and modifications[199] pertaining to passive income apply to exclude the organization's share of interest or other passive income distributed by the partnership. This rule applies to organizations that are general and limited partners.[200]

Until January 1, 1994, distributions from publicly traded partnerships were fully taxable to the tax-exempt partner, including retirement plans. Since 1994, the partnership's income is fragmented to allow each type of income to flow through to the tax-exempt partner according to the general rule outlined previously. Thus, partnership income or loss retains its character as either taxable business income or passive investment income in the hands of the tax-exempt partner.[201] A publicly traded partnership is one for which interests in it are traded on an established securities market or are readily tradable on a secondary market.[202]

Partnership return instructions to Form 1065 require that the entity provide sufficient information to tax-exempt partners to allow them to correctly report unrelated income items. In the author's experience, such information is sometimes found lacking or is confusing. Financial advisors to institutional investors have created sophisticated forms of investment vehicles in recent years. Some trade securities, some buy rental buildings, some buy security hedges, and some invest venture capital. The income tax rules pertaining to the character of income earned are complex. Those that invest in real estate commonly distribute income attributable to indebted property that may be taxable.[203]

A partnership that elects to use the mark-to-market rules[204] for security trading reports the income on line 1 of Form K-1, "ordinary income from trade or

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[197] IRC §512(b)(9).
[198] IRC §513(c)(1).
[199] IRC §513(c)(1).
[200] *Service Bolt Nut Co. Profit Sharing Trust v. Commissioner*, 724 F.2d 519 (6th Cir. 1983), *aff'g.* 78 T.C. 812 (1982).
[201] IRC §513(c)(2), revised effective January 1, 1994.
[202] IRC §469(k)(2).
[203] See Section 21.12.
[204] IRC §475.

business," to its partners, although it actually has not realized short-term capital gain. Such income is not, therefore, treated as unrelated business income.[205] Dividends, interest, payments with respect to securities loaned, annuities, income from notional principal contract, or other substantially similar income from ordinary and routine investment[206] is modified or excluded from unrelated business income. Income from the sale of property "other than stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the tax year" is also excluded.[207] Thus, the gain or loss is specifically excluded from the computation of unrelated business income unless the partnership is a dealer in securities. Additionally, gain from the lapse or termination (sale) of options to buy or sell securities written in connection with the organization's investment activity is excluded from unrelated business income.[208]

Subchapter S Interests. Organizations exempt under—§501(c)(3) and 401(a) are eligible, effective for tax years beginning after December 31, 1997, to become shareholders of an S corporation.[209] Stock in an S corporation, however, represents an interest in an unrelated trade or business. Unlike partnership distributions, all items of income, loss, or deduction taken into account under IRC §1366(a), and any gain or loss on disposition of the stock in the S corporation, shall be taken into account in computing the unrelated business taxable income of such organizations, including passive income otherwise modified from tax.[210] Thus, where possible, an exempt organization's investment in an entity that will produce a significant amount of passive income should preferably be held in partnership form.

21.11 CALCULATING AND MINIMIZING TAXABLE INCOME

When an otherwise tax-exempt organization has taxable UBI, the tax is calculated under the normal income tax rules. Gross unrelated business income, minus allowable deductions and exemptions, is subject to tax (UBIT). As long as the percentage of an organization's UBI is modest in relation to its overall revenues,[211] the significant problem UBIT presents is the reduction in profit because income tax is due to be paid. Maximizing deductions to calculate the income is important. The income tax sections applicable to for-profit taxpayers govern, and the same concepts apply. Issues an organization earning such income must consider include the following:

- *Form 990-T.* The UBIT is calculated on Form 990-T. The *990 Handbook* contains a filled-in form and detailed suggestions for its completion.

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[205] Reg. §1.512(b)-1(d)(1) and (2).
[206] Reg. §1.512(b)-1(a)(1).
[207] Reg. §1.512(b)-1(d)(1).
[208] Reg. §1.512(b)-1(d)(2).
[209] The Small Business Job Protection Act of 1996, §1316.
[210] IRC §512(e).
[211] See Section 21.3.

- *Tax rates*. The income tax is calculated using the normal tables for all taxpayers, that is, §1(e) for trusts and §11 for corporations. For controlled groups of exempt organizations (also including 80 percent owned for-profit subsidiaries), the corporate tax bracket must be calculated on a consolidated basis under the rules of §1561. The tax liability is payable in advance during the year, as the income is earned, similar to for-profit businesses and individuals.
- *Alternative minimum tax.* Accelerated depreciation, percentage depletion, and other similar tax benefits may be subject to the alternative minimum tax, just as with for-profit taxpayers with certain levels of income.
- *Ordinary and necessary criteria*. Deductions claimed against the unrelated income must be "ordinary and necessary" to conducting the activity and must meet the other standards of §162 for business deductions. *Ordinary* means common and accepted for the type of business operated; *necessary* means helpful and appropriate, not indispensable. The activity for which the expenditure is incurred must also be operated with profit motive.[212] Additionally, allowable expenses are those directly connected with the unrelated business. The organization's expenses attributable to its exempt functions are not deductible unless the activity generating the unrelated income exploits an exempt activity.[213]
- *Profit motive*. To be deductible, an expenditure must also be paid for the production of income or in a business operated for the purpose of making a profit. IRC §183 specifically prohibits the deduction of hobby losses, or those activities losing money for more than two years out of every five. The IRS will challenge the deduction for UBI purposes of any expenditure not paid for the purposes of producing the profit or expenses attributable to exempt revenues.[214]
- *Depreciation.* Equipment, buildings, vehicles, furniture, and other properties that have a useful life to the business are deductible, theoretically over their life. As a simple example, one-third of the total cost of a computer that is expected to be obsolete in three years would be deductible during each year the computer is used in the business. Unfortunately, Congress uses these calculation rates and methods as political and economic tools, and the code prescribes rates and methods that are not so simple. IRC §§167, 168, and 179 apply and must be studied to properly calculate allowable deductions for depreciation.
- *Inventory.* If the nonprofit keeps an inventory of items for sale, such as books, drugs, or merchandise of any sort, it must use the inventory method to deduct the cost of such goods. The concept is one of matching the cost of the item sold with its sales proceeds. If the exempt organization buys ten widgets for sale and, as of the end of a year, only five have

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[212] Reg. §1.512(a)-1(a).
[213] Reg.§1.512(d)-2.
[214] *Iowa State University of Science and Technology v. U. S.,* 500 F.2d 508 (Ct. Cl. 1974); *Commissioner v. Groetzinger,* 480 U.S. 23 (1987); Reg. §1.513-1(4)(d)(iii).

been sold, the cost of the five is deductible and the remaining five are capitalized as an asset to be deducted when those widgets are sold. Again, the system is far more complicated than this simple example, and an accountant should be consulted to ensure use of proper reporting and tabulation methods. IRC §§263A and 471–474 also apply.

- *Capital and nondeductibles.* A host of nondeductible items contained in IRC §§261–280H might apply to disallow deductions, either by total disallowance or required capitalization of permanent assets. Again, all the rules applicable to for-profit businesses apply, such as the luxury automobile limits, travel and entertainment substantiation requirements, and the 50 percent disallowance for meals.
- *Dividend deduction*. The dividends-received deduction provided by IRC §§243–245 for taxable nonexempt corporations is not allowed. As a general rule, a corporation is allowed to exclude 70 percent of the dividends it receives on its investments; exempt organizations are not. This rule presents a problem only for dividends received from investments that are debt financed. Most dividends received by exempts are excluded from the UBI under the modifications previously discussed.

Net Operating Losses. A loss realized in operating an unrelated business in one year may be carried back for 2 years and forward for 20 years, for offset against another year's operating income under IRC §172(b)(1). Gains and losses for different types of UBI earned within any single exempt organization are netted against profits from the various business activities of the organization, including acquisition of indebted investment property. Tax years in which no UBI activity is realized are counted in calculating the number of years for permissible carryovers. Conversely, net operating losses are not reduced by related income.

Exploitation and Fragmentation. In some instances, items that are unrelated to the organization's exempt purposes are sold alongside items that are fundamentally exempt, such as those found in a museum gift shop or hospital pharmacy. Each type of revenue and its associated expenses are fragmented into the respective related and unrelated parts.[215] The unrelated sales activity is said to exploit the exempt function. If the activity is of a kind carried on for profit by a taxable organization, expenses attributable to the exempt activity, net of its revenue, may be deducted against the unrelated income.[216]

Similarly, a dual-use rule requires that employees, facilities, overhead, and other costs shared between related and unrelated activities be allocated between the two on a reasonable and consistent basis.[217] A social club, for example, cannot offset losses on serving nonmembers against income from its investments.[218]

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[215] See Sections 21.4(f) and 21.13(a).
[216] Reg. §1.512(a)-1(d).
[217] Reg. §1.512(a)-1(c).
[218] *Portland Golf Club v. Commissioner,* 90-1 U.S.T.C. ¶50,332; *Iowa State University of Science and Technology v. United States,* 500 F.2d (Ct.Cl. 1974); *Groetzinger,* supra note 6. 110 S.Ct. 2780 (1990).

There were conflicting decisions among the U.S. Circuit Courts of Appeal for several years, and clubs claiming such losses had to file amended returns to report tax resulting from the loss disallowance.

It is extremely important for an exempt organization to file Form 990-T despite the fact that it incurs a loss. Reporting the loss allows for carryback or carryover of the loss to offset past or future income. An election is available to carry losses forward and forgo any carryback in situations where the organization has not previously earned UBI.

$1,000 Exemption. An exemption of $1,000 is allowed annually.

21.12 DEBT-FINANCED PROPERTY

The modifications exempting passive investment income, such as rent and interest, from the UBIT do not apply to the extent that the investment is acquired with borrowed funds. *Debt-financed property* is defined to include property held for the production of income that was acquired or improved with borrowed funds and has a balance of acquisition indebtedness attributable to it during the year.[219] The classic examples are a margin account against the exempt organization's endowment funds used to acquire additional securities or a mortgage financing the purchase of a rental building. Indebted property producing no recurrent annual income, but held to produce appreciation in underlying value, or capital gain, is subject to this rule.[220] A look-back rule prevents deliberate payoff prior to sale to avoid the tax. The portion of the taxable gain is calculated using the highest amount of indebtedness during the 12 months preceding the sale as the numerator.[221]

(a) Properties Not Subject to Debt-Financed Rules

The type of indebted property subject to the debt-financed rules is best defined by listing those that are not included in the term.

Exempt-Use Property. When substantially all of the actual use of real, tangible, or intangible property is substantially related to the performance of the organization's charitable, educational, or other exempt functions, the property is not subject to the debt-financed rules[222] The exempt purpose usage must occur at least 85 percent or more of the time. Such use must be actually devoted to exempt activity purposes and used directly in the organization's exempt or related activities to be exempt.[223] Assume a university borrows money and builds an office tower for its projected staff needs over a 20-year period. During the period its staff occupies less than 85 percent of the building, the nonuniversity use portion of the property will be treated as debt-financed and a portion of the income

[219] IRC §514.
[220] Reg. §1.514(b)-1(a), thus capital gain on sale will be taxed.
[221] Reg. §1.514(a)-1(a)(1)(v).
[222] IRC §514(b)(1)(i).
[223] Reg. §1.514(b)-1.

reportable as unrelated business income. A building rented by a foundation dedicated to medical training for a medical clinic with which it had a close relationship was found to be exempt-use property.[224] Similarly, a building rented at below-market rates to encourage industry to a business development area was am exempt-use building.[225] In what arguably was an incorrect ruling, the historic properties acquired by an educational organization promoting an appreciation of history and architecture were treated as unrelated properties for this purpose. The market rentals were found not to bear a relationship to the buildings' historical or architectural significance nor accommodate viewing by the public.[226] The fact that the income from the property is needed and/or used in conducting exempt programs does not qualify the property as *exempt-use property.*

Property used by one or more related tax-exempt organizations is considered to be exempt usage by the related property owner. For this purpose, organizations are related if more than 50 percent of the members of one are members of the other.[227]

Income Otherwise Excluded. When the income from property is treated as unrelated business income for some other reason, such as hotel room rentals or royalties paid by a 50%+ owned subsidiary, the income is not treated as unrelated for this purpose. The code specifically excludes debt-financed property taxable for another reason so as to not count the income twice.[228] Similarly, an indebted property used in an unrelated activity that is excluded from UBI because it is managed by volunteers; is operated for the convenience of members, students, or visitors; or is a facility for sale of donated goods, is not treated as unrelated debt-financed property.[229] Research property producing income otherwise excluded from the UBIT is also not subject to the acquisition indebtedness taint.[230]

Property financed with federal funding provided or insured by the Federal Housing Administration, if used to finance purchase, construction, or rehabilitation of residential property for low-income persons, is excluded.

A charitable gift annuity issued as the sole consideration in exchange for property worth more than 90 percent of the value of the annuity is not considered acquisition indebtedness. The annuity must be payable over the life (not for a minimum or maximum number of payments) of one or two persons alive at the time. The annuity must not be measured by the property's (or any other property's) income.

Neighborhood Land. Real property acquired for the principal purpose of, and intention for use in conducting the organization's exempt activities within 10 years commencing from the time of acquisition is not necessarily treated as debt-

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224 *Gundersen Med. Found., Ltd. v. U.S.*, 536 F. Supp. 556 (W.D. Wis. 1982).
225 Rev. Rul. 81-138, 1981-1 C.B. 358.
226 Rev. Rul. 77-47, 1977-1 C.B. 157.
227 Reg. §1.514(b)-1(c)(2); see Priv. Ltr. Rul. 7833055 for example of a charitable organization renting portions of its building to a related charity and a business league.
228 IRC §514(c)(2); Reg. §1.514(b)-1(b)(2)(ii).
229 IRC §514(b)(1)(B) and (C); see Sections 21.9(a), (b), and (c).
230 IRC §514(b)(1)(C) by reference to §512(b)(7), (8), and (9).

financed property. This exclusion ceases to apply if the intention to devote the property to exempt purposes is abandoned before the expiration of the 10-year period. Except in the case of a church, the future exempt-use classification ceases to apply after the end of the 10-year period. The future-use time period for a church or convention or association of churches is 15 years and applies whether or not the acquired land meets the neighborhood test.[231] At least 90 days before the end of the fifth year, a ruling request must be submitted with information to satisfy the IRS that it is reasonably certain that the land will be used for exempt purposes before the expiration of the 10-year period. Binding contracts do not necessarily have to be in place to get approval. The organization, however, must at least have definite plans with completion dates and have taken affirmative action (funding campaign, for example) toward fulfillment of the plans.[232]

Property is in the *neighborhood* of other property owned and used by the organization in the performance of its exempt purposes if the acquired property is contiguous with the exempt purpose property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property. When the facts and circumstances make it unreasonable to acquire contiguous property, property located within one mile of existing exempt property(ies) may be treated as neighborhood land. In one situation, contiguous land was substantially developed and thereby unavailable. Three parcels one city block away were considered qualified neighborhood land because the organization planned to demolish existing structures to make way for a new building site. [233]

A structure on the future-use land is also excluded if the plans for the land require that the structure be demolished or removed in order to use the land for exempt purposes. This exception does not apply to structures erected on the land after the acquisition of the land nor to property subject to a business lease.

The future-use land, not including buildings, acquired and held for use by an exempt organization within 10 years (for churches, 15 years) from the date it is acquired, and located in the neighborhood in which the organization carries out a project, is exempt from this provision. This exception applies until the plans are abandoned; after five years, the organization's plans for use must be "reasonably certain."[234]

Tax status of the tenant or user is not necessarily determinative. Rental of an indebted medical office building used by staff physicians was found to be related to a hospital's purposes.[235] Although their restoration served a charitable purpose, the rental of restored historic properties to private tenants was deemed not to serve an exempt purpose where the properties were not open to the public.[236] Regulations suggest that all facts and circumstances of property usage will be considered.

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[231] IRC §513(b)(3)(E).
[232] Reg. §1.514(b)-1(d)-1(iii).
[233] Priv. Ltr. Rul. 9603019; see also Priv. Ltr. Rul. 9241052 that contains no mention of the distance.
[234] IRC §514(b)(3)(A)-(E).
[235] Reg. §1.514(b)-1(c)(1); Rev. Rul. 69-464, 1969-2 C.B. 132; Tech. Adv. Memo. 8906003.
[236] Rev. Rul. 77-47, 1977-1 C.B. 156; Tech. Adv. Memo. 9017003.

Property Acquired Subject to Debt. Where property is acquired subject to a mortgage or similar lien at the time of acquisition, the amount of the indebtedness secured by such mortgage or lien shall be considered acquisition indebtedness. This rule applies even though the organization does not assume or agree to pay such indebtedness. Debt placed on property by a donor will be attributed to the organization when the organization agrees to pay all or part of the debt or makes any payments on the equity.[237] Liens similar to mortgages are also treated as acquisition indebtedness, such as a security interest under the Uniform Commercial Code, pledges, an agreement to hold title in escrow, and certain tax obligations.

Bequeathed or donated property that is encumbered and subject to existing debt at the time it is given to the exempt organization is not treated as acquisition indebted property for 10 years following the date of its acquisition. Encumbered property that is donated to the organization as a gift is subject to a similar 10-year exclusion if the donor placed the mortgage on the property more than 5 years prior to the gift and had owned the property more than 5 years before the gift. In the case of both bequeathed and gifted property, there must be no assumption or agreement to pay the indebtedness secured by the mortgage. Nor can the organization make any payment for the equity in the property owned by the decedent or donor.

(b) Other Types of Debts

The obligation to make payments to the donor in connection with a charitable remainder trust gift does not constitute a debt. When some other individual or organization is entitled to income from the property for life or another period of time, a remainder interest in the property is not considered to be subject to acquisition indebtedness.[238]

Both the indebtedness incurred by a partnership and any indebtedness incurred by the organization to acquire its interest in the partnership are treated as acquisition indebtedness.[239] The fact that the organization's undivided interest is legally subject to debt on the entire property was considered in one situation. Because the charity paid off its share of the mortgage and received releases of liability from the mortgages and co-owners, the remaining lien was not treated as acquisition indebtedness to the organization.[240] Conversely, the borrowed funds used to purchase a mineral production payment to provide program-operating funds was acquisition indebtedness. The fact that the indebtedness was only payable out of the production with borrowed funds and the use of the net proceeds for exempt purposes did not allow exclusion of the indebtedness.[241]

Although investment of pension fund assets is admittedly inherent in its exempt purposes, debt-financed investments made by such a fund (or most other

[237] Reg. §1.514(c)-1(b).
[238] Reg. §1.514(b)-1(c)(3).
[239] Tech. Adv. Memo. 9651001.
[240] Rev. Rul. 76-95, 1976-1 C.B. 172.
[241] Rev. Rul. 76-354, 1976-2 C.B. 179.

exempt organizations) are not inherent in a fund's purposes.[242] The Southwest Texas Electric Cooperative's purchase of Treasury Notes with Rural Electrification Administration (REA) loan proceeds represented a debt-financed investment. The loan proceeds were required to be used to pay construction costs. The cooperative's cash flow, however, allowed it to pay part of the construction costs with operating funds. To take advantage of a more than 4 percent spread in the REA loan and prevailing Treasury Note rates, the cooperative deliberately "drew down" on the REA loan. The Tax Court agreed with the IRS that the interest income was taxable debt-financed income.[243]

Schools and their supporting organizations, certain pension trusts, and §501(c)(25) title-holding companies may have a special exception for indebted real property. These rules are referred to as the *tax-exempt entity leasing* rules. If the property is purchased in a partnership with for-profit investors, profit- and loss-sharing ratios must have substantial economic effect and not violate the disproportionate allocation rules.[244] These so-called leasing rules are fully discussed in *The Law of Tax-Exempt Organizations, 8th Edition*.[245]

(c) Acquisition Indebtedness

Acquisition indebtedness is the unpaid amount of any debt incurred to acquire or improve property or any debt "reasonably foreseen" at the time of acquisition that would not have been incurred otherwise.[246] The test is whether the debt would have been incurred but for such acquisition or improvement.[247] An extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness is not treated as the creation of new indebtedness. Securities purchased on margin are debt financed; payments for loan of securities already owned are not. Indebtedness the incurrence of which is inherent in the performance or exercise of the organization's exempt functions is excluded. For example, the indebtedness incurred by a credit union in accepting deposits from its members is not acquisition indebtedness. Although the author finds no citation, it seems reasonable to say that margin debt borrowed against the organization's securities to pay its operating expenses is not acquisition indebtedness in relation to the securities. One could argue, however, that the margin allows the organization not to sell the securities and essentially constitutes their acquisition.

[242] §514(c)(4); *Elliot Knitwear Profit Sharing Plan v. Commissioner,* 71 T.C. 765 (1979), *aff'd.* 614 F.2d 347 (3d Cir. 1980); see also Rev. Rul. 71-311, 1971-2 C.B. 184 and Rev. Rul. 74-197, 1974-1 C.B. 143 regarding investments of employee trusts.

[243] *Southwest Texas Electric Cooperative, Inc. v. Commissioner,* 68 T.C.M. Dec. 50,008(M), T.C. Memo. 1994-363.

[244] IRC §§ 168(h)(6), 514(c)(9), and 704(b)(2); Reg. §1.514(c)-2.

[245] B. R. Hopkins, *The Law of Tax-Exempt Organizations, 8th ed.*(Hoboken: Wiley, 2003), pp. 890–896. The disproportionate allocation rules are also discussed by William B. Holloway, Jr. in "Structuring Real Estate Investment Partnerships with Tax-Exempt Investors," *The Exempt Organization Tax Review*, vol. 29, no. 1, July 2000, and by R. M. Nugent in "Possible Approaches for Avoiding UBTI on Real Estate Investments," *The Exempt Organization Tax Review*, August 2002.

[246] IRC §514(c).

[247] IRC §51(c)(1)(C).

(d) Calculation of Taxable Portion

A portion of the income from property subject to acquisition indebtedness, not excludable for one of the reasons previously discussed, is taxable as unrelated business income.[248] The taxable portion is calculated by comparing the average amount of the acquisition indebtedness for the year in relation to the average tax basis of the property. The formula for calculation of income subject to tax is as follows:

$$\frac{\text{Income from property} \times \text{Average acquisition indebtedness}}{\text{Average adjusted basis of property}}$$

Each property subject to debt is calculated separately, with the resulting income or loss netted to arrive at the portion includable in UBI. Expenses directly connected with the property are deducted from gross revenues in the same proportion. The normal income tax rules apply to determine includable income and qualifying deductions.[249]

The average acquisition indebtedness equals the arithmetic average of the principal balance due on the debt at the end of each month or partial month of the tax year. The average adjusted basis is similarly calculated, adding up the net of the property cost less allowable depreciation, using the straight-line method of depreciation, on a monthly basis. The proportion-of-use test is applied to identify property used for exempt and nonexempt purposes and can be based on a comparison of the number of days used for exempt purposes with the total time the property is used, or on the basis of square footage used for each, or on relative costs.[250]

The formula for calculating the portion of taxable capital gain or loss on the sale of the property is different in one respect. The average value of indebtedness (the numerator) is equal to the highest amount of indebtedness during the full year preceding sales, rather than the number of months the property was held during the tax year being used as the numerator.

21.13 MUSEUMS

Museum gift shop sales and related income-producing activities are governed by the fragmentation[251] and exploitation[252] rules. Since 1973, when it published a ruling concerning greeting cards,[253] the IRS has agreed that items printed with reproductions of images in a museum's collection are educational and related to the exempt purposes so that their sale does not produce UBI. The ruling expressed two different reasons: (1) The cards stimulated and enhanced public awareness, interest in, and appreciation of art; and (2) a self-advertising theory stated that a

[248] IRC §514(a)(1) and (2).
[249] See discussion in Section 21.11.
[250] Reg. §1.514(b)-1(b)(ii), §1.512(b)-1(b)(iii) Example 2; Priv. Ltr. Ruls. 8030105 and 8145087; see Section 21.12(a) for definition of exempt-use property.
[251] See Section 21.4(c).
[252] See Section 21.11.
[253] Rev. Rul. 73-104, 1973-1 C.B. 263; these rulings still cited.

"broader segment of the public may be encouraged to visit the museum itself to share in its educational functions and programs as a result of seeing the cards."

A second 1973 ruling[254] explored the fragmentation rule and expanded its application to trinkets and actual copies of objects and distinguished items. The IRS thought that educational benefit could be gained from utilitarian items with souvenir value. Since that time, it has been clearly established that a museum shop often contains both related and unrelated items, and the museums are expected to keep exacting records to identify the two.

(a) Identifying Related and Unrelated Objects

After the IRS and museums argued for 10 years about the relatedness of a wide variety of objects sold, four exhaustive private rulings were issued in 1983 and are still followed.[255] The primary concern for a museum is to identify the relatedness of each object sold in its shops and to segregate any unrelated sales. The connection between the item sold and achievement of the museum's exempt purpose is evidenced by the facts and circumstances of each object and the policy of the curatorial department in identifying, labeling, and categorizing objects on public view, reproductions of which are made and sold. The rulings direct that each object be examined to prove that the items being sold have educational value. The following factors are to be considered in designating an item as related or unrelated:

- Interpretive material describing an artistic, cultural, or historical relationship to the museum's collection or exhibits
- Nature, scope, and motivation for the sale activity
- Are sales solely for production of income or are they an activity to enhance visitor awareness of art?
- Curatorial supervision in choosing related items
- Reproductions of objects in the particular museum or in other collections, including prints, slides, posters, postcards, and greeting cards, are generally exempt.
- Adaptations, including imprinted utilitarian objects such as dishes, ashtrays, and clothing, must be accompanied by interpretive materials and must depict objects or identify an exhibition. Objects printed with logos were deemed unrelated, although in practice, the IRS has been lenient.
- Souvenirs and convenience items are generally unrelated unless imprinted with reproductions or promoting a particular event or exhibi-

[254] Rev. Rul. 73-105, 1973-1 C.B. 265.

[255] Priv. Ltr. Ruls. 8303013, 8326003, 8236008, and 8328009; see also Tech. Adv. Memo 9550003, in which the IRS reviewed its rulings and provided an extensive listing of eight categories of items that it considered related to a "living museum" and six groups of unrelated objects. Importantly, the IRS found off-site sales activity is not, solely for that reason, treated as an unrelated activity, if the museum can show that such sales enhance a broader public appreciation of the artworks and encourages visits to the museum facilities.

tion. Souvenirs promoting the town in which the museum is located are not considered related to the museum's purposes.

- Toys and other teaching items for children are deemed inherently educational and therefore related.[256]

(b) Original Works of Art

Original works of art created by living (or deceased) artists and sold by museums are considered unrelated by the IRS. They think it is inconsistent with the purpose of exhibiting art for public benefit to deprive the public of the opportunity of viewing the art by selling it to an individual. This opinion is questioned by some, and readers may observe that original works are routinely sold by museums and art centers. In one instance the author is aware of, the IRS approved the sale of craft items by a craft museum as an educational activity. Thus, a museum that sells, or is considering the sale of, original works of art in its gift shop or bookstore has no absolute clear guidance in deciding whether such sales are related or unrelated to its exempt purposes. Unquestionably, when the sales activity is undertaken simply to raise funds, the sales are unrelated. Whether the items sold promote an exempt purpose may be difficult to determine, as the first two of the following citations indicate.

- A cooperative art gallery established to encourage individual emerging artists was not allowed to qualify as an exempt organization because, in the IRS's opinion, the interests of the general public were not served by promoting the careers of individual artists. The art sales were deemed to serve no exempt purpose and constituted UBI. Because the organization was supported entirely by UBI from the sales of art of the artists, it was not exempt.[257]
- A community art center located in an isolated area with no commercial galleries obtained exemption, and the Tax Court decided that its sales of original art were related to exempt purposes. The decision was based on the fact that no other cultural center existed in the county, the art sales were not the center's sole source of support, and a complex of other educational activities were conducted.[258]
- An unrelated gallery managed by volunteers and/or selling donated works of art produces unrelated income, but the income is not taxable because of exceptions. Exempt status depends on whether the gallery is a substantial part of the organization's activities. See Section 21.3 for consequences of receiving such income.

[256] In Priv. Ltr.Rul. 9720002, the IRS found that "items that develop a child's artistic ability are related to the museum's educational purposes, blocks and play items that generally develop a child's motor skills are not so related."

[257] Priv. Ltr. Rul. 8032028.

[258] *Goldsboro Art League, Inc. v. Commissioner,* 75 T.C. 337 (1980).

21.14 TRAVEL TOURS

Museums, schools, and other types of exempt organizations sponsor study tours as educational and fund-raising tools. The issue is whether such tours advance exempt purposes other than the organization's need for funds. Such tours are often professionally organized in a fashion similar to those conducted by travel agents and commercial tour guides. To be related to an exempt function, the purpose of the tour must be to educate, rather than to provide a recreational trip to raise money. One must evaluate the difference between *serendipitous acquisition of knowledge* and a deliberate intent to educate.[259]

To scrutinize the bona fide educational methodology of the tour, the professional status of leaders (teachers) and the educational content of the program are considered. Advance preparation, such as reading lists, evidence relatedness. The actual amount of time spent in scheduled instruction, curriculum, visits to historic sites, mandatory participation in lectures, preparation of reports, and opportunity for university credit are other attributes evidencing the educational nature of a tour.[260] Conversely, a large amount of recreational time allowed to participants, the resort-taint of the places the tour visits, and holiday scheduling suggest predominantly personal pleasure purposes and cause the tour to not qualify as educational.[261] The regulations contain seven very detailed examples that should be carefully studied by organizations conducting such tours.[262] Performance of archaeological dig duties or collection data about bird species observed are examples of participant activity that serves the mission of the tour sponsor.

Documentation of the trip's relatedness should start during its planning stage. The EO's records should indicate how and for what reason the destination(s) is chosen, how guides are chosen, and other information evidencing the educational mission of the trip. Proving the educational nature of a tour may be more difficult for an organization whose sole purpose is conducting tours. An organization that uses professional travel companies to arrange tours also has a burden of proving it was not established to benefit the private operators. Not only the profit from the tour itself, but the additional donation requested as an organizational gift from all participants in a travel tour program, may be classed as unrelated income if the tour is not considered as educational.[263]

21.15 PUBLISHING

Exempt organization publications present two very different exposures to trouble: the unrelated income tax and potential revocation of exemption. Without question, the most universal problem is that publication-advertising sales create UBI in most cases. A less common, but more dangerous, situation occurs when the underlying exemption is challenged because the publication itself is a business.

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259 Remarks of Marc Owens, then director of IRS Exempt Organization Division, Non-Profits in Travel Conference, March, 1995.

260 Rev. Rul. 70-534, 1970-2 C.B. 113.

261 Rev. Rul. 77-366, 1977-2 C.B. 192.

262 Reg. §1.513-7.

263 Tech. Adv. Mem. 9027003.

(a) Advertising

Revenue received from the sale of advertising in an otherwise exempt publication is considered business income by the IRS and is taxed unless

- The publication schedule or ad sale activity is irregularly carried on.
- The advertising is sold by volunteers.
- The advertising activity is related to one of the organization's underlying exempt purposes, such as ads sold by college students or trainees.
- The ads do not contain commercial material, appear essentially as a listing without significant distinction among those listed, and represent acknowledgment of contributors or sponsors.
- The content of the advertisement is not *quantitative or qualitative* and thereby qualifies as a permissible acknowledgment of a sponsor.[264]

The IRS has continually taken the position that advertising sold using the exempt organization's name is unrelated activity, despite creative contracts attributing the activity to an independent commercial firm.[265]

(b) Readership versus Ad Lineage Costs

Even if ad revenue is classified as unrelated business income, the tax consequence is limited by the portion of the readership and editorial costs allowed as deductions against the ad revenue. The important question is what portion of the expense of producing and distributing the publication can be allocated against the revenue.[266] It is helpful first to study Exhibit 21.5, Calculating the Taxable Portion of Advertising Revenue, a worksheet reflecting the order in which readership and editorial costs versus advertising costs are allocated.

The formula prorates deductions in arriving at taxable advertising income. Publication costs are first divided into two categories: direct advertising and readership. Because readership costs are exempt function costs, under the exploitation rule they theoretically should not be deductible at all against the UBI income. In a limited exception, the regulations allow readership costs, if any, in excess of readership income to be deducted against advertising income. In other words, advertising revenues can be offset with a readership loss. Arriving at a readership loss, however, means the publication's underlying production costs must be more than its revenues.

(c) Circulation Income

Circulation income is income attributable to the production, distribution, or circulation of a periodical (other than advertising revenue), including sale of reprints and back issues.[267] When members receive an organization's publication as a part of their basic membership fee, a portion of the member dues is allo-

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[264] See Section 21.8(e).

[265] Rev. Rul. 73-424, 1973-2 C.B. 190; IRS Tech. Adv. Memo. 9222001; see also Sections 21.8(d), (e), and (h).

[266] Reg. §1.512(a)-1(f)(6); Rev. Rul. 81-1-1, 1981-1 C.B. 352.

[267] Reg. §1.512(a)-(f)(3)(iii).

cated to circulation income. Other types of member income, such as educational program fees or convention registration, are not allocated.[268] When the publication is given free to members but is sold to nonmembers, a portion of the members' dues is allocated to readership revenue. The formula requires allocation of a hypothetical portion of the dues, as illustrated in the calculation. Free copies given to nonmembers have been subject to controversy with the IRS. If the organization has more than one publication, the IRS and the courts disagree on the denominator of the fraction for calculation of allocable exempt function costs.[269]

(d) Commercial Publication Programs

A publication program can be considered a commercial venture, despite its educational content. Distinguishing characteristics are found by examining the organization's motivation and management decisions. Characteristics found to evidence a commercial nature include the following:

- *Presence of substantial profits*. Accumulation of profits over a number of years evidences a commercial purpose. The mere presence of profits, by itself, does not bar exemption,[270] but other factors will be considered. For what purpose are profits being accumulated? Do the reserves represent a reasonable amount of working capital or a savings account for future expansion plans?
- *Pricing methods*. The method of pricing books or magazines sold yields significant evidence of commercial taint. Pricing at or below an amount calculated to cover costs shows nonprofit motive. Pricing below comparable commercial publications is not required, but certainly can evidence an intention to encourage readership and to educate, rather than to produce a profit.
- *Other factors*. Other factors can show commerciality:
    - Aggressive commercial practices resembling those undertaken by commercial publishers[271]
    - Substantial salaries or royalties paid to individuals
    - Distribution by commercial licensers
- *Nonprofit publications*. By contrast, nonprofit and noncommercial publications[272]
    - Rely on volunteers and/or modest wages
    - Sell some unprofitable books and magazines

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[268] Tech. Adv. Memo. 9204007; see also Tech. Adv. Memo. 9734002.

[269] *North Carolina Citizens for Business and Industry v. U.S.*, 89-2 U.S.T.C. §9507 (Cl. Ct. 1989).

[270] *Scripture Press Foundation v. U. S.*, 285 F.2d 800 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1982).

[271] *American Institute for Economic Research v. U. S.*, 302 F.2d 934 (Ct. Cl. 1962).

[272] *Presbyterian and Reformed Publishing Co. v. Commissioner*, 70 T.C. 1070, 1087, 1083 (1982).

- ◦ Prepare and choose materials according to educational methods, not commercial appeal
- ◦ Donate parts of press runs to other exempt organizations or members
- ◦ Balance deficit budgets with contributions

A Christian school publishing program, for example, was treated as an unrelated activity despite the educational nature of the books it sold.[273] Although the program had significant commercial attributes—more than 1,200 titles produced on presses that ran 16 hours a day and sold throughout the world—the IRS said two particular characteristics caused it to consider the activity as unrelated:

1. The methods used in selling the textbooks are indistinguishable from ordinary commercial sales practices.
2. Fifty percent of the schools' highly compensated employees were sales representatives.

The IRS provided some useful criteria for deciding what constitutes a periodical in a 1994 private ruling.[274] The definition is important because that portion of membership dues allocated to published periodicals is treated as taxable unrelated income. An educational organization devoted to the study of reproduction distributed a variety of publications, some of which were deemed periodicals and others of which were not. A quarterly newsletter and annual meeting programs distributed to members were periodicals for the following reasons:

- Each was published at regular recurring intervals.
- The right to receive the publication was associated with membership or similar status in the organization for which dues, fees, or other charges were received (even though nonmembers may also receive the publication).
- Each contained editorial materials related to the accomplishment of the organization's exempt purposes, in this case, publicizing scientific developments in the field, technical articles, and reports of annual meetings.
- The newsletter was part of an ongoing series, with each issue indicating its relation to prior or future issues; it contained a regular feature column, president's message, and reports of organizational meetings and activities.
- With respect to the advertising portion of the publications, the purpose was the production of income, each issue of a periodical indicated a relation with prior or subsequent issues.

[273] Priv. Ltr. Rul. 9636001.
[274] Priv. Ltr. Rul. 9402005.

CHAPTER TWENTY-TWO

Relationships with Other Organizations and Businesses

As a nonprofit organization gains maturity and complexity, its board and/or its staff may wish to undertake an activity not appropriate for the organization itself, but suitable for another form of organization. To accomplish that objective, there are two classic types of reorganizations or spin-offs: One is to form a title-holding company[1] or a supporting organization[2] to hold assets and/or to raise funds to hold for the benefit of the organization. The other common step is for an Internal Revenue Code (IRC) §501(c)(3) organization to form a §501(c)(4) organization to conduct lobbying activities that would be unallowable for a charitable organization for the reasons outlined in Chapter 23.

[1] Discussed in Chapter 10.
[2] See Section 11.6.

A new and separate exempt organization might also be formed to conduct a program that exposes the organization's assets to unacceptable risk of financial loss. The motivation is similar to the reasons for forming a title-holding company, except that a title-holding company cannot actively operate programs or projects. A new organization might also be formed to qualify for funding not available to the existing organization. A common example of this type of spin-off is an auxiliary formed to allow the individuals involved in fund-raising to control the funds that they raise while not controlling, or being controlled by, the underlying organization. The creation of a charity to benefit a business league or labor union can attract deductible gifts that are not available to the benefited organization itself.

The new organization must, of course, meet its requirements for its category of exemption under which it is formed. The application for recognition of exemption must describe in detail the relationship and the reasons why the new organization is being created. While interlocking directorates are not prohibited in either situation, prudence usually dictates the establishment of a separate, noncontrolling board for the new organization. Criteria for attributing activities back to the creating organization have been developed by the Internal Revenue Service (IRS) to evaluate for-profit subsidiaries.

As a practical matter, the existing organization's assets are not usually transferred as might be implied by the term *spin-off*, except in the formation of a title-holding company or supporting organization. In fact, to retain the distinct tax exemption and legal identity, separate and distinguishable operations are imperative. Nevertheless, the two organizations often operate side by side and share employees and facilities. Record keeping will necessarily need to be expanded to ensure documentation of assets, liabilities, revenue, and expenditures attributable to the new separate entity.[3]

22.1 CREATION OF (c)(3) BY (c)(4), (5), OR (6)

Business leagues, labor unions, civic clubs, and other noncharitable exempt organizations are typically organized and operated to further the interests of their members. Conversely, a (c)(3), often called a charitable organization, is created to raise funds in support of programs benefiting the general public.[4] The possible motivations for non-(c)(3)s to establish (c)(3)s are many. Often, such organizations already conduct charitable programs and wish to raise grant funds from nonmembers to support them. A (c)(3) organization might also be created as a vehicle to honor respected members upon their deaths or as the recipient of split-interest trust or life insurance gifts during members' lives. A charitable wing might be created to enhance the public image of the profession through the sponsorship of scholarships and community service projects. Business leagues often form (c)(3) organizations to conduct their continuing education programs. The

[3] See Section 22.3(c).

[4] Standards for exemption described in Chapter 2; additional considerations for a business league forming a (c)(3) are discussed in Section 8.11; see also Priv. Ltr. Rul. 200022056.

issues involved in the converse—a (c)(3) establishing a (c)(4)—are similar, but focus on plans to conduct lobbying not permitted for a (c)(3).[5]

(a) Form of Relationship

The relationship between the two organizations can take many forms. Typically, the board members overlap. While it is acceptable for both boards to be identical, they may be totally separate. If public status as a supporting organization is desired, the link must be evident and the purposes and organizational documents must meet very specific requirements[6] Regardless of the organizational governance, it is imperative that the separateness and differences between the activities of related organizations qualified under different categories of tax exemption be respected and distinguished.

When one category of tax-exempt organization associates with another category, it is important that the activities of the different categories be kept distinctly separate.[7] The electronic age has added a new dimension to this issue—sharing a Web site and/or linking from one site to another. There is no specific IRS guidance on this issue. There exists, nonetheless, a burden that a (c)(3) organization, for example, not use its resources to promote the interests of its related (c)(4) or (c)(6) organization. Materials on a shared site should clearly identify that portion displayed on behalf of each entity. The cost of establishing and maintaining the site can be shared based on adequate records evidencing costs attributable to space used by each entity. Readers should be alert for promised IRS guidance on this issue.

Another question that arises is whether it is acceptable for associated organizations in different §501 categories to have the same name. Can the Save the Cats Foundation operate alongside a Save the Cats Advocacy Fund and a Save the Cats PAC? In an annual training article, the IRS said, "The mere fact that a §501(c)(4) organization has a similar name to a §501(c)(3) organization is not sufficient to cause the activities" of one to be attributed to the other.[8]

(b) Category of Public Charity

Public charity status is an important question in structuring this type of relationship. Though affiliated charities formed by business leagues and other non-(c)(3)s are often called foundations, such charities can normally qualify as public charities rather than as private foundations. The appropriate type of public charity is dictated both by the anticipated sources of funding for the foundation and by the scope of its activities. If the majority of the support will be received from the related organization or a small group of members, formation of a supporting organization under IRC §509(a)(3) is clearly indicated. If donations are expected from a wide segment of the membership and the general public, the new organi-

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[5] See Section 6.1.

[6] See Section 11.6.

[7] Suggestions for documenting the separation when employees and facilities are shared are presented in Section 22.3.

[8] Kindell and Reilly, "Election Year Blues," *IRS CPE Text,* 2002, p. 367.

zation can also qualify for public status under IRC §509(a)(1) or (2). When the proposed organization can qualify as publicly supported under more than one category of IRC §509, a choice must be made. The §509(a)(1) and (2) categories allow the new organization to operate and be controlled more independently than it could as a supporting organization under §509(a)(3). The fact that no public support test calculations are required makes the §509(a)(3) category more desirable. The difference between §509(a)(1) and (a)(2) is primarily mathematical and depends on the sources of revenue.[9]

(c) Donation Collection System

A subset of the public support question arises when the professional society, civic league, or union solicits donations as a part of its annual dues collection process. Typically, the donations to the separate charitable foundation are optional for society members. The notice may suggest an amount or allow members to add whatever amount they choose. The society collects the donations and periodically pays them over to the charity. A question may arise as to who is making the gift—the individual member or the society. Particularly for optional gifts, there is evidence of donative intention on the member's part, rather than the society's. Such donations should be segregated and recorded on the society's books as a liability being held by the society as agent for the foundation. Guidelines provided by the accounting profession and the IRS can be applied in distinguishing payments collected by one organization on behalf of another.[10]

(d) Grants to and from the (c)(3)

The (c)(3) organization raises the funds to carry out educational, scientific, or other charitable activities on behalf of or in concert with the organization that creates it. The interesting question is whether the (c)(3) must disburse the funds itself and directly undertake charitable projects, or whether it can grant funds to the (c)(4), (5), or (6) to enable it to undertake the activities. Both scenarios are permissible. If the funds are paid over to the parent non-(c)(3) organization, the grant should be restricted under a written agreement specifying the qualifying charitable purposes for which the moneys can be spent and, if possible, annual reports should be made back to the funding charity.

Often, the society furnishes the charity with office space, personnel, and other necessary operating overhead items. Reimbursement of expenses incurred by either organization is permissible.[11] However, the charity has the burden of proving that the expenditures do not benefit the society and its members. When it is financially possible, payment of the expenses by the society without reimbursement eliminates questions of this sort.

A related foundation of a (c)(6) business association did not engage in appropriate tax-exempt activities, for example, because it operated primarily for the benefit of the association. The foundation's only activity was to provide a no-

[9] Chapter 11 explains the intricacies of public status.

[10] Financial Accounting Standards Board Statement #136; see Section 24.2(b).

[11] Under standards discussed in Section 22.3(c) for a for-profit subsidiary.

rent lease to the related membership association. Since such a leasing arrangement is not an inherently charitable activity, the charity was operated only to further the interest of the parent organization, and the foundation did not qualify for exemption.[12] Loaning the foundation's non-(c)(3) parent money to conduct lobbying, or for any other noncharitable purpose, is also not acceptable.[13]

Respecting the separateness of the (c)(3) is very important. The projects it sponsors should be discrete and identifiable as its own, though they may focus on issues of concern to their affiliate business league or union. When the (c)(3) was created by a (c)(4) that conducts extensive lobbying, it is absolutely necessary that adequate records be maintained to evidence allocation of moneys and separateness of activity.[14]

(e) Creation of a Triumvirate

Due to the limitations on expenditures for lobbying and political campaign activity,[15] a triumvirate of organizations may also be created to accomplish a publicly spirited group's mission. A §501(c)(3) educational organization may be needed to provide information by conducting classes, gathering data with research, writing papers for publication,[16] and being eligible to receive deductible charitable contributions. A §501(c)(4), (5), or (6) can focus on improvement of civic, labor, and business conditions and lobby (without limitations) persons in legislative positions. Lastly, a §527 political action committee (PAC) is established to finance efforts to elect persons to public office. Often, such a triumvirate is united behind its avocation of better working conditions, the environment, relief of the poor, or some other social cause.

The need to maintain separateness between the organizations is strategic because the (c)(3) can have absolutely no campaign participation and limited lobbying activity. Careful consideration must be given to the propriety of the three organizations having separate, or overlapping, boards.[17] If one of the noncharitable entities controls and uses that position to cause the charity to operate for its benefit, the charity's status could be jeopardized.[18] It is common for a (c)(3) to create and control a (c)(4) to isolate lobbying activity, and then for the (c)(4) to create a PAC. The IRS says it is important that PAC activity not be identified or ratified in minutes or other documents as official actions of the (c)(3).[19] The PAC should not use the (c)(3)'s letterhead nor should the charity's representatives be identified as responsible for PAC activity.

[12] Priv. Ltr. Rul. 9017003.

[13] Priv. Ltr. Rul. 9812001.

[14] See Chapter 6 for further discussion about companion (c)(3) and (c)(4) organizations.

[15] See Exhibit 23-1 and accompanying text in Chapter 23.

[16] Following "methodology test" to prove its information is unbiased and impartial as discussed in Section 5.1(j).

[17] See further discussions in Section 6.1(b).

[18] Ward L. Thomas and Judith E. Kindell, "Affiliations Among Political, Lobbying, and Educational Organizations," *IRS CPE Text,* 2000 (1999).

[19] Thomas and Kindell, supra note 7.4 at p. 263; also see Priv. Ltr. Rul. 200103084.

Record-keeping systems must be implemented to capture the direct costs attributable to each member in the related group. Personnel, facilities, and other costs can be shared so long as a cost allocation system is maintained to arrive at a fair and reasonable portion attributable to each separate entity.[20] The Expenditure Documentation Policy reflected in Exhibit 14-2 might be used to evidence the group's intention to properly allocate its expenditures and activities. Some question whether the organizations can all share the same name and, if they do, whether there is the need to compensate for use of such an intangible, sometimes very valuable, asset. The IRS has traditionally encouraged the creation of such a group and has not in the author's experience questioned the use of similar names. Under the self-dealing rules applicable to private foundations, the use of a name is considered to provide "incidental and tenuous benefit" that is not valued and does not cause self-dealing.[21] Nonetheless, the goodwill associated with a charity's name could be found to have value for which the (c)(4) and the PAC should compensate it for using. [22]

22.2 ALLIANCES WITH INVESTORS

In the face of declining governmental support for housing and education during the 1970s, exempt organizations began to turn to the private sector for capital funding for buildings and equipment. In the medical field, the cost of technological discoveries and the establishment of health-care conglomerates compounded capital needs. Accelerated depreciation rates encouraged such arrangements until 1984.[23] With the advent of longer depreciable lives and the passive loss limitations in 1986, the advantage of such alliances was diminished. Despite the reduced tax benefits, joint ventures with private individuals and businesses still proliferate. The strength of a nonprofit's intangible properties—its research capabilities and civic accomplishments and recognition—continue to attract investors interested in working with it to provide capital and benefit from its expertise.

(a) Exempt Organization as General Partner

Originally, the IRS ruled that an exempt organization was completely prohibited from serving as a general partner with private limited partners. Since the general partner has an obligation to maximize profits for the benefit of the limited partners, the general partner role violates the basic private inurement standards and automatically causes loss of exempt status. The IRS said that "the arrange-

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[20] Cost allocation systems are discussed in Section 18.2(g); it is imperative that personnel keep a record of time devoted to the respective entities activity and that physical space occupied by everyone be identified.

[21] See Section 14.5(e).

[22] Gregory Colvin, "CPE Text Surveys Affiliated Charitable, Lobbying, and Political Organizations," *Journal of Taxation of Exempt Organizations,* vol. 11, no. 4, January/February 2000, p. 177, and Rosemary Fei and Gregory Colvin, "How to Set up and Maintain an Action Fund Affiliated with a Charity," *Taxation of Exempts*, Vol. 15, No. 4, January/February, 2004.

[23] IRC §168(j)(9), the so-called tax-exempt entity leasing rules lengthened depreciable lives for certain properties.

ment is inherently incompatible with being operated exclusively for charitable purposes."[24]

By 1980, the IRS relaxed its prohibition and agreed that an exempt organization could serve as a general partner if, and only if, the venture is one that serves its charitable purposes. Each case is to be carefully scrutinized and the facts and circumstances considered in detail to evaluate the purposes served by the venture. First and foremost, the underlying exempt purposes of the EO are considered. Building ventures have been condoned when they attract and keep qualified physicians at a charity hospital.[25] Acquisition of new equipment necessary to serve the community with home health care, made possible with investor funds, has also been condoned.[26]

Not only must exempt purposes be primarily served, but the exempt organization must not bear unreasonable risk to its financial condition. Insulating the exempt partner's assets from venture liabilities is equally important. Among the facts that provide such insulation are the following:

- Contractual limitation of liability[27]
- Right of first refusal or option to purchase on dissolution or sale granted to the EO[28]
- Limitation or ceiling on returns to limited partners[29]
- Presence of other general partners or managers with responsibility to serve the limited partners[30]
- Organizational control exercised by the exempt partner and attention paid to the charitable mission carried on by the partnership[31]
- Methods for calculating profit sharing, asset purchases, and cost reimbursements designed to protect the EO's interests

The first factor is of primary concern in protecting the exempt organization's assets. The organizational test for continued charitable exemption requires that the assets be dedicated to charitable purposes and that earnings be similarly used. Consequently, liabilities associated with any joint venture must be identifiable and limited, and must not pose a threat to the organization's underlying assets. Such protection can be achieved with insurance coverage, with indemnity agreements specifying the extent of exposure, or by the nature of the activities. For example, a student dormitory building project has less inherent risk than a nuclear fission research laboratory and may provide lower exposure to an exempt general partner.

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[24] Gen. Coun. Memo. 36293 (May 30, 1975).
[25] Priv. Ltr. Rul. 8940039.
[26] Priv. Ltr. Rul. 8943063.
[27] Gen. Coun. Memo. 39546 (August 27, 1986).
[28] Priv. Ltr. Rul. 8344099.
[29] Priv. Ltr. Ruls. 8940039, 8417054, and 8344099; *Plumstead Theatre Society, Inc. v. Commissioner,* 675 F.2d 244 (9th Cir. 1982), aff'g. 74 T.C. 1324 (1980).
[30] Gen. Coun. Memo. 39005 (June 29, 1983).
[31] Priv. Ltr. Ruls. 9122061, 9122062, 2122070, 9021050; see also Section 4.2(b) regarding a low-income housing project, Housing Pioneers, Inc., failure to qualify for exemption.

The second and third factors ensure that the limited partners do not reap unreasonable compensation or gain at the expense of the EO. Conversely, the exempt organization taking the risk of serving as general partner should be appropriately rewarded with the greater share of the return. Another method of protecting the EO's interest is to allow the charity to repurchase the venture asset or to specifically limit the profits.[32] The discussion regarding management contracts and compensation levels has more examples of fair compensation.[33]

The fourth factor mitigates the fiduciary responsibility problem. An important IRS objection to exempt general partners is the conflict between their responsibilities to create gain for the limited partners and to serve their exempt constituents. In some cases, the exempt organization requires a dual general partner to actually manage the venture to suitably limit its role.

The last two factors were used by the IRS in approving the reorganization of a resonance imaging center established by an exempt hospital group's for-profit corporate subsidiary, partly with its own funds and partly with funds furnished by limited partner physicians. All financial arrangements between the parties were at fair market value, and profits and losses were to be allocated in relation to the investments made and risks assumed. Mutually binding termination and buyout agreements were in place to protect the charitable interests from undue risk of loss.

Two new forms of organization, limited liability companies (LLCs) and limited liability partnerships (LLPs), add another dimension to this issue. Such entities are to be judged by the same criteria used to judge partnership arrangements.[34]

(b) Joint Ventures

In 1983, Medicare changed its cost-based reimbursement system for inpatient hospital services to fixed, per case, prospective payments. Cost recoupment became dependent on the number of patients served, and hospitals began to adopt policies to enhance patient population. Consequently, the emphasis shifted to admissions and physician referrals. To give tangible encouragement to the doctors, hospitals designed incentive profit-sharing arrangements based on patient revenue. As long as the total compensation to the doctor is reasonable, incentive compensation is not necessarily prohibited.

One version of such plans attracted IRS attention—joint ventures to operate certain departments were set up between the hospitals and the physicians. Both the exempt hospital and the doctors invested funds. The transferability of interests for the doctor partners was restricted; in some situations, there was a mandatory repurchase agreement. Basically, the patients would still be served in the same manner, with the hospital retaining the equipment, overhead, and so on. The net revenue stream, discounted to present value, from the department was sold to the venture up front, sometimes with and sometimes without, investment by the doctors.

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[32] Suitable terms under which a laboratory venture operated can be found in G.C.M. 37852

[33] See Section 22.5.

[34] Comments of Jay Rotz, IRS National Exempt Organization Office, about Priv. Ltr. Rul. 9517029, May 19, 1995, ABA meeting of the Exempt Organization Section.

The IRS initially approved such ventures.[35] In December 1991,[36] it reversed its position in a memorandum that reviewed three net revenue stream ventures and found that the exempt status of the hospital ventures should be revoked. The revenue-sharing plans represent two problems: excessive compensation and per se inurement resulting from assignment of the hospital's assets to individuals who essentially control it. The IRS found very little community or public benefit resulting from the doctor ventures; no new resources, treatment modalities, enhanced patient care, or cost savings resulted.[37] In another situation, however, prohibited private inurement or benefit was found not to result. The permissible joint venture was formed by a for-profit hospital and an exempt supporting organization to operate an acute care facility. The following tests were applied to find that the proposed venture would not jeopardize the exempt partner's status:[38]

The *relatedness* criterion requires that the activity of the venture further the organization's exempt purposes. The venture is related when patients benefit from the more medically sophisticated state-of-the-art systems and services not otherwise available in their region. Lives would be saved for the exempt partner's patients now able to use the trauma center.

The *financial benefit* criterion was used to measure whether the venture terms adequately protected the exempt organization's financial interest. The agreement required equal sharing of capital contributions, profit and losses, distributions, and assumption of liabilities and use of fair market value to determine amounts. The assets of the exempt and its affiliates were not placed at risk to benefit the for-profit partner. The transactions were to take place at fair market value.

The *conflict-of-interest* criterion evaluates whether the venture terms allowed the exempt to operate in furtherance of its organizational objectives. Management of the partnership was by consensus, with each partner placing three members on the controlling board. The exempt had the right to negotiate directly with managed care providers, and the for-profit partner had no control over the exempt.

Hospitals participating in similar joint ventures were given the opportunity to undo the relationships without losing exempt status. Such entities were given until September 1, 1992, to enter into closing agreements with the IRS.[39] The factors just enumerated were incorporated into the IRS hospital audit guide.[40]

Another tool for analyzing the impact of participation in an activity operated as a partnership, or limited liability company treated as a partnership, is the aggregate theory. This theory assumes that the activity of the partnership is attributable to those of the partners, despite the fact that the activity is operated by a separate entity. When there is a possibility the activity will be aggregated, or attributed to an exempt organization, it may be prudent to form a corporation to conduct the venture. An "entity theory" applies to treat the corporate activity

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[35] Priv. Ltr. Rul. 8820093; revocation discussed in Priv. Ltr. Ruls. 9231047 and 8942099.

[36] Gen. Coun. Memo. 39862.

[37] October 1992 remarks of T.J. Sullivan of the National Health Lawyers Association Conference in Washington, D.C.

[38] Gen. Coun. Memo. 39862.

[39] Announcement 92-70, 1992-19 IRB.

[40] *Exempt Organizations Examination Guidelines Handbook,* 333 (IRM 7(10)69-38).

as separate from that of its shareholders. Gain on sale of stock acquired by an exempt organization without acquisition indebtedness[41] is not taxed. Gain on the sale of a partnership interest was said to be taxable to an exempt partner using the aggregate theory because it was deemed to have sold the underlying indebted assets of the partnership.[42]

(c) Continuing Evolution of Standards

Between 1992 and 1997, the health-care industry evolved so fast that many alliances were formed between tax-exempt and for-profit health-care providers without prior IRS approval. Although private rulings were issued on such joint operating agreements, no precedential guidance was issued. In March 1998, Rev. Rul. 98-15 was issued to provide guidance on joint ventures between exempt organizations and for-profit entities.[43] The ruling compares and contrasts two scenarios—one acceptable and the other causing loss of exempt status. The question remains the same: Does the venture provide private inurement to the for-profit investors?

The ruling contained two significant factors not included in the criterion outlined previously. In the acceptable scenario, the exempt organization controlled the LLC. The organization appointed three of the directors; the for-profit appointed two. The nonexempt venturer had 50-50 control. The documents in the acceptable venture explicitly placed a duty on the governing board to operate the hospital in a manner that furthered a charitable purpose. Documents of the venture failing to qualify as tax exempt placed no such constraint upon the operation nor in management contracts it entered into with other for-profits. In 1999, the Tax Court sustained the IRS's position that a tax-exempt partner should control the venture to ensure its operation for charitable purposes.[44] Commentators lament this strict construction and suggest that acceptable joint venture arrangements can be fashioned to contain provisions to safeguard the tax-exempt organization's charitable interests short of absolute control.[45]

Many alliances between tax-exempt and for-profit organizations are formed with terms and conditions that fail to qualify under the strict requirements outlined here. Between 1998 and 2003, organizations and their professional advisors encouraged the IRS to issue additional guidance on joint ventures. The IRS continuing education materials each year contain discussion of the controversies outlined in Section 4.6. Readers should look for new developments on the issue promised in the IRS Implementing Guidelines for 2004.

For any proposed venture, the factors listed at the beginning of the subsection, particularly the level of control the exempt partner exercises, are alive and well and should still be used to evaluate the possible consequence of a tax-exempt

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[41] Discussed in Section 21.12.

[42] Tech. Adv. Memo. 9651001.

[43] 1998-12 I.R.B. 6, facts outlined in Section 4.6(b).

[44] *Redlands Surgical Services v. Commissioner,* 113 T.C. No. 3 (July 1999), aff'd. 9th Cir. No. 99-71253 (March 2001); as more fully discussed in Section 4.6.

[45] Phil Royalty and Donna Steele Flynn, "Not-For-Profit/For-Profit Joint Ventures: A White Paper," *The Exempt Organization Tax Review,* vol. 25, no. 1, July 1999, pp. 37–48.

organization's alliances with for-profit organizations. "Day-to-day decision making on monetary matters"—who hires and fires and decides how to spend money—should rest in the hands of the exempt venture partner.[46]

(d) Trouble-Free Relationships

A joint venture with another exempt organization of the same §501 category, to own and operate exempt function assets or to sponsor a charitable program, poses no threat to either organization's status. A trouble-free example might have three museums buying a Georgia O'Keeffe painting, each receiving an undivided one-third interest. The costs are shared equally, and each museum exhibits the work one-third of each year. This joint ownership is established to reduce the funds expended by each museum and to enable them to reduce their storage requirements, and thus serves an exempt purpose.

What if the venture borrows money from a private individual to buy the painting? Assume that the loan is to be paid back over a four-year period, as fund-raising permits. Interest on the debt is paid at the prevailing prime rate. If the loan is unpaid at the end of four years, the painting can be foreclosed by the lender in return for any principal payments made against the loan, adjusted for any increase in value as determined by an independent outside appraiser. Since (1) purchasing and exhibiting artwork advances the educational purposes of the museums, (2) their underlying endowments are not used to purchase the painting (i.e., limited liability), and (3) the museums reap any increase in the value of the artwork, this venture involving a private investor should not pose a threat to their exempt status.

Another arrangement is possible when an exempt organization needs to expand. Assume that it needs to acquire a building to provide additional space. After meetings with major donors, it is clear that funds cannot be raised entirely through donations. Some of the donors, however, offer to build the facility and lease it back to the organization. If the building serves exempt purposes and the four aforementioned factors are present, a tenant-landlord relationship is permissible.[47]

(e) Unrelated Business Income Aspect

Formation of a partnership does not shelter an exempt organization from classification of an activity as an unrelated business. The activity of the partnership is considered those of its partners. The income earned by a partnership, limited liability company, or similar venture passes directly through to the partners, retaining its same character. The partnership itself pays no tax but submits Form 1065, reporting each partner's distributive share of profits or losses. The exempt organization partner then reports its share of profits or losses directly on its own Form 990 or 990-T and pays an applicable tax directly.

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[46] Comment of Marcus Owens, then head of the IRS EO Group, at the American Bar Association Tax Section's Exempt Organizations Committee in Washington, D.C., April 1999.

[47] The private inurement rules discussed in Chapter 20 should be reviewed in evaluating the terms of such a relationship.

One must also determine whether the business activities of the partnership will be attributed to the exempt organization, and, if so, will the exempt status of the organization be jeopardized because of the activity? The primary purpose of the exempt organization cannot be to participate in the venture. The IRS applied a "more than incidental" test in private rulings. When no more than 15 percent of its computerized database users would be nonexempt users, an organization qualified for exemption.[48]

22.3 CREATION OF A FOR-PROFIT CORPORATE SUBSIDIARY

A customary motivation for forming a for-profit corporate subsidiary, instead of a partnership, is to segregate the tax aspects of unrelated business activities and to avoid the liability problems inherent in the partnership form of organization. Typically, the subsidiary is formed to conduct a business: to commercially develop patents resulting from research, to operate a restaurant and ski lodge on investment property being held for future expansion, or to establish a computer facility open to the public for example. When such a corporation is formed without outside investors, the more flexible profit/loss-sharing ratios available to a partnership are not needed. In a circumstance where the activity is related to the organization's mission, it might be appropriate to form a limited liability company treated as a disregarded entity.[49]

(a) Maintaining Separate Corporate Identity

Attribution of the subsidiary's activities back to its exempt parent might defeat the purpose for its formation. Thus, it is important to structure the subsidiary to ensure its separate corporate identity. If the exempt organization owns less than 100 percent of the stock,[50] the outside owners provide the separateness. When the exempt organization owns all of the stock, proof of independence includes a separate board of directors and officers and independent management of daily affairs.[51] Actual evidence of separate operation should be maintained, such as board meetings, operating budgets, and financial reports. The fact that the parent corporation retains control over significant corporate actions, such as dissolution, does not constitute interference with the subsidiary's day-to-day affairs.[52]

The makeup of the board of directors can be evidence of the subsidiary's independent operation. While there is technically no requirement for it, independent and nonemployee members of the board are noted as a positive factor. A hotel-operating corporation established by a historic village foundation was ruled to be autonomous and "operated at arms' length" partly because of the outsiders sitting on the board of directors.[53] A for-profit subsidiary in a hospital con-

[48] Priv. Ltr. Ruls. 200325004, 200218037, and 8636079; see also Section 21.3.
[49] See Section 1.7(d).
[50] For unrelated business income tax purposes, under 50 percent is desirable, as discussed in Section 21.10(e).
[51] Gen. Coun. Memos. 39326 and 39598.
[52] Priv. Ltr. Rul. 8909029.
[53] Priv. Ltr. Rul. 8952076.

glomerate group was also found to be valid because of its independent board.[54] Two private rulings, one attributed to the American Association of Retired Persons[55] (AARP) and another involving the creation of a for-profit subsidiary to operate an Internet portal, enhanced the list of factors that indicate the subsidiary is indeed a separate entity, the operation of which does not jeopardize the tax-exempt parent. Regarding governance of the subsidiary, it is desirable that most of the following characteristics be present:

- The majority of the subsidiary's board members are not officers or directors of the nonprofit parent.
- The subsidiary's board is its sole governing and policymaking body.
- The subsidiary's officers and employees are responsible for daily activities.
- The subsidiary's board holds regular meetings (in one ruling, three times a year).
- The subsidiary's board was composed of five persons.
- The subsidiary kept complete and accurate records of its meetings.

The subsidiary must be established for a valid business purpose to avoid its being considered merely a guise to allow the exempt organization to conduct excess business or other impermissible activity. The subsidiary should not be merely an arm, an agency, or an integral part of the parent.[56] The creation of a subsidiary by a business league to "isolate into one single taxable entity" all of its unrelated activities was condoned.[57]

The facts and circumstances are important to prove the separateness of an exempt organization and its subsidiary when customers are referred by the nonprofit to the for-profit. Exempt organizations involved in such relationships will be well served by studying the complex and extensive rules found in IRC §482, Allocation of Income and Deductions among Taxpayers. The IRS is empowered by the section to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among" two or more organizations owned or controlled directly or indirectly by the same interests. The regulations contain 12 different factors that may indicate a basis for reallocations.[58]

(b) Subsidiary Pays Its Own Income Tax

As a separate taxpayer, the subsidiary files its own Form 1120 and pays its own income tax. Dividends are therefore paid to the exempt parent with after-tax profits. To avoid circumvention of this rule, payments to a controlled parent (owning 50 percent or more of the stock) in the form of rent, interest, or royalty

[54] Priv. Ltr. Rul. 9046045.
[55] Priv. Ltr. Ruls. 199938041 and 200225046.
[56] Gen. Coun. Memo. 33912.
[57] Priv. Ltr. Rul. 9119060; see also Priv. Ltr. Rul. 9305026.
[58] Outlined in Section 20.1(b).

are taxed to the parent.[59] In other words, tax on unrelated business income cannot be escaped by paying it back to an exempt parent as a deductible expense. Additionally, transfer of assets upon sale or liquidation from the taxable subsidiary to the exempt parent may be taxable.[60] As a for-profit business entity, the corporate subsidiary will also be subject to local and state taxes.

(c) Sharing Facilities and/or Employees

Combining exempt organizations of more than one category of §501(c), private foundations, and/or nonexempt organizations into sharing arrangements for office space, employees, group insurance, project management, or a variety of other operating necessities may be permissible. There is no absolute prohibition as long as the following conditions are met:

- The activity (rental of office space, hiring of employees, etc.) serves an exempt purpose of the organization.
- The organization reaps cost savings by combining with others in securing the shared items or services.
- Documentation is maintained to evidence each organization's allocable portion of each expenditure. This may be done through
  - Time sheets
  - Space utilization
  - Asset cost (e.g., "We buy the copier, you buy the phones.")
  - Automobile and travel logs
- The arrangement does not allow unfair advantage to any of the parties, unless such advantage inures to the 501(c)(3)s involved.
- The exempt organization assumes no risk of loss on behalf of the other organization(s).
- For private foundations, the organization pays its share directly to the outside vendors and carefully structures the arrangement to adhere to the self-dealing rules.[61]

The first of the preceding conditions is of primary importance in evaluating a sharing relationship between an EO and either another EO or a nonexempt organization. The primary motivation for the expenditure of the organization's funds must always be to serve its own exempt purposes, not those of another. The proof is often easy, however. Space in which to operate the exempt organization is necessary. Why not accept the use of space in a major contributor's building? Significant equipment not owned by the organization may be made available at little or no cost; a lease and/or a deposit may not be required. Often, the rent is below market value because it is space not otherwise rentable at the time, although payment of full fair market value is not prohibited.

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[59] IRC §512(b)(13); discussed in Section 21.10(e).
[60] Reg. 1.337(d); see Section 21.10(e).
[61] See Section 14.7.

Another common arrangement is the sharing of employees. If a new charity needs only a part-time secretary, it may engage the available time of an associated organization's employee. As long as the compensation paid to such workers is fairly allocated among the organizations for whom each person performs services, there again is no reason why staff cannot be shared.[62] Evidence of the time actually devoted to each organization must be maintained as a basis for allocating salary and associated costs.

Combining related organization employees into one group for health insurance has been specifically sanctioned by the IRS.[63] In a hospital conglomerate group, the (c)(3) charitable hospital, its (c)(3) supporting, its fund-raising arm, and two for-profit subsidiaries (a health equipment rental company and an administrative services provider) combined their employees into a self-funded, self-insured major medical plan. The inclusion of the subsidiary employees increased the number of plan participants and resulted in decreased cost of insurance, spreading the risk of loss over more participants. The per-participant cost for all entities was the same. The IRS found that providing employee benefits was consistent with the hospital's exempt purposes. It also noted that the insurance trust was separate from all of the organizations. Presumably, this fact was important because the §501(c)(3)s were not assuming any unforeseen risks on behalf of the for-profits.

(d) Individual or Outside Shareholders

For a variety of reasons, an exempt organization's for-profit subsidiary may issue or sell shares to others. An employee stock option plan may be desirable to offer incentive compensation to employees.[64] Investment capital may be raised by selling shares, or the corporation may be formed as a joint venture with others. Such relationships serve the economic or business purposes of the subsidiary; the question is whether the exempt purposes of the nonprofit shareholder are served by it. Selling shares to investors and issuing incentive shares to employees serves the purposes of the exempt as long as the shares are sold and issued at their fair market value.[65] The presence of outside ownership may be useful to prove that the subsidiary has separate corporate identity. The IRS astutely pointed out that this issue should be judged in view of the reasonableness of the executive compensation and whether the prices being paid for the shares are at fair market value.[66]

22.4 ACTIVE BUSINESS RELATIONSHIPS

Partly due to limited access to investment capital and limited ability to compete for qualified permanent personnel, an exempt organization may wish to engage

[62] Priv. Ltr. Rul. 8944017.

[63] Priv. Ltr. Rul. 9025089. Priv. Ltr. Rul. 9242039 reaches the same result.

[64] Discussed in Section 20.2(c).

[65] Priv. Ltr. Rul. 9242038.

[66] Priv. Ltr. Rul. 9530009; in Priv. Ltr. Rul. 200225046, the reasonableness test was satisfied by the opinion of an outside consultant. Additionally, issuance of the shares to the tax-exempt parent's key employees was also approved, subject to the same reasonableness standard.

an outside professional, either an individual or a company, to manage a project, facility, or other activity. The issues involved in consideration of such a relationship with a for-profit company are similar to the partnership/subsidiary issues.

(a) Criteria for Approval

The exempt organization must satisfy itself that two important criteria exist before entering into such a relationship. The issues of primary concern are as follows:

1. Are exempt purposes served by the relationship? Can the EO more effectively promote its mission by engaging the commercial manager to set up and administer the new facility?
2. Is the compensation reasonable? Are terms equal to similar commercial arrangements? Is there other evidence of private inurement in the relationship?

Proof that exempt purposes are served could include a broad range of factors. The ability to secure, on a part-time basis, the medical staff, development personnel, and insurance claims staff necessary to operate a proposed health-care facility, at an estimated cost savings equal to one-half of the organization's reserves, and allowing the facility to obtain licensing and begin serving the public six months earlier than otherwise, are good examples of factors indicating that an arrangement serves the organization's underlying exempt purpose. In the case of a blood bank's joint venture with a commercial laboratory for a plasma fractionation facility, costs were reduced and plasma was more effectively furnished, and thereby the project served the exempt organization's goals.[67]

Particularly if the manager is supervised by representatives of the EO, ensuring adherence to the EO's standard of care for charitable constituents, there is no constraint against an EO operating efficiently and with a high level of expertise and professionalism. A university that lacked the skills to operate a first-rate university press and wanted to avoid the financial risks inherent in publishing purely academic works served its purposes in engaging a commercial publisher. It retained 5 percent of the gross revenues and proprietary rights in the publications.[68] A charitable health-care provider can contract with a for-profit medical group to provide its needed radiology services.[69] A day care center can hire a for-profit center operator.[70]

An educational TV production company was permitted to undertake a project to be financed partly with funding from a commercial network.[71] It was noted that the amount was comparable to the typical investment in a commercial animated series on the network's part. In return, the network received exclusive broadcast rights for one year, renewal rights for four years, a percentage of the revenues from

[67] Priv. Ltr. Rul. 7921018.
[68] Priv. Ltr. Rul. 9036025.
[69] Priv. Ltr. Rul. 9215046.
[70] Priv. Ltr. Rul. 9208028.
[71] Priv. Ltr. Rul. 9350044; see also Rev. Rul. 76-443, 1976-2 C.B. 149.

home video sales, if any, and programming control for purposes of meeting standards and practices required by the broadcasting industry.

The purchase and resale of a beachfront golf course to private developers, subject to a conservation easement, was found to serve the objectives of an organization focused on preserving the environment. The easement retention ensured protection of the natural habitat for fish and wildlife. Benefits to the developers were incidental to the mission-oriented goal accomplished.[72]

(b) Factors to Evaluate Reasonableness

A number of factors can indicate reasonableness of the compensation of a commercial vendor. An excessive amount, however, cannot be paid to secure such services. To test for reasonableness, another series of questions can be asked:

- Are the outside managers or professionals totally independent of the organization? Is the compensation being negotiated at arm's length? Are there interlocking directorates or family relationships? In other words, does the exempt organization retain ultimate authority over the activities being managed?[73]
- Are the terms equivalent to (or more favorable than) similar commercial arrangements? Is the price equal to the fair market value? Were competitive bids or comparable price studies obtained? Were CPAs, economists, appraisers, or others capable of determining the value engaged?
- Does the relationship prevent earnings from accruing to the benefit of the private individuals, or does it provide economic gain to the manager(s) at the expense of the exempt organization's charitable public interests?
- How is the compensation calculated: a fixed fee, percentage of gross or net income, or some other basis?
- Does the contract provide for sufficient funds to the exempt organization to compensate for its allocation of resources, the capital it is investing, and the risks it assumes?
- Is the contract period too long or too short to provide economic benefit to the EO?
- Are services rendered for constituents who are unable to pay? Will the credit policies of the manager recognize the organization's charitable nature and lack of profit motive in conducting the operation?

(c) Net Profit Agreements

A long-standing IRS policy frowns upon net profit agreements. On one hand, maximizing profits ensures efficiency and may provide the funds for the exempt

[72] Priv. Ltr. Rul. 9407005.

[73] *Broadway Theatre League of Lynchburg, Virginia, Inc. v. U.S.*, 293 F.Supp. 346 (W.D.Va. 1968) and *Est. of Hawaii v. Commissioner*, 71 T.C. 1067(1979), aff'd. 647 F.2d 170 (9th Cir. 1981 unpublished).

organization as well as for the manager, which is usually a desirable result. The quality of services rendered to the exempt constituency, however, must not be compromised by the manager's desire to produce profits. The IRS allows net profits-interest contracts if they contain a ceiling, cap, or maximum amount that the for-profit company or individual is to receive. The cap prevents windfall benefit to the managers.[74]

In any arrangement, it is advisable to require by contract that the compensation terms be alterable, if necessary, to retain tax-exempt status, along with self-serving language that the relationship must be conducted in a fashion that serves the exempt constituents of the engaging organization. Regarding pricing, the IRS has required that charitable services must be provided at the least feasible cost.[75] Again, the contract must require the manager to operate the project in a fashion that serves the organizational objectives.[76] If it is determined that the excess benefits are paid in a net profit agreement, penalities called *intermediate sanctions* can be imposed. The care an organization should exercise in entering into such an agreement is evidenced by the fact that (as of October 2003) regulations on the penalties added to the Tax Code in 1996 had not yet been issued.[77]

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[74] Gen. Coun. Memo. 38905.

[75] Rev. Rul. 75-198, 1975-1 C.B. 157.

[76] See Section 22.2 for additional consideration of this subject.

[77] See Section 20.9.

CHAPTER TWENTY-THREE

Electioneering and Lobbying

One possible detriment to achieving §501(c) exempt status is a limitation on an organization's participation in political campaigns and the legislative processes of governments. The amount and extent of the political and legislative activity allowed for any particular type of exempt organization is limited by both the Internal Revenue Code (IRC) of 1986 and the Federal Election Campaign Act (FECA). For organizations exempt under §501(c)(3), there is an absolute prohibition against participation in a political campaign on behalf of a candidate for public office. IRC §4955, added to the Tax Code in 1987, imposes a penalty tax on a (c)(3) organization and its managers who approved of any prohibited political activities.[1] The penalty enables the IRS to punish the organization short of revoking its exempt status when the campaign activity is a minor part of its activities. Private foundations are, in addition, strictly prohibited from conducting either legislative or campaign activity, and penalties for such actions are imposed.[2] A(c)(3) organization that loses its exempt status due to excessive electioneering or lobbying activities cannot thereafter qualify to obtain exemption as a (c)(4) organization.[3]

The regulations pertaining to many types of nonprofits that are exempt under IRC §501, including charities, civic associations, social clubs, cemetery companies, fraternal societies, and others, specifically require that the organization devote itself exclusively to achieving its defined purpose. *Exclusively* for this purpose does not necessarily mean 100 percent. Whether political campaign and legislative activities further the exempt purpose of an organization is a question based upon its particular facts and circumstances.

23.1 ELECTION CAMPAIGN INVOLVEMENT

To understand the morass of rules and regulations that pertain to public policy activities, it is important to distinguish politically oriented activity that constitutes electioneering, or attempts to influence an election, from attempts to influence the decisions of a legislature body, or lobbying activity. Electioneering involves intervention in the electoral process—the election or appointment of someone to public office. Lobbying, or legislative, activity involves attempts to influence those persons once they have been elected or appointed. Both types of activities are commonly referred to as political activity. The specific definition of political campaign activity found in the regulations says that an organization has political activity if it

> . . . participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. The term candidate for public office means an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, state, or local.[4]

Efforts to create a new party or to stop a candidate's nomination certainly are treated as influencing the choice of candidates for public office, as well might be an effort to impeach someone in office. Those officials who occupy public office must be identified. Public office includes any position that is filled by a vote of the people at the federal, state, or local level. It must also be determined whether an appointment is, in fact, an election under the applicable local election laws. The answers vary from state to state. Not only is the person nominated by a political party a candidate, but also someone being drafted to run for office.

The absolute ban on spending money for political purposes by a charitable organization exempt under IRC §501(c)(3) is contained in both the organizational

[1] See Section 23.2(d).
[2] IRC §4945, discussed in Chapter 17.
[3] IRC §504.
[4] Reg. §1.501(c)(3)-1(c)(3)(iii).

and the operational tests for qualification.[5] Most other nonprofit organizations exempt from income tax are not similarly constrained from participating in political campaigns. All Form 990–filing exempt organizations are asked to submit the amount of their "political expenditures, direct or indirect." If any amount is reported, they are further directed to file Form 1120-POL. A (c)(3) organization answering this question with an amount is also penalized.[6] The 990 instructions define a political expenditure as one intended to influence the selection, nomination, election, or appointment of anyone to a federal, state, or local public office, or office in a political organization, or the election of presidential or vice presidential electors. The IRS notes it does not matter whether the attempt succeeds. An expenditure for this purpose includes a payment, distribution, loan, advance, deposit, gift of money, or anything of value. It also includes a contract, promise, or agreement to make an expenditure, whether or not it is legally enforceable.

(a) Permissible Campaign Involvement

The amount of permitted campaign involvement for certain categories of exempt organization is different. The basic guidelines are as follows:

- *501(c)(3):* An organization qualified as charitable is absolutely prohibited from participation or intervention in a political election campaign.[7]
- *501(c)(4):* A civic welfare organization must be *exclusively* devoted to social welfare (not a 100 percent test), and the regulations simply state that political activity does not promote social welfare. There is not a complete ban. The IRS has ruled that supporting candidates cannot be a primary purpose of a civic organization, but can be a secondary one.[8]
- *501(c)(5):* A labor organization will not "be disqualified merely because it engages in some political activity."[9] Traditionally, unions have been significantly involved in political elections.
- *501(c)(6):* A business league's permissible political activity is not mentioned in the code, regulations, or handbook. Rulings indicate that, like (c)(5)s, business leagues may have political involvement as long as they devote their primary attention and resources to their exempt purposes.[10]

When political involvement is permitted, the percentage of the annual budget expended on the campaign may be quantified to prove whether the activity is not substantial. Any amount of money in excess of $100 spent on political activity by a §501(c) organization—to the extent of its investment income—is taxed under IRC §527(f) with the filing of Form 1120-POL.[11] Federal election laws also make it unlawful for a corporation to make a contribution or expenditure in a federal election. To avoid both tax on an organizational level and controversy

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[5] See Chapter 2.

[6] IRC §4955, discussed in Section 23.2(d); such expenditures are reported and penalty calculated on Form 4720.

[7] Reg. §1.501(c)(3)-1(b)(3) and (c)(3)(iii); *Exempt Organizations Handbook* (IRM 7751) §370.

[8] Rev. Rul. 81-95, 1981-1 C.B. 332; watch for promised IRS guidance on this issue.

[9] *Exempt Organizations Handbook* (IRM 7751), §544.

[10] Rev. Rul. 61-177, 1961-2 C.B. 117.

[11] See Section 23.3 for definitions, tax rates, and other guidance regarding paying this tax.

regarding the extent of political activity, a §501(c)(4), (5), or (6) or other exempt (but not a (c)(3)) can create a separate political action committee (PAC). Exhibit 23.1 illustrates these important rules.

The IRS has said it is possible for a relationship to exist between a (c)(3) organization and a political organization, as long as the political one is not established by, administered by, solicited for, or funded by the charitable organization.[12] For example, a political organization could rent space from the charity at its fair market value or purchase its materials.[13]

(b) Impact on Exempt Status

The absolute ban against participation by (c)(3) organizations in political campaigns has given way to refinements and distinctions among actual campaign intervention, voter education, and other political activities. Organizations have unexpectedly lost exempt status for involvement in school board, water commission, and other local campaigns. The IRS found that an organization would lose its exempt status due to involvement in political party precinct elections.[14] An analysis of relevant local election laws indicated to the IRS that the precinct committee position possessed the characteristics of public office. The organization's counsel had advised it that the positions were administrative, not political. In another important distinction, appointed members of the federal judicial system are not considered to be elected public officials. Attempts to influence the U.S. Senate confirmation of a nominee to the Supreme Court do not constitute intervention in a political campaign, but, instead, constitute influencing, or attempting to influence, legislation.[15]

The Fund for the Study of Economic Growth and Tax Reform is a good example to study. The fund was formed to conduct a project eventually known as the Kemp Commission. It was established by then Senate Majority Leader Bob Dole and House Speaker Newt Gingrich, who appointed members of the Republican Party as its officials. It studied ideas for reforms to create economic opportunity through tax reduction. Though it conducted no overt lobbying, its creators and members were widely quoted making statements such as, "Tax reform is, of course, political (partisan)." The court found it to be an action organization that conferred substantial private benefit to the Republican Party and did not qualify for tax exemption under §501(c)(3).[16] The IRS found, and the courts agreed, that

[12] IRS EO Continuing Professional Education Technical Instruction Program for 1985; see also discussion entitled "Issue Advocacy, Social Movements, and Y2K Election Issues," presented at the American Bar Association Tax Section Exempt Organizations Committee meeting in Washington, D.C., on May 12, 2000, reprinted in *The Exempt Organizations Tax Review*, vol. 2, no.1, July 2000.

[13] Such revenue could be classed as unrelated business income; see Chapter 21.

[14] Gen. Coun. Memo. 39811.

[15] The IRS announced that confirmation lobbying may be treated as a political expenditure for purposes of the IRC §527 tax unless the effort is handled in a segregated fund. IRS Announcement 88-114, 1988-37IRB 26.

[16] *Fund for Economic Growth and Tax Reform v. Commissioner*, 81 AFTR 2d ¶98,472 (D.C. Dist.Ct.1998).

EXHIBIT 23.1

Permissible PAC Involvement

	(c)(3)	(c)(4)	(c)(5) or (6)
Establish the PAC	No*	Yes	Yes
Pay administrative costs	No**	Yes	Yes
Control PAC's board	No*	Yes	Yes
Allow PAC to solicit funds from exempt's members	No**	Yes	Yes
Use exempt's name (ABC Charity's PAC)	No***	Yes	Yes
Use exempt's mailing list	If PAC pays	Yes	Yes

* PAC cannot be created by the (c)(3) itself. Individual board or staff members can establish the PAC if they act in their individual capacities. The PAC essentially must be a "nonconnected committee" in relation to the (c)(3).

** Election laws, which are generally more lenient than the tax rules, permit a charitable organization to create a PAC, pay for the PAC's overhead and administration, and raise funds from the exempt organization's constituents.

*** Use of name implies support or endorsement of the campaign and also represents a donation of the (c)(3)'s intangible asset—its goodwill. State and federal laws conversely require the PAC name to include the name of its corporate, union, or other organizational sponsor.

its purposes could be accomplished only by adoption of a flat tax.[17] The court did not address the parallel issue advanced by the IRS that its activities constituted political intervention on behalf of the Republican Party.

In another political intervention case, a church's exempt status was revoked. Running full-page advertisements in the *Washington Times* and *USA Today* four days prior to the presidential election cost The Church at Pierce Creek its tax-exempt status. The ad said, "Christian Beware. Do not put the economy ahead of the Ten Commandments," and went on to criticize then-governor Clinton for his stand on a number of issues.[18]

Though Branch Ministries' tax exemption was revoked, the court said it might regain its exempt status simply by refraining from intervention in political campaigns.[19] It was also noted that the church was entitled to create a §501(c)(4) organization that could in turn create a political action committee to conduct the very same political activity that caused loss of its exemption.

The Christian Coalition's application for qualification as a §501(c)(4) civic welfare organization failed to receive IRS approval after 10 years of discussions. The coalition withdrew Form 1024 and chose to operate as a business corporation with freedom to endorse political candidates and make financial contributions to support candidates of its choice. Although the facts are not known, it is likely the coalition's voter guides and other election-related activities represented too high

[17] *Fund for the Study of Economic Growth and Tax Reform v. IRS*, 82 AFTR 2d ¶98-5581 (D.C. Appeals Court 1998).

[18] *Branch Ministries, Inc., et al. v. Commissioner*, 83 AFTR 2d ¶99-569 (D.C. Dist. Ct. 1999), aff'd. D.C. Cir. May 2000.

[19] The church actually did not need to seek IRS recognition as long as it could meet the 14-point test discussed in Section 3.2(b).

a portion of its overall activities.[20] Some commentators question why the organization had sought (c)(4) status in the first place rather than classification as a political organization.[21]

Legislative proposals to expand permissible election activity have been discussed. Frances R. Hill[22] examined the validity of the prohibition against certain exempt organizations' participation in elections and concluded the current system prohibiting campaign involvement for charities should continue. The primary flaw she suggests needs to be corrected is the creation of §501(c)(3) organizations by wealthy donors and political parties to further their platforms. The article looks extensively at the four different forms of political money—hard money, soft money, softer money, and independent expenditures—and concludes that "the deconstruction of political money has brought with it the fragmentation of political structures."

(c) Actions of Organizational Officials

Questions may arise when organizational officials are involved in electioneering activity. Endorsements of political candidates or other electioneering statements by an organization's officials in their individual capacities should not be attributed to the nonprofit organization itself. However, such endorsements will be imputed to the organization and can endanger exempt status of a (c)(3) organization, if the organization directly or indirectly authorized or ratified their actions.[23] It is very important for such persons to clearly disclose the actions as their own. IRS Publication 1828, Tax Guide for Churches and Religious Organizations,[24] contains the following examples to define the fine line between speaking on behalf of the organization and one's self.

- *Example 1*: A candidate, with their permission, publishes an advertisement that lists five prominent ministers who endorse him. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The fact that the names of the churches are listed is deemed not to be political intervention because the candidate paid for the ad and the endorsement is made by the minister in a personal capacity.
- *Example 2*: A church monthly bulletin contains a column entitled "My View," containing comments of the minister. During the month before an election, the column contains the words "It is my personal opinion that Candidate X should be elected." Because the words appear in an official church publication, the comments are impermissible political intervention.

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[20] C. Wright, "Christian Coalition Fails to Obtain Tax-Exempt Status," *The Exempt Organization Tax Review*, vol. 25, no. 1, July 1999, p. 9.

[21] See Section 23.3 for definitions and requirements under IRC §527.

[22] Ms. Hill is a professor at the University of Miami School of Law and coauthor of *Taxation of Exempt Organizations* (Warren, Gorham, & Lamont, 2002). The article was entitled "Softer Money: Exempt Organizations and Campaign Finance," based on a study supported by the American Tax Policy Institute and published in *The Exempt Organization Tax Review*, vol. 32, no. 1, April 2001, pp. 27–53.

[23] Gen. Coun. Memo. 33912.

[24] Released in July 2002 as part of IRS emphasis on plain language guidance under the direction of Roberta Zarin, Director, Customer Education and Outreach.

- *Example 3*: Three weeks before an election, a well-known minister speaks at a press conference at Candidate V's headquarters and publicly states he should be reelected. The minister does not say he is speaking on his own behalf, and his endorsement is reported on the front page of the local newspaper. Since the endorsement was not made at a church function and did not appear in a church publication or otherwise use church assets, his actions do not constitute campaign intervention attributable to the church.
- *Example 4*: A minister preached on voting in an upcoming election. When he says, "It is important that you all do your duty in the election and vote for Candidate X," he is intervening in the election during an official church service.

23.2 VOTER EDUCATION VERSUS CANDIDATE PROMOTION

Activities focused on public policy issues, such as who should be allowed to emit chemicals suspected of depleting the ozone layer and the public policy makers who get to decide the issues, may also be classified as prohibited political activity. Express advocacy in favor of the election or defeat of a particular candidate is unquestionably intervention in a political campaign. Discussion or comment on an elected official's actions may or may not, however, be treated as express advocacy. When a tax-exempt organization addresses issues involving election of persons to public office, its activity is governed not only by federal tax rules but also by the Federal Election Commission (FEC) rules. The FEC took the lead in 1999 by issuing an advisory opinion sanctioning "D-Net," a project of two (c)(3) organizations online and a nonpartisan information service on political candidates. Organizations using the Internet to disseminate voter information should seek advisors familiar with the FEC rules.[25]

(a) Voter Education

Voter registration drives do not constitute intervention in a political campaign when conducted in a nonpartisan manner.[26] Drives that are targeted at members of a particular party, or that are in support of or against named candidates, are likely to be classified as political activity.[27] Partisan language on materials handed out to potential voter registrants that implies endorsement of a political persuasion can cause the campaign to be classified as political activity. Private foundations may finance multistate voter registration drives under very specific rules.[28]

Factors that the IRS suggests will show that an organization's advocacy communications serve no electoral purpose, and therefore are voter education, include[29]

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[25] IRS Advisory Opinion 99-25.

[26] Chapter N, "Election Year Issues," *IRS CPE Text*, 1992, p. 427; standards applied by the Federal Election Commission can be applied to determine nonpartisanship; see Section 5.1.

[27] *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

[28] See Section 17.2.

[29] Kindell and Reilly, "Election Year Blues," *IRS CPE Text*, 2002.

- A preexisting commitment to promoting awareness of the issue outside the election context
- Statements by officers or directors (including board resolutions) indicating the organization's nonelectoral purpose and intent not to endorse or oppose any particular candidate or party
- Records of research and analysis by the organization consistent with its asserted nonelectoral purpose—for example, studies showing a low level of public awareness of an issue, thus indicating a need for public education on the topic
- Where appropriate, explicit and credible public disclaimers of any endorsement (positive or negative) of any candidate during the conduct of an activity
- Limitation of the content of the communication to the substance of the issue, avoiding any characterization of persons who favor or oppose the organization's position on the issue

The IRS retroactively revoked an ostensible educational organization's exemption due to a variety of political activity. It found the following language to be incriminating:

> Conservatives in the U.S. Senate and House of Representatives are giving us economic prosperity, reducing government intervention and instilling pride in America and our way of life. All of this will be lost if Conservatives like you and me do not head off the huge voter registration drive by the liberals.

The ruling contains a broad analysis of voter education and campaign workshops, and is mandatory reading for any organization participating in similar activities.[30] If an organization publishes materials that discuss and, particularly, criticize governmental policies and officials, it is important that the information be nonpartisan. The following questions should be asked in evaluating whether the analysis constitutes participation in a campaign:

- Can the discussions be tied to a candidate running for election?
- Are the voting records of government officials reported, compared, or criticized?
- Is there an attempt to affect voter acceptance or rejection of a candidate?
- Are materials distributed only to the membership or to the public?
- Do the evaluations relate directly to the organization's exempt purpose?
- Are the reports based on scientific studies or research?
- Do the comments include "full and fair exposition" of all facts about the issue, or will they be construed as biased opinion?[31]

The following criteria are used to judge whether publication of congressional representatives' voting records on selected issues constitutes political action[32]:

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[30] Priv. Ltr. Rul. 91170011; see also Rev. Rul. 2004-6 supra note 151.

[31] See Section 5.1.

[32] Rev. Rul. 80-282, 1980-2 C.B. 154, amplifying Rev. Rul. 78-248, 1978-1 C.B. 154; Gen. Coun. Memo. 38444.

- Voting records of all incumbents are presented.
- Candidates for reelection are not identified.
- No comment is made on any individual's qualification for public office.
- No candidate is endorsed or rejected.
- No comparison of the candidates is made.
- A statement is included pointing out the inherent limitations of judging a candidate on the basis of selected votes, and stating the need to consider such unrecorded matters as performance on subcommittees and constituent service.
- The organization does not distribute the report widely, but distributes it only to members.
- Publication is not targeted toward particular areas in which elections are occurring, nor timed to concur with elections.

The IRS provided the following standards used to judge permissible a particular voter education project.[33] Charity M sponsored candidate forums and issued candidate evaluations. A scientifically selected group of voters chosen to reflect the demographics of the state evaluated the candidates, picked those eligible to debate, and issued their personal opinions on the candidates. The ruling outlined the following factors to consider whether the method used to choose candidates invited to debate was aimed at voter education or at influencing the campaign:

- Whether inviting all legally qualified candidates is impractical
- Whether the organization adopted reasonable, objective criteria for determining which candidates to invite
- Whether criteria were applied consistently and to all candidates
- Whether all candidates are treated fairly and impartially without promoting or advancing a particular candidate over another

The holding of press conferences and publication of the opinions of its voter groups were considered impermissible. The content of an organization's fundraising letters was deemed to violate the prohibition against political intervention and resulted in taxable expenditures under §4955. Letters encouraged readers to imagine certain political candidates as defeated and said that "together we can change the shape of American politics."[34]

(b) Examples of Permissible Political Education

The IRS has issued the following guidance regarding campaign involvement that is considered educational:

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[33] Priv. Ltr. Rul. 9635003 in reliance on Rev. Rul. 86-95, 1986-2 C.B. 73.
[34] Priv. Ltr. Rul. 9609007.

- Public television and radio stations can provide airtime to political candidates as long as it does so equally to candidates.[35] The Federal Communications Commission also has procedures for neutral debates or forums that allow candidates to explain their views to the public.
- Publishing a newsletter containing voting records and grading the votes according to the organization's ideals, without any expression of endorsement for or opposition to the candidates themselves, is educational. The newsletter's circulation must be directed at constituents and must not be aimed at affecting an election.[36]
- Disseminating information concerning campaign practices, furnishing teaching aids to political science and civic teachers, and publicizing proposed codes of fair campaign practices without soliciting the signing or endorsement of the code by candidates all constitute qualified political education.[37]
- As a part of a political science program, a university can require students to participate in political campaigns for candidates of their choice.[38]
- A student newspaper's coverage of political campaigns and student editorial opinions about such elections are not considered to be university political activity.[39]
- An exempt organization established for the purpose of collecting and collating campaign speeches, interviews, and other materials of a candidate for a historically important elective office for donation to a university or public library was engaged in permissible political education.[40]

The IRS took a surprisingly lenient position regarding peace promotions run during the 1984 presidential campaign.[41] Advertisements urged readers: "Think about it when you vote this November," and "Choose leaders who will lead us away from a nuclear nightmare, not into one." The IRS "reluctantly concluded that the organization probably did not intervene in the campaign," apparently because the ads did not overtly support a candidate (even though everyone knew that the peace candidate was Democratic nominee Walter Mondale).

Use of an organization's Web site to disseminate voter education, including links to political party sites, is permissible under rules applicable to print and broadcast media—the motivation for posting the information and its educational nature is determinative. Does the information displayed attempt to educate voters or to influence their vote? The standards for compiling a vote scorecard outlined in Rev. Rul. 80-282[42] can be studied for a partial answer. The ruling discusses a scorecard that reflected votes on a broad range of issues, was released after the

[35] Rev. Rul. 74-574, 1974-2 C.B. 160.
[36] Gen. Coun. Memo. 38444.
[37] Rev. Rul. 76-456, 1976-2 C.B. 151.
[38] Rev. Rul. 72-512, 1972-2 C.B. 246.
[39] Rev. Rul. 72-513, 1972-2 C.B. 246.
[40] Rev. Rul. 79-321, 1970-1 C.B. 129.
[41] Tech. Adv. Memo. 8936002.
[42] See text for footnote 32.

close of a legislative session, was not timed to coincide with elections, and was distributed only to the organization's members. Posting the same scorecard on a Web site accessible only by members with a password certainly should be permissible. The unanswered question is why should access to the information be limited only to members? What is the rationale for that position? One IRS official said: "The principle the writers of Rev. Rul. 80-282 tried to enunciate is that the timing and distribution of the scorecard and the fact that the members of Congress it rated were not limited to those running for reelection indicated that the scorecard was not aimed at elections."[43]

(c) Impermissible Political Activity

The IRS found political activity that constituted impermissible electioneering for a (c)(3) organization in the following examples:

- Attempting to improve a public school system by campaigning on behalf of candidates for election to the school board is political campaign activity.[44]
- A bar association that published a rating system for elective judicial candidates was also deemed to be intervening in a political campaign.[45]
- Assisting a governor-elect was held to be involvement in a political campaign. The organization interviewed and screened applicants for appointive offices and prepared the legislative message to reflect a party's platform and budget.[46]

A school to train political campaign workers was found to operate for partisan purposes because all of its graduates were affiliated with the Republican Party, operated for substantial nonexempt (political) purpose, and provided private inurement to the party.[47]

(d) Penalty Tax on (c)(3) Political Expenditures

Until 1987, the only tool the IRS had to punish a (c)(3) organization for participation in an election campaign was revocation of its exempt status. While making it clear such activity continued to be absolutely prohibited, Congress believed a penalty was a suitable sanction for minor violations of the rule prohibiting political involvement. The primary targets were ostensibly educational organizations established to promote the campaign of particular candidates and/or controlled

[43] Comments of John F. Reilly, project leader in the Exempt Organizations Division, at the May 12, 2000, meeting of the Exempt Organizations Committee of the American Bar Association in Washington, D.C., when asked if the IRS would approve of D-Net, a joint project between the League of Women Voters' Education Fund and the Center for Government Studies—both (c)(3) organizations—that was approved by the Federal Election Commission in 1996.

[44] Rev. Rul. 67-71, 1967-1 C.B. 125.

[45] *The Bar Association of the City of New York v. Commissioner*, 88-2 USTC ¶9535 (2nd Cir. 1988), rev'g. 89 T.C. 599, 609-610 (1987).

[46] Rev. Rul. 74-117, 1974-1 C.B. 128.

[47] *American Campaign Academy vs. U.S.*, 92 T.C. 1053 (1989).

by candidates. To avoid loss of its exempt status, the organization is expected to correct a political expenditure by recovering the money to the extent possible and adopting safeguards to prevent future political expenditures.[48] If the violation is due to reasonable cause and not to willful neglect, the tax may be abated.[49]

A first-tier excise tax of at least 10 percent (up to 100 percent) is imposed on political campaign expenditures of a (c)(3) organization, in addition to a 2-1/2 percent tax on the manager(s) involved in the activity.[50] Managers subject to the tax are those officers, directors, trustees, or other individuals with authority or responsibility to make the expenditure in question.[51] The initial tax is not imposed if the organization and its managers can prove that the political expenditure was not willful and flagrant, that the funds have been recovered, and that the organization has established safeguards to prevent future political expenditures.[52] The tax is reported on Form 4720. Managers who, after full disclosure of relevant facts, relied upon the advice of counsel in approving the activity, are not ordinarily considered as willfully approving of the expenditure.[53]

The §4955 regulations[54] emphasize the continued and concurrent application of the absolute prohibition against a §501(c)(3) organization's participation in an election campaign. Political expenditures subject to the tax are defined by reference to activity that causes a (c)(3) organization to be classified as an action organization due to campaign intervention.[55]

Any expenditures by a candidate-controlled organization are treated as political expenses. Such an exempt organization is one both formed primarily to and that is availed of (operated) primarily to promote a candidate or prospective candidate.[56] An organization is effectively controlled when a candidate or prospective candidate has a continuing, substantial involvement in the organization's day-to-day operations. Mere affiliation with the candidate or acquaintance of the candidate with the organization's directors and officers is not sufficient. Conducting research, study, or other educational activities regarding issues of concern to the candidate likewise do not make the organization candidate-controlled. The fact that the research is made available only to the candidate, however, indicates that the purpose of the organization is to promote that person, as will payment of his or her traveling expenses.[57] The code specifically lists expenses paid for travel, speeches, polling, surveys, advertising, and similar expenses of a person in office or running for office as examples of such political expenditures.[58]

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[48] H.Rep. No. 100-391, 100th Cong., 1st Sess. 1623-1627 (1987).
[49] IRC §§4961–4963.
[50] IRC §4955(a)(1).
[51] IRC §4955(f)(2); Reg. §53.4955-1(b)(2).
[52] Reg. §53.4955-1(b)(2); see Section 16.2(c) for discussion of these standards.
[53] Reg. §53.4955-1(b)(7).
[54] See also regulations for §§6852 and 7409.
[55] Reg. §53.4955-1(c)(1) cross-references to Reg. §1.501(c)(3)-1(c)(3)(iii).
[56] IRC §4955(d)(2).
[57] After the House Ethics Committee hearings on Newt Gingrich, his organization was examined by the IRS and found to be educational.
[58] IRC §4955(d); Reg. §53.4955-1(c)(2)(ii).

23.3 TAX ON POLITICAL EXPENDITURES

Until 1968, the tax status of political organizations and political expenditures was uncertain, except for the absolute prohibition against participation by a charitable (c)(3) organization. In that year, the IRS announced that the investment income of a political organization was to be taxed by filing a fiduciary income tax return on Form 1041. Political contributions received would continue to be untaxed as gifts, but would not be deductible for the giver.

Effective in 1975, IRC §527, entitled Political Organizations, took its place among the code sections governing nonprofit organizations; Form 1120-POL was introduced for reporting the taxable income. Essentially, an organization that spends money for political (called *exempt function*) purposes is taxed on its investment income.[59] A political organization with no more than $100 of investment income need not file. The tax applies to nonprofits devoted solely to political activity and to §501(c) exempt organizations that expend their own funds for political purposes. The definitions and constraints are found both in IRC §527 and in the Federal Election Campaign Act.

Any amount paid in connection with or for participation in or intervention in any political campaign on behalf of (or in opposition to) any candidate for public office is not deductible for income tax purposes.[60] Further, the gain inherent in any property donated to a political organization is considered a taxable sale of the property.[61] Such gifts, however, are not taxable for gift tax purposes.[62] Section 501(c)(4), (5), (6), and (7) organizations involved in campaign activities must be mindful of this complex of income tax rules (in addition to the campaign finance laws). Creation of a political organization to conduct such activities may be appropriate if the amounts to be solicited in support of the activity exceed gift tax exclusion amounts.

Effective July 1, 2000, certain political organizations that intend to be tax exempt must notify the IRS no later than 24 hours from their creation and provide specific information evidencing their qualification for exemption.[63] The recognition will be effective only prospectively from the date of notification. The filings must be made both electronically and physically. Except for charitable organizations, all other categories of nonprofit organizations qualify without making notification.[64] Failure to file notification in a timely fashion results in the political organization being treated as a normal taxpayer subject to income tax on all of its income. The exempt function expenses, or disbursements for political campaign activity, would not be deductible,[65] and income is taxed at the

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[59] To the extent of the political expenditures.

[60] IRC §162(e)(1)(B).

[61] IRC §84.

[62] IRC §2501(a)(5).

[63] See new Section 23.3(d).

[64] Despite the presumed exemption, a non-§501(c)(3) organization that files Form 990 with the Ogden Service Center is asked to submit Form 1024, as discussed in Chapter 18. Such recognition is granted retroactively to date of formation (if activity and organizational documents were suitable for exemption from inception); the new political organization only receives recognition prospectively from the notice date.

[65] IRC §162(e) denies a deduction for political campaign expenses.

highest current corporate rate (currently 35 percent). So a committee that fails to make notice will not only have to pay tax on net investment income but also on its campaign contributions.[66]

(a) What Is a Political Organization?

The Internal Revenue Code defines a *political organization* as[67]

> A party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function.

The *exempt function* for a political organization (PAC) is

> The function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of presidential or vice-presidential electors, whether or not such individual or electors are selected, nominated, or appointed.

A qualifying campaign group can function in favor of or in opposition to candidate(s).

The definition of an *office* for this purpose is:

> Based upon the facts and circumstances applying the principles consistent with the private foundation rules, which essentially mean the candidate must seek to become a government official.[68]

Elected federal executive or legislative officials, appointed federal executive or judicial officers, elected or appointed officials in any branch of the government in any state that receive pay in excess of $20,000, and certain other government workers are listed in the regulations. The distinction between a public officeholder and a public employee is based on whether the individual's activities include performing independent policymaking functions.[69]

A political organization's exempt activities focus on what the regulations refer to as the *selection process*. Any amounts spent to advance an individual's campaign for public office or to defeat another, including unannounced candidates, is treated as exempt function. The following examples of qualifying expenditures are provided in the regulations:[70]

- A prospective candidate's expenses to travel throughout a state to rally support for an intended race
- Voice and speech lessons taken to improve the candidate's skills
- An officeholder and candidate for reelection's purchase of tickets to attend a testimonial dinner

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66 Discussed in Section 23.3(b).
67 IRC §527(e)(2).
68 Reg. §1.527-2(d).
69 Reg. §53.4946-1(g).
70 Reg. §1.527-2(c).

- Between-election activities to train staff members, draft party rules, implement party reform proposals, and sponsor a party convention
- Conducting seminars and conferences intended to influence persons who attend to support individuals to public office whose political philosophy is in harmony with the organization
- Payment of debts and other expenses, such as reasonable cash awards to campaign workers,[71] incurred after the conclusion of a candidate's campaign

Exempt function expenditures include the cost of conducting public opinion polls and voter canvasses,[72] election night parties,[73] direct mail campaigns,[74] and grassroots lobbying focusing on opinions of candidates on selected issues targeted in a geographic area and timed to coincide with an election.[75] Indirect expenses that are necessary to support the directly related activities of the political organization are also treated as exempt function expenditures. The legal and accounting costs associated with the program; fund-raising expenses, such as polling; focus groups; acquisition and enhancement of voter lists to target distribution of materials; and telephone calls to voters to determine their attitudes on issues for targeting purposes are considered indirect exempt function costs.

A political organization need not engage exclusively in activities that are exempt functions, although campaign-related activities should be primary. The distinction between exempt and nonexempt expenses is important because any funds spent for nonexempt functions lose their tax-free status. Exempt function expenses include anything that supports candidates seeking election.[76] The activities need not focus on any one particular candidate or race, though they must involve the selection process.[77] Examples of expenses treated as nonexempt function (because they do not involve choosing a candidate) include[78]

- Nonpartisan educational programs.[79]
- An incumbent's office expenses
- Nonpartisan voter registration or get-out-the-vote efforts
- Committee to support an initiative or referendum measure

Permissible expenditures by political campaign committees may include certain lobbying efforts, although such expenses may be treated as nonexempt function expenses. In a situation where a candidate was named and pictured on the flyer of a statewide referendum on fiscal responsibility, the expense was an exempt function because the candidate was identified as the leader of the effort. Even though the candidate had not yet filed to run for governor, the ruling found that

[71] Rev. Rul. 87-119, 1987-2 C.B. 151.
[72] Rev. Rul. 79-13, 1979-1 C.B. 208.
[73] Rev. Rul. 87-119, 1987-2 C.B. 151.
[74] Rev. Rul. 79-13, 1979-1 C.B. 208.
[75] Priv. Ltr. Rul. 9724005.
[76] Chapter N, "Election Year Issues," *IRS CPE Text*, 1992, p. 448.
[77] Rev. Ruls. 79-12 and 79-13, 1979-1 C.B. 208.
[78] Reg. §1.527-2(a)(3).
[79] Priv. Ltr. Rul. 9808037.

the piece was packaged to identify him as a potential candidate for governor, and was therefore an exempt function expense for the campaign committee.[80]

A political organization must be organized for the primary purpose of carrying on the exempt function of influencing the selection, nomination, or election of public officeholders. Formal articles of incorporation, association, or trust are acceptable, but are not required. "Consideration is given to statements of the members as to how they intend to operate the political organization primarily to carry on one or more exempt functions."[81] An officeholder's newsletter fund is taxed as a political organization, but funds cannot be expended for campaign, personal, or any other purposes. Special distinctions, affecting tax rates and permissible activities, apply to segregated funds and to the principal campaign committee of any office seeker. The regulations and legislative history should be studied for those types of organizations.

(b) Taxable Income

Both a §501(c) exempt organization and a political organization that spends any amount directly for a political expenditure as defined by IRC §527 is taxed on such expenditure or its net investment income (interest, dividends, rents, royalties, and capital gains), whichever is lower. A grant from one exempt organization to another exempt organization to be used specifically for political purposes will also be taxed to the granting exempt organization. Both organizations exempt under §501(c) that make political expenditures and political organizations file Form 1120-POL whereby a tax is essentially imposed on investment income. The highest corporate income tax rate applies as a rule.[82] A designated principal campaign committee of a congressional candidate is taxed at the appropriate corporate rate for its level of income.[83]

Taxable income is taxed at the highest corporate tax rate (currently 35 percent) and is defined to include the following[84]:

- Gross income for the year (not including exempt function)
- Less deductions directly connected to production of such income, excluding exempt function expenses, but including an allocable part of dual-use facilities or personnel
- Less a modification (reduction) of $100 (except for newsletter funds).

No net operating loss or dividend-received deductions are allowed.[85] Only those exempt function revenues expended for exempt functions are excluded from taxable income. Exempt function revenues for this purpose consist solely of the following:

- Contributions of money or other property

[80] Priv. Ltr. Rul. 913008; see also Priv. Ltr. Ruls. 9516006, 9409003, and 9320002 and Topic O, "Election Year Issues," *IRS CPE Text*, 1995 (for fiscal year 1996).

[81] Reg. §1.527-2(a)(2).

[82] IRC §527(b)(1).

[83] IRC §527(h).

[84] IRC §527(c)(1).

[85] IRC §527(c)(2), Reg. §1.527-4.

- Membership dues or assessments
- Proceeds of fund-raising or entertainment events, including sales of political campaign materials not sold in a commercial manner[86]
- Raffle income received in connection with a political event[87]

A transfer of political contributions or dues collected by an organization to a segregated fund is not treated as a political expenditure.[88] The interest an organization earns by temporarily keeping PAC funds in a general interest-bearing checking account was found to provide administrative efficiency and did not constitute prohibited investment of the funds by the organization.[89] For ease of collection, a professional association and a labor union issued billings for normal dues and PAC contributions together to its membership. Moneys were collected continually throughout the year. For the organizations' convenience, PAC funds were periodically transferred (in one case twice a month and in the other once a month) to the PAC. The "negligible" amount of interest that was earned by the exempt organization on funds it temporarily held was not taxed.

(c) Segregated Funds (Political Action Committees)

A segregated fund, usually called a political action committee (PAC), can be created by a §501(c) exempt organization, or by any individual, that plans to engage in political activity and wishes to ensure proper identification of the funds subject to tax.[90] A segregated fund is treated as a political organization for tax purposes. Thus, when funds are collected from the members or employees of the exempt organization and are paid directly into the segregated fund, the conduit exempt organization is able to prove that it has not made a political expenditure on its own behalf.

An exempt organization's indirect expenses, such as its accounting department, attributable to the creation of and management of a PAC are not necessarily treated as political expenditures. The regulations direct that they are exempt function expense "to the extent provided" in a reserved, or unissued, section. Thus, while mentioning the issue, the regulations provide no guidance. The legislative history indicates Congress intended that indirect expense not be allowed as deductions against taxable investment income.[91] A prudent organization can ask its PAC to reimburse its expense of soliciting and paying over the funds to avoid this issue.[92]

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[86] Reg. §1.527-3(a).

[87] December 1, 1999, IRS Memorandum; tickets sold over a period of time by phone with no evidence the raffle is connected to an event would produce taxable revenue.

[88] Reg. §1.527-6(e)(3).

[89] Priv. Ltr. Ruls. 9105001 and 9105002.

[90] Reg. §1.527-2(b)(1).

[91] S. Rep. No. 93-1374, 93d Cong., 2d Sess. 29 (1974).

[92] For more discussion of political organizations, see the 23-page article entitled "Political Organizations," by Milton Cerney and Frances R. Hill, published in *The Exempt Organization Tax Review*, vol. 13, no. 4, April 1996; see also Kip Dellinger, "Federal Taxation of the Political Process," *The Tax Advisor*, February 1999, pp. 106–113.

The Federal Election Campaign Act specifically permits labor unions and business leagues to spend money for internal communications involving support of particular candidates with members and their families, but not with the general public. They are also permitted to establish, administer, and solicit contributions for PACs.

(d) Public Disclosure Reports: Forms 8871 and 8872

After a flurry of demands for disclosure of campaign contributors, effective July 1, 2000, Congress imposed enhanced reporting rules on certain §527 organizations. The rules are designed to require reporting for those so-called soft money organizations not previously required to report donor and expenditure information to either the IRS or the FEC. Such PACs receive unlimited donations used to support political parties or legislation rather than individual candidates. The rules also apply to congressional leadership PACs that are not required to make FEC reports. Tax legislation in October 2002 and subsequent Revenue Rule 2003-49, issued in January 2003, removed some of the filing requirements for state and local political organizations. The following chart lists the current filing requirements and the exceptions to them.

Form	When Filed	Exceptions to Filing Requirement
8871	Within 24 hours of establishment or within 30 days of any material change, including termination	• Organization that does not seek tax-exempt status • Political committee required to report to the FEC • Campaign committee of state and local candidates • State or local committee of political parties • Organizations that reasonably expect annual gross receipts to always be less than $25,000
8872	At organization's option Quarterly/semiannually or monthly, on same basis for entire calendar year	• Any organization excepted from the Form 8871 filing requirement • Qualified state or local political organization (QSLPO). See definition below.
1120-POL	Due the 15th day of the 3rd month after the close of the year	• Political organization with no taxable income after taking the $100 specific deduction
990 OR 990EZ	Due the 15th day of the 5th month after the close of the tax year	• Any organization excepted from the Form 8871 filing requirement (see above) • Caucus or association of state and local officials

A *qualified state or local political organization* is a political organization that meets the following criteria:

- All of its political activities relate solely to state or local public office (or office in a state or local political organization).
- It is subject to state law that requires it to report (and it does report) to a state agency information about contributions and expenditures that is

similar to the information that the organization would otherwise be required to report to the IRS.

- The state agency and the organization make the reports publicly available.
- No federal candidate or officeholder controls it or materially participates in its direction, solicits contributions for it, or directs any of its disbursements.

Form 8871 must be filed electronically within 24 hours of formation and contain the following[93]:

- The name and both the physical mailing and electronic addresses of the organization
- The purpose of the organization
- The names and addresses of its officers, highly compensated employees, contact person, custodian of the records, and members of the board of directors
- The names and addresses of, and relationships to, any related entities

An amended Form 8871 must be filed within 30 days if the organization has a material change in any of the information reported on the original Form 8871. The IRS must make information submitted by political organizations available at its offices and on the Internet no later than five business days after it receives the notice. The political organization itself must make Form 8871 available for public inspection under the same rules applicable to Form 990 and 1023 availability.[94]

The term *highly compensated employees*, for this purpose, means the five employees (other than officers or directors) who are expected to have the highest annual compensation in excess of $50,000. Cash and noncash payments, whether paid currently or deferred, are included. For an organization existing when the rules were imposed, the 12-month period began on July 1, 2000.

The term *related entity* is defined to include one of two types:

1. The related entity and the organization have significant common purposes and substantial common members or substantial common direction or control, whether direct or indirect.
2. The related entity or the organization owns, directly or indirectly through one or more entities, at least 50 percent capital or profits interest in the other.

Form 8872 is to be filed annually each year and also periodically during a year.[95] In nonelection years (any odd-numbered year), the political organization may choose to file monthly or semiannually. The monthly filer must submit the form electronically by the twentieth day after the close of each month, except the December report can be included in the annual report due January 31. Semiannual filers submit a report for the first half of the year by July 31 and for the second half by Jan-

[93] Is completed directly on the IRS Web site at www.irs.gov/bus_info/eo/pol-file.html and physically mailed to Internal Revenue Service Center, Ogden, UT 84201.
[94] Described in Section 27.2(a).
[95] Is also completed directly on the IRS Web site, see note 93.

uary 31. Why organizations were given the choice of a more frequent monthly filing option is not stated. Certainly the monthly reports would be shorter and would inspire regular attention to record keeping.

During election years (any even-numbered year), reports may be filed monthly or quarterly. In addition, a preelection report is filed 12 days before the election and a post–general election report 30 days after the election. An election is defined for this purpose to include a general, special, primary, or runoff election for a federal office, a convention or caucus of a political party with authority to nominate a candidate for federal office, a primary election to select delegates to a national nominating convention, or a primary election to express a preference for the nomination of an individual for election to the office of president. Local and state elections are not included for filing requirement purposes.

For donors giving $200 or more and for vendors paid $500 or more during the calendar year, the name, address, and, if an individual, the occupation and employer of any person must be reported. Independent expenditures made without the authorization, suggestion, or request of a candidate need not be reported. Form 8872 is filed with the Ogden Service Center. The penalty for failure to file is a tax equal to the amount not disclosed multiplied by the highest corporate tax rate. Form 8872 must be made available for public inspection.[96] Also, organizations that are tax exempt under §§501(c)(4), (5), and (6) are now required to disclose all assistance they provide to §527 organizations. Those that spend $10,000 or more on political expenditures must also disclose the names of contributors of $1,000 or more.

23.4 LOBBYING ACTIVITY OF §501(c)(3) ORGANIZATIONS

Carrying on propaganda or otherwise attempting to influence legislation, commonly referred to as lobbying activity, cannot be a substantial part of the activities of a §501(c)(3) organization. A (c)(3) organization must devote itself exclusively to one or more charitable objectives and primarily conduct activities that advance its mission.[97] An organization that conducts excessive lobbying whose purposes can be accomplished only through the passage of legislation is considered an action organization that cannot qualify for (c)(3) exempt status.[98] For (c)(3) exempt organizations, different rules apply for organizations falling in the following categories:

- Nonelecting organizations measuring permissible lobbying under the ill-defined substantial part test, as described later in Section 24.3(a). The rules outlined in Section 24.3(b) through (e) do not apply.
- Exempt organizations that elect under §501(h) to measure their permissible lobbying activity using the expenditure test
- Private foundations that can conduct absolutely no lobbying[99]

[96] IRC §6104(b) and (d); the rules are the same as those for Form 990 discussed in Section 27.2.
[97] Reg. §1.501(c)(3)-1(c)(3).
[98] See Section 2.2(g).
[99] See Chapter 17.

The definitions and numerical tests applied to measure the permissible amount of lobbying under the first two tests listed are very different. The rules applied for an organization electing to calculate its permissible lobbying expenditures under §501(h) are very clear and specific. The range of public affairs activities excluded from the definition of lobbying for an electing organization is much broader. It is for that reason that the Exempt Organizations Committee of the American Bar Association and the Internal Revenue Service recommend that charities involved in public affairs file a §501(h) election. Steve Miller, Manager of IRS Exempt Organizations, confirmed that charities that elect the optional sliding-scale approach do not run an increased risk of audit.[100] The IRS 1996 training manual contains a 107-page chapter, entitled "Lobbying Issues," that is a must-read for any tax-exempt organization planning to conduct any more than an inconsequential amount of lobbying activity.[101]

(a) Rules for Nonelecting Exempt Organizations

A charitable organization exempt under §501(c)(3) choosing not to make a §501(h) election to govern its lobbying activity is subject to the basic exemption criteria requiring that no substantial part of its activities consist of attempting to influence legislation by propaganda or otherwise. The definitions and other rules applicable to electing organizations cannot be used to identify and define its lobbying activity. A (c)(3) organization is regarded as attempting to influence legislation if it

- Contacts or urges the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation
- Advocates the adoption or rejection of particular legislation[102]

Legislation is defined generally for (c)(3) purposes to include "actions by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure."[103] Administrative bodies are not considered as governing for this purpose.[104] After the Senate hearings on Robert Bork's nomination to the Supreme Court, the IRS issued notice that the U.S. Senate's action of advising and consenting to a judicial appointment is legislative activity.[105] In interpreting the congressional mandate to limit exempt organization lobbying, the IRS has adopted the following clarifying rules:

- The desirability of the legislation (such as protecting the environment, animals, or children, or other issues unquestionably serving the public good) does not influence an activities classification as lobbying.[106]

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[100] June 26, 2000, letter to Charity Lobbying in the Public Interest, a project of Independent Sector.
[101] Topic P, *IRS CPE Text*, 1997.
[102] Reg. §1.501(c)(3)-1(b)(3).
[103] Reg. §1.501(c)(3)-1(b)(3)(i); note that this definition is the same as contained in Reg. §56.4911-(2)(d)(1)(I) applicable to charities electing §501(h).
[104] Topic P, "Lobbying Issues," *IRS CPE Text*, 1997, p. 271.
[105] IRS Notice 88-76. 1988-2 C.B. 392.
[106] Rev. Rul. 67-293, 1967-2 C.B. 185.

- Legislation can include zoning matters if the decisions are under the jurisdiction of a local council or legislative representatives.[107] (Actions by executive, judicial, or administrative bodies are specifically not legislative matters under §4911.)[108]
- Legislation includes proposals for making laws in other countries.[109] Acts undertaken by the organization itself, not by its members or constituents as individuals, are constrained.[110]

Supporting activities of an educational nature—study, research, preparation of papers—that concern subjects of legislation may be considered as lobbying expenditures.[111] The time spent discussing public issues, formulating and agreeing upon positions, and studying them preparatory to adopting a position must be taken into account as legislative activity. Information gathered prior to the moment the exempt organization makes a legislative appeal can be associated with the later act of lobbying, although there is no specific test for making the connection.[112] Nonpartisan analysis, study, or research of matters pertaining to legislation will not constitute attempts to influence legislation if reports of the work do not advocate the adoption or rejection of the legislation.[113] Since nonpartisan analysis is oriented to issues, a fair exposition of both sides of the issue is expected to be presented.[114] It is these vague standards that the §501(h) election seeks to replace, as explained in the following section.

The amount of lobbying expenditures includes directly attributable expenses, and a portion of an organization's operating budget is allocable to the lobbying activity, making a detailed allocation of organizational costs necessary. Nonelecting exempt organizations should carefully study the IRS recommendations for making such allocations to calculate costs associated with lobbying activity.[115] In several instances, the IRS suggests such an organization be guided by provisions governing those organizations that elect §501(h).

There is no precise mathematical test for the substantial part test. One court opined that using "a percentage test to determine whether activities were substantial obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances."[116] Nevertheless, a common measure of substan-

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[107] Rev. Rul. 67-6, 1967-1 C.B. 135 regarding a historical restoration association.
[108] Reg. §56.4911-2(d)(4).
[109] Rev. Rul. 73-440, 1973-2 C.B. 177.
[110] Rev. Rul. 72-513, 1972-2 C.B. 246; Gen. Coun. Memos. 34631 (Oct. 4, 1971) and 39414 (Feb. 29, 1984).
[111] *League of Women Voters v. U.S.*, 180 F. Supp. 379 (Ct.Cl. 1960), cert. denied, 364 U.S. 882 (1960).
[112] *Kuper v. Commissioner*, 332 F.2d 562 (3d Cir. 1964), cert. denied, 379 U.S. 920 (1964).
[113] *Hasall v. U.S.*, 500 F.2d 1133, 1144 (Ct.Cl. 1974, cert. denied), 419 U.S. 1107 (1975); see also Rev. Ruls. 64-195, 1964-2 C.B. 138 and 70-79, 1970-1 C.B. 127.
[114] The IRS applies a methodology standard to determine when information is educational, as discussed in Chapter 5.
[115] Rev. Ruls. 78-111, 78-112, 78-113, and 78-114, 1978-1 C.B. 41, 42, 43, and 44 (the so-called Halloween rulings).
[116] *Christian Echoes National Ministry, Inc*. v. U.S., 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973).

tial is the actual dollars expended by the organization on lobbying efforts. No specific limit is provided, and as little as 5 percent of an organization's budget has been questioned.[117] Moreover, the efforts of volunteers, the amount of research and discussion to formulate a position on a legislative matter, the continuous rather than intermittent attention to the matters, and the whole context in which the activity is conducted may also be considered.[118] In a more precise fashion, only actual dollars spent by the organization are considered for an exempt organization electing to use the expenditure test.

For business expense deduction purposes, goodwill advertising or institutional pieces intended to bring the organization's name before the general public by presenting views on economic, financial, social, or other subjects of a general nature are not lobbying if the material does not directly or indirectly propose, support, or oppose legislation.[119] When the information published has some connection to pending legislation, potentially limited grassroots lobbying may be found.[120]

(b) The §501(h) Election

Congress has enacted specific numerical parameters and definitions within which (c)(3)s can conduct lobbying efforts when the organization makes an election provided in IRC §501(h). The tax-exempt status of an electing organization can be revoked only if the exempt organization normally has expenditures to carry on propaganda, or otherwise attempts to influence legislation, that exceed prescribed limits. It is important to emphasize that these rules apply only to charities electing their application. The regulations under IRC §501(h) and the parallel penalty provision, IRC §4911, total 57 pages and were proposed and reproposed three times over a four-year period before the final version became effective on August 31, 1990. The rules are surprisingly lenient for public charities. Churches and their integrated auxiliaries, private foundations, supporting organizations of business leagues, unions, and civic associations are not permitted to make the election.[121]

The regulations interact with a number of other provisions: regulations under IRC §501 (conversion of a (c)(3) to a (c)(4)); §501(h); §504 (revocation of exempt status due to excessive lobbying); §4911 (excise tax on excessive lobbying); §4945 (nonpartisan analysis by private foundations); §170, §2055, and §2522 (limitations on charitable donations); and §162(e) (nondeductible dues due to lobbying by business and civic leagues and unions). The following material only skims the surface. A comprehensive treatment of the subject can be found in *Charity, Advocacy, and the Law*,[122] a good reference book for any organization conducting more than an insignificant amount of lobbying.

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[117] *Seasongood v. Commissioner*, 227 F.2d 907, 912 (6th Cir. 1955).
[118] *League of Women Voters v. U.S.*, supra note 84. Gen. Coun. Memo. 36148 (Jan. 28, 1975).
[119] Reg. §1.162-29(a)(2).
[120] See Section 23.5(b).
[121] IRC §501(h)(5).
[122] Bruce Hopkins (New York: John Wiley, 1992).

(c) Definition of Lobbying

Lobbying is defined in IRC § 4911 as either one of the following:

- Any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segments thereof
- Any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of specific legislation

The *IRS Handbook,* however, cautions that lobbying is not limited to these definitions. The regulations contain eight pages of examples on direct and grassroots lobbying alone that should be studied. The facts and circumstances of each communication is to be examined.

(d) What Is Legislation?

Legislation is defined to include "action with respect to acts, bills, resolutions, or similar items by the Congress, any state legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar item."[123] Legislative bodies do not include executive, judicial, or administrative bodies such as school boards, housing authorities, sewer and water districts, and zoning boards, whether they are appointive or elective.

Specific legislation, as the name implies, includes both legislation that has already been introduced in a legislative body and a specific legislative proposal that the organization either supports or opposes. A referendum or ballot initiative becomes specific legislation when the petition seeking signatures is first circulated among voters.[124] Before a bill is actually formulated, debate about a subject that may become the subject of legislation is not lobbying.

A similar item, according to examples in the regulations, includes confirmation of a cabinet-level appointee and a Supreme Court nominee.[125] A proposed treaty subject to Senate approval is a legislative matter from the time when treaty negotiations start.[126] Referenda and ballot initiatives are legislative actions in which the members of the general public constitute the legislature, so an attempt to influence a referendum vote is direct lobbying.[127]

(e) What Lobbying Is Not

IRC §4911(d) excludes the following activities from the meaning of the term *influencing legislation*:

- Dissemination of the results of nonpartisan analysis, study, or research

[123] IRC §4911(2); Reg. §56.4911-2(d); essentially the same language applied to nonelecting charities.
[124] Reg. §56.4911-2(d)(1)(ii).
[125] Reg. §56.4911-2(b)(4)(ii)(B), Example (6).
[126] Reg. §56.4911-2(d)(1)(i).
[127] Reg. §56.4911-2(b)(1)(iii); see also Gregory L. Colvin and Lowell Finley, *Seize the Initiative*, (Washington, D.C.: Alliance for Justice, 1996).

- Provision of technical advice or assistance in response to a written request by a governmental body
- Appearances before, or communications to, any legislative body with respect to a possible decision by that body that might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to it (self-defense)
- Communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to them, unless the communications directly encourage the members to influence legislation or urge members to contact nonmembers to influence legislation
- Routine communications with government officials or employees, including the executive branch and agencies[128]

Nonpartisan Analysis. An independent and objective exposition on a particular subject that advocates a viewpoint on legislation is not considered lobbying if it qualifies as nonpartisan analysis, study, or research.[129] Sufficiently fair and full exposition of the pertinent facts on the subject, not merely unsupported opinion, must be communicated to the general public to enable the public to form an independent opinion or conclusion. Preparing a paper on a state issue and sending the study to members of the state legislature when there is no legislation pending is not legislative lobbying.[130]

The information can be communicated in any form, whether visual or auditory: radio, television, public forums, magazines, publications, or newspapers. No direct encouragement to "take action" may be contained in the materials. If the research material is subsequently used for lobbying purposes, the expenses of preparing the research paid within six months of such use is reclassified as a lobbying expense.[131] The regulations contain 11 pages of examples.

Grassroots Lobbying. Contacting the general public (instead of the legislators themselves) is classified as grassroots lobbying.[132] More restrictive limitations apply to this indirect lobbying method, so the distinction between direct and grassroots is important. Grassroots expenditures cannot constitute more than 25 percent of an electing organization's overall lobbying expenditures. The portion of a member's dues attributable to grassroots (and direct) lobbying is not deductible under IRC §162.

This issue has been the focal point of much controversy between the IRS and the exempt community. The regulations somewhat narrowly define grassroots lobbying to include only communications that contain all of the following three elements:

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[128] Reg. §56.4911-2(c).
[129] Reg. §56.4911-2(c)(1).
[130] Reg. §56.4911-2(b)(4), Example (3).
[131] Reg. §56.4911-2(c)(v).
[132] IRC §4911(c)(3); Reg. §56.4911.2(b)(2).

1. It refers to specific legislation (including legislation that has already been introduced in a legislative body and specific legislative proposals that the exempt organization either supports or proposes).
2. It reflects a view on such legislation.
3. It encourages the recipient of the communication to take action with respect to the legislation.[133]

Mass media communication may be classified as lobbying even if it does not meet the three-part definition. When a press release or advertisement sponsored by the exempt organization and taking a position on legislation is published within two weeks before the vote is scheduled, such a publication is considered grassroots lobbying if it either refers to the highly publicized legislation or encourages the public to lobby about the legislation.

A requisite characteristic of a lobbying communication is that it directly urges the public to take action. Taking action is urged directly if any one of the first three elements in the following list is present. The fourth attribute, taken alone, does not constitute a call to action.[134]

1. The communication states that the recipient should contact legislators, their employees, or other governmental representatives who may participate in the formulation of the legislation.
2. The address, telephone number, or similar information facilitating contact is furnished on the notice, letter, or other form of communication.
3. A petition, tear-off postcard, or the like is provided for the recipient to communicate views to the appropriate governmental party.
4. One or more legislators who will vote on the legislation is specifically identified as opposing it or undecided, is the recipient's representative, or is a member of the committee considering the legislation.

Attempts to influence highly publicized legislation, such as paid advertisements placed in mass media (television, radio, billboards, and general-circulation newspapers and magazines) that do not contain one of the take-action elements may still be grassroots lobbying if

- The advertisement is placed within two weeks prior to a vote by a legislative body or a committee (but not a subcommittee).
- The advertisement offers a view on the general subject of the legislation and either refers to the legislation or encourages the public to communicate with legislators on the general subject of the legislation.[135]

The presumption that an advertisement fits these conditions can be rebutted if the organization can show one of the following:

[133] Reg. §56.4911-2(b)(2)(ii).
[134] Reg. §56.4911-2(b)(2)(iii).
[135] Reg. §56.4911-2(b)(5)(ii).

- It regularly publishes such communications without regard to the timing of legislation.
- The timing of the particular advertisement is unrelated to the legislative action. In other words, if the organization can prove that it placed the advertisement without any knowledge that the vote would occur within two weeks, it may escape its classification as grassroots lobbying.

Member communications are governed by additional standards. The member rules were substantially altered each time the proposed regulations were issued (in 1980, 1986, and again in 1988), becoming more lenient with each new version. Under the following specific conditions, information sent to members is not treated as lobbying:

- The communication is directed only at members.
- The communication refers to and reflects a view on specific legislation that is of direct interest to the organization and its members.
- Members are not encouraged to engage in direct lobbying.
- Grassroots lobbying is not encouraged.

Direct lobbying occurs when the third requirement is failed; grassroots lobbying occurs when the fourth one is failed. A member is one who pays dues or makes a contribution of more than a nominal amount, makes a contribution of more than a nominal amount of time, or is one of a limited number of "life or honorary" members. Prospective members are not considered members. A member of one of an affiliated group of organizations is treated as a member of each of the exempt organizations in the group.[136]

23.5 PERMISSIBLE AMOUNTS OF LOBBYING

Nonelecting 501(c)(3)s must prove that their lobbying activities do not represent a substantial part of their activities. The portion is measured largely, though not entirely, by expenditures. Not only is the cost of time expended by paid staff taken into account, but also the value of volunteer board members and others can be considered. For example, an organization that uses its prestige to influence legislation, achieving a high degree of success with a minimal expenditure of money, could be found to conduct excessive lobbying. Regarding the amount of actual expenditures, 5 to 10 percent of an organization's overall budget is generally considered a permissible expenditure level.[137] IRC §4912 places an excise tax on nonelecting 501(c)(3)s and their managers when excessive lobbying causes the exempt organization to lose its exemption. When lobbying activities are insignificant and an exempt organization wishes to avoid the increased record keeping and scrutiny presumed to be caused by a §501(h) election, this nonelective method may be preferable.

[136] Reg. §56.4911-5(f).
[137] Discussed in Section 23.4(a).

(a) Making the Election

A (c)(3) organization that elects to monitor its lobbying expenditures under IRC §501(h) buys a safe harbor and removes the discretionary factors used in the substantial part test. Under this election, the exempt organization agrees to a mathematical limit based upon a percentage of its exempt purpose expenditures (EPEs) to prove that legislative efforts are not substantial. Unless lobbying expenditures exceed 150 percent of the prescribed amounts over a four-year period, exempt status remains intact.[138]

Form 5768 is filed to make the election. It can be filed with Form 1023 or with an annual Form 990. The election is effective until it is revoked and can be voluntarily revoked at any time, effective for the next tax year. A new election is effective for the following year after at least one intervening nonelection year. For example, if a revocation is in effect for 2003, an exempt organization can elect for 2004 anytime between January 1, 2003, and December 31, 2004. Private foundations, churches, and supporting organizations cannot make the election.

(b) Mechanical Test

Overall lobbying expenditures, including direct and grassroots efforts combined, cannot exceed the sum of the following amounts. Grassroots lobbying expenditures (contacting the general public rather than contacting legislators directly) cannot exceed 25 percent of the total lobbying limits, as follows[139]:

- 20 percent of the first $500,000 of the exempt organization's exempt purpose expenditures (EPEs), plus
- 15 percent of the next $500,000 of EPE, plus
- 10 percent of the next $500,000 of EPE, plus
- 5 percent of the rest, up to a maximum total lobbying allowance of $1 million for any one organization

Exempt purpose expenditures[140] include the following:

- Amounts paid to accomplish one or more charitable purposes, including grants paid for charitable projects, program expenses, employee compensation (including deferred), and administrative and general expenses, and depreciation on assets used for exempt purposes
- Lobbying expenditures, including grants to a noncharity earmarked for lobbying
- Amounts paid for nonpartisan analysis, study, or research, and for examination of broad social, economic, and similar problems
- Expenses for responding to requests for technical advice, self-defense efforts, and member nonlobbying communications

[138] IRC §501(h)(2)(B).
[139] IRC 501(h); Reg. §1.501(h)-3(e).
[140] Reg. §56.4911-4.

Exempt purpose expenditures do not include expenses incurred for the production of income, including managing an endowment or other investments and an unrelated business activity. Expenses incurred by a separate fund-raising unit are also excluded.

Affiliated organizations are consolidated for application of the lobbying tests, to prevent the creation of new entities to avoid the spending limits. An exempt organization that is bound under its governing instrument by the decisions of another exempt organization regarding legislative issues is affiliated. Interlocking directorates also create affiliation.[141]

Accounting for lobbying involves identifying expenditures directly connected with specific legislation, as opposed to matters that are subjects of legislation. It is critical to isolate costs of associated research on issues and review of pending legislation until the exempt organization decides to support or oppose the legislation.

Mixed-purpose expenditures involving both direct and grassroots lobbying activities are presumed to be grassroots, except to the extent that the organization can demonstrate a reasonable allocation between the two types of lobbying.[142] Likewise, the expense of publications or communications sent to members or to the public must be allocated among the various elements of lobbying, fund-raising, and education. The portion of telephone, fax, computer, staff, and other costs attributable to lobbying efforts must be documented with time sheets and usage records.

(c) Penalty Tax and Revocation

A 25 percent tax is imposed under IRC §4911(a)(1) on excess lobbying expenses of public charities electing to limit their lobbying expenses by IRC §501(h). The taxable excess is the higher of excessive overall lobbying expenditures (including grassroots) or excessive grassroots lobbying expenses. If an organization's lobbying expenses normally rise above 150 percent of the permissible amounts, exempt status is denied.[143] The calculation year and the three preceding years are combined to arrive at the normal amount. A newly electing organization's status will not be revoked until the end of the base period.

A charitable organization reports the amount of its lobbying expenditures each year on Form 990, Schedule A, page 5. Organizations electing to measure permissible lobbying by applying the "expenditure test" of §501(h) should complete Part VI-A with detailed information for direct and grassroots lobbying. The applicable percentages are applied to total expenditure and the results compared to the actual amounts. If the limits are exceeded, Form 4720 is filed to pay a penalty tax.

An organization using the "substantial part test" to limit its lobbying completes Part VI-B, which presents lobbying expenditures only in generic categories. The form does not indicate whether the amounts were excessive. If the IRS subsequently determines that excessive lobbying occurs, the organization's exempt status is revoked. In such a case, Part H of Form 4720 is completed. A 5 percent

[141] Reg. §56.4911-7; see Priv. Ltr. Rul. 9236028.
[142] Reg. §56.4911-3(a)(2).
[143] IRC §501(h); Reg. §1.501(h)-3.

penalty is imposed on the organization and, possibly, its managers. Independent Sector sells a useful book entitled *Nonprofit Lobbying Guide* that can serve as a useful tool to monitoring satisfaction of these limits on lobbying activity.[144]

(d) Pros and Cons of Election

Although the elective lobbying provisions were expected to eliminate confusion about the consequences of lobbying, the three sets of regulations proposed over the years contain radically different interpretations of the terms. Although there are those who propose that the rules should be unified and those who propose that all (c)(3) organizations elect 501(h),[145] uncertainty exists. Due partly to the confusion, very few organizations have made the election. Accordingly, there is meager guidance on the subject and the pros and cons must be carefully considered. Among the advantages of electing are the following facts.

Advantages of Electing. The advantages of making the election under IRC §501(h) include the following:

- Volunteers' time and influence are not counted; only actual expenditures count.
- The revocation of exemption calculation is based on a four-year average, not on an ongoing annual test.
- Mathematical limits are specific.
- The degree of certainty provided by specific tests applied to electing organizations is preferable to the subjective and untested standards for nonelecting ones. IRC §501(h) allows examining agents to use the definitive rules only for electing organizations, not for nonelecting ones.
- Some practitioners expect the IRS to scrutinize nonelecting organizations.
- The membership communications exclusion does not classify as lobbying the "objective reporting on the contents and status of legislation" to members.
- Record-keeping requirements may be less because volunteer time need not be recorded.

Advantages of Not Electing. The advantages of not making the election under IRC §501(h) include the following:

- Grassroots lobbying limit is not separately limited to a percentage of lobbying expenditures.
- Record-keeping requirements may be less if the organization need not distinguish between direct lobbying and grassroots efforts. However, the information furnished on Form 990 may need to be more detailed.

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[144] The book is available for purchase on the Internet at www.IndependentSector.org.

[145] Independent Sector, in August 1998, announced a campaign entitled Charity Lobbying in the Public Interest. IS says "Charity Lobbying: It's the Right Thing to Do" in informing charitable organizations of the limits within which lobbying efforts can be undertaken.

- Drawing attention to the organization by making the election is thought by some to possibly trigger an IRS audit. The IRS disavows this view, and the author is unaware of such a case.
- Directors and officers can be personally liable for penalties for excess lobbying.
- Affiliated organizations' lobbying activities must be consolidated or combined to measure limitations under the election, but are otherwise measured on a per-entity basis.
- The maximum amount of expenditures for an electing organization is $1 million. For an exempt organization with a $50 million annual budget, for example, the maximum of $1 million equals 2 percent of the budget, a de minimus amount in relation to the 5 to 10 percent considered permissible by some for a nonelecting exempt organization.
- It may be preferable to avoid the uncertainty caused by the multiple proposed regulations and the controversy surrounding the allocation of indirect expenses.

23.6 LOBBYING LIMITS FOR 501(c)(4), (5), (6), AND OTHER EXEMPT ORGANIZATIONS

There is no specific numerical lobbying limit for exempt organizations other than those recognized as tax exempt under §501(c)(3). The facts of each case will determine whether the league is focused on accomplishing its primary exempt purpose when lobbying or political activities are carried on alongside more traditional activities. In some situations, an EO's purposes can be accomplished only through the passage of legislation. For example, a 1961 ruling allowed a business league to spend all of its money on lobbying as long as the legislation was germane to its specific exempt purpose.[146] Member dues deductions are limited under IRC §162. To the extent that dues finance political campaigning, grassroots lobbying, or direct lobbying, they are not deductible. If an association spends a substantial portion of its funds for lobbying, the dues deduction is allowed only for that portion that can be clearly identified as attributable to exempt activities.[147]

Lobbying activities are also restricted by the U.S. Postal Service, which denies second- and third-class mailing permits to nonprofits whose primary purpose is lobbying. Registration of lobbying activities is also required in many states and by federal election laws.

All exempt organizations, except private foundations and title-holding companies, can engage in lobbying or attempts to influence legislation. A business league, civic welfare organization, or labor union that discloses the nondeductible portion of dues attributable to lobbying expenditures to its members[148] may spend an unlimited amount of expenditures on lobbying that accomplish its

[146] Rev. Rul. 61-177, 1961-2 C.B. 117.
[147] Reg. §1.162-20(c)(2)(i).
[148] See Section 6.4.

exempt purposes.[149] When the organization's lobbying efforts involve a discussion of the positions of public officials who are also candidates for public office, the associated expenditures may be treated as political campaign intervention rather than lobbying. If so, the expense constitutes an *exempt function* within the meaning of IRC §527(e)(2) and is taxable.[150] Organizations that make any mention of elected officials in their lobbying communications will benefit by studying the six situations described in Rev. Rul. 2004-6.[151] When the communiqué is issued during an election period and notes that a candidate does or does not support the issues discussed in the advocacy information, the activity is treated as political intervention.

In addition to the tax rules, the Lobbying Disclosure Act of 1995 requires, effective beginning in 1996, certain exempt organizations to register to conduct lobbying activities and subsequently to file semiannual reports.[152] Organizations subject to this registration requirement are those that perform both of the following functions:

- Employ a lobbyist, or one who makes at least two lobbying contacts in a six-month period and devotes at least 20 percent of his or her time to lobbying
- Incur, or expect to incur, lobbying expenditures of $20,000 or more in a six-month period

23.7 ADVOCACY AND NONPARTISAN ANALYSIS

Many nonprofit groups are focused on issues with political overtones that are the subject of legislation and positions taken by seekers of public offices. An organization whose mission can be accomplished only by the passage of legislation is treated as an action organization not qualified for exemption under §501(c)(3). Since part of the rationale for granting tax exemption is that nonprofits relieve the burdens of government by performing socially useful activities, opinions change over the years regarding the types of actions that exempt organizations can properly take. Stopping commercial development in the national forests may or may not be a concern of a particular administration in the White House and may or may not be accomplished only by the passage of legislation. A nationwide boycott campaign against Exxon in response to its oil spill may or may not primarily serve to preserve the environment. A U.S. District Court allowed the exempt status of the Infant Formula Action Coalition, whose only activity is relieving starving children by boycotting Nestlé, a company that manufactures baby formula for sale in underdeveloped countries.[153]

IRS policies may change according to the current political climate. The following subjects may present problems with the determination and field representatives of the IRS:

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[149] "Lobbying Issues," *IRS CPE Text*, 1997.
[150] See section 23.3.
[151] I.R.B. 2004-4, 238.
[152] Form LD-2 due in February and August.
[153] *Infant Formula Action Coalition v. U.S.* (D.D.C. No. 79-0129).

- Issues of race—segregation, immigration
- Issues of sex—sexual preference, discrimination
- Issues of faith—abortion, sun worship
- Economic issues—tax protesters, communists/capitalists
- Survival issues—pollution, nuclear power, no smoking
- Human rights issues—legal representation, refugee centers, freedom of speech, right to life
- Foreign policy issues—weapons treaties, apartheid, war or peace

Pursuing one of these subjects with activities that encourage the passage of legislation can jeopardize exempt status. The regulations describe three different possibilities for classification as an action organization[154]:

1. A (c)(3) that has substantial lobbying
2. A (c)(3) that participates or intervenes in political campaigns
3. A (c)(3) whose primary objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation, and that advocates or campaigns for such objective (as distinguished from engaging in nonpartisan analysis, study, or research and making the results available to the general public)

The most troublesome provision is the third action category. An exempt organization involved in controversial subjects must be able to pass the following hurdles:

- Prove that its purposes can be accomplished through means other than legislation, such as court intervention to enforce existing laws, publication of educational materials, or direct provision of services not being provided by the government.
- Show that its activity is not illegal or is protected by the rights of free speech and association. Demonstrations, boycotts, strikes, and picketing raise red flags with the IRS.
- Conduct its politically tainted activity, if possible, within a larger complex of traditionally exempt activities.
- Meet the educational test for information published in its newsletters, publications, or research reports on topics or issues that are potentially the subject of legislation. "Disparaging terms, insinuations, innuendoes, and suggested implications drawn from incomplete facts" are not educational.[155]

[154] Reg. §1.501(c)(3)-1(c)(3).
[155] Reg. §1.501(c)(3)-1(c)(3); see Section 5.1.

CHAPTER TWENTY-FOUR

Deductibility and Disclosures

Tax-exempt organizations must be mindful of the income tax consequences of payments received from their supporters, for a couple of reasons. First, an organization can enhance its development activity by seeking payments that are fully deductible as either a contribution or a business expense. Second, organizations are required to disclose the tax character of payments solicited from their supporters. Penalties are imposed on organizations that fail to provide proper tax information. This chapter briefly outlines standards for tax deductibility and describes the different types of disclosure rules applicable to §501(c)(3) organizations. Special disclosure rules applicable to social welfare organizations, business leagues, and labor unions are discussed in Chapters 6, 7, and 8.

24.1 OVERVIEW OF DEDUCTIBILITY

Tax-exempt organizations in many categories are eligible to receive payments that are potentially deductible for income tax purposes, as either a business expense or a contribution. A payment's character is determined by the motivation for making the payment, but deductibility may also depend upon the recipient organization's category of exempt status. One pays dues to a (c)(6) business league to maintain and improve one's professional standing, thereby making the payment a deductible expense directly related to one's business. One pays dues to the (c)(4) civic association to better one's neighborhood, city, or country. If such dues are paid for business reasons, they are deductible as a business expense; if paid for personal reasons, the dues are not deductible. As discussed in Chapter 6, certain civic associations qualify as (c)(3) organizations, thereby making payments to them deductible as a charitable contribution.

Tax-exempt organizations in most categories are not eligible to receive payments that qualify for a contribution deduction for income tax purposes. Interestingly enough, IRC §170 that allows such deductions does not specifically mention §501(c)(3). Instead, it describes eligible recipient organizations by using the same words found in §501(c)(3).[1] The Tax Code defines the term *charitable contribution* by saying that it means a contribution or gift to or for the use of one of the following:

1. A state, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes
2. A corporation, trust, or community chest, fund, or foundation
   a. Created or organized in the United States or in any possession thereof, or under the laws of the United States, any state, the District of Columbia, or any possession of the United States
   b. Organized and operated exclusively for religious, charitable, scientific, or literary purpose, or to foster national or international amateur sports competition (but only if no part of its activities involves the provision of athletic facilities or equipment), or for preventing cruelty to children or animals
   c. No part of the net earnings of which inures to the benefit of any private shareholder or individual
   d. Which is not disqualified for tax exemption under §501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in any political campaign on behalf of (or in opposition to) any candidate for public office
3. A post or organization of war veterans, or an auxiliary unit or society of such a post, organized in the United States and not allowing provate inurements to any private person
4. Individual gifts to a domestic fraternal society exclusively for charitable purposes
5. Certain cemetery companies

Another interesting connection between §§170 and 501 lies in the fact that the definition of organizations qualifying as public charities under §509(a)(1) is not found in that section but instead is contained in §170(b) and its associated regulations.[2]

[1] With the exception of organizations that test for public safety reasons. See Chapter 2.
[2] See Chapter 11.

(a) Contribution Defined

In a deceptively simple fashion §170(c) states that an income tax deduction is allowed for "a contribution or gift to or for the use of qualified charitable organizations."[3] Neither the code nor the regulations define the word *contribution*. The commonly used definition of a contribution is "a voluntary transfer without consideration." In other words, only a gift for which nothing is received in return is fully deductible. The intention to give with no expectation of financial benefit must be present for a donation to occur.[4] In the Supreme Court's words, "the gift must proceed from detached and disinterested generosity."[5]

When a donor receives services, goods, or other property of value, a rebuttable presumption exists that there is no gift.[6] Therefore, all the moneys paid for attendance at dinners, balls, theatrical performances, and other fund-raising events are presumed to be payments for value received and not deductible. To overcome the presumption, the donor must prove that the fair market value (FMV) of the benefits, entertainment, or other items furnished is less than the amount paid. Since 1994, charitable organizations have been required to provide valuation information.[7]

The requirement that the payment to a charity be disclosed for deductibility caused many charities to reexamine donor-designated payments. Amounts paid directly to an individual are, of course, not deductible. What about amounts paid to support a particular program conducted by an individual? The Tax Court found that the naming of two missionaries, unrelated to a decedent, as the beneficiaries of a charitable trust did not defeat the charitable nature of the bequest.[8] The judge thought that the church had sufficient control and enforceable rights over the bequest to ensure that the funds would be used for charitable purposes as required by the statute. Following this logic, a scholarship fund donation accompanied by a suggestion that tuition be awarded to a particular person could conceivably be deductible, although the IRS might disagree.[9]

The IRS also says if a person related to the donor is suggested to the recipient organization, specifically in one case a theological seminarian, there is no gift.[10] Such a gift is not made "to" a charity if the charity merely acts as a conduit to a particular person. The test of deductibility is whether the organization has full control of the donated funds, and discretion as to their use, so as to ensure that they will be used to carry out its functions and purposes. The parents who directed that their gift be used to pay their son's tuition argued unsuccessfully that although they designated the use of their gift, they had no right to demand such use. Organizations that currently conduct designated gift programs face the problem of whether

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[3] IRC §170(c).
[4] *U.S. v. American Bar Endowment*, 477 U.S. 105, 116–117 (1986).
[5] *Duberstein v. Commissioner*, 363 S. Ct. 278 (1960); *William S. Allen v. U.S.*, 541 F.2d 786 (9th Cir. 1976); Rev. Rul. 86-63, 1986-1 C.B. 88; Rev. Rul. 76-232, 1976-2 C.B. 62.
[6] Rev. Rul. 67-246, 1967-2 C.B. 104, 105.
[7] See Section 24.2.
[8] *Estate of Hubert*, T.C. Memo. 1993-482.
[9] Rev. Rul. 83-104, 1983-2 C.B. 46.
[10] Tech. Adv. Memo. 9405003.

they sufficiently control the funds so as to remove any benefit to the donor. Likewise, a church school that allows church members to enroll children for a tuition less than that of nonmembers may need to value the member discount.

As another example, a Roman catholic church parish combined the sale of columbaria for internments of deceased parishioners and cenotaphs with a fundraising program. Presumably due to the uncommon nature of the program, the church sought IRS sanction for treating a portion of the purchase price of the burial spaces as a donation. The parish's solicitation materials specifically requested a donation and disclosed the amount by which the price exceeded the fair market value.The IRS found that the payments represented a combined purchase and a donation and that the contribution portion qualified as a charitable gift. The IRS also concluded that the sale and maintenance of burial niches was not an unrelated business for the church.[11]

(b) Limitations on Deductions

The allowable tax deduction for a gift to a qualifying charitable organization depends on a number of different factors. Limitations that influence the deductible amount include the following:

- Varying percentages of the donor's income
- Type of property donated
- Classification of the recipient organization as a public or private charity
- Character of the property given as a capital versus an ordinary income property
- Type of transfer—whether the gift is made outright or in trust and whether the donation is of a taxpayer's entire interest or a partial interest.

The following percentage limitations apply:[12]

- An individual may annually deduct up to 50 percent of his or her adjusted gross income (AGI) for gifts of cash and ordinary income property to public charities[13] and private operating foundations.[14]
- Up to 30 percent of an individual's AGI may be offset by donations of long-term capital gain property to public charities and private operating foundations and for gifts of cash to a private foundation.
- Up to 20 percent of an indiividual's AGI may be offset by donations of cash and readily marketable securities to a private foundation. The deduction for other gifts of appreciated property, such as land or shares of a private company, are limited in their deductibility to the taxpayer's cost basis.
- Corporate donations are deductible up to 10 percent of the company's pretax income.

[11] Priv. Ltr. Rul. 200213021; Rev. Rul. 79-359, 1979-2 C.B. 226.
[12] IRC §170(b).
[13] See Chapter 11.
[14] See Section 15.5.

- No percentage limitation applies for gift and estate tax charitable deduction purposes.[15]

Carryover. If the total donations made in any one year exceed the foregoing limits, the excessive amount can be carried over and treated as a donation for up to five subsequent years, again subject each year to the applicable percentage limitations.[16]

Fair Market Value. The deduction amount for a gift of property other than cash is normally the fair market value (FMV) of the property. The FMV is the price that property would sell for in the open market. It is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type that the taxpayer sells in the course of his or her business, the FMV of the contributed property is the price that the taxpayer would have received if he or she had sold it in the usual market in which he or she customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed.[17]

The *usual market place* standard means that used clothing must be valued at the price for which it can be sold in a resale shop, considering its age, condition, style, and usefulness. In making and supporting the valuation of donated property, the IRS recommends that all of the following factors affect value and are relevant:[18]

- The cost or selling price of the item
- Sales of comparable properties[19]
- Replacement cost
- Opinions of experts

Property that is sold in an active market for which information is routinely published, like shares of common stock and used automobiles, are relatively easy to value for donation purposes. Closely held company shares, office buildings, fine art, and similar unique properties have no readily established market value. Consequently, in addition to consideration of the foregoing four factors, IRS procedures require that a qualified appraisal be obtained for all donations of property other than money and publicly traded securities where the value of the property is more than $5,000.

Additionally, for such donations, Form 8283 must be acknowledged by both the recipient organization and the independent appraiser and attached to the donor's tax return. To provide the IRS with clues about valuations that should be questioned, a charity that sells property reported on Form 8283 within two

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[15] IRC §§2055 and 2522.

[16] IRC §170(d).

[17] Reg. §1.170A-1(c)(2) subject to the *tangible personal property* rule.

[18] IRS Publication 561 entitled *Determining the Value of Donated Property*.

[19] See Rev. Rul. 80-69, 1980-1 C.B. 55 in which the IRS indicates that arm's-length sales of similar property are the most probative evidence of fair value.

years of its receipt must itself file Form 8282 to report to the IRS the price at which the property was sold.

The value of property subject to restrictions on its use or subsequent disposition must reflect the decrease in value attributable to such restriction.

Capital Gain Property. Except for capital gain property, the contribution deduction is limited to the taxpayer's cost for the property donated. The rule says that for deduction purposes the value of the property must be reduced by the amount of gain that would not have been long-term capital gain had the property been sold by the donor.[20] The definition of capital gain property is property eligible for special tax rates applicable to long-term capital gains tax because of its holding period and investment nature.[21] Goods normally sold in a business activity, such as inventory, are considered ordinary income property, not capital in nature. Inventory items used solely for the care of the ill, the needy, or infants and scientific property used for research are subject to a partial limitation.[22] Nicely enough, the untaxed gain inherent in donated property is not taxed.

A donation of personal services is also limited by this rule. One has no tax basis inherent in one's own time. Theoretically, to claim a deduction for volunteer services rendered, one would have to first report the value of the services as income to achieve some tax basis. The charitable donation is reported on the individual income tax form as an itemized deduction and is potentially limited in deductibility even if the service provider recognizes income. Therefore, no deductions are available for the value of time contributed to a charitable organization, though unreimbursed expenses paid incident to rendering the services are deductible.[23] For Form 990 purposes, donated services are also not reported, even where they are valued and shown as contributions for financial reporting purposes.

Tangible Personal Property. The deduction for gifts of tangible personal property, such as clothing, art, or other collectibles, may be limited unless the charity actually keeps and uses the property. This limitation applies when the use by the donee is unrelated to its charitable purposes constituting the basis for its exemption, or in the case of a governmental unit, its function.[24] When applicable, this rule limits the deduction to the donor's tax basis, ordinarily what was originally paid for the property.

The deduction for property donated to charitable auctions and to resale shops is therefore limited to the taxpayer's basis in the property or the value, whichever is lower. The donor is responsible for valuing such property, but the helpful charity assists the donor in valuing such donations for two reasons. The price for which the charity ultimately resells the goods can be treated as determinative of value. Purchasers at charity auctions traditionally pay more than FMV as a way to

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[20] IRC §170(e).

[21] IRC §§1(h) and 1223; holding period after July 28, 1997 must be at least 18 months. Gains on certain business property may also be considered capital gain property under IRC §1231.

[22] IRC §170(e)(3) & (4).

[23] Reg. §1.170A-1(g).

[24] IRC §170(e)(1)(B)(i).

make a donation to the charity. Providing a list of auction item values gives the purchaser documentation necessary to calculate the donation amount.

Special Private Foundation Limitations. When Congress created private foundations in 1969, the rule-makers were intent upon not only enhancing regulation of them,[25] but also discouraging their formation. Thus, as a general rule property donated to a private foundation is limited in its deductibility to the amount of the donor's tax basis.[26] Further, the percentage of income limits is lower for gifts to a private foundation. A private operating foundation that conducts its own active programs is not subject to these restrictive limitations.

Qualified Appreciated Stock. From 1984 through 1994 and after July 1996 (now permanently extended), Congress lifted the deduction reduction to basis limitation for gifts of certain marketable securities to private foundations. The full fair market value of qualified appreciated stocks is allowable as a deduction. To qualify, the stock has to possess the following characteristics:[27]

- Market quotations are readily available on an established securities market on the date of contribution.
- Stock is capital gain property.
- The foundation's sale of the stock cannot be limited by securities laws as to the volume or other insider trading rules.
- The value of the stock contributed, when added to any prior gifts by the donor and his or her family members, cannot exceed 10 percent of the value of all of the outstanding stock of the corporation.

The fact that only six to eight sale transactions had taken place in the 10 years prior to the gift, each by a local stockbroker, indicated that corporate shares were not readily marketable. The local stockbroker's attempts to facilitate *matchmaking* between buyers and sellers of the private company stock did not meet the marketability standard.[28] The donors had also failed to meet the substantiation requirements for noncash gifts, making their gift technically not deductible.[29] The IRS, approved by the court, was lenient and allowed for the deduction equal to the stock basis.

Foreign Organizations. Only gifts to domestic organizations, those created or organized in the United States, are deductible for U.S. tax purposes.[30] Because of the limitation and the fact that U.S. tax-exempt organizations are permitted to conduct activities anywhere in the world, domestic *Friends Of* organizations are created to raise U.S. support for foreign organizations. So long as the U.S. charity has control and discretion over the ultimate spending of the money,[31] funds

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[25] See Chapters 12–17.
[26] IRC §170(e)(1)(B)(ii).
[27] IRC §170(e)(5).
[28] *John C. Todd, et ux. v. Commissioner*, 118 T.C. No. 19, No. 170-99.
[29] Discussed in Section 24.2(b).
[30] See list of qualifying recipients of charitable donations at beginning of the chapter.
[31] See Section 2.2(i).

raised to conduct foreign activities or for regranting to a foreign organization by individuals[32] do qualify as charitable contributions. A U.S. charity supporting overseas projects can follow specific standards regarding the activity to ensure the U.S. supporters receive an income tax deduction.[33] Most importantly, the U.S. entity must maintain ultimate control over the funds. It may accept donations from individuals and businesses that suggest their gift be used for specific foreign organizations, but it must have discretion to approve the granting of funds under the following six rules:

1. The U.S. organization's charter, bylaws, or other governing instruments should not restrict activities to domestic programs; there should be no constraint on support for foreign organizations (and in silence allows it).
2. Solicitation for and acknowledgment of donations from and to U.S. and foreign individuals and businesses should refer to support for the domestic organization's programs.
3. The making of grants to the foreign organization must be within the exclusive power of the domestic organization's board of directors. Such power should be evidenced by overt board approval prior to payment of such grants. Funding might either be authorized as part of the annual budget for such programs or specifically approved at board, executive, or staff meetings.
4. The U.S. charity should also obtain a written grant proposal from the foreign organization(s) that it funds. The proposal should be subject to the same approval systems applied to domestic programs. Authorizing officials should be provided with sufficient detail to allow them to satisfy themselves that the grant serves the domestic charity's purposes. Brochures and other materials describing the domestic organization's programs should contain a description of information to be submitted with grant requests and terms under which grants are awarded.
5. Grant recipients can be required, subsequent to the grant, to submit annual reports to show that the grant funds were expended for the purpose for which they were approved by the board. Reports should contain copies of exhibition catalogs, photographs of installations, and other actual evidence of the program.[34] For a private foundation, this report may be contractually agreed to ahead of time in the expenditure responsibility agreement.[35]
6. Grant payment should be accompanied by an award letter reiterating the terms of the agreement and outlining documentation requirements grantees must complete. The U.S.-Canadian tax treaty makes special provisions for reciprocal qualification of charitable organizations and permits a U.S. taxpayer to offset donations to Canadian charities against their Canadian income reported for U.S. income tax purposes.[36]

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[32] See Section 24.1(c) for rules applicable to corporations.
[33] Rev. Rul. 66-79, 1966-1 C.B. 48.
[34] Rev. Rul. 75-65, 1975-1 C.B. 79.
[35] Illustrated in Section 17.6.
[36] IRS Notice 99-47.

(c) Business "Donations"

Classifying a corporate, or other type of business, payment as a contribution may not be advantageous, for a number of reasons. The corporate contribution deduction is limited to 10 percent of a company's taxable profit for the year (before the deduction).[37] A contribution disallowed by the percentage limitations of §170 is not otherwise deductible as a business expense.[38] Correspondingly, no §162 business expense deduction is allowable if any part of a payment qualifies as a charitable gift under §170.[39]

The Tax Code says that "a contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for" charitable purposes.[40] Therefore, a corporate gift to support activites outside the US is not deductible. This geographhic limitation does not restrict the activity of charities formed as corporations. As a practical matter, it is contrary to basic corporate responsibility to private shareholders to make a contribution without some kind of economic motivation. Advertising and promotional expenses have no similar limitation. From a corporation's standpoint, a contribution in many situations is not preferable. A transfer of property to a charitable organization that "bears a direct relationship to the taxpayer's business and is made with a reasonable expectation of financial return commensurate with the amount of transfer" may be deductible as an "ordinary and necessary business expense rather than as a charitable contribution." The following decisions give a flavor to the issue.

- A corporation agreeing to pay a certain amount to a named charity in return for each unit of a particular product it sold (for which a label was returned) incurred a business expense for its payments to the named charity, in an early cause-related marketing case.[41]
- A sewing machine manufacturer was not allowed to claim charitable deductions for discounts given to school districts. Its expectation that the students using the machines would become future customers indicated an anticipated financial return for the discounts.[42]
- Payments made by a newspaper publisher to fund a first-grade reading program in the local school, however, were not a deductible business expense but, instead, a charitable contribution. There was no direct relationship between the program and the publishing business, nor a reasonable expectation of commensurate financial return.[43]

Businesses are encouraged to donate certain types of inventory with an exception to the general rule that, except for capital gain property, the charitable deduc-

[37] §170(b)(2).
[38] Reg. §1.170A-(c)(5), although the excess contributions can be carried over for five years.
[39] Reg. §1.162-15.
[40] IRC §170(c)(2).
[41] Rev. Rul. 63-73, 1963-1 C.B. 35.
[42] *Singer Co. v. Commissioner*, 71-2 U.S.T.C. ¶9685 (Ct. Claims 1971).
[43] Priv. Ltr. Rul. 8145020.

tion is limited to the taxpayer's basis.[44] Part of the value of food, clothing, and similar items to be used for the care of the ill, the needy, or infants; computer equipment given to elementary and secondary schools; and scientific property constructed by the business for research are afforded special deductions.[45] An example of a business donation that yields no charitable deduction is the contribution of a film library by a broadcasting company. The library was composed of footage documenting local news stories and had zero tax basis.[46] Similarly, a newspapaer was not allowed a deduction for the gift of its clippings library.[47] In both situations, the library materials were ordinary income property, and not capital assets. So, because no special exception applied, the deduction was limited.

The IRS has announced that "whether or not an activity constitutes advertising or acknowledgment for the recipient charity's purposes does not determine whether a sponsor may deduct its payment under §162 or §170."[48] See Section 21.8(e) for the corollary rules on corporate sponsorships for unrelated business income tax purposes. Those interested in further exploring the motivations behind corporate giving—social responsibility versus profit maximization—and how the reasons interact with the tax law, should consult the June 1995 issue of *The Exempt Organization Tax Review.*[49]

(d) Planned Gifts

Planned gifts are those donations that occur over a period of time, either with the creation of a trust during one's life or as a bequest effective upon death. A classic planned gift separates the property into its income and principal attributes in what is referred to as a *split-interest trust*. Such a gift is a perfect marriage of a donor's desire to support charity, to avoid the income tax, and to keep some of the benefits of owning a lot of property. The underlying property is often a low-yield, significantly appreciated stock.

Charitable Remainder Trust. As its name implies, a charitable remainder trust is created to pay income to the donor or other person(s) for a period of time after which time the rest or remainder is payable to one or more named charities.[50] The written agreements creating such trusts must provide for specified income distributions at least annually. Such a trust that distributes a percentage of its assets is referred to as a *charitable remainder unitrust*, or a CRUT. A *charitable remainder annuity trust*, or CRAT, instead annually pays out a fixed sum of money. A CRUT or CRAT can last for a term of up to 20 years or for the income beneficiary's life.

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[44] See Section 24.1(b).
[45] IRC §§170(e)(3), (4), and (6).
[46] IRS Tech. Adv. Memo. 200119005.
[47] *Chronicle Publishing Co. v. Commissioner*, 97 T.C. 445 (1991).
[48] IRS Notice of Proposed Rulemaking, January 19, 1993, concerning corporate sponsorships.
[49] Article entitled "The Paradox of Corporate Giving: Tax Expenditures, The Nature of the Corporation, and the Social Construction of Charity," by Nancy J. Knauer of Temple University School of Law.
[50] IRC §664.

The deduction allowed for creation of a qualifying trust is essentially the FMV of the properties placed in trust less a calculated value of the retained income interest. The IRS provides tables of life expectancy and prevailing interest rates for this purpose. The tables calculate the present value of the life interest based upon the assumed rate of income to be paid annually and the life expectancy of the person(s) possessing the retained income interest. Both public and private charities can be named as charitable beneficiaries.

Charitable Lead Trust. A charitable lead trust reverses the pattern of a remainder trust by paying a defined percentage of its principal for a defined period of time to charity(s). At the end of the trust's life, or lead period, the property is returned to the donor or other designated beneficiary. The lead trust must also be either a qualifying annuity or a unitrust. The advantage of this type of planned gift is an immediate tax deduction for the donor equal to the present value of the charity income stream. Unlike the remainder trust, however, the donor is treated as a *grantor* of the trust and must annually report the trust income.[51]

Pooled Income Fund or Charitable Annuity. Two other forms of planned gifts popular with public charities encompass a gift of property directly to the charity rather than a separate trust. Similar to a CRUT or CRAT, the charity promises to pay income to the donor for some period of time. Essentially, such trusts have the same elements as a charitable remainder trust, but are established and managed by the public charity itself.[52]

24.2 THE SUBSTANTIATION AND QUID PRO QUO RULES

Contributors often receive benefits in return for support of their favorite charitable organization: dinner, entertainment, prizes, and a wide variety of premiums are provided to donors to entice their support. Commonly, those valuable items are provided to donors at no cost to the charity because businesses and patrons donate the items of benefit offered to the attendees. In such cases, the proceeds of fund-raising events and memberships add directly to an organization's coffers, and it seems logical to treat all of a donor's payment as a charitable donation. The trouble with this premise is it belies the basic concept of a charitable donation—a payment made with the intention of making a gift.[53] When one pays the going price for a nice dinner dance with friends, a contrarian might say the minimum price charged for admission to an event establishes its FMV, resulting in no charitable gift being made. It is also reasonable to propose that the social nature of fund-raising events implies lack of donative intent. Partly due to this imprecision, until 1988, a charity was neither expected nor required to assign value to such benefits, or to inform the givers that the ticket price is not fully deductible. "Deductible to the extent allowed by law" was a common refrain.

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[51] IRC §671 treats the donor as owner of the trust property because of the retained reversionary interest in the principal.

[52] IRC §642(c)(5); §664.

[53] See §24.1(a).

(a) History of Disclosure Rules

In the late 1980s, the House Budget Committee decided that "charities fail to make sufficient disclosures in soliciting gifts to allow donors to calculate the nondeductible portion of donations." Legislation was passed that made it mandatory for non-§501(c)(3) organizations to prominently print on all fund-raising materials that payments were not deductible.[54] The IRS was directed to measure tax revenues lost due to overstated donations to §501(c)(3) organizations and to investigate any abuses found. In response, the IRS initiated a special emphasis program entitled Exempt Organization Charitable Solicitations Compliance Improvement Study. It mailed Publication 1381 to the more than 500,000 tax-exempt organizations eligible to receive deductible contributions, sent IRS representatives around the country to give public education talks on the subject, and examined major charities to test compliance.

Based on the relatively poor results of the study, Congress ended the deductibility dilemma in 1993 by adding §170(f)(8) and §6115 to the income tax code to require that charities provide information to donors revealing the value of benefits provided. The Senate said, "Taxpayers may not simply rely on a canceled check as substantiation." The Revenue Reconciliation Bill of 1993, passed by the Congress as part of the Omnibus Budget Reconciliation Bill, imposed a substantiation rule on persons claiming charitable donations and disclosure rules on the charities themselves, effective for gifts after 1993, as follows:

- A written receipt from the donee organization is required for taxpayers claiming a charitable gift of $250 or more. Congress said this burden is on the giver, but it also falls on the organization that must produce the receipt. See Exhibit 24.1.
- A donee organization furnishing economic benefit in the form of goods or services in return for donations in excess of $75 must provide a written statement revealing the deductible portion of donor payments. See Exhibit 24.1.

(b) Substantiation Rules

No charitable deduction is allowed for a gift of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization with sufficient information to evidence the amount of the deductible contribution.[55] Separate payments are not aggregated; only a single payment of $250 or more requires substantiation. For example, a monthly contribution of $200 resulting in a total of $2,400 for the year is not subject to receipting.[56] The acknowledgment must be written and contain the following information:

- The amount of cash the taxpayer paid and a description (but not necessarily the value) of any property other than cash the taxpayer transferred to the donee organization

[54] IRC §6116 applicable to non-§501(c)(3) organizations with gross receipts of over $100,000; see Section 6.4.
[55] Reg. §1.170A-13(f).
[56] Even for gifts below this threshold, the helpful charity can provide receipts to all donors.

Exhibit 24.1

Sample Donor Disclosure Receipts

Failure to disclose the value of benefits provided is subject to a $10 penalty for each donor for each event. The language can vary, but three very specific items of information must be provided to satisfy the IRS:

1. Donor name with amount and date of cash paid
2. Description of other property donated (without a valuation)
3. Statement of whether or not benefits were provided, and if so, a good faith estimate of the value.

NO BENEFITS PROVIDED—CHARITABLE GIFT OF $250+ OR MORE

Donor Name

Thank you for your contribution of ________ in cash and property ___________ (description) on _________ (date). Your gift will be devoted to our organizational charitable objectives and we will provide no benefits or services required to be valued in consideration for this gift.

Organization Name

BENEFITS PROVIDED—PAYMENT OF $75.01 OR MORE

Donor Name

Thank you for your contribution of _________ in cash and property _________ (description) on _________ (date). We estimate the fair market value of the benefits we provided to you in consideration for this gift was $_________ per person. We are a §501(c)(3) organization and you may be entitled to claim a donation deduction for the difference between the cash and property donated and the value of the benefits you received.

Organization Name

INTANGIBLE RELIGIOUS BENEFITS—GIFT OF $250+

Donor Name

Thank you for your contribution of $_________ in cash and _________ (description of property donated) on __________ (date). The church furnishes intangible religious benefits that need not be valued for tax purposes. You may claim the full value of your gift as a donation.

Name of Religious Organization

CHARITABLE BENEFITS—TICKET PRICE $75.01 OR MORE

Donor Name

Thank you for your purchase of benefit tickets for $__________ in cash on _________ (date). We estimate the fair market value of the meal and entertainment furnished in connection with the event was $_________ per person (ticket). We are a §501(c)(3) organization and therefore you may be entitled to claim a donation deduction for the difference between the cash you paid and the value of the benefits, or $___________.

Organization Name

AUCTION PURCHASE RECEIPT

Purchaser's Name

Thank you for your purchase of auction item #________ (description) for $_______ in cash on _______ (date). We estimate the fair market value of this item is $_________. We are a §501(c)(3) organization and therefore you may be entitled to claim a donation deduction for the difference between the cash you paid less the value of the item, or $________.

Organization Name

- A statement of whether the donee organization provided any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization
- If the donee organization provides any intangible religious benefits, a statement to that effect

Timing. A "contemporaneous acknowledgment" is one obtained on or before the earlier of (1) the actual filing date of the taxpayer's original return for the year in which the contribution was made, or (2) the due date (including extensions) for filing the taxpayer's original return for that year. In other words, a donor may not file a return claiming a contribution deduction for a charitable payment of $250 or more without a proper receipt in hand.

In Consideration Of. Benefits are treated as being "in consideration of" the donation where there is a connection between the transactions. The charity is deemed to have provided goods and services in consideration of a donation *if* at the time the taxpayer makes the payment, he or she expects to receive the benefits in exchange for the payment. It is a matter of the donor's intention. To receive a full deduction for support of a solicitation in which a benefit is offered, a donor can refuse the benefits and indicate the rejection in writing. Goods received in a year other than the year of payment are included if the donor had an expectation of their receipt. An unannounced or irregularly scheduled recognition dinner held to honor supporters would not be a quid pro quo benefit, but a routine and anticipated dinner could be connected to annual giving. The de minimus amounts used to identify donor benefits of insubstantial value in 2004 are $8.20, $41.00, and $82.00.[57]

Good Faith Estimate. The donor is entitled to rely upon the charity's estimation of the value of benefits provided unless he or she has some reason to know the value is incorrect.[58]

Disregarded Benefits. Due to the difficulty of valuing certain donor privileges, the IRS, in August 1995, significantly eased the disclosure requirements by extending the *token item* rules to apply to certain benefits. Benefits can be disregarded if they fall into one of two categories:[59]

1. Goods and services that have insubstantial value, referred to as the token items. As discussed in Section 24.3(a), coffee mugs, posters, calendars or similar premiums that cost the organization a modest amount ($8.20 for 2004 and annually adjusted), furnished to donors of $41 (adjusted annually) or more, do not reduce the deductible contribution.[60]
2. Annual membership rights and privileges offered to members in exchange for a payment of $75 or less per year that consist of

[57] Rev. Proc. 2003-85. IRB 2003-49, 118.
[58] Benefit valuation issues are discussed in Section 24.3 and illustrated in Exhibit 24.3.
[59] Reg. §1.170-13(f)(8).
[60] See also section 24.3(a).

- Any rights and privileges that the member can exercise frequently (and not limited as to use) during the membership period, including but not limited to free or discounted admission or parking, preferred access to goods or services, and discounts on purchases of goods or services.
- Admission to events during the membership period that are open only to members for which the charity reasonably estimates that cost per person is below the prevailing low-cost article amount (determined at the time the membership package is first offered for the year). A reception with light refreshments prior to an opera performance would, for example, be considered of "insubstantial value" if the event costs the organization $8.20 (figure adjusted annually) or less per person.

Members paying amounts above $75 are entitled to disregard (not reduce their contribution) the value of those privileges included in a basic membership priced at $75 or less. *Frequently exercised* is defined only by example of what it is not. Free tickets to all of a theater group's eight summer performances are not disregarded because of the limited (and specific) number of performances. Benefits provided to the member's employees can also be disregarded under this rule without regard to the number of employees who actually use the benefits.

The contemporaneous receipt need not mention the fact that rights and privileges can be disregarded. The receipt can say "no goods or services were provided."[61] Goods and services provided to the employees or partners of the donor can be disregarded if they are the same token benefits offered to all other individual members.

Payroll Deductions. Contributions paid through a payroll withholding system need not be acknowledged by the donee organization directly to the donor. The substantiation rules apply when $250 or more is withheld for a particular paycheck, not the cumulative amount of the annual deductions. Taxpayers can substantiate a $2501 payroll deduction with a combination of two documents:

1. A pay stub, Form W-2, or other document furnished by the taxpayer's employer that evidences the amount withheld from the taxpayer's wages for purposes of payment to a donee organization
2. A pledge card or other document prepared by the donee organization that includes a statement that the organization does not provide goods or services in whole or partial consideration for any contributions made by payroll deduction

During united giving campaigns, donors may designate specific amounts to be redistributed by the collecting charity to named charities. For disclosure purposes, the fund-raising and distributing charity is treated as the donee.

Volunteer out-of-pocket expenses are also subject to contemporaneous written receipt rules. Volunteers must themselves keep adequate substantiation (meaning

[61] Reg. §1.170A-13(f)(8), Example 2.

airline tickets, meal chits, and other §274 expense-account-type receipts) plus obtain a disclosure statement containing the following:

- Description of services provided by the taxpayer
- Statement that benefits were or were not received
- Quid pro quo benefit description plus valuation, if applicable

Gifts to charitable remainder and lead trusts, but not pooled income fund gifts, are exempted from the $250+ substantiation requirement. The IRS reasoned that the donee of such transfers is often unknown and subject to change. Partnerships and S corporations need not obtain separate substantiation receipts for each partner reporting a contribution deduction passed through to them. The partnership or S corporation is considered as the donor required to obtain a $250+ receipt.

Rights to Buy College Athletic Tickets. When an amount paid to an institution of higher education entitles the donor to purchase tickets for seating at an athletic event in an athletic stadium of the college or university, 20 percent of the amount paid is considered as the value of the right to buy tickets.[62]

Tax-Exempt Grantors. A tax-exempt organization wishing to claim a contribution deduction for unrelated business income tax purposes must obtain a disclosure receipt for any grants it wishes to claim as a charitable gift for that purpose.[63]

Donation Collection Agents. When one entity, for-profit or not-for-profit, collects funds on behalf of a charitable organization, it is important to verify whether the fund-raising entity is serving as agent for the charity. The question is whether or not the funds are *to or for the use of*[64] the charity. The payment is deductible only if it is paid to the agent subject to the ultimate discretion and control of the recipient charity. An agency relationship exists when the charity enters into a fiduciary agreement with the fund-raiser to act on its behalf, subject to the charity's control and consent.[65] Luckily, the accounting profession has issued FASB #136 as guidance to aid in identifying whose income is whose.

Identifying the ultimate donee is important for several reasons. The donor needs to receive adequate disclosure information to document his or her payment to a qualifying entity for donation deduction purposes. The second question is whose revenue it is for purposes of calculating the public support ratio.[66] When the agent is itself a charitable fund solicitation organization, such as a United Way campaign, that allows its donors to unequivocally designate a gift to a particular charity, the gift is not treated as revenue to the united campaign. Instead, the gift is treated as being made to the ultimate charity designated by the donor.

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[62] IRC §170(I); Reg. §1.170A-13(f)(14).
[63] See Section 27.11.
[64] See Section 24.1(a).
[65] *Black's Law Dictionary* 62 (7th ed.1996).
[66] See Chapter 11.

When the solicitor is a commercial business, additional questions arise. Does the arrangement result in private inurement to the agent? When the solicitation program involves personal property, such as used cars, boats, or clothing, are the donated items properly valued? If the solicitation agent sells the property, does the charity get a fair share of the proceeds of the sale? The IRS has conducted examinations of organizations with such property donations and, in July 2002, issued a road map for any charity considering such a program.[67]

Information Returns. Instead of furnishing an acknowledgment for each individual $250+ contribution, §170(f)(8)(D) provides an alternative. "If the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, which includes the information described in §170(f)(8)(B)," individual receipts are not required. Such a form has not been issued as of January 2004.

Whether the charity produces individual substantial receipts or files an information return, the disclosure rules require a communique with donors. As a practical matter, most charities already send a thank-you to donors using computer systems that efficiently generate such mailings. For them, this requirement does not impose a difficult burden. The Conference Committee Managers Report said the acknowledgments need not take any particular form—a postcard, letter, or computer-generated form is acceptable. Sample receipts are shown in Exhibit 24.1.

The IRS revised Publication 1771 in 2002 to expand the medium allowed for donor acknowledgments. The publication admits there are no prescribed IRS forms for §170(f)(8) purposes (the $250 or more receipt) and quid pro quo disclosures of benefits provided to donors.[68] Happily, the revised publication also provides use of electronic media as follows:

> Letters, postcards, or computer-generated forms with the above information are acceptable. An organization can provide either a paper copy of the acknowledgment to the donor, or an organization can provide the acknowledgment electronically, such as via an e-mail addressed to the donor.

Until the revision, the IRS had not condoned electronic receipts and allowed only the use of *computer-generated forms.*

(c) Quid Pro Quo Disclosure Rules

When an organization described in §170(c)(2), (3), (4), or (5) receives a quid pro quo contribution in excess of $75, the organization shall, in connection with the solicitation or receipt of the contribution, provide a written statement that:[69]

- Informs the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of the amount of any money and the value of any property other than money contributed by the donor over the value of goods or services furnished in return
- Provides a good faith estimate of the value of such goods or services

[67] Priv. Ltr. Rul. 200230005.
[68] Discussed in Section 24.2(c).
[69] IRC §6115(a).

A quid pro quo contribution is defined by §6115(b) as "a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization." The fact that the goods or services were donated to the organization at no cost does not make a quid pro quo payment fully deductible. Neither does the fact that the money will be used exclusively for the organization's exempt purposes.[70] A pure exchange transaction, such as a museum gift shop or church bookstore purchase, has no donative element, so that no disclosures are required.

Intangible Religious Benefits. Payments to religious organizations in return for "intangible religious benefit that generally is not sold in a commercial transaction outside the donative context" are not required to be valued. The regulations provide no guidance on the definition of *intangible religious benefit*. U.S. tax policy does not define religion so as to foster the separation of church and state.[71] The results are not necessarily logical or fair. Fees paid for the many weddings and funerals performed outside churches are not deductible. Where it is customary for the church secretary to suggest a $300 donation be paid to the minister performing such services in the church, one wonders why payment is not treated as a quid pro quo?

Voluntary Disclosures. The value of *all* benefits provided in connection with an ostensibly charitable payment must be subtracted from the amount paid to the charity, regardless of whether the charity is required to disclose such amount to the donor. Although the charitable disclosure rule requires the value of goods and services be provided where the solicitation is for a gift of more than $75, the helpful charity might choose to value all benefits not excluded by the de minimis rules explained in Section 24.3(a). The following illustrates the fact that the $50 contributor also needs to receive valuation information to correctly claim the charitable deduction portion of his or her gift.

Charitable event ticket sells for	$50	$100
Fair market value of event is	– 40	– 40
Amount of donation	$10	$60

Timing. The disclosure is to be made in "connection with the solicitation or receipt of the donation." The Ways and Means Committee report says it intends for the disclosure to be made in a manner reasonably likely to come to the attention of the donor. "For example, a disclosure of the required information in small print set forth within a larger document might not meet the requirement." Timing of the disclosure can be troublesome. Mostly charities have chosen to disclose an estimated value on the invitation printed well in advance of the actual event. What should a prudent organization do if they find the valuation was mistaken? Do they send a follow-up receipt once the more accurate valuation is

[70] Rev. Rul. 67-246, 1967-2 C.B. 104.
[71] See discussion in Section 3.1.

available? If possible, at least the required follow-up $250 plus substantiation acknowledgments would reflect the subsequently corrected value.

The charity has issues to consider in deciding where to print the disclosure information. Without question, it is preferable to print the benefit valuation disclosure on the event invitation, not on the RSVP card that is returned (and consequently not available later to the donor). If the value of the benefit is printed on the return card sent back with the donor's check, the charity can expect unnecessary calls at tax filing time from donors who did not keep a copy of the valuation information.

Note that the code seems to give a choice: Information can be furnished at the time the gift is requested or when payment is received. As a practical matter, the charity may not be able to assign an accurate valuation for an event when invitations are mailed. The de minimus rules do require a statement on the solicitation, and it is unfortunate that Congress provided a choice.[72] The $250+ gift acknowledgment clearly will be provided after the gift is received, perhaps only once a year listing all such gifts by a particular giver.

Donative Intent. The connection between a benefit conferred by a charity and the actual donation is sometimes vague. What if one purchases tickets but does not use them? How does a charity determine when a payment is made in "consideration for" a benefit that was not necessarily expected or bargained for? What if the charity invites potential donors to be guests at a dinner reception worth $50 a person? If no consideration is paid specifically for the dinner, the question is whether the value of the "free" dinner reduces an attendee's subsequent payment. Does the result change if the charity regularly holds such dinners? Does it matter whether a donation is made at the dinner or within a short time after the dinner?

Auctions. Purchases in a charity auction are not quid pro quo transactions, but the purchase may involve a partial donation. A bidder who pays more than the FMV for an item for sale in a charitable auction is entitled to treat the amount paid in excess of the value as a charitable gift. A catalog, label, or other evidence of the value of the items should be available, and the helpful charity will also print the estimated value on the purchase receipt. Though the charity is not technically required to place a value on the donated items in acknowledging the gift to auction donors, it must do so if it wishes to provide documentation for the purchasers. When the donation portion exceeds $250, an acknowledgment should be provided, as discussed previously.

Raffles. A purchase of a raffle ticket is without donative intention and, consequently, the price paid is not deductible as a charitable gift. The prize value is reportable as taxable income by the winner, and the charity sponsoring the raffle has reporting and tax withholding requirements as outlined in Exhibit 24.2 and Section 25.3(f).

[72] See Section 24.3(a).

A donor that desires a full deduction for support of a charitable raffle must refuse to participate in the raffle by returning the ticket or otherwise not accepting it. The purchase of a raffle ticket is treated as an exchange transaction in which no gift occurs. What if, instead, a prospective donor's name is entered into a sweepstakes without regard to whether an actual donation is made? The IRS has privately ruled that just such a fund-raising program conducted by a public university resulted in deductible contributuions by persons who returned the sweepstakes mailing.[73]

Tickets for entry were mailed free of charge to prospective donors. A letter inviting entry into the contest complete with a description of prizes to be awarded, suggested donation levels, and a date for the drawing was sent. Respondents were asked to return a preaddressed envelope to enter the contest and enclose any contribution they wished to make voluntarily. Neither the envelope nor the entry form indicated whether a donation was enclosed. Because there was no obligation to pay to enter the sweepstakes, payments voluntarily sent were fully deductible. No quid pro quo occurred.[74]

§6714(a) Imposition of Penalty. If an organization fails to meet the disclosure requirements or discloses incomplete or inaccurate information with respect to a quid pro quo contribution, a $10 penalty for each contribution, in respect of which the organization fails to make the required disclosure, is due. Form 990 asks, "Did the organization comply with the disclosure requirements relating to quid pro quo contributions?" When the answer to this question is *No*, the total penalty with respect to a particular fund-raising event or mailing can be up to $5000.

§6714(b) Reasonable Cause Exception. No penalty shall be imposed under this section with respect to any failure if it is shown that such failure is due to reasonable cause. Although an organization relied upon compliance information furnished as *industry standard* by a national organization, it could not escape the penalty. Neither would the IRS relent because the solicitations were made by volunteers.[75]

24.3 VALUING DONOR BENEFITS

The value of a benefit provided to a donor is the fair market value (FMV), or the amount "a willing buyer will pay a willing seller for the same item, object or service purchased individually in the normal marketplace in which the item is sold."[76] This general rule is hard to follow for many charitable events have no commercial counterpart. The value of a gala is not necessarily equal to the organization's cost, particularly when the items are donated or purchased below market prices. The prescribed method for valuing the use of a museum room for

[73] Priv. Ltr. Rul. 200012061, citing Rev. Rul. 67-26, 1967-2 C.B. 104.
[74] Discussed in Section 24.2(c).
[75] Priv. Ltr. Rul. 9315001.
[76] Reg. §1.170A-1(c)28(2).

EXHIBIT 24.2

Tax Reporting/Withholding for Raffles and Drawings

Prizes awarded as a part of a charitable fund-raising activity may be subject to tax reporting on Form 1099 or W-2G. The fair value of a raffle prize is reported on Form W-2G. A prize received in a drawing for which no separate ticket was purchased to be eligible (door prize-type) is reported on Form 1099-MISCELLANEOUS. Also, tax withholding may be required. Imagine how happy the charity will be to take $930 out of its coffers to pay the tax due on a $3000 (donated) cruise!

PRIZE IS $600 OR MORE

- Step 1: Form W-9 requesting the winner's taxpayer federal identification number should be completed and signed by the winner before prize is awarded.
- Step 2: Form W-2G or 1099 MISC is filed by the charity. If the winner fails or refuses to give their ID number, the charity is required to pay 31 percent of the prize to the IRS as backup withholding. In other words, tax due is payable by the charity if it fails to get the number.

PRIZE OF MORE THAN $5000

- Step 1: Form W-9 requesting the winner's taxpayer ID number must be completed and signed. For a *cash prize*, 28 percent of the net prize must be subtracted or withheld from the prize. For a *noncash prize* (such as a car or a trip), the winner should pay the charity 28 percent of the net prize before the prize is awarded. The net prize is equal to the value of the prize less the wager paid (essentially equal to the amount on which the winner must pay tax). If the winner refuses to furnish ID number, the withholding rate is 31 percent
- Step 2: Form W-2G or 1099-MISC is filed by the charity and furnished to winner by January 31 of the following year.

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a private reception is the price for hotel space of comparable size. The value of the art collection need not be taken into account.[77] Celebrity presence at an event can similarly be ignored and items of modest value provided in connection with a donation can also be disregarded. Exhibit 24.3 is a list of typical benefits and suggestions for valuing gifts.

Who Values. The burden of proving the value of donor benefits has now shifted to charities providing benefits.[78] A charity's good faith estimate of the value of benefits provided can be relied upon by a donor, unless the taxpayer knows, or has reason to know, that the estimate is erroneous. Thus, the charity has a burden to obtain sufficient information to make an accurate valuation, although any reasonable methodology can be used. The factors used should be documented and preferably include independent opinions. While the cost of rendering a service or providing a benefit to members and/or attendees is not the prescribed measure of the value, the cost is often instructive in making a valuation when there is no commercial counterpart. Merchants who donate goods and services inherent in bene-

[77] Reg. §1.6115-1(a)(3), Example 1.

[78] This rule is sometimes confused with the fact that the donor, rather than the charity, is responsible for valuing items of property contributed to a charity.

fits can, for example, be asked to furnish an invoice reflecting the normal cost of the items they contribute. Commercial price lists of similar items can be sought.

Other Valuation Issues. Where the market value of an event is determined in reference to the cost of the event, there is often a question of which denominator to use. Does one count the number of tickets sold, the number that actually attend, or the number one prepared to serve? The good faith standard expects the charity to arrive at a fair value, taking all relevant information into account under the circumstances, to value the direct benefit provided.

The organization's administrative staff, facility, and fund-raising costs are not counted as part of the cost of benefits provided for this purpose, for Form 990 reporting purposes, or for financial reporting purposes. Similarly, the non-profit using actual cost to value entertainment or favors provided for disclosure purposes (due to lack of a comparable commercial event) should exclude overhead costs.

Fortunately, intangible recognition, such as having one's name placed on a building or donor listing, is as a general rule considered to be of incidental or tenuous benefit, and does not reduce the value of the gift.[79]

Failure to use the tickets or privileges does not entitle the purchaser to a deduction, but written refusal of the ticket or privilege from the outset enables the donor to evidence a gift. Returning tickets received can also convert such transactions into a pure gift.[80]

(a) The de Minimus Rule

Premiums or benefits of insubstantial value given in connection with a qualified fund-raising campaign are de minimus and can be ignored.[81] In response to charities' complaints that the valuation process was too difficult and subjective, benefits can be disregarded and do not reduce the donation in the following circumstances:

- The fair market value of all benefits received for the payment is not more than 2 percent of the payment, or $82, whichever is less (e.g., a benefit worth up to $82 can be given to a $4,100 contributor).
- The donation is $41[82] or more (during 2004 and adjusted annually) and the benefits received are token items (bookmarks, calendars, key chains, mugs, posters, T-shirts, etc.) bearing the organization's name or logo, with a cost (as opposed to FMV) of no more than $8.20 (during 2004 and adjusted annually). All benefits received during a year are aggregated to calculate the total amount furnished. For example, the combined cost of a $4.50 mug and a $4 T-shirt exceed the de minimus amount, and thus reduce the donation by the entire $8.50.

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[79] Reg. §53.4941 (d)-2(f)28(2); Rev. Rul. 66-358, 1966-2 C.B. 216; Rev. Rul. 73-407, 1973-2 C.B. 383.

[80] Rev. Rul. 65-432, 1968-2 C.B. 104.

[81] Rev. Proc. 90-12, IRS News Release IRB 90-20, February 1990; updated by Rev. Proc. 2003-85, IRB 2003-49, 1184.

[82] This amount was originally set at $25 and the permissible cost started at $5; see note 81.

EXHIBIT 24.3

Suggested Guidelines for Valuing Gifts

Benefit	Value Assigned
Objects or services sold normally in stores and by service providers	Price at which goods or services normally sell
Benefit dinner dance in the nonprofit's facility	Cost of event, including value of donated goods and services
Benefit golf tournament	Normal cost of playing golf on course
Chance to play with pro	Price of the chance
Raffle or door prize ticket	Price paid for ticket
Participation in educational tour	Price of similar commercial tour
Attendance at performance or movie or admission to facility	Normal ticket or admission price
Publications, posters, buttons, bumper stickers, and books	Comparable market price unless de minimus rules apply
Goods or services purchased at charitable auction	Normal selling price in commercial setting
Name printed in program or on a building	None

Organizations following this procedure are instructed to include this statement in their fund-raising literature:

> Under IRS guidelines, the estimated value of [benefits received] is not substantial; therefore the full amount of your payment is a deductible contribution.

De minimus benefits provided to the employees of a donor or to partners of a partnership may be disregarded.

Qualified Campaign. A qualified fund-raising campaign has three elements:

1. It is designed to raise tax-deductible donations.
2. The charity uses reasonable methods to value benefits offered in return for donations.
3. Solicitations state how much of the donation is deductible and how much is not. (This statement may be written on tickets or receipts, broadcast, telephoned, or made in person.)

Commercial-Quality Publications. Publications, such as newsletters or program guides, are assigned value if they are commercial-quality publications (CQPs). A CQP (1) is one the primary purpose of which is not to inform members about the organization's activities, (2) is available to the general public, (3) contains paid advertising, and (4) contains articles written for compensation.

(b) Benefits That Need Not Be Valued

It is sometimes difficult to tell whether a donor is receiving something of value treated as a quid pro quo, or if the charity is simply fulfilling its exempt functions by furnishing services. Furnishing educational benefits to donors in the form of newsletters, lectures, or training is normally considered an exempt function. Civil Air Patrol squadron dues entitling members to be trained for rescue missions and to purchase items at a military exchange were deemed to be deductible, because the specific benefits were merely incidental to the charitable purposes of the patrol and to the public services rendered by the members.[83] The rights to attend an annual meeting, vote for officers, attend semiannual social functions, and conduct an annual rummage sale did not make a convalescent home member's dues nondeductible.[84]

Intangible Religious Benefits. Goods and services that consist solely of intangible religious benefits are not valued and do not reduce one's donation to a religious organization. Such benefits are those provided by an exclusively religious organization for religious purposes and generally not sold in a commercial transaction outside the donative context.[85] Pew rents, and payments for performing weddings, funerals, and other religious services by churches are, for example, classed as charitable donations.[86] The Supreme Court, in 1989, found *auditing fees* of the Church of Scientology to be valuable personal services in upholding IRS disallowance of their deduction as charitable donations.[87] Later the IRS reversed its position, issued a favorable determination letter for the church, and deemed such payments deductible effective January 1, 1993.

Member Privileges. Until 1995, member dues were deemed to represent a pure charitable donation only if members are given no *commensurate rights and privileges* other than the personal satisfaction of being of service to others and furthering the charitable cause in which the members share a common interest.[88] Due to the difficulty of valuing such privileges, the substantiation rules allow certain member privileges to be disregarded under specific conditions.[89]

24.4 UNRELATED BUSINESS INCOME ASPECTS OF FUND-RAISING

Many fund-raising events look like business activities, are conducted in competition with businesses that sell the same goods and services, and are potentially subject to tax as unrelated business income (UBI). Event profits are, however, not often taxable as UBI because exclusions apply. The typical fund-raising event is organized and operated by volunteers,[90] is irregularly carried on,[91] involves the sale of donated merchandise,[92] and/or may be related to the entity's exempt

[83] *Miller v. Commissioner*, 34 T.C.M. 1207 (1975).
[84] Rev. Rul. 55-70, 1955-1 C.B. 506.
[85] IRC §170(f)(8)(B)(iii).
[86] Rev. Rul. 70-47, 1970-1 C.B. 49.
[87] *Hernandez v. Commissioner*, 109 S.Ct. 2137 (1989).
[88] Rev. Rul. 68-432, 1968-2 C.B. 104 and Rev. Rul. 55-70, 1955-1 C.B. 506.
[89] See Section 24.2(b).
[90] IRC §513(a)(1).
[91] IRC §512(a)(1).
[92] IRC §513(a)(3).

purposes. Special standards apply to determine when a corporate sponsorship can be classified as taxable advertising revenue rather than a donation.[93]

The IRS has targeted for examination the types of fund-raisers usually claimed to be excluded from UBI classification because of their relatedness to the organization's exempt purposes, such as travel tours and athletic facilities. For a travel tour to be classified as related to an organization's exempt purposes, the tour must include a fairly high level of educational content and professional direction. The IRS found a typical travel tour program was unrelated, so that all of the proceeds, including the donation element, were subject to the UBI tax.[94] Management of athletic events and rental of school athletic facilities to outsiders is considered business income to a school.

Bingo games are given a special exclusion from UBI if the operation of bingo by the organization does not violate state law.[95] It is extremely important to note that other games of chance (such as raffles, lotteries, and casino parties) do not qualify for this exclusion, meaning the profits are potentially taxable unless the volunteer or irregular exclusions apply. The Tax Code specifically defines bingo to include only those games in which (1) wagers are placed, (2) winners are determined, and (3) prizes or other property are distributed, in the presence of all persons placing wagers in such game. The regulations delineate this definition to include games of chance played with cards that are generally printed with five rows of five squares each, during which participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners.[96]

The winnings in a game of chance must be reported as taxable income to the winner. The type of reporting, either a Form 1099 or W-2, depends upon the amount of the prize. As outlined in Exhibit 24.2, tax withholding is also required in certain cases.

24.5 STATE AND LOCAL REGULATIONS

Proper disclosures are also of concern on a local level. In many states, charitable solicitation statutes require registration by professional fund-raisers and certain organizations. Many cities also have standards and registration requirements for solicitors. The focus of such registration requirements is on truth in the solicitation materials and private benefit to professional fund-raisers. Fund-raising literature that does not reflect the actual amount of money devoted to charitable purposes constitutes a deceptive trade practice under the common law. It is the opinion of the Charitable Trust Section of the Texas Attorney General's office that charities have a fiduciary responsibility to maximize funds available for programs.

The Better Business Bureau and the National Charities Information Bureau, among others, monitor the levels of fund-raising costs. They publish public information reporting cost percentage ratios and other information intended to

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[93] See Section 21.8(e).
[94] Tech. Adv. Memo. 9029001; see Section 21.11.
[95] IRC §513(f).
[96] Reg. §1.513-5(d).

inform donors about the use of their donations. For a comprehensive view of these rules see *The Law of Fund-Raising*.[97]

The National Association of Attorneys General (NAAG) and the National Association of State Charities Officials (NASCO) have developed a system for standardized registration for nonprofits. The system allows registration for fund solicitation purposes and filing of Form 990. they are also working in concert with the Urban Institute's National Center for Charitable Statistics (NCCS) and the IRS to develop electronic filing capabilities. Beginning in 2002, a free software package was available to download and file with the states of Colorado and Pennsylvania.[98]

[97] Bruce Hopkins, *The Law of Fund-Raising*, 8th Edition (Hoboken: Wiley, 2003) supplemented annually.

[98] www.efile.form990.org.

CHAPTER TWENTY-FIVE

Employment Taxes

Employment taxes and associated payroll costs, such as workers' compensation and health insurance, equal between 10 and 25 percent of an exempt organization's payroll. These taxes represent a substantial expense to most organizations and there is sometimes a temptation to classify a worker as an independent contractor, in order to avoid such costs. Until 1973, exempt organizations (EOs) were exempt from Social Security taxes, and their employees were eligible to be covered only if the organization elected to participate in the system. Until 1989, Internal Revenue Service (IRS) exempt organization examiners had no authority to look at employment taxes. For these reasons, many EOs ignored the complexities of employment taxes, until the IRS announced its intention to emphasize employment tax issues. This posture was costly to many colleges and universities that were assessed payroll tax liabilities in the millions for part-time student workers after mid-1990 IRS audits.

Since 1978, the IRS's hands have been tied by a congressionally mandated safe harbor that prevents IRS reclassification of workers for an entity that uses some reasonable basis for its policy and files information returns reporting compensation to nonemployees. An organization is presumed to be correct if it relies on IRS precedent, long-standing industry practice, or a prior IRS audit. Generally, exempt organizations have operated under this safe harbor. However, the General Accounting Office and the Treasury Department actively look for ways to enhance collections of income taxes from independent contractors, so these issues are important.

The character of payments made by exempt organizations to individuals—whether employees or independent contractors—is basically governed by the same rules as those applied to nonexempt businesses. There are a few exceptions, but the rules for payroll tax deposits, annual reporting, fringe benefits, and taxability of pensions paid to retirees are mostly the same. If there is any doubt about the importance of employment tax issues to an exempt organization, proof can be found in the tax law changes in recent years. Several provisions enacted at that time impact EO employers.

- *Employer-Provided Educational Assistance.* IRC §127(d) retroactively extended the tax-free treatment of nongraduate level educational assistance for up to $5,250 per individual.[1]
- *Medical Research Institution Employee Housing.* IRC §119(d)(4)(A) was added to the code to exempt subsidized housing for employees of certain medical research institutions that are classified as §170(b)(1)(a)(iii) organizations.[2] This exemption previously applied only to schools.
- *Long-Term Care Insurance.* Benefits paid under a qualified long-term care contract are treated like payments from an accident and insurance plan and are excluded from income as amounts received for personal injuries and sickness,[3] with a cap of $175 per day. Payments for such plans, effective in 1997, are deductible as medical expenses.[4]
- *Health Insurance Portability.* Group health plans, including health maintenance organizations (HMOs) covering two or more persons, must contain provisions intended to enhance continued coverage for employees who change jobs and those with preexisting conditions.[5] Governmental, accident, dental or vision, Medicare supplement, disability income, liability, and certain other insurance plans are not covered.

25.1 DISTINCTIONS BETWEEN EMPLOYEES AND INDEPENDENT CONTRACTORS

Whether a worker is an employee or an independent contractor is a factual question based on common law, which often requires a detailed analysis. The case law and rulings provide some guidance, and the IRS has developed a 20-factor test.[6] The IRS Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding, reflects the factors. The criteria developed by the courts and the IRS are briefly capsulated in Exhibit 25.1, Employee versus Independent Contractor Checklist.

[1] Small Business Job Protection Act §1202.
[2] Small Business Job Protection Act §1123.
[3] IRC §§106(c), 125(f), 807(d)(3)(A)(iii), and 4980B(g)(2); Health Insurance Portability and Accountability Act §321.
[4] IRC §§162(1) and 213(d)(1)(C); Health Insurance Portability and Accountability Act §401.
[5] IRC §§9801-9806 and 4980B(f).
[6] Reg. §31.3401(c)-1(a) and (d); Rev. Rul. 87-41, 1987-1 C.B. 296.

EXHIBIT 25.1

Employees vs. Independent Contractor Checklist

Revenue Ruling 87-41 lists the primary characteristics distinguishing employees from independent contractors. These characteristics are listed on this checklist. Whichever blank best describes the predominant characteristic of a worker or position is to be checked. There is no specific mathematical test, although more than one-half of the checkmarks on either line is a strong indication. The facts and circumstances of each payee-payor relationship should be analyzed. Classifying a worker as an employee is seldom challenged; finding justification for treating one as independent is more troublesome. The most common reason for making the distinction is to identify persons—the employees—who are subject to federal income tax withholding and unemployment taxes. Independent contractors are abbreviated as "ICs."

	YES	NO
INSTRUCTION AND TRAINING		
Employees are required to comply with instructions as to when, where, and how work is performed, and their training is provided either by formal program or work supervision.	☐	☐
ICs are free to perform work according to their own professional standards, use their own methods, and receive no training from purchasers of their services.	☐	☐
PAYMENT TERMS		
Employees are paid by the hour, week, or month on a regular, indefinite, and continuous basis. Employees' business expenses are paid. Fringe benefits are usually provided.	☐	☐
ICs are often paid by the engagement with a fee calculated without regard to time spent. ICs are not paid for excess time to perform the task nor given paid vacation or sick leave. ICs pay their own expenses.	☐	☐
ENGAGEMENT TERMS		
Employer has the right to discharge an employee; control is exercised with threat of dismissal. Employees have the right to quit without incurring liability.	☐	☐
ICs complete the agreed task without regard to the time it takes and may suffer damages if work is not performed as contracted.	☐	☐
RELATION TO ENTITY		
Employees' services are an integral part of the ongoing success and continuation of the organization. Services are rendered personally by employees, who work only for, have loyalty to, and do not compete with the employer. Employees are bonded and provided workers' compensation.	☐	☐
ICs consult on a per-job, limited-term, or special-project basis. ICs can hire and pay assistants to perform the work. ICs' services are available to the others on a regular basis. Some ICs work under a company name.	☐	☐
WORKPLACE AND HOURS		
Employees work on business premises or are physically directed and supervised by employer. Hours of work are established by employer.	☐	☐
ICs often work at their own places of business, and usually set their own time for performing work.	☐	☐

EXHIBIT 25.1 *(CONTINUED)*

Employees vs. Independent Contractor Checklist

INVESTMENT	**YES**	**NO**
Employees are dependent upon employer for tools and facilities, and usually make no investment in the job. Employees bear no risk of loss for financial costs of employer.	☐	☐
ICs buy their own tools, hire workers, pay licensing fees, and are responsible for costs of engagement. ICs bear financial risk of losing money.	☐	☐

(a) Employees

Employees are typically subject to tighter employer controls than independent contractors are: Hours of work are regular and specified; the place of work is the employer's; compensation is regular and continuing; and tools, training, and work supplies are normally furnished by the employer, among other benefits and advantages. Employees are given paid vacations and accrue pension and sick pay benefits, and are generally thought to have a more secure position than independent contractors.

The term *contract worker* is often misleading. Typically, workers hired on a part-time or temporary basis are given this title, and are often not treated as employees, partly because they are not given certain advantages of employees. Nonetheless, the fact that a worker is not hired for a permanent position does *not* determine his or her status as an employee, and most contract workers are employees subject to withholding.

(b) Independent Contractors

As the title implies, independent contractors work when they please, use their own tools, have independent professional standing, and bear a risk of loss if the job is not completed satisfactorily or within the prescribed time. Outside accountants, computer consultants, fund-raising advisors, and consulting psychologists are examples of independent workers.[7] No vacation or sick pay is provided, no taxes are withheld, pension eligibility is not furnished, and the engagement is for a limited time period for a specific task.

Form SS-8 should be completed to evidence the status of each worker treated as a contractor. This form can be used to show that the organization made a good faith effort to determine a worker's proper classification. The form's length and the variety of criteria developed by the IRS indicate the subjective nature of the distinction and the difficulty that may occur in identifying the proper category for a worker.

The terms of engagement should validate a worker's status as an independent contractor. At the minimum, three important documents evidence the arrangement and prove that the person is not an employee:

[7] See Priv. Ltr. Rul. 9231011 regarding a part-time grant proposal writer and Priv. Ltr. Rul. 9227025 about a food bank manager—both deemed employees.

1. A contract or other type of engagement letter with the contractor (see Exhibit 25.2) describing the respective responsibilities and terms of the contract, including three important elements
   - The engaging company does not essentially control the work product of the independent contractor
   - The contractor's engagement can be terminated if the work is not performed to specifications and all obligations are met
   - The contractor has the right to hire and fire assistants.
2. A signed Form W-9 is obtained to show that the contractor claims exemption from withholding and that the organization is not responsible for backup withholding. This step also obtains the federal identification number for purposes of preparing Form 1099.
3. An invoice or periodic billing statement evidences the independence of the contractor. The billing should appear professional and support the organization's position that the worker is independent.

(c) Employee Benefits

Payments made on behalf of employees for fringe benefits, expense reimbursements, and deferred compensation are, as a general rule, not taxed to employees. The rules governing the taxability of such payments are the same as for employees working for nonexempt entities. For example, an exempt organization employee's car allowance is reportable on Form W-2 unless the employee submits an accounting for the mileage.

An exempt organization can adopt a cafeteria plan to provide day care, tuition, and other benefits.[8] Health insurance and medical reimbursement plans can be established for employees.[9] Most types of qualified pension plans, including defined benefit, defined contribution, thrift, 401(k) plan, and simplified employee plans (SEPs) can be provided for exempt organization employees. A §403(b) plan can be adopted by a (c)(3) organization. Special limitations are placed on deferred compensation arrangements.[10] A thorough discussion of pension benefits is beyond the scope of this book.

(d) Volunteer Fringe Benefits

An exempt organization may pay certain expenses on behalf of its volunteers, and may reimburse its volunteers for expenses they incur on behalf of the organization in conducting its projects. After some years of question, the regulations provide that an exempt organization volunteer who performs services (including services as a director) for an organization or for a federal, state, or local governmental unit, is deemed to have a profit motive for purposes of IRC §162.[11] This means that such expenses, up to the value of services rendered, are not taxable to

[8] IRC §125.
[9] IRC §106.
[10] IRC §457.
[11] Reg. §1.132-5.

EXHIBIT 25.2

Sample Contractor Engagement Letter

This letter is intended to serve only to provide suggestions. Qualified legal assistance may be required.

In consideration of payment by _____________ (name of contractor)

Fixed fee or

Hourly rate $____________ per hour times _________ hours =_________

Reimbursable expenses (describe nature and estimated cost):

____ ______________

____ ______________

____ ______________

Invoices for services will be issued monthly, along with receipts and other documentation for reimbursable expenses listed above. For consideration, we (I) agree to perform the following services: ____

____

____

____

____

We (I) agree to perform the specified services in good order in a timely fashion. We (I) are independent contractors, not employees or agents of _____________, and are responsible for all federal and state payroll taxes and insurance in connection with this engagement. This agreement may be terminated by either party at any time after payment for any unpaid charges for services rendered up to termination. In acknowledgment of our understandings, we have both signed below.

By: _____________ Date: ______________ By: _____________ Date: ______________

Name of Contractor ________________ Name of Organization ________________

the individual volunteer and are not reportable by the organization as compensation. Of particular importance to some exempt organizations, this rule applies to officer and director liability insurance and indemnification. Premiums previously had to be reported as compensation to the officers, directors, and volunteers.

(e) Fellowships, Scholarships, and Awards

Although it seems incongruous with the motivation for making grants to individuals, certain individual grants must be reported to the IRS on Form 1099 or Form W-2, and taxes must be withheld as the following discussion outlines.

Tuition and Fees. A scholarship grant is fragmented into two parts. The portion awarded for payment of tuition and related expenses required for enrollment in an educational institution (such as books, fees, supplies, and equipment) is not taxable to the recipient, nor is it reportable to the IRS by the organization. Such payments are called *qualified scholarship* payments and are specifically excluded from gross income of a person who is a candidate for a degree.[12]

[12] IRC §117.

IRC §6050S requires reporting of tuition payments by schools. The information reporting requirements were designed to aid in calculating the HOPE Scholarship and Lifetime Learning credits under IRC §25A.

Room and Board. Payments for room, board, travel, and any other expenses are includable in income after the 1986 Tax Reform Act. Such taxable payments however, are not reportable to the IRS as income unless they represent compensation.[13] The 2003 instructions to Form 1099 clearly state, "DO NOT use this form to report scholarship or fellowship grants." They go on to say, "Other taxable scholarship or fellowship payments are not required to be reported by you to the IRS on any form."[14]

Teaching Fellows and Other Student Workers. For income tax purposes, scholarships or fellowships paid on the condition that recipients teach, perform research, or provide other services for the institution granting the scholarship do produce taxable income.[15] Such income is considered to be wages reportable on Form W-2, even though students are eligible to claim an exemption from income tax withholding.[16]

Social Security taxes may or may not need to be withheld, matched, and paid for amounts paid to students for work performed for colleges they attend. Students receiving payments from a state or federal agency that does not participate in the Social Security system are not subject to FICA. IRC §3121(b)(10) provides what is referred to as a *Student FICA exception,* which exempts payments for employment services to a student who is enrolled and regularly attends classes at a school, college or university (whether or not it is tax-exempt), or an affiliated organization of such an institution. The regulations somewhat vaguely say a student performing services incident to and for the purpose of pursuing a course of study at a school, college, or university qualifies. After significant controversies during examinations of colleges and universities, the IRS issued Rev. Proc. 98-16 to establish specific standards.[17] The ruling contains a series of questions designed to provide answers to schools employing students eligible for exclusion from the FICA tax.

To qualify for the exemption, the student must be a part-time undergraduate or professional student as those terms are defined by the Department of Education. Services for career employees, postdoctoral students and fellows, and medical residents and interns do not qualify. The definitions contained in the procedure should be carefully studied by any institution exempting students from FICA withholding. The IRS previously had taken the position that a student had to take 12 credits of courses and work less than 20 hours a week to be qualified for the exemption.

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[13] Prop. Reg. 6041-3(q).
[14] IRS Notice 87-31, 1987-1 C.B. 475.
[15] IRC §117(c).
[16] Reg. 1.117-6(d)(4); it is presumed a student's earnings will not exceed the minimum standard deduction.
[17] Rev. Proc. 98-16, 1998-5 IRB.

Awards. Prizes or awards paid to recognize someone's accomplishment are taxable to the recipient and reported on Form 1099-MISC. Only if the money is paid by the recipient to a charitable organization does the award escape taxation.[18] See discussion in §25.3(f) regarding raffles and gaming awards.

Medical Residents. Medical residents are considered not to perform services incident to and for the purpose of pursuing a course of study, the characteristic necessary for their support to be excluded from income tax. Instead, the IRS says, "We believe that medical residents are engaged in a structured form of on-the-job training."[19] The IRS denied hundreds of applications for refund of FICA tax imposed on medical residents.

Foreign Grant Recipients. For foreign grantees, the portion of a scholarship grant paid for study, training, or research in the United States (not including tuition and fees) is also taxable. As a general rule, income tax must be withheld at the rate of 14 percent on the taxable portion.[20] Treaties may exempt certain of these payments. A withholding agent may not give a treaty benefit to anyone who does not have an individual taxpayer identification number. Forms W-8 and 8233 have been redesigned to meet the needs of organizations making payments of compensation or scholarships to foreigners. Additionally, the rules applicable to U.S. residents for travel and expense reimbursements can be followed for nonresidents; if accounted for, the payments are not reportable compensation. After a number of years of controversy, the withholding requirements for foreign grant recipients are determined by the *situs* or residence of the person or organization making the payment, in addition to the residence of the recipient.[21] In two circumstances, fellowship or scholarship payments are not subject to withholding:

1. The payor is a U.S.-based citizen, domestic partnership, or corporation, a state, or a federal agency, and payment is made to a non-U.S. person for study pursued outside the United States.
2. The payment is made for study within the United States by a foreign government, international organization, or person other than a U.S. citizen.

The regulations specifically say that this rule does not apply to salary or other compensation for services, but does apply to prizes and awards for artistic, scientific, or charitable achievements. Reporting requirements are outlined in Section 25.3(d) IRS Publication 515, *Withholding of Tax of Nonresident Aliens and Foreign Corporations,* reflects withholding rates and tax treaty provisions for this purpose.

25.2 MINISTERS

Duly ordained ministers of a church hold a special place in employment tax procedures. The clergy of some sects take vows of poverty and, as a matter of reli-

[18] IRC §74.
[19] IRS Internal Legal Memorandum 200212029
[20] IRC §1441(b)(1).
[21] Reg. §1.863-1(d), effective August 25, 1995.

gious conscience, take no compensation for their work. The procedures for reporting compensation of ministers have evolved with respect for the need to maintain separation of church and state. The result is a set of confusing rules.

(a) Who Is a Minister?

The term *minister* is defined in the Internal Revenue Code and Regulations by a job description. Services provided by a minister in the exercise of his (her) ministries include:[22]

- Ministration of sacerdotal functions (marriage, baptism, funerals, and similar services)
- Conduct of religious worship
- Conduct, control, and maintenance of religious organizations, including religious board, societies, and other integral agencies of such organizations (such as schools)
- Performance of teaching and administrative duties at theological seminaries

A minister need not be ordained, but may also be commissioned, licensed, appointed, or otherwise authorized by a religious organization. The important criterion is that the minister must perform religious duties within the scope and practices of a religious denomination.[23] Interestingly, these standards use the term *religious organization,* not *church,* although the criteria for defining organizations performing the foregoing functions apply to churches and their integrated auxiliaries for exempt-status purposes.[24]

Employees of a church, other than qualified ministers, are subject to the rules discussed in Section 25.1. Failure to follow the employment tax rules for its personnel resulted in a $3.5 million assessment against the Indianapolis Baptist Temple.[25]

In a 1992 private ruling, the IRS considered whether a particular sect's *commissioned ministers* qualified for the housing allowance exclusion discussed in Section 25.2(b). The sect ordained ministers who officiated in public administration of the sacraments and led public worship. The commissioned ministers "in some circumstances lead the liturgy in prayer, read the scriptures or perform a baptism but more often served as deacon or director of Christian education." The IRS found that the commissioned ministers performed full-time ministerial duties. The qualifying functions included classroom teaching; evangelizing; counseling individuals; leading Bible study groups, devotion, worship studies for youth, and a congregation's music ministry; giving the children's service at Sunday worship service; addressing the congregation in worship services; coor-

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[22] Reg. §1.1402(c)-5(b)(2).
[23] Rev. Rul. 78-301, 1978-2 C.B. 103.
[24] Section 3.2.
[25] The church lost its battle in court to claim its First Amendment religious liberties were violated by the employment taxes in *U.S. v. Indianapolis Baptist Temple*, No. 00-102 (7th Cir, 2000).

dinating lay church workers; administering or guiding the congregation's youth ministry events; participating in ministries to those with special needs; and caring spiritually for the sick, the imprisoned, and their families.[26]

Qualifying ministers have also included a probationary member of the United Methodist Church,[27] cantors of the Jewish faith,[28] and retired ministers.[29]

Not qualifying as ministers are chaplains not employed by a religious organization or its integral auxiliary. *Ministers* do not include chaplains employed to teach at a university,[30] employed at a human service organization[31] or the Veterans Administration,[32] or chaplains in the Armed Services (chaplains are commissioned officers).[33]

(b) How Ministers Are Special

Ministers are exempt from income tax and Social Security tax withholding[34] and a portion of the compensation for services they perform as a minister may not be subject to income and the self-employment tax in situations listed below. However, if the minister is subject to one or both of these taxes, the compensation is considered to be attributable to the carrying on of a trade or business,[35] which permits the deduction of ordinary and necessary expenses in arriving at tax-able income for both income (as an itemized deduction for employees) and self-employment purposes.[36]

A 28-page *Tax Guide for Churches and Religious Organizations* was released in July 2002 and is available on the IRS Web site.[37] Payroll tax reporting issues unique to ministers are explained, with a reminder that most church workers are normal employees subject to withholding and other rules outlined in this chapter.

Income Tax. Any amounts paid as compensation to a minister for services are subject to income tax, just as for other individual taxpayers. Offerings and fees received for marriages, baptisms, funerals, and the like are taxable income.[38] Ministers are classified as employees or independent contractors by applying the standards listed in Section 25.1. If the minister is classified as an employee, the income tax liability is paid either through the estimated tax system or through voluntary income tax withholding. An employed minister receives Form W-2, in

[26] Priv. Ltr. Rul. 9221025.
[27] *Wingo v. Commissioner,* 89 T.C. 922 (1989).
[28] Rev. Rul. 78-301, 1978-2 C.B. 103; *D. Silverman,* 73-2 USTC ¶9546 (8th Cir. 1973), *aff'g.* 57 T.C. 727 (Dec. 31,290).
[29] Rev. Rul. 63-156, 1963-2 C.B. 79.
[30] *L. D. Boyer,* 69 T.C. 521 (Dec. 34,900).
[31] Rev. Rul. 68-68, 1968-1 C.B. 51.
[32] Rev. Rul. 72-462, 1972-2 C.B. 76.
[33] Reg. §1.107-1(a).
[34] Reg. 31.3401(a)(9)-1; IRS Publication 15-A Supplement to Circular E, *Employer's Tax Guide,* for 1998, p. 77.
[35] IRC §1402(c)(2)(D).
[36] Rev. Rul. 80-110, IRB 1980-16, 10.
[37] www.irs.gov.
[38] Reg. §1.162-2(a)(1) and IRS Publication 525, *Taxable and Nontaxable Income.*

most cases reflecting only the gross wage amount. If the minister is not an employee, the tax is paid individually through the estimated income tax system, and the church reports the compensation on Form 1099.

Self-Employment Tax. A minister's earnings are excepted from "employment" for the purpose of imposing the Social Security tax.[39] A minister is instead subject to the self-employment tax, unless he or she is one of the following persons:[40]

- Members of a religious order whose members have taken vows of poverty.[41]
- Duly ordained ministers who have not taken a vow of poverty but who make an individual election out of the Social Security system on Form 4361. A statement must be signed indicating that the minister is opposed by conscience or religious principle to the acceptance of any public insurance and is so informing his or her church.
- Clergy members of a church or church-controlled organization that makes the election for its employees to be exempt from Social Security coverage pursuant to IRC §3121(w). This exemption applies only to remuneration of less than $100 per year and generally applies to "vow of poverty" situations.

In a test case, the Tax Court found that a Methodist minister was an employee and not self-employed for purposes of claiming business expense deductions on Schedule C. The expenses were deductible as miscellaneous itemized deductions subject to the 2 percent-of-adjusted-gross-income floor.[42] The court found a long list of reasons why he was not an independent businessman. He was required to be amenable to the church in the performance of numerous required duties, was required to provide explanations of his sermons to church officials, could not unilaterally discontinue services or refuse an appointment, was bound by mandatory retirement rules, and was subject to supervision. In addition, he was not required to invest in church facilities, was not in a position to increase his profits as a minister, and received benefits (including a pension, vacation, paternity leave, disability pay, and a guaranteed salary) when not assigned to a church.

Housing Allowances. Amounts designated by a church as housing allowance for its ministers are not taxable for income tax purposes,[43] but are subject to self-employment tax. The allowance must be designated in advance of its payment or provision, as evidenced by an employment contract, church budget, deacons' res-

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[39] IRC §3121(b)(8)(A) for purposes of the Federal Insurance Contributions Act; see IRS Publication 15-A, *Employer's Supplemental Tax Guide.*

[40] IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

[41] IRC §1402(c); see also Section 3.3.

[42] *Weber v. Commissioner,* 103 T.C. No. 19 (Aug. 25, 1994); *aff'd.* 95-2 USTC ¶ 50,409 (4th Cir. 1995); for cases involving Assembly of God ministers see *Alford vs. U.S.,* Civil No. 94-1074 (D.C. W. Arkansas, 1996) and *Richard G. and Anne C. Greene v. Commissioner,* T.C. Memo. 1996-531.

[43] IRC §107; IRS Publication 525, p.10.

olution, or similar official action. The minister must actually expend the amount provided. Any allowance not used or used for nonresidential purposes is taxed.[44] The taxable amount is equal to the fair rental value of housing (including utilities and other costs). A parsonage may be furnished rent-free, or allowances may be paid to cover the parsonage utilities and other maintenance, or to cover rents, or to cover the minister's costs of individually owning and maintaining a house.

(c) Conscientious Objectors

As noted previously, a minister may make an individual election not to participate in the Social Security system by filing Form 4361, Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners. A minister, however, is subject to income tax on compensation paid for services he or she renders that is not otherwise excluded as a fringe benefit. Some religious organizations, peace groups, and other exempt organizations employ persons who protest payments of federal income taxes for spiritual reasons. These conscientious objectors have traditionally objected to money allocated to armaments that bring harm to human beings caused by war or to government-supported abortions. How should an organization respond if it is asked not to levy taxes against such an employee? What is the responsibility of the organization to the IRS? The answers are that the IRS basically holds the exempt organization responsible, but may use some leniency.

The Quakers produced answers to some of these questions when they faced a federal district court in December 1990. The judges decided that the collection of taxes applied to all citizens equally, and did not specifically regulate religious practice or beliefs. The church was therefore required to withhold the full amount of taxes from its regular employees' wages. Out of deference to the church's exercise of religious freedom, however, the court imposed no penalties for failure to withhold the taxes in question.[45]

25.3 REPORTING REQUIREMENTS

Whether paid to employees or individual contractors, almost all payments made by exempt organizations to individuals or unincorporated entities are reportable to the IRS. The annual W-2 Form is filed for employees. The Form 1099 Miscellaneous (also called an information return) is filed for most other payments to independent contractors and other nonemployees. Exhibit 25.3 is used to facilitate annual compliance review.

(a) Penalties

The penalty for failure to file an information return is \$15 to \$50 per return, up to a maximum of \$250,000. However, if the IRS determines that a contractor should have been classified as an employee, the exempt organization will be billed for all

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[44] Reg. §1.107-1(c).

[45] *U.S. v. Philadelphia Yearly Meeting, Religious Society of Friends,* No. 88-6386 (E.D. Pa), Dec., 19901.

EXHIBIT 25.3

Employer Tax Requirements Checklist

Nonprofit organization employers are subject to the same rules that govern for-profit employers, including rules administered by the Department of Labor, workers compensation statutes, the Employee Retirement Insurance Security Act (ERISA) rules, and federal and state employment taxes. Since the costs of employee benefits range from 10 to 30 percent of direct payroll costs, these matters deserve close attention. Severe penalties in the Internal Revenue Code are imposed on failure to pay over employment taxes.

1. Does the organization have a policy for distinguishing between employees and independent contractors? ☐

- Verify satisfaction of at least four factors in Exhibit 25.1, Employee versus Independent Contractor Checklist. ☐
- Review questions on Form SS-8, Information for Use in Determining whether a Worker Is an Employee for Federal Employment Taxes and Income Tax Withholding. ☐
- Does the organization have a contract and a signed Form W-9 for independent contractors? (See Exhibit 25.1.) ☐
- Have Social Security numbers been secured? ☐
- Are invoices obtained from independent contractors to prove their professionalism? ☐

2. Are meals, cars, tuition, or housing allowances furnished to employees? Determine whether they are reportable compensation and whether withholding is required. ☐

3. Does the pension plan adhere to ERISA rules? ☐

4. Is Form 5500, 5500C, or 5500R required for employee plan? ☐

5. Are the terms of any qualified or nonqualified deferred compensation plan being adhered to? ☐

6. Do Consolidated Omnibus Budget Reconciliation Act (COBRA) rules entitle former employees to continued medical benefit coverage? ☐

7. Is workers' compensation coverage required? ☐

8. Verify adherence to federal withholding requirements. Study IRS Circular E, *Employer's Tax Guide*, and Publication 15-A for filing requirements and an excellent chart on wages subject to or exempt from taxes. The types of employment taxes are as follows:

- Income tax withholding. Most wages are subject to this tax, but certain ministers, members of religious orders, student workers, and fellowship or grant recipients are exempt. ☐
- Social Security tax. Review Circular E chart; wages over $100 are taxable. ☐
- Federal unemployment tax. §501(c)(3) organizations are exempt from this tax. Several types of compensation subject to income tax are also exempt. See Circular E. ☐

9. Verify timely filing of the following IRS reports: ☐

- Form 940, federal unemployment tax report (due January 31) (Form 940 is not filed by §501(c)(3) organizations.) ☐
- Form 941, employer's quarterly federal tax return (due January 31, April 30, July 31, and October 31) ☐
- W-2 Forms for all employees (due January 31) ☐

EXHIBIT 25.3

Employer Tax Requirements Checklist

- W-3 Form to IRS with copies of W-2s (due February 28) ☐
- W-4 placed in each employee's file ☐
- Form 1099-MISC for all independent contractors ☐
- Form W-2G Prizes and Awards ☐
- Form W-2P Statement for Recipients of Pensions ☐

10. Verify timely deposit of federal employment taxes. ☐

- Taxes deposited by fifteenth of next month following wage payment. ☐
- Tax deposited biweekly for employers whose tax for prior year exceeded $50,000. ☐
- Tax deposited electronically. ☐

11. Is the exempt organization subject to unemployment taxes? ☐

- On the federal level, only 501(c)(3)s are exempt. ☐
- On the state level, obtain instructions from the employment commission of the state where the worker is employed. The rules differ by state. ☐
- Many states exempt 501(c)(3) EOs with fewer than four employees. ☐
- A *reimbursing* or self-insured employer status may be available. ☐

12. Are state employment (workforce) commission requirements satisfied? ☐

- Are quarterly returns filed and is tax paid on time? ☐
- New organizations must first obtain an account number by filing a status report. ☐

13. Verify timely payment of federal unemployment tax liability (if applicable). ☐

employment taxes that would have been payable if the worker had been classified as an employee, plus interest and penalties. Before 1997, responsible parties, starting with the board members, were assessed a penalty up to 100% of this amount for failure to withhold the taxes. Congress followed the lead of the many states that encourage board service by allowing a degree of immunity from penalties for volunteers serving on nonprofit organization boards. The IRC §6672 contains an important exception from the penalties for failure to collect and pay employment taxes for an unpaid, volunteer member of a board or a trustee or director of a tax-exempt organization that possesses the following characteristics:[46]

- Is serving solely in an honorary capacity
- Does not participate in the day-to-day or financial operations of the organization
- Does not have actual knowledge of the failure on which such penalty is imposed

[46] Taxpayer Bill of Rights §904.

(b) Tax Withholding Requirements

An exempt organization is subject to the income and Social Security tax withholding system for most of its employees.[47] An individual paid less than $100 is not subject to Social Security tax withholding, but is subject to income tax withholding. Special rules apply to ministers and foreigners, as discussed previously and in the special circumstances discussed below.

(c) Unemployment Tax

Only charitable organizations classified as exempt under IRC §501(c)(3) are exempt from the federal unemployment tax; all other exempt organizations are subject to such tax. Exemptions may be available in some states. For example, in Texas the following exemptions apply:

- Charities with fewer than four employees are not subject to the tax.
- A charity may elect to be a *reimbursing employer* by agreeing to directly pay any benefits that may come due as employee claims are made.

(d) Backup Withholding

The backup withholding system allows the U.S. Treasury to collect funds up front from independent contractors who potentially will not pay their taxes. Form W-9, Request for Taxpayer Identification Number and Certification is furnished by organizations to payment recipients. This is the same form used by banks and stockbrokers to ask individuals to verify their federal identification numbers and to claim exemption from backup withholding.

Unless the organization receives a signed W-9 reflecting a Social Security number from nonemployees receiving payments for services and from individuals receiving taxable grant or fellowship payments, income tax must be withheld from the payments. Absent completion of Form W-9 or when there is some reason to believe that the Social Security number furnished is incorrect, a flat 31 percent of the amounts paid must be withheld and remitted. The system is designed to cause the organization to collect the tax if the individual is unable or unlikely to do so.

The Institute of International Education reported that 547,867 non-U.S. citizens were studying in the United States during the academic year 2000-2001. Dizzying arrays of tax treaties allow different exemptions and exceptions and impose significantly different tax burdens on foreign students.[48]

Nonresident Aliens. Reporting and withholding requirements for nonresident aliens depends on the alien's visa status, the existence of a treaty between the alien's home country and the United States, and the character of the payments the alien receives. The IRS has created a Foreign Payments Division to coordinate enforcement issues related to this complicated subject. After some years of confusion and controversy, the IRS wrote regulations governing these withholding

[47] IRS Circular E, *Employer's Tax Guide*.

[48] Helpful charts of the rules applicable to each country are contained in an article by Edmund Outslay, "The U.S. Taxation of International Students: An Analysis and Call for Reform," *The Exempt Organization Tax Review*, September 2002, pp. 439-451.

requirements under IRC §1441.[49] An organization making such payments may have to file a number of special forms designed particularly for aliens, as follows:

- *Form 1001.* The form furnished by the student to the institution to claim exemption from withholding on the taxable portion of any grants or awards that are excluded under treaty provisions with the student's country.
- *Form 1040-NREZ.* Individual income tax return specially designed for use by nonresident alien students and professors.
- *Form 1042-S.* Report for each nonresident alien student of the amount of his or her scholarship that is nontaxable (award that is equal to or less than the tuition and fees the alien would be required to pay), the taxable portion (award amounts in excess of fees and tuition and not excluded under a treaty), and the amount of the tax that was withheld (14 percent) on the taxable portion.
- *Form 8233.* The form completed by institution to report to the IRS treaty-based exemptions for payments for teaching and research services rendered by nonresident aliens. This exemption is not effective until 10 days after filing the form.

(e) Payroll Depository Requirements

Nonprofits with tight cash flows are sometimes tempted to pay the employees the net amount of salary (less taxes) and use the tax money to pay the rent or some other pressing expense. However, the amounts withheld from an employee's salary are held in trust on behalf of the employee, so the money does not belong to the organization. The penalties for failure to pay over such taxes are steep. Taxes withheld are due to be deposited in as few as three days from the date wages are paid.

The deadline for paying withheld employment taxes to the IRS varies according to the amount of the payroll tax liability. The current version of IRS Publication 15, *Employer's Tax Guide*, should be studied because the rules may change from year to year. For example, the threshold for employment tax deposits was increased from $1,000 to $2,500 effective January 1, 2002. Thus, a modest organization with quarterly payroll taxes of under $2,500, may be allowed to pay the tax with a check sent with the quarterly Form 941.

(f) Withholding for Bingo, Raffles, and Other Contests

Income taxes are imposed on gambling winnings, including prizes of all sorts won in a raffle, sweepstakes, lottery, or other contest. The rules for exempt organizations are the same as those for nonexempts.[50] A serious trap for the unsuspecting exempt is the 31 percent withholding requirement placed on an organization (exempt or nonexempt) awarding any prize with a value in excess of $5,000. Form W-2G is due to be filed reporting the winnings. See Exhibit 24.2 for a checklist on this subject.

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[49] Reg. §1.1441-4

[50] IRC §3402.

CHAPTER TWENTY-SIX

Mergers, Bankruptcies, and Terminations

26.1 MERGERS AND OTHER COMBINATIONS

Strategic alliances, collaborations, networks, duplication of effort, modernization of facilities and methods, constituency changes, human disagreements, and countless other factors might indicate the need for a nonprofit organization to combine with another organization. Achieving economies of scale in the operations, eliminating duplicated services, integrating service delivery, acquiring needed skills and assets, and strengthening administrative capability are just a few of the reasons why one or more organizations might combine themselves through a merger or other type of organizational combination. In some instances, forming a partnership, engaging a professional management company, or entering into a relationship with a for-profit or nonprofit organization can accomplish the needed improvement without a change in the structure of the organization itself. The tax issues to consider in such a situation are discussed in Chapter 22.

Once it is decided that an alliance or some other form of cooperating operation is not suitable, a formal combination with another organization may in some circumstances be appropriate. The terms used to describe such transactions are those normally applicable to businesses—merger or acquisition. This section briefly addresses the tax issues involved when such combinations occur for tax-exempt organizations. A wide range of management, operational, and legal issues involved in alliances, mergers, and other combinations are beyond the scope of this book, but good resources are available.[1] The state and local laws regarding mergers must also be considered with local advisors familiar with the rules.

First and foremost, any merger or combination must be entered into with cognizance of the fact that a tax-exempt organization of any category is essentially required to devote its assets—both during its life and upon its demise—primarily to the purposes for which it is exempt. As discussed in Chapters 2 through 10, particular standards of formation apply to organizations qualifying for the various categories of exemption. A charitable organization's charter, for example, must specifically require that its assets be distributed only upon dissolution for charitable purposes. Applicable fiduciary responsibilities and responsiveness to members and past supporters must be considered in combinations of all types of tax-exempt organizations. The bottom line in any merger is an obligation that the assets of a nonprofit ideally be distributed to an organization whose purposes will accomplish the goals for which moneys were accumulated by the organization going out of existence. From a federal tax standpoint, in a formal merger, one organization survives. In its simplest form, all of the assets of one organization are assigned, or transferred, to another.

What have been referred to as virtual mergers for hospitals are actually joint operating agreements, not true mergers.[2]

For the purposes of this discussion, it is presumed in a merger there will be one surviving organization. All of the parties to the merger have recognition of tax-exempt status and normally are exempt under the same subsection of §501(c)—(c)(3), (c)(4), or (c)(6), for example. The assets of a (c)(3) should not, as a general rule, be distributed to an organization that is qualified for tax exemption under some other category. On the other hand, a business league might, for some good reason, contribute its assets to a labor union of persons working in the same profession or to a charity.

(a) Tax Attributes

Concepts normally applicable to for-profit business combinations can be referred to in evaluating tax attributes that are assigned or attributed to the successor organization in a merger.[3] Conceptually, all of the tax attributes of the entity transferring its property carry over to the recipient organization.[4]

Carryover Basis. A merger is classically a nontaxable transaction, meaning no gain or loss is recognized upon the transfer of assets from one organization to another. This discussion assumes the organizations participating in the merger are themselves tax-exempt and therefore excused from tax on the transaction.[5] Any unrealized gain inherent in the assets[6] is allowed to go untaxed (even if an

[1] The reader can consult Thomas McLaughlin, *Nonprofit Mergers and Alliances; A Strategic Planning Guide* (New York: Wiley, 1998), and Alceste T. Pappas, *Reengineering Your Nonprofit Organization: A Guide to Strategic Transformation* (New York: Wiley, 1995) for those issues.

[2] Defined in, Roderick Darling and Marvin Friendlander, Chapter J., Virtual Mergers, Hospital Joint Operating Agreement Affiliations, IRS *CPE Text,* 1997.

[3] IRC §351.

[4] IRC §381.

[5] See Section 21.10(e) regarding distributions from a for-profit subsidiary of a tax-exempt organization.

[6] See Section 12.4(e).

entity is taxable) because the tax basis of the assets of the transferee is carried over to the surviving organization. Particularly when unrelated business or private foundation assets are involved, this rule serves to permit the transfer. The tax impact comes when the recipient party to the merger disposes of the asset. The asset-holding period of the entity ceasing to exist also carries over. Depreciation for assets transferred, for example, will continue to be calculated in the same manner as before the transfer.

Other Tax Attributes. Activities classified as an unrelated business to the expiring entity will very likely be considered as such for the recipient organization. Net operating loss, foreign tax, and contribution deduction carryovers and accumulated corporate earnings (ACE) accounts attributable to the unrelated business will carry over to the surviving entity.[7]

Public Charity Status. The ongoing public status of the surviving organization will depend partly upon the category of Internal Revenue Code (IRC) §509 under which the surviving organization operates. A church, school, hospital, medical research organization, or college support organization that continues to conduct such activities after it receives assets of another organization can continue to so qualify.[8] Although the author could find no ruling or procedures addressing the question, it seems logical that the combined, or surviving, organization might be required to calculate its public support test on a combined basis. Conceivably, the past revenues of the transferring organization would be added to those of the recipient (surviving) organization to determine qualification as a public charity. The unusual grant rules and facts and circumstances test can be availed of, if necessary, to achieve public status.[9] A 2002 private ruling approved the merger of two §509(a)(1) organizations with no comment on the consequences to the public support test.[10]

(b) Seeking IRS Approval

The Internal Revenue Service (IRS) does not require advance approval for a distribution in termination of all of the assets of any form of §501(c) organization. The Forms 990, 990-EZ, and 990-PF annually ask whether there have been any changes in the organization's operations, purposes, or governing documents. A complete termination of a tax-exempt organization is essentially accomplished under state law.[11] Full information, including documents approved by appropriate state authorities, must be attached to the final Form 990 filed by the terminating organization. Similar documents are attached to the recipient, or surviving, organization. Private foundations have additional issues that are outlined in Section 12.4.

Advance approval for a merger or other transactions involving transfers of significant assets is not required, but may be desirable. In a complicated situation, particularly where there is some question as to the ongoing qualification of

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[7] See Chapter 21.
[8] Standards for qualification are outlined in Chapters 3, 4, 5, and 11.
[9] Discussed in Section 11.2.
[10] Priv. Ltr. Rul. 20236049.
[11] See Section 26.3.

the survivor, an IRS ruling prior to completion of the merger might be requested. If prior approval is not requested, another choice is available. The documents, along with full a description of facts and circumstances, can be furnished to the Ohio Service Center (assigned with responsibility for making determinations of tax-exempt status) with a letter request that they decide whether the completed transaction has any impact upon the survivor's qualification. Last, the parties to the transaction can simply furnish full details with the Forms 990 filed for the year of the merger in response to Question 76, and possibly 77 in Part VI. The latter choice has, in the past, brought no overt response from the IRS. The choice of method of informing the IRS depends on a desire for overt approval as discussed in Section 18.3.

(c) Other Types of Transformations

The reverse of a merger—creating a subsidiary or brother-sister nonprofit—presents tax considerations similar to those pertaining to merging organizations. To provide protection from liability, for management reasons, to satisfy a regulatory requirement, or other reasons, an existing nonprofit(s) might create a new nonprofit to conduct some aspects of its activities. A title-holding company might be created to hold investments, buildings, or other long term assets.[12] A service-providing management company might be formed to consolidate administrative services. A nonprofit might be created in a neighboring state to facilitate an expansion of programs.[13] Care must be exercised to ensure that the provision of services to an affiliated entity are not classified as unrelated business income.[14]

A nonprofit organization might also transform itself by splitting up into two or more parts. Sometimes the activities of the organization are of a sort that exposes the organization to liability for claims of damages. In such situations, a title-holding company or a supporting organization might be created by transferring the organization's investment assets and permanent operating assets, such as buildings, into a separate nonprofit corporation. Such a holding company can qualify for independent tax-exemption if it is dedicated to holding the assets and paying over the income generated therefrom to its parent organization. [15] A new Form 1023 or 1024 is filed for the holding company.[16]

In a similar fashion, one organization might split itself into several parts for one of the reasons suggested at the opening of this chapter. Separate, independent organizations might be formed to conduct certain programs and hold certain assets. Again a new Form 1023 or 1024 is required for any newly created trust or corporation receiving a distribution of assets, and the multitude of rules and procedures outlined in Chapters 2 through 11 must be taken into consideration in determining its proper tax status. Another possibility is for a local organization to reorganize itself to become part of a group exemption.[17] This might

[12] Requirements described in Chapter 10.
[13] Priv. Ltr. Rul. 9840049.
[14] See Section 21.8(b).
[15] See Chapter 10.
[16] Rules and procedures for seeking recognition for exemption with Form 1023 or 1024 are discussed in Chapter 18.
[17] See Section 18.1(d).

be accomplished either with a spin-off of a particular activity or with transformation of the entire organization. Private foundations have requested a slew of private rulings for split-ups, as discussed in Section 12.4.

(d) Conversion to a For-Profit

A tax-exempt organization might also terminate its existence by converting itself into, or selling its assets to, a for-profit business. This type of structure change occurs for a number of reasons. Many health care organizations during the late twentieth century took advantage of offers for new capitalization not available in the nonprofit sector, for example. When a nonprofit wants to commercially exploit its activities on a level that would cause loss of tax-exempt status,[18] such a conversion might also be desirable.

First and foremost, the assets of the tax-exempt organization must continue to be dedicated to its exempt purposes. To qualify as a §501(c)(3) organization, the charter must require that assets be permanently dedicated to charitable purposes and that, on dissolution, its assets be distributed to another charitable organization.[19] The proceeds of selling its assets or the nonprofit corporation itself must continue to be used by the selling entity for charitable purposes or be distributed to an existing or newly created 501(c)(3) organization. Another provision of the charter of most tax-exempt organizations requires that none of its assets be used to give benefit to private individuals. Thus, the price received for sale of assets, whether received as cash, notes, and/or shares, must be no less than the fair value of the property transferred. Care must be exercised in negotiating the deal to apply the standards for determining whether impermissible private benefit, or in the case of insiders, private inurement, will transpire.[20]

Ongoing qualification as a public charity is sometimes problematic for the nonprofit survivor of an asset sale. Consider a hospital classified as a public charity under §509(a)(iii) that sells its operating assets for cash. Assume the proceeds are invested in bonds so that its primary source of revenue becomes interest income. Unless it undertakes a fund-raising campaign or converts itself into a supporting organization, it will eventually fail the tests to avoid becoming a private foundation.[21] Indeed, such transactions can take many different forms, have varying consequences, and require the assistance of lawyers versed in applicable tax rules.[22]

26.2 BANKRUPTCY

Despite the best intentions and dreams of their creators and managers, exempt organizations on occasion expend funds in excess of their resources. Some organizations are fortunate enough to have philanthropists or other supporters who are willing and able to cover operating deficits they might incur. Sometimes,

[18] Discussed in Sections 2.2(e) and 21.1.
[19] Discussed in §2.1(b).
[20] Discussed in Chapter 20.
[21] Discussed in Chapter 11.
[22] See the very helpful and thorough article by D. Mancino and F. Hill, "Converting an Organization's Status from Nonprofit to For-Profit," *Taxation of Exempts,* January/February 2002.

however, an exempt organization may become insolvent to the point that it must declare bankruptcy. In such cases, the interests of the (normally) for-profit creditors and the nonprofit constituents of the organization can be in conflict, and a number of issues must be considered.

A consideration of the federal Bankruptcy Code is also beyond the scope of this book, and any organization facing insolvency and considering bankruptcy should seek an attorney knowledgeable about the field. In most respects, the Bankruptcy Code provides the same rules for nonprofit and for-profit organizations. The intention of the rules is to protect the insolvent organization, to prevent any particular creditor from taking unfair advantage, and to allow an orderly allocation among creditors of the proceeds of the asset liquidation.[23]

The Bankruptcy Code is divided into chapters, with bankruptcy cases referred to by the numbers of the chapters they are brought under. A Chapter 7 bankruptcy allows the organization, under the supervision of a court-appointed trustee, to sell off its assets, allocate the proceeds of such sales among its creditors, dissolve its legal existence, and cease to operate. The other common type of bankruptcy, Chapter 11, allows the organization to reorganize and remain in existence after providing for a payment plan for its indebtedness.

Bankruptcy may be voluntary or involuntary. A voluntary bankruptcy is filed by an insolvent organization to seek the protection from unfriendly creditors. In contrast, an involuntary bankruptcy is filed by a group of three or more creditors. However, only a "moneyed, business, or commercial operation" qualifies for an involuntary bankruptcy, a significant matter on which the Bankruptcy Code provides different treatment for nonprofit corporations. "Moneyed" organizations are profit-motivated ones operated to create income for their shareholders or members. Most tax-exempt organizations would not continue to qualify for exemption if they could meet such a definition. Thus, it is generally the case that an organization qualified for tax exemption under one of the subsections of IRC §501(c) cannot be placed in involuntary bankruptcy. However, failure to qualify for the exception from involuntary bankruptcy can cause the organization to lose its tax-exempt status, because it would show that the assets are not dedicated to exempt purposes.

(a) How Tax Status Is Affected by a Bankruptcy

All categories of IRC §501 organizations—(c)(1-27) plus §501(d), (e), and (f)—must be organized and operated for their specifically defined category, as discussed in Chapters 2 through 10. Charities, social welfare organizations, business leagues, social clubs, and all other types of exempt organizations must permanently dedicate their assets under organizational documents to their specified purposes, and must then, in fact, operate for such purposes throughout the life of the organization to maintain tax-exempt status.

An insolvent exempt organization considering bankruptcy may face a challenge that it did not operate for exempt purposes. Any revocation of exemption would be based on the facts and circumstances of the case. There is no rule that

[23] U.S.C. §303.

automatically revokes exempt status upon the declaration of bankruptcy, and there are no revenue rulings or other statements of IRS policy on the subject. The questions that must be asked in reviewing a particular situation (all versions of the same theme) would include:

- Were the activities in which the debt was incurred exempt activities?
- Why was adequate revenue not provided to pay for the exempt activities? Were revenues diverted to some other nonexempt purposes? Are there unrecorded liabilities attributable to restricted donors whose funds were diverted to other purposes?
- If the debts were incurred in connection with an unrelated business activity, did that business subsume the exempt activities and therefore evidence lack of substantial exempt purposes?
- Were exempt assets diverted to some nonexempt project violating the requirement that assets be dedicated to exempt purposes? Were jeopardizing investments purchased? Particularly for a private foundation, this could provide the additional complication of excise taxes.[24]
- How can assets be allocated to creditors when the organization's charter requires that assets be dedicated permanently to exempt purposes?
- Were members of the governing body of trustees or directors in any way fiscally irresponsible in allowing the deficits to occur? Should any of the deficiencies be paid by such directors to preserve the organizational assets for the exempt constituents?

(b) Revocation of Exempt Status

The Bankruptcy Code automatic stay against collection, assessment, or recovery of a claim against the bankrupt organization does not prevent the IRS from revoking exempt status. In abusive situations, that is, when the debts were incurred in providing benefits to insiders rather than in serving the exempt public or membership, an attempt to revoke should be expected. Such a challenge would be bolstered when there are no assets left upon dissolution for distribution for exempt purposes, as is required by any exempt organization's charter.

The revocation has been ruled to be a preliminary step or prerequisite to the collection of tax and not restrained by the filing of bankruptcy.[25] The anti-injunction provision of IRC §7421 prohibits the bankruptcy trustee or others from interfering in the revocation of exempt status when the IRS deems it appropriate. Whether the IRS can be successful in collecting any taxes assessed is another question to be answered by a bankruptcy specialist.

When exempt status is revoked, tax issues including forgiveness of indebtedness, deductions for bad debts, and recapture of tax attributes, among other issues, must be carefully considered. Even if the exempt status is not revoked, such issues would be of consequence in calculating any tax liability for unrelated business income.

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[24] See Chapter 16.

[25] *Bob Jones University v. Simon*, 416 U.S. 725 (1974); *Heritage Village Church and Missionary Fellowship, Inc.*, 851 F.2d 104 (4th Cir., 1988).

(c) Filing Requirements

After the exempt organization voluntarily files bankruptcy, a new organization does not come into being. Under IRC §1399, the existing entity continues and normal filing requirements continue. As a matter of tax policy, the exempt status of the organization is allowed to remain intact unless factors evident in the bankruptcy indicate that the exempt status of the organization should be revoked, as discussed previously.

The gross annual revenues of the bankrupt organization govern its annual federal filing requirements.[26] As the bankruptcy proceeds, returns are to be filed as usual except in the year of liquidation, dissolution, termination, or substantial contraction. An entity with more than $25,000 but less than $100,000 of gross receipts files Form 990-EZ, and one with more than $100,000 files Form 990. In the contracting or final year, a lower threshold of $5000 of gross receipts sets the limit for required reporting. In other words, the Form 990 must be filed in almost all cases.

Prior to the actual year of dissolution or termination, the filing requirements for other purposes—annual information, payroll, and all other types of federal returns—remain the same during the period of bankruptcy. Even though the organization ceases normal operations and receives no contributions, gross revenue for filing purposes includes proceeds from the sale of its assets. The parties responsible for filing information returns are either the board of directors and the organization's ongoing managers or the bankruptcy trustee appointed to replace the directors or organizational trustees.

Information revealing the bankrupt status should be attached to Form 990 in response to the question, "Has the organization engaged in any activities not previously reported to the IRS?" At a minimum, the documents filed with the bankruptcy trustee and a synopsis of the expected outcome should be attached to the return. An explanation of the cause of the bankruptcy and its effects on ongoing operations (under Chapter 11) or on its orderly dissolution (under Chapter 7) should also be attached to the return. It is very important at this point to indicate that the exempt purposes of the organization are not compromised by the bankruptcy, and that the exempt status should not be revoked or jeopardized as a consequence (when it is possible to so argue).

Section 6043 of the IRC contains specific requirements for information to be reported in the year of dissolution of an exempt organization, which apply to organizations dissolving due to bankruptcy. Although the answer is full of innuendo from the question of jeopardy to exempt status, this section specifically requires that the following information be reported in Form 990 for the distribution year:

- Names and addresses of persons receiving the terminating distributions
- Kinds of assets distributed
- Fact that the assets are distributed and dates of distribution
- Each asset's fair market value

[26] See Chapter 18.

When the asset distribution and settlement with creditors takes place over a series of reporting years, the regulations should be carefully considered for determining when a "substantial contraction" occurs, to allow properly timed reporting.

Related Organization. What if one member of an affiliated group of exempt organizations becomes insolvent and is considering declaring bankruptcy? Particularly in a statewide or nationwide group whose reputation might be damaged by the bad credit rating of a related entity, questions in addition to those listed previously under Section 26.2(a) should be asked. Will the parent or other affiliates be held responsible in any way for the bankrupt affiliate's debts? Must the group intervene to provide services to ensure the exempt purposes of the group are served? Should the crippled affiliate be given financial assistance? The systems for monitoring, assisting, and controlling related organizations should be reviewed and revised to avoid reoccurrence.

26.3 TERMINATIONS

An organization exempt under IRC §501(a) may cease to operate and dispose of its assets for a number of different reasons (some discussed previously) and in a variety of ways. Most tax-exempt organizations, including private foundations, are free to terminate their existence so long as they do so in a fashion that serves their tax-exempt purposes. There is no procedure under the tax law that requires an organization to seek the permission of the IRS to terminate. A private foundation (PF) that has committed repeated and flagrant violations of the special PF sanctions discussed in Chapters 14 through 17 may be involuntarily terminated by the IRS.[27]

Termination of an exempt organization is mainly a matter of local law that should occur with the assistance of a qualified attorney. Those exempt organizations formed as corporations should seek permission to terminate from the appropriate state officials. Exempt organizations formed as trusts may be able to simply follow the provisions set out in their trust instrument. The IRS instructions to Forms 990 ask if there has been a termination or contraction, presuming that the reporting organization has followed the suitable procedures on a state or local level.

However it is accomplished, an exempt organization must report its liquidation, dissolution, termination, or substantial contraction to the IRS when it files Form 990 or Form 990-PF.[28] A blank on the front page is provided to be marked "final." The instructions to the forms request that a statement be attached to explain what took place. The following specific information is to be attached to the return:

- Statement reporting assets distributed and the date
- Certified copy of any resolution or plan of liquidation or termination with all amendments or supplements not already filed

[27] See Section 12.4.
[28] IRC §6043(b).

- Schedule listing the names and addresses of all organizations and persons receiving assets distributed in liquidation or termination, the kind of assets distributed to each, and the asset fair market value.

(a) No Special Filings Required

Certain types of organizations do not have to provide reports of their dissolution, liquidation, termination, or contraction, as follows:

- Any organization not required to file Form 990, including all churches, as well as their integrated auxiliaries, or conventions or associations of churches and an organization, not a private foundation, normally receiving not more than $5,000 a year of gross receipts[29]
- A private foundation terminating its status by converting to a public charity[30]
- Subordinate member covered by a group exemption where the central organization files Form 990 for the group
- Instrumentality of the United States created by an Act of Congress and their title-holding companies
- Certain pension plans and credit unions

(b) Substantial Contraction

A partial liquidation or other major disposition of assets must also be reported on Form 990 or Form 990-PF. The instructions stipulate that such a disposition occurs in two situations:

- At least 25 percent of the fair market value of the organization's net assets at the beginning of the year are given to another organization.
- Current-year grants, when added to related dispositions begun in an earlier year or years, equal at least 25 percent of the net assets the organization had when the distribution series began.

[29] Reg. §1.6043-3(b).
[30] Such a foundation would have first sought approval for its conversion under rules discussed in Section 12.4.

Table of Cases

Table of IRS Revenue Rulings

Revenue Rulings	Sections
54-394, 1954-2 C.B. 131	§6.2
55-31, 1955-1 C.B. 72	§6.3(b)
55-70, 1955-1 C.B. 506	§24.3(b)
55-230, 1955-1 C.B. 71	§7.2(a)
55-311, 1955-1 C.B. 72	§6.2
55-406, 1955-1 C.B. 73	§4.1
55-449, 1955-2 C.B. 599	§21.8(g)
55-587, 1955-2 C.B. 261	§5.1(e)
55-676, 1955-2 C.B.266	§21.7(c)
56-84, 1956-1 C.B. 201	§8.4(b)
56-138, 1956-1 C.B. 202	§4.1
56-185, 1956-1 C.B. 202	§4.6(a)
56-245, 1956-1 C.B. 204	§7.2(a)
56-305, 1956-2 C.B. 307	§9.1(b)
56-403, 1956-2 C.B. 307	§§2.2(a), 4.5
57-574, 1957-2 C.B. 161	§3.4
58-224, 1958-1 C.B. 242	§8.4(b)
58-293, 1958-1 C.B. 146	§8.11
58-294, 1958-1 C.B. 244	§8.3(b)
58-455, 1958-2 C.B. 261	§10.3(a)
58-501, 1958-2 C.B. 262	§§9.2, 9.2(a)
58-588, 1958-2 C.B. 265	§9.3(b)
58-589, 1958-2 C.B. 266	§§9.1(a), 9.2(a), 9.3
59-6, 1959-1 C.B. 121	§7.1(b)
59-129, 1959-1 C.B. 58	§3.2(b)
59-234, 1959-2 C.B. 149	§§8.4(b), 20.7(b)
60-80, 1960-1 C.B. 198	§7.2
60-143, 1970-1 C.B.192	§21.7(c)
60-144, 1960-1 C.B. 636	§18.2(d)
60-106, 1960-1 C.B. 153	§20.7(c)
60-384, 1960-2 C.B. 172	§10.2
61-72, 1961-1 C.B.188	§21.7(a)
61-87, 1961-1 C.B. 191	§4.5
61-170, 1961-2 C.B. 112	§8.4(b)
61-177, 1961-2 C.B. 117	§§8.2, 8.4(a), 8.9, 23.1(a), 23.6
62-10, 1962-1 C.B. 305	§18.2(d)
62-17, 1962-1 C.B. 87	§7.1(b)
62-23, 1962-1 C.B. 200	§5.1(a)
62-113, 1962-2 C.B. 109	§2.2(a)
62-167, 1962-2 C.B. 142	§6.2
62-191, 1962-2 C.B. 146	§7.1(b)
63-73, 1963-1 C.B. 35	§24.1(c)
63-156, 1963-2 C.B. 79	§25.2(a)
63-190, 1963-2 C.B. 212	§§9.1(b), 9.2(b)
63-220, 1963-2 C.B. 208	§4.5
63-235, 1963-2 C.B. 210	§4.5
64-118, 1964-1 C.B. 182	§§5.1(f), 9.1(b)
64-174, 1964-1 C.B. 183	§5.1(g)
64-175, 1964-1 C.B. 185	§5.1(g)
64-182, 1964-1 C.B. 186	§§2.2(d), 2.2(e)
64-187, 1964-1 C.B. 354	§6.2
64-195, 1964-2 C.B. 138	§23.4(a)
65-1, 1965-1 C.B. 226	§5.3(a)
65-14, 1965-1 C.B. 236	§8.4(b)
65-61, 1965-1 C.B. 234	§5.4
65-64, 1965-1 C.B. 241	§9.2(a)
65-164, 1965-1 C.B. 238	§8.4(a)
65-195, 1965-2 C.B. 164	§6.2
65-244, 1965-2 C.B. 167	§20.7(c)
65-270, 1965-2 C.B. 160	§5.1(e)
65-271, 1965-2 C.B. 161	§5.1(g)
65-298, 1965-2 C.B. 163	§§4.5, 5.1(e), 5.3(a)
65-299, 1965-2 C.B. 165	§6.2
65-432, 1965-2 C.B. 104	§24.3
66-59, 1966-1 C.B. 142	§6.3(a)
66-79, 1966-1 C.B. 48	§§8.11, 24.1(b)
66-102, 1966-1 C.B. 133	§10.3(b)
66-103, 1966-1 C.B. 134	§4.5
66-105, 1966-1 C.B. 145	§7.2(b)
66-147, 1966-1 C.B. 137	§§5.1(j), 5.3, 5.3(a)
66-150, 1966-1 C.B. 147	§§9.1(b), 10.3(a)
66-177, 1966-1 C.B. 132	§13.5
66-178, 1966-1 C.B. 138	§5.1(h)
66-179, 1966-1 C.B. 139	§§6.2, 7.3, 8.3(c), 9.1(b)
66-223, 1966-2 C.B. 224	§8.4(a)
66-295, 1966-2 C.B. 207	§10.3(a)
66-338, 1966-2 C.B. 226	§20.7(c)
66-354, 1966-2 C.B. 207	§7.1(c)

Revenue Rulings	Sections
66-358, 1966-2 C.B. 216	§24.3
66-359, 1966-2 C.B. 219	§5.6
67-4, 1967-1 C.B. 121	§§4.5, 5.1(j)
67-6, 1967-1 C.B. 135	§§6.4, 23.4(a)
67-7, 1967-1 C.B. 137	§§7.1(b), 7.1(c)
67-8, 1967-1 C.B. 142	§§2.2(a), 9.1(b)
67-26, 1967-2 C.B. 104	§24.2(c)
67-71, 1967-1 C.B. 125	§23.2(c)
67-77, 1967-1 C.B. 138	§8.3(b)
67-138, 1967-1 C.B. 129	§4.2
67-139, 1967-1 C.B. 129	§9.1(b)
67-148, 1967-1 C.B. 132	§5.1(e)
67-150, 1967-1 C.B. 133	§4.1
67-151, 1967-1 C.B. 134	§5.6
67-176, 1967-1 C.B. 140	§8.4(b)
67-217, 1967-2 C.B. 181	§4.5
67-246, 1967-2 C.B. 104	§§24.1(a), 24.2(c)
67-248, 1967-2 C.B. 204	§9.3(b)
67-250, 1967-2 C.B. 182	§4.2
67-251, 1967-2 C.B. 196	§§7.2(b), 8.7
67-252, 1967-2 C.B. 195	§7.2(b)
67-284, 1967-2 C.B. 55	§21.9(f)
67-292, 1967-2 C.B. 184	§§4.2, 5.1(h)
67-293, 1967-2 C.B. 185	§23.4(a)
67-294, 1967-2 C.B. 193	§6.2
67-295, 1967-2 C.B. 197	§8.4(b)
67-325, 1967-2 C.B. 113	§4.6(g)
67-368, 1967-2 C.B. 194	§6.0
67-392, 1967-2 C.B. 191	§§5.1(e), 5.1(g)
68-14, 1968-1 C.B. 243	§6.2
68-15, 1968-1 C.B. 244	§4.2
68-68, 1968-1 C.B. 51	§25.2(a)
68-70, 1968-1 C.B. 248	§4.2
68-72, 1968-1 C.B. 250	§3.1(c)
68-117, 1968-1 C.B. 251	§17.5
68-118, 1968-1 C.B. 261	§6.2
68-165, 1968-1 C.B. 253	§§5.1(e), 17.5
68-168, 1968-1 C.B. 269	§§9.1(b), 9.2(b)
68-182, 1968-1 C.B. 263	§8.3(b)
68-222, 1968-1 C.B. 243	§10.3(a)
68-224, 1968-1 C.B. 222	§6.2
68-264, 1968-1 C.B. 264	§8.4
68-265, 1968-1 C.B. 265	§8.4(b)
68-306, 1968-1 C.B. 257	§3.1(b)
68-307, 1968-1 C.B. 258	§5.1(j)
68-371, 1968-2 C.B. 204	§§10.3, 10.3(c)
68-372, 1968-2 C.B. 205	§5.1(h)
68-373, 1968-2 C.B. 206	§§5.3(a), 5.4
68-432, 1968-2 C.B. 104	§24.3(b)
68-438, 1968-2 C.B. 609	§4.2
68-504, 1968-2 C.B. 211	§§5.1(e), 21.8(b)
68-534, 1968-2 C.B. 217	§7.1(b)
68-535, 1968-2 C.B. 219	§9.2(b)
68-563, 1968-2 C.B. 212	§3.1(c)
68-609, 1968-2 C.B. 227	§20.6
68-639, 1968-2 C.B. 220	§9.2
68-655, 1968-2 C.B. 613	§4.2
69-68, 1969-1 C.B. 153	§9.1(b)
69-106, 1969-1 C.B. 153	§8.4(a)
69-174, 1969-1 C.B. 149	§4.1
69-175, 1969-1 C.B. 149	§20.7(b)
69-247, 1969-1 C.B. 303	§18.2(d)
69-253, 1969-1 C.B. 151	§2.1(d)
69-256, 1969-1 C.B. 151	§2.2(a)
69-257, 1969-1 C.B. 151	§4.5
69-266, 1969-1 C.B. 151	§20.6
69-279, 1969-1 C.B. 152	§§2.1(d), 2.2(a)
69-381, 1969-2 C.B. 113	§10.3(a)
69-383, 1969-2 C.B. 113	§§4.6(b), 20.2(c)
69-384, 1969-2 C.B. 112	§6.2
69-386, 1969-2 C.B. 123	§7.1(c)
69-441, 1969-2 C.B. 115	§4.1
69-464, 1969-2 C.B. 132	§21.12(a)
69-526, 1969-2 C.B. 115	§5.3(a)
69-527, 1969-2 C.B. 125	§9.1(b)
69-528, 1969-2 C.B. 127	§10.3(a)
69-545, 1969-2 C.B. 117	§§4.6(a), 4.6(b), 4.6(e)
69-635, 1969-2 C.B. 126	§§9.1(a), 9.1(b)
70-31, 1970-1 C.B. 130	§8.6
70-32, 1970-1 C.B. 140	§9.1(b)
70-47, 1970-1 C.B. 49	§24.3(b)
70-48, 1970-1 C.B. 133	§9.2
70-79, 1970-1 C.B. 127	§§2.2(j)(iii), 23.4(a)
70-81, 1970-1 C.B. 131	§8.8
70-95, 1970-1 C.B. 137	§8.4(b)
70-129, 1970-1 C.B. 128	§5.3(a)
70-186, 1970-1 C.B. 128	§4.2
70-187, 1970-1 C.B. 131	§8.4(a)
70-372, 1970-2 C.B. 118	§7.2(b)
70-533, 1970-2 C.B. 112	§§4.1, 5.1(a)
70-534, 1970-2 C.B. 113	§§5.1(e), 21.14

Revenue Rulings	Sections
74-587, 1974-2 C.B. 162	§4.2(b)
74-595, 1974-2 C.B. 164	§5.1(e)
74-596, 1974-2 C.B. 167	§7.1(b)
74-600, 1974-2 C.B. 385	§14.2(c)
74-614, 1974-2 C.B. 164	§§2.2(j)(i), 21.8(b)
75-25, 1975-1 C.B. 359	§14.1(c)
75-38, 1975-1 C.B. 161	§§2.1(f), 12.2
75-42, 1975-1 C.B. 359	§14.5(e)
75-47, 1975-1 C.B. 152	§4.2(c)
75-65, 1975-1 C.B. 79	§24.1(b)
75-74, 1975-1 C.B. 152	§4.0
75-75, 1975-1 C.B. 152	§4.2(c)
75-76, 1975-1 C.B. 152	§4.2(c)
75-85, 1975-1 C.B. 150	§4.2
75-159, 1975-1 C.B. 48	§6.2
75-196, 1975-1 C.B. 155	§5.1(h)
75-198, 1975-1 C.B. 157	§§4.1, 22.4(c)
75-200, 1975-1 C.B. 163	§21.6(a)
75-201, 1975-1 C.B. 164	§21.6(a)
75-207, 1975-1 C.B. 361	§15.1(c)
75-283, 1975-2 C.B. 201	§4.1
75-285, 1975-2 C.B. 203	§4.2
75-286, 1975-2 C.B. 210	§6.2
75-288, 1975-2 C.B. 212	§7.1(b)
75-336, 1975-2 C.B. 110	§13.1(c)
75-384, 1975-2 C.B. 204	§§4.2, 6.2
75-387, 1975-2 C.B. 216	§11.5(c)
75-392, 1975-2 C.B. 447	§15.1(c)
75-393, 1975-2 C.B. 451	§17.3(a)
75-410, 1975-2 C.B. 446	§13.3(a)
75-435, 1975-2 C.B. 215	§§11.2(f), 13.5
75-442, 1975-2 C.B. 448	§15.5(e)
75-470, 1975-2 C.B. 207	§5.1(h)
75-471, 1975-2 C.B. 207	§5.1(g)
75-473, 1975-2 C.B. 213	§7.1(b)
75-492, 1975-2 C.B. 80	§5.1(a)
75-494, 1975-2 C.B. 214	§9.1(b)
75-495, 1975-2 C.B. 449	§15.4(f)
75-511, 1975-2 C.B. 450	§15.4(g)
76-4, 1976-1 C.B. 145	§5.1(g)
76-10, 1976-1 C.B. 355	§14.7(b)
76-18, 1976-1 C.B. 355	§14.2(a)
76-21, 1976-1 C.B. 147	§4.1
76-22, 1976-1 C.B. 148	§§2.2(j)(iii), 4.1
76-31, 1976-1 C.B. 157	§7.1(b)
76-37, 1976-1 C.B. 148	§21.7(a)
76-42, 1976-2 C.B.177	§21.7(c)
76-47, 1976-2 C.B. 670	§§17.3(e), 17.3(f)
76-81, 1976-1 C.B. 156	§6.2
76-85, 1976-1 C.B. 357	§15.1(c)
76-94, 1976-1 C.B. 171	§21.7(a)
76-95, 1976-1 C.B. 172	§21.12(b)
76-96, 1976-1 C.B. 23	§21.8(i)
76-147, 1976-1 C.B. 151	§§4.2, 6.4
76-167, 1976-1 C.B. 329	§5.1(a)
76-204, 1976-1 C.B. 152	§4.2
76-207, 1976-1 C.B. 1578	§8.8
76-208, 1976-1 C.B. 161	§11.6(c)
76-232, 1976-2 C.B. 62	§24.1(a)
76-248, 1976-1 C.B. 353	§§13.3(a), 15.5(e)
76-296, 1976-2 C.B. 141	§5.3(a)
76-335, 1976-2 C.B. 141	§§10.3, 10.3(a)
76-354, 1976-2 C.B. 179	§21.12(b)
76-384, 1976-2 C.B. 57	§5.1(a)
76-399, 1976-2 C.B. 147	§§7.2(a), 7.2(b)
76-401, 1976-2 C.B. 175	§8.2
76-410, 1976-2 C.B. 155	§8.4(b)
76-416, 1976-2 C.B. 57	§11.2(f)
76-419, 1976-2 C.B. 146	§§4.2, 4.2(b)
76-420, 1976-2 C.B. 153	§7.1(c)
76-424, 1976-2 C.B. 367	§13.2(a)
76-440, 1976-2 C.B. 58	§11.2(h)
76-441, 1976-2 C.B. 147	§20.4
76-443, 1976-2 C.B. 149	§§5.1(g), 22.4(a)
76-456, 1976-2 C.B. 151	§23.2(b)
76-459, 1976-2 C.B. 369	§14.7(b)
76-460, 1976-2 C.B. 371	§17.3(a)
76-461, 1976-2 C.B. 371	§17.3(a)
77-4, 1977-1 C.B. 141	§5.1(j)
77-7, 1977-1 C.B. 354	§15.4
77-7, 1977-1 C.B. 540	§15.4(g)
77-44, 1977-1 C.B. 118	§17.3(b)
77-46, 1977-1 C.B. 147	§7.1(c)
77-47, 1977-1 C.B. 156	§21.12(a)
77-47, 1977-1 C.B. 157	§21.12(a)
77-111, 1977-1 C.B. 144	§§4.2, 4.2(a)
77-112, 1977-1 C.B. 149	§8.2
77-114, 1977-1 C.B. 153	§18.1(b)
77-153, 1977-1 C.B. 147	§7.2(b)
77-154, 1977-1 C.B. 148	§§7.1(b), 7.1(e)

Revenue Rulings	Sections
77-160, 1977-1 C.B. 351	§§14.5(c), 14.5(d)
77-164, 1977-1 C.B. 20	§10.2
77-165, 1977-1 C.B. 21	§10.2
77-206, 1977-1 C.B. 149	§8.7
77-213, 1977-1 C.B. 357	§17.6(d)
77-246, 1977-2 C.B. 190	§§2.2(j)(iii), 4.1
77-259, 1977-2 C.B. 387	§§14.2, 14.4(e)
77-272, 1977-2 C.B. 191	§5.1(e)
77-288, 1977-2 C.B. 388	§14.4(e)
77-331, 1977-2 C.B. 388	§§14.5, 14.5(e)
77-366, 1977-2 C.B. 192	§§3.1(b), 21.14
77-379, 1977-2 C.B. 387	§§14.2(b), 14.3
77-380, 1977-2 C.B. 419	§17.3(a)
77-429, 1977-2 C.B. 189	§10.3(b)
77-430, 1977-2 C.B. 1914	§3.1(b)
78-41, 1978-1 C.B. 148	§2.2(h)
78-51, 1978-1 C.B. 165	§8.4(b)
78-68, 1978-1 C.B. 149	§4.3
78-69, 1978-1 C.B. 156	§6.2
78-77, 1978-1 C.B. 378	§14.2(a)
78-82, 1978-1 C.B. 70	§5.1(a)
78-90, 1978-1 C.B. 380	§16.2(c)
78-98, 1978-1 C.B.167	§21.7(c)
78-102, 1978-1 C.B. 379	§15.4(f)
78-111, 1978-1 C.B. 41	§23.4(a)
78-112, 1978-1 C.B. 42	§23.4(a)
78-113, 1978-1 C.B. 43	§23.4(a)
78-114, 1978-1 C.B. 44	§23.4(a)
78-144, 1978-1 C.B. 168	§§15.1(c), 21.9(a)
78-148, 1978-1 C.B. 380	§15.4(g)
78-225, 1978-1 C.B. 159	§§8.3(b), 8.8
78-248, 1978-1 C.B. 154	§23.2(a)
78-288, 1978-2 C.B. 179	§§7.1(c), 7.1(e)
78-301, 1978-2 C.B. 103	§25.2(a)
78-305, 1978-2 C.B. 172	§5.1(e)
78-315, 1978-2 C.B. 271	§15.5(b)
78-385, 1978-2 C.B. 174	§3.1(c)
78-387, 1978-2 C.B. 270	§12.4(e)
78-395, 1978-2 C.B. 270	§14.3
78-426, 1978-2 C.B. 175	§5.4
78-428, 1978-2 C.B. 177	§§2.2(j)(iii), 4.1
79-12, 1979-1 C.B. 208	§23.3(a)
79-13, 1979-1 C.B. 208	§23.3(a)
79-18, 1979-1 C.B. 152	§4.6(i)
79-18, 1979-1 C.B.194	§21.7(a)
79-71, 1979-1 C.B. 249	§5.1(e)
79-128, 1979-1 C.B. 197	§6.3(b)
79-319, 1979-2 C.B. 388	§15.4
79-321, 1979-1 C.B. 129	§23.2(b)
79-359, 1979-2 C.B. 226	§§3.1(c), 21.7(a), 24.1(a)
79-369, 1979-2 C.B.226	§21.7(a)
79-375, 1979-2 C.B. 389	§15.4(d)
79-630, 1979-2 C.B. 236	§4.6(g)
80-18, 1980-1 C.B. 103	§13.1(a)
80-63, 1980-1 C.B. 116	§6.4
80-69, 1980-1 C.B. 55	§24.1(b)
80-97, 1980-1 C.B. 257	§17.7
80-110, 1980-16 I.R.B. 110	§25.2(b)
80-114, 1980-_ C.B. ___	§21.7(a)
80-118, 1980-1 C.B. 254	§13.1(b)
80-132, 1980-1 C.B. 255	§14.3
80-133, 1980-1 C.B. 258	§16.2(b)
80-205, 1980-1 C.B. 184	§6.2
80-206, 1980-2 C.B. 185	§6.2
80-215, 1980-2 C.B. 174	§§5.1(e), 5.5
80-278, 1980-2 C.B. 175	§§4.2, 4.6(b)
80-279, 1980-2 C.B. 176	§§4.2, 4.6(b)
80-282, 1980-2 C.B. 154	§§23.2(a), 23.2(b)
80-286, 1980-2 C.B. 179	§§4.5, 5.1(e)
80-287, 1980-2 C.B. 185	§§8.4(a), 8.11
80-295, 1980-_ C.B. ___	§21.7(c)
80-296, 1980-_ C.B. ___	§21.7(b)
80-301, 1980-2 C.B. 180	§2.2(a)
80-302, 1980-2 C.B. 182	§2.2(a)
80-310, 1980-2 C.B. 319	§14.5(e)
81-1-1, 1981-1 C.B. 352	§21.15(b)
81-29, 1981-1 C.B. 328	§2.2(j)(i)
81-29, 1981-1 C.B. 329	§§4.5, 21.7(a)
81-40, 1981-1 C.B. 508	§§14.2(b), 14.10(a)
81-46, 1981-1 C.B. 514	§17.3(f)
81-60, 1981-1 C.B. 335	§8.7
81-61, 1981-1 C.B. 355	§4.6(i)
81-69, 1981-1 C.B. 351	§9.5(c)
81-94, 1981-1 C.B. 330	§3.1(e)
81-95, 1981-1 C.B. 332	§§6.1, 23.1(a)
81-108, 1981-1 C.B. 327	§10.3(a)
81-125, 1981-1 C.B. 515	§17.4(a)
81-127, 1981-1 C.B. 357	§8.4(a)

Revenue Rulings	Sections
81-138, 1981-1 C.B. 358	§§8.8, 21.12(a)
81-175, 1981-1 C.B. 337	§8.4(b)
81-178, 1981-2 C.B. 135	§§21.8(c), 21.10(d)
81-217, 1981-2 C.B. 217	§17.3(g)
81-276, 1981-2 C.B. 128	§4.6(h)
81-284, 1981-2 C.B. 130	§4.2(b)
81-295, 1981-2 C.B. 15	§21.9(f)
81-811, 1981-1 C.B. 509	§16.1(b)
82-21, 1982-_ C.B. ___	§6.1
82-136, 1982-2 C.B. 300	§14.5(e)
82-137, 1982-2 C.B. 303	§15.1(d)
82-138, 1982-2 C.B. 106	§8.6
82-223, 1982-2 C.B. 301	§§14.5(a), 17.7
83-74, 1983-1 C.B. 112	§§6.4(a), 6.4(c)
83-104, 1983-2 C.B. 46	§24.1(a)
83-153, 1983-2 C.B. 48	§11.5(c)
83-157, 1983-2 C.B. 94	§§4.6, 4.6(a)
83-164, 1983-2 C.B. 95	§8.3(a)
83-170, 1983-2 C.B. 97	§9.1(b)
84-41, 1984-1 C.B. 130	§21.8(i)
84-169, 1984-2 C.B. 216	§13.5
85-1, 1985-1 C.B. 177	§4.3
85-2, 1985-1 C.B. 178	§4.3
85-162, 1985-2 C.B. 275	§14.5(e)
85-175, 1985-2 C.B. 276	§17.3(d)
86-23, 1986-1 C.B. 564	§3.2(c)
86-43, 1986-2 C.B. 729	§§5.1, 5.1(k)
86-63, 1986-1 C.B. 88	§24.1(a)
86-95, 1986-2 C.B. 73	§23.2(a)
87-41, 1987-1 C.B. 296	§25.1
87-119, 1987-2 C.B. 151	§23.3(a)
88-56, 1988-2 C.B. 126	§6.4(a)
94-16, 1994-1 C.B. 19	§21.9(f)
95-8, 1995-14 I.R.B. 1	§21.10(b)
97-21, 1997-18 I.R.B. 115	§4.6(b)
97-25, 1997-__ C.B. ___	§20.2
98-15, 1998-12 I.R.B. 6	§§4.2(a), 4.6(b), 4.6(c), 22.2(c)
2002-28, 2002-20 I.R.B. 912	§12.4
2002-43, 2002-28 I.R.B. 85	§14.3
2002-87, 2002-__ I.R.B. ___	§12.4(e)
2003-13, 2003-4 I.R.B. 1	§§12.4, 12.4(c)
2003-32, 2003-14 C.B. 689	§17.3(e)
2003-49, 2003-__ I.R.B. __	§23.3(d)
2004-6, 2004-4 I.R.B. 238	§23.6

Table of IRS Revenue Procedures

Index

Note: References are to book section numbers (§), complete chapters (Ch.), appendices (App.), and/or exhibits (Exh.). A zero section reference (e.g., §1.0) indicates unnumbered introductory material at the beginning of a chapter.