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Course #29450-002: Exempt Organizations Determinations Unit 2 (Rev 9-2009)

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Type of Error or problem:
  technical
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  content clarity
  other

Describe error or problem with the material:

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Lesson 1
Introduction

Overview

Unit 2 provides technical instruction for Internal Revenue Code sections most commonly encountered in Grade 12 determination cases. This course includes in-depth lessons, overviews of specialized topics that are reserved for specific groups, and overviews of Grade 13 topics.

Note: Training modules are being developed for reserved topics and will be presented as needed; Unit 3 is being developed for Grade 13 topics and will be presented to agents upon promotion to the Grade 13 level.

Topics covered in this training include:

- Economic development
- Elderly and low-income housing
- For-profit related organizations
- Fundraising as primary activity
- 509(a)(3) Type I and II organizations
- Less frequently seen subsections
- Overview of Grade 13 topics
- Overview of case topics reserved for specific work groups

Course Objectives

After completing this course you be able to:

- Identify issues related to each topic
- Recognize higher graded issues and issues that are reserved for specific work groups
- Work grade 12 cases within each of these topics
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Lesson 2
Lessening the Burdens of Government and Economic Development as an Exempt Activity

Overview

Introduction

Where an organization benefits a charitable class of individuals directly, the charitable purpose intended to be accomplished is clear. If the direct beneficiaries of an organization do not represent a charitable class, such as the “poor and distressed” or “underprivileged,” exemption is not necessarily precluded, but, instead, will be dependent on whether the activity furthers charitable purposes.

Treas. Reg. 1.501(c)(3)-1(d)(2) provides that lessening the burdens of government is, in itself, a “charitable” activity that qualifies an organization for exemption under IRC section 501(c)(3). The determination of whether an organization’s activities lessen the burdens of government is based on facts and circumstances.

Economic development organizations may accomplish a charitable purpose either through direct assistance to members of a charitable class or indirectly through assistance to for-profit businesses located in depressed areas (combating community deterioration or relieving the poor and distressed), even though the businesses are not proper charitable objects.

If it is determined that an applicant organization is not organized and operated exclusively for purposes within IRC section 501(c)(3), consideration may be given to exemption under IRC section 501(c)(4) or 501(c)(6).

Continued on next page
Overview, Continued

Objectives

At the end of this lesson, you will be able to:

- Identify activities that a governmental unit would consider to be its burden
- Determine if proposed activities of an organization actually relieve the burdens of government
- Determine if an organization meets the public purpose requirement for exemption under IRC section 501(c)(3)
- Distinguish between economic development organizations that may and may not qualify for exemption under IRC section 501(c)(3)
- Recognize different types of economic development organizations and their qualifications for exemption
- Determine when an economic development organization may qualify for exemption under IRC section 501(c)(4)
- Determine when an economic development organization qualifies for exemption under IRC section 501(c)(6)

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Requirements of Lessening the Burdens of Government

“Charitable” Position

Treas. Reg. 1.501(c)(3)-1(d)(2) provides that the term “charitable” is used in IRC section 501(c)(3) in its generally accepted legal sense and includes lessening the burdens of government.

Service Requirements

Rev. Rul. 85-2, 1985-2 C.B. 178, sets forth two requirements for an organization requesting exemption under IRC section 501(c)(3) as serving the charitable purpose of relieving the burdens of government. These requirements are:

1. An organization’s activities must be activities that a governmental unit considers to be its burdens and

2. The activities of the organization must actually lessen such governmental burdens.

Lessening the Burdens of Government May Be Sole Basis for Exemption

"Lessening the burdens of government" is, in itself, a charitable purpose and does not require any additional charitable-type purposes such as relieving poverty or advancing science in order to qualify for exemption under IRC section 501(c)(3).

However, although it may be determined that an organization does in fact lessen the burdens of government, the organization must still meet all other requirements for exemption under IRC section 501(c)(3) including the prohibition on private benefit and inurement.
Determining Eligibility as Lessening the Burdens of Government

**Burden of Proof**

The burden of proof for demonstrating that an organization lessens the burden of government lies with the applicant organization. Based on all the facts and circumstances, an organization must demonstrate that a governmental unit considers the organization to be acting on the government’s behalf.

“Acting on the government’s behalf” means the activities of the organization free up governmental assets (such as human, material or fiscal) that would otherwise have to be devoted to that activity if carried out by the governmental unit itself.

**Objective Manifestation**

Rev. Rul. 85-1, 1985-1 C.B. 177, holds that lessening the burdens of government occurs **only** if the governmental unit acknowledges the activities of the organization to be its burden. This objective manifestation may be evidenced by the interrelationship between the organization and the governmental unit.

The fact that a governmental unit praises or expresses approval of an organization’s activities is not sufficient to establish that those activities lessen the burdens of government.

**Verification Methods**

In cases where the application does not clearly establish that a proposed activity does in fact lessen the burdens of government, the specialist may ask the organization to submit a written statement from the governmental unit that the proposed activity would be a burden on the governmental unit if the activity were to be carried on by it.

*Continued on next page*
Determining Eligibility as Lessening the Burdens of Government, Continued

Factors to Consider

In order to establish that an organization’s activities lessen the burdens of government, the following factors should be considered:

• Is there a statute that specifically creates the organization and clearly defines the organization’s structure and purpose?

• Is the activity an integral part of a larger governmental program or operated jointly with a governmental unit?

• Does the governmental unit control the activities of the organization, such as appointing all the board members?

• Does the organization pay governmental expenses?

• Is there governmental funding of the organization’s activities through grants or general obligation bonds backed with the full faith and credit of the governmental unit (as opposed to general revenue bond financing)?

• Is the governmental unit prohibited from performing the activity conducted by the organization?

• Did the governmental unit engage in the activity on a regular basis for a significant length of time before it was taken over by the applicant organization?

If it is determined that the organization does not meet the requirements for exemption under IRC section 501(c)(3), the specialist may review the facts of the case to determine whether exemption under another subsection of the Code should be considered, such as (c)(4). Consideration of other subsections may require additional case development.

The application of these factors is demonstrated in the following examples.
Application to Facts and Circumstances

Example 1: 
Researching Regional Problems

A nonprofit organization assisted local governments of a metropolitan area by researching solutions for common regional problems, such as water and air pollution, waste disposal, water supply and transportation.

- The chief elected officers of the local jurisdictions constituted the membership of the organization.

- Receipts included assessments on the local jurisdictions.

The ruling holds that:

- The membership of the organization indicates the existence of a burden of government because the organization’s membership was composed totally of government officials appointed by the local governments involved.

- Developing regional plans and policies for regional problems is an activity normally conducted by governmental units and indicates a burden of government.

The organization qualifies for exemption as a charitable organization under IRC section 501(c)(3). (Rev. Rul. 70-79, 1970-1 C.B. 127)

Continued on next page
Example 2: Bus Transportation

An organization was formed as a Model Cities demonstration project under the Demonstration Cities and Metropolitan Act of 1966 to provide bus transportation to isolated areas of a community not served by the existing city bus system.

- As a Model Cities project, the organization has been approved by the local government and works in coordination with local governmental agencies.
- The organization’s receipts are from fares, contributions, and governmental grants.
- The organization was formed in conformity with the statute that defined the organization’s structure and purpose.

Based upon the above facts, the ruling concludes that:

- The organization is providing bus service under the authority of the Federal and local governments
- It is lessening the burdens of government so long as it is operated as a government program.

The organization qualifies for exemption as a charitable organization under IRC section 501(c)(3). (Rev. Rul. 78-68, 1978-1 C.B. 149)
Example 3: Funding a Law Enforcement Agency

A nonprofit organization was formed to fund a county’s law enforcement agencies to police illegal narcotic traffic.

- The funds allow undercover narcotics agents to purchase drugs in the course of their efforts to apprehend persons engaged in illegal drug traffic.

- No government funds are otherwise available for these purposes.

- The organization’s officers include the local district attorney, sheriff and medical examiner.

- The organization is supported by contributions from the general public.

The ruling concludes that:

- The organization funds activities that the county treats as an integral part of its program to prevent the trafficking of illegal narcotics. The county thereby demonstrates that these activities are part of its burden.

- The law enforcement agencies can engage in the undercover work without the appropriation of additional government funds.

- The organization is actually lessening the burdens of government because without the funds the undercover investigations could not be conducted, since no other funds are available.

The organization qualifies as a charitable organization by lessening the burdens of government under IRC section 501(c)(3). (Rev. Rul. 85-1, 1985-1 C.B. 177)
Example 4: Lessening the Burdens vs. Social Welfare

An organization provides bus transportation during rush hours between a suburban community and the major employment centers in the metropolitan area. Local bus service is inadequate at those times.

- The membership of the organization is made up of residents of the suburban community.
- The organization contracts for buses and drivers, plans their routes and schedules, and arranges for volunteers to collect fares on each trip.
- The service is provided to the community in general but is used primarily by the residents of the suburban community.
- The board of directors is elected by members of the suburban community and members serve without compensation.
- All meetings of the board are publicized and open to the general public.
- Fares are not sufficient to cover the cost of operations and the organization solicits and receives financial assistance from local government entities to continue its operation of the bus service.

The ruling concludes that:

- The organization provides a useful service to the community; the service is not commercially available and is open to all community residents, and the service is subsidized by governmental financial assistance.
- The activity is conducted by volunteers and, therefore, is not the conduct of a business with the general public in a manner similar to organizations that operate a bus service for a profit.
- The organization is promoting the common good and general welfare of the people of the community within the meaning of Treas. Reg. 1.501(c)(4)-1(a)(2).

The organization qualifies for exemption under IRC section 501(c)(4). (Rev. Rul. 78-69, 1978-1 C.B. 156)
Example 4: Lessening the Burdens vs. Social Welfare (continued)

The revenue ruling compares its findings to Rev. Rul. 78-68 (Model Cities demonstration project) in which exemption under IRC section 501(c)(3) was granted to an organization providing bus service to areas of a community not served by the existing city bus system. Also, the organization was not formed by statute or governmental entities or governed by any governmental appointees as in Rev. Rul. 78-68.

It is important to note that the receipt of financial assistance from one or more governmental entities is not sufficient to qualify the organization as a charitable organization that lessens the burdens of government under IRC section 501(c)(3). However, such organizations may qualify for exemption under another section of the Code.
IRC Section 501(c)(3) - Public Purpose Requirement

Public Purpose Test Must Be Met

Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) holds that an organization must establish that it is not organized or operated for the benefit of private interests (such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests).

If it is determined that an organization’s activities lessen the burdens of government, it must also show that any private benefit received by individuals or businesses is both qualitatively and quantitatively incidental to its exempt purposes.

(See GCM 37789 for a discussion of “qualitatively” and “quantitatively” incidental private benefit.)

Example 1: Seed Certification

In the case of Indiana Crop Improvement Association, Inc. v. Commissioner, 76 T.C. 394 (acquiesced by the Service in 1981), the Court concluded:

- The Association was delegated the responsibility of seed certification by state and federal law.

- The seed certification was available to any seed producer or farmer that was a member of the Association.

- The seed certification was a recognized governmental function.

- The organization furthered the “charitable” purpose of lessening the burdens of government by conducting the seed certification activity.

- The Association’s seed certification activity did not primarily benefit the private business interests of the member seed producers and farmers.

The Association qualified for exemption under IRC section 501(c)(3).

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Rev. Rul. 81-276, 1981-2 C.B. 128, describes a Professional Standards Review Organization (PSRO) that is created by Federal statute to assure that payments for health care services under governmental health care programs will be made only when, and to the extent, such services are "medically necessary."

- The PSRO is composed of doctors who assume the responsibility of the government in restricting federal health care payments to services that are medically necessary.

- The PSRO is funded from contracts with the Department of Health and Human Services (HHS).

- Membership is open by law to all licensed physicians without charge.

- The board of directors is not tied to any membership or association with any medical society.

- The PSRO’s activities may indirectly further the interests of the medical profession by promoting public esteem for the medical profession, and by allowing physicians to set their own standards for the review of Medicare and Medicaid claims and thus prevent outside regulation.

The ruling holds that:

- Benefits to members of the medical profession are **incidental** to the benefits M provides in promoting health and lessening the burdens of government.

The organization qualified for exemption under IRC section 501(c)(3).

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Example 3: Regional Health Information Organization (RHIO)

As part of the American Recovery and Reinvestment Act of 2009, Congress enacted legislation designed to promote health information technology development and information exchange. Regional Health Information Organizations (RHIOs) are organizations formed and operated to facilitate the exchange of electronic health records among hospitals, physicians, and others in the health care system.

By enacting the new law, Congress recognized that facilitating health information exchange and technology (such as through RHIOs) is important to improving the delivery of health care and reducing the costs of health care delivery and administration. The legislative history of these provisions acknowledges that certain organizations that are organized and operated to facilitate the exchange of health information and satisfy standards established by Health and Human Services lessen the burdens of government and may qualify for exemption under IRC section 501(c)(3).

Applications for exemption from RHIOs are currently reserved for EO Technical.
Economic Development as an Exempt Activity

What Is “Economic Development”? Economic development organizations engage in a broad range of activities to promote, support and develop economic interests. They generally are established to assist existing and new businesses located in a particular geographic area through a variety of activities including grants, loans, provision of information and expertise, or creation of industrial parks.

Incubators are a type of economic development corporation generally formed to provide assistance to induce new businesses to locate in communities whose economies are depressed or deteriorating or to provide assistance to existing, emerging businesses so that they may remain in such communities. Incubators provide low-interest loans, facilities and equipment to new and emerging businesses as well as clerical and technical services in an effort to encourage such businesses to locate in the depressed areas. The services provided to the new businesses are offered by the incubator at reduced rates or even free of charge.

Incubators may be set-up and/or sponsored by local and state governments, they may be affiliated with universities, or they may be an offshoot of an existing tax-exempt organization. In many cases, incubator organizations operate a "technology center" where businesses can be assisted (nurtured) through provision of business expertise, lower rental rates, or pooled or shared services.

Application for Exemption Frequently, applicants interpret their activities to meet one or more of the purposes defined in IRC section 501(c)(3). While these organizations may indeed qualify for exemption under IRC section 501(c)(3), the facts and circumstances of each case must be evaluated to determine the appropriate subsection for exemption, if any. Other subsections which may warrant consideration are IRC section 501(c)(4) and IRC section 501(c)(6).

Continued on next page
Although an organization’s activities may not directly benefit a charitable class (for example, the elderly or the poor and distressed), the organization may nonetheless qualify for exemption on the basis of accomplishing a charitable purpose.

The rationale for recognizing economic development corporations as exempt under IRC section 501(c)(3) is that, although services are provided directly to for-profit businesses, the benefits received by the general public outweigh the private benefits provided to the direct beneficiaries (the businesses).

Determining factors for economic development organizations requesting exemption under IRC section 501(c)(3) include operating in a deteriorated or blighted area, providing assistance to a disadvantaged group, aiding businesses experiencing difficulties in obtaining conventional financing, or aiding businesses providing jobs and training to the unemployed or underemployed. (Extreme caution is suggested when considering an economic development organization under the lessening the burdens of government rationale.)

A careful analysis is often necessary in making a determination. You may find economic development corporations engaged in a multitude of activities which may not exclusively further an exempt purpose under IRC section 501(c)(3).
Guidance in Determining Exempt Status

When reviewing an application, the most important factual determination for the specialist to make is whether the activities of the economic development organization serve a public rather than a private interest consistent with Treas. Reg. 1.501(c)(3)-1(d)(1)(ii), which prohibits private benefit and inurement. In applying a facts and circumstances test, the Service has provided some guidance in the form of three revenue rulings.

**Rev. Rul. 74-587**

Rev. Rul. 74-587, 1974-2 C.B. 162, holds that an organization that devotes its resources to programs to stimulate economic development in economically depressed, high-density urban areas, inhabited mainly by low-income minority or other disadvantaged groups, qualifies for exemption under IRC section 501(c)(3).

The organization made loans and purchased equity interests in businesses unable to obtain funds from conventional sources because of financial risks associated with their location and/or because of being owned by members of a minority or other disadvantaged group. The organization established that its investments were not undertaken for profit or gain but to advance its charitable goals. Funds for its program were obtained from foundation grants and public contributions.

**Rev. Rul. 76-419**

Rev. Rul. 76-419, 1976-2 C.B. 146, holds that a nonprofit organization that purchases blighted land in an economically depressed community, converts the land into an industrial park, and induces industrial enterprises to locate new facilities in the park through favorable lease terms that require employment and training opportunities for unemployed and underemployed residents of the area is operated exclusively for charitable purposes and is exempt under IRC section 501(c)(3).

The rationale for exemption in this ruling includes relieving poverty and lessening neighborhood tensions caused by the lack of jobs in the area, combating community deterioration by establishing new businesses, rehabilitating existing ones, eliminating conditions of blight, and lessening prejudice and discrimination against minorities.

Continued on next page
Rev. Rul. 77-111: Facts

Rev. Rul. 77-111, 1977-1 C.B. 144, holds that two organizations formed to promote economic development in deteriorated areas did not qualify for exemption under IRC section 501(c)(3).

In Situation 1, the organization's purpose is to increase business patronage in a deteriorated area mainly inhabited by minority groups. It accomplishes this purpose by:

- presenting television and radio advertisements describing the advantages of shopping in the area
- creating a speakers bureau composed of local businessmen who discuss the shopping environment with various groups
- operating a telephone service providing information to prospective shoppers on transportation and accommodations in the area
- informing the news media on the area's problems and potential

In Situation 2, the organization's purpose is to revive retail sales in an area suffering from continued economic decline.

- The organization proposes to limit further decline of retail sales within the area caused by competing outlying shopping centers by constructing a center that would complement the area's existing retail features.
- The organization purchased the land for the construction of a retail center that will include a department store and a shopping mall.
- The land purchased by the organization was sold to the city at no economic benefit to the organization.
- Additional land for the project was acquired by the city through its use of eminent domain.
- The city rents all the land to the organization and to a private developer who actually will construct and lease out the project.
- The city requires that minorities be utilized in both the construction and operation of the project.
- Stores located within the project are required to employ a certain percentage of minority group employees.
Rev. Rul. 77-111 holds that, although the organizations' activities might contribute to achieving IRC section 501(c)(3) purposes, their overall thrust was to promote business as an end in itself rather than to accomplish exclusively exempt purposes. Rev. Rul. 77-111 distinguishes itself from Rev. Rul. 74-587 by stating that, unlike the organization in Rev. Rul. 74-587, the organizations in Situations 1 and 2 do not limit their assistance to businesses located in a deteriorated area that could not obtain conventional financing.

The organization described in Situation 1 does not limit its activities to businesses similar to those assisted in Rev. Rul. 74-587, but also to businesses which are not owned by minority groups and which are not experiencing difficulty because of their location in a depressed area.

The activities of the organization in Situation 2 result in major benefits accruing to the stores that will locate within the shopping center. It does not limit its aid to businesses that are owned by members of a minority group or to businesses that would only locate within the area because of the existence of the center. The end result is that the organization's activities are directed to benefit the businesses in the shopping center rather than exclusively to accomplish IRC section 501(c)(3) purposes.

In analyzing these revenue rulings, the following factors are necessary to conclude that an economic development corporation is primarily accomplishing charitable purposes despite the element of private benefit present. Assistance is targeted to:

- Aid an economically depressed or blighted area
- Benefit a disadvantaged group (such as minorities, the unemployed or underemployed)
- Aid businesses that have actually experienced difficulty in obtaining conventional financing because of the deteriorated nature of the area in which they were or would be located, or because of their minority composition
- Aid businesses that would locate or remain in the economically depressed or blighted area and provide jobs and training to the unemployed or underemployed from such area only if the economic development corporation's assistance was available.
Additional Types of Economic Development Organizations

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<td>Many “Main Street” organizations have requested exemption under IRC section 501(c)(3) as economic development organizations.</td>
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<tr>
<td>What is a “Main Street” organization? According to the National Trust for Historic Preservation, <a href="http://www.mainstreet.org">www.mainstreet.org</a>:</td>
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<tr>
<td>In the 1970s, the National Trust developed its pioneering Main Street approach to commercial district revitalization, an innovative methodology that combines historic preservation with economic development to restore prosperity and vitality to downtowns and neighborhood business districts. The Center has led the preservation-based revitalization movement by serving as the nation's clearinghouse for information, technical assistance, research, and advocacy. Through our consulting services, conferences, publications, membership, newsletter, and trainings, it has educated and empowered thousands of individuals and local organizations to lead the revitalization of their downtowns and neighborhood commercial districts.</td>
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<tr>
<td>These organizations often identify themselves as “Main Street” organizations in their names or in their narrative of activities.</td>
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### Main Street Activities

Main street-type organizations describe their activities as economic development in nature and frequently engage in a specific activity where:

- The geographic area is usually confined to a downtown business area
- The organization has a membership composed of businesses and individuals
- Members pay dues
- A landscape beautification program is implemented only within the confines of the defined geographic area
- A façade-improvement program is planned in the defined geographic area under the premise of historical preservation --including a grant or loan program to assist members in carrying out the preservation activity
- Directors are often also governing body members of a chamber of commerce or other similar organization
- The organization may claim to support the municipality where further scrutiny finds that the municipality is providing grants to the organization
- The organization conducts events such as festivals, business “meet-and-greet” events open to the public, farmer’s market, and similar events where the emphasis is to increase foot traffic and patronization of businesses located within the organization’s geographical area
- A directory of business members may be produced and distributed
- Seminars, training sessions, and other “educational” activities requiring membership in the organization as a condition for attendance

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“Main street” type organizations generally engage in a multitude of activities which may not exclusively further an exempt purpose under IRC section 501(c)(3). For example,

- The area represented may or may not be recognized as an economically depressed or blighted area

- The organization’s beautification and promotional activities are generally confined to a defined geographical area

- Grants or loans may be made available to members located within the defined geographic area (almost exclusively businesses, but occasionally residences) for façade development or improvement for the purpose of “historical preservation;” yet, requests for historical registry listings or operations consistent with the facts and circumstance of relevant revenue rulings are rarely provided

In developing the activities of these organizations and analyzing the corresponding authority, these organizations most frequently conduct a combination of activities best defined under IRC section 501(c)(6), and, to a lesser extent, IRC section 501(c)(4) or 501(c)(3).

As such, organizations engaged in economic and “Main Street” activities generally do not meet the requirements of IRC section 501(c)(3) as being organized exclusively for one or more exempt purposes under IRC section 501(c)(3), similar to the organization described in Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945). In this case, the Supreme Court determined that while some activities of the organization were educational, a substantial purpose of the organization was to promote business; thus, the organization was not operating exclusively for educational purposes, and as such, did not meet the requirements of IRC section 501(c)(3).

Nevertheless, careful consideration of the activities of these organizations and application of relevant authority is necessary in each instance to ensure consistent application of tax law and classification of tax exempt status.
Additional Types of Economic Development Organizations,
Continued

Small Business Administration Organizations

Applications are often received from organizations whose sole purpose is to administer various programs regulated by the Small Business Administration (SBA). Under the Small Business Investment Act (the Act), the SBA is authorized to license for-profit Small Business Investment Corporations (SBICs) that will provide capital and long-term loans to small businesses and, in some instances, provide management and technical assistance and advice on a free basis.

Section 301(d) licensees originally arose as a specialized administrative application of this SBA program to minority owned and managed small business enterprises. A section 301(d) licensee, like any other SBIC licensed under the Act, was originally required to be incorporated as a for-profit corporation. By Public Law 92-595, 86 Stat. 1314 (1972), Congress amended the Act to permit the incorporation and operation of section 301(d) licensees on a nonprofit basis. Before the 1972 amendment, a section 301(d) licensee was termed a "Minority Enterprise Small Business Investment Company" or "MESBIC."

Rev. Rul. 81-284

Rev. Rul. 81-284, 1981-2 C.B. 130, holds that a nonprofit section 301(d) licensee which was formed to relieve poverty, eliminate prejudice and discrimination, reduce neighborhood tensions, and combat community deterioration, and that provides 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 the underemployed residents of economically depressed areas, may qualify for exemption under IRC section 501(c)(3).

Continued on next page
The principal difference between a section 301(d) licensee and the organization described in Rev. Rul. 74-587 is the presence of the limitations imposed by the SBA regulations. A section 301(d) licensee may be prevented by the SBA regulations from engaging in certain loan transactions which it might otherwise wish to engage in to further its exempt purposes. In contrast, the organization described in Rev. Rul. 74-587 is free to engage in transactions without regard to the limitations imposed by the SBA regulations.

Nonetheless, the SBA regulations do not foreclose all opportunities for a section 301(d) licensee to achieve charitable purposes, nor do they compel it to enter into transactions that do not further a charitable purpose. Although a narrower range of permissible transactions is available than to the organization described in Rev. Rul. 74-587, a section 301(d) licensee may still provide loans to businesses that cannot secure financing through conventional commercial sources, the operation of which businesses will achieve charitable purposes in the manner described in Rev. Rul. 74-587.

Rev. Rul. 81-284 is not intended to imply that all section 301(d) licensees qualify for exemption under IRC section 501(c)(3). As in any determination, the mere fact that an organization is incorporated or operated on a nonprofit basis does not qualify it for exemption under IRC section 501(c)(3). Additionally, under section 301(d) of the Act and its regulations, an organization may be properly classified as a section 301(d) licensee even though it is not organized or operated exclusively for charitable purposes. Whether a section 301(d) licensee qualifies for exemption under IRC section 501(c)(3) depends upon the facts and circumstances of each case.
Economic Development as Lessening the Burdens of Government

Extreme caution should be exercised before employing a lessening the burdens rationale for an economic development corporation. An economic development corporation may qualify for exemption as lessening the burdens of government based on a preponderance of facts. Look for specific identification of the organization by the local or state government as well as significant involvement by the governmental authority.

The following specific factors represent an example favoring exemption for an economic development corporation based on a lessening of governmental burdens rationale.

- There is a state statute specifically authorizing government funding of an economic development corporation to operate by assisting fledgling businesses within the state as a means to help alleviate severe unemployment.

- The economic development corporation was established to specifically qualify under the statute and was funded under the statute.

- The state statute provides that the funding is more than a mere grant and provides the state with approval authority over projects to be financed by the corporation; approval must be obtained from the state on an ongoing basis.

- As part of its assistance, the economic development corporation operates in conjunction with a state university.

- The specific cities which will be the corporation's primary beneficiaries provide officials who sit on the corporation's board of directors in their official capacity.

- The commissioner of the state's Department of Economic Development utilizes the corporation as an extension to carry out services formally conducted by the Department. The Department was unable to continue such services because of budgetary constraints and is not otherwise prohibited from providing such services.

- The corporation is required to provide annual reports of its activities and finances to the state government.
Qualification Under IRC Section 501(c)(4)

**Economic Development Under IRC Section 501(c)(4)**

IRC section 501(c)(4) provides for exemption from federal income tax of organizations not organized for profit but operated exclusively for the promotion of social welfare.

There are two revenue rulings in which economic development corporations were found to be exempt under IRC section 501(c)(4). Rev. Rul. 64-187, 1964-1 C.B. 187 (Part 1), holds that a nonprofit corporation organized to provide funds through loans, to be used to purchase or develop land and facilities for industrial and commercial usage to alleviate unemployment in areas classified as "redevelopment areas" under the Area Redevelopment Act (Public Law 87-27), qualifies for exemption under IRC 501(c)(4).

Rev. Rul. 67-294, 1967-2 C.B. 193, holds that a nonprofit organization created to make loans to business entities as an inducement to locate in an economically depressed area may qualify for exemption under IRC section 501(c)(4). It was concluded that by encouraging industry to settle in an economically depressed area, the organization is helping alleviate unemployment and is being operated to bring about civic betterment and social improvement.

**Analysis**

While both of the organizations in the revenue ruling were determined to qualify for exemption under IRC section 501(c)(4), the questions left unanswered by these revenue rulings are whether the organizations would have qualified for exemption under IRC section 501(c)(3) and, if not, why.

It may be that the organization’s criteria in selecting businesses for which it will provide assistance is too broad so it more resembles the facts in Rev. Rul. 77-111. Failure to meet the requirements of the public benefit standard of IRC section 501(c)(3) should raise questions about whether the organization can satisfy the community benefit standard of IRC section 501(c)(4).

An examination of the specific activities and whether they are controlled to any significant degree by those to be benefited would be reasonable lines of inquiry. Conversely, if a case is under consideration in which an economic development corporation requests exemption under IRC section 501(c)(4), it may also be appropriate to see whether the organization would qualify for exemption under IRC section 501(c)(3).
Economic Development Under IRC Section 501(c)(6)

IRC section 501(c)(6) provides for the exemption from federal income tax for business leagues and chambers of commerce not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Business leagues and chambers of commerce are often sponsors of economic development corporations. In general, a chamber of commerce is an organization which is dedicated toward improving the general business conditions of the community.

Rev. Rul. 70-81, 1970-1 C.B. 131, holds that the exempt status of a chamber of commerce is not adversely affected by the development of an industrial park in order to attract new industry to the area. Sites are offered to businesses at low prices, sometimes less than cost, to induce them to locate in the community.

Rev. Rul. 81-138, 1981-1 C.B. 358, involves an exempt organization that was created by a chamber of commerce to encourage business development in a particular area. The organization obtained a mortgage to help finance the construction of a building that is leased to an industrial tenant at less than fair rental value. The ruling holds that these activities are substantially related to the chamber's exempt purpose.

Analysis

The rationale for these rulings is that the exempt purpose of improving the general business conditions of a community can be accomplished by attracting new industry to the community. Moreover, the manner in which the activities were conducted demonstrated that they were not business enterprises of the kind ordinarily carried on for profit.

Economic development is seldom the sole activity of an IRC section 501(c)(6) organization. Instead, economic development is often one of many activities. The above revenue rulings make it clear that the formation and operation of an economic development corporation may be in furtherance of 501(c)(6) purposes. Care should be undertaken, however, to ensure that the business league or chamber of commerce does not use the economic development corporation to provide services to its members since this would constitute the performance of particular services prohibited by Treas. Reg. 1.501(c)(6)-1.
Summary

Treas. Reg. 1.501(c)(3)-1(d)(2) provides that the term “charitable” is used in IRC section 501(c)(3) in its generally accepted legal sense and includes lessening the burdens of government. "Lessening the burdens of government" is, in itself, a charitable purpose and does not require any additional charitable-type purposes such as relieving poverty or advancing science in order to qualify for exemption under IRC section 501(c)(3).

To qualify for exemption as lessening the burdens of government, an organization’s activities must be activities that a governmental unit considers to be its burdens and the activities of the organization must actually lessen such governmental burdens.

If it is determined that an organization’s activities lessen the burdens of government, it must also show that any private benefit received by individuals or businesses is both qualitatively and quantitatively incidental to its exempt purposes.

Economic development organizations engage in a broad range of activities to promote, support and develop economic interests. They generally are established to assist existing and new businesses located in a particular geographic area through a variety of activities including grants, loans, provision of information and expertise, or creation of industrial parks.

The rationale for recognizing economic development corporations as exempt under IRC section 501(c)(3) is that, although services are provided directly to for-profit businesses, the benefits received by the general public outweigh the private benefits provided to the direct beneficiaries (the businesses).

Determining factors for economic development organizations requesting exemption under IRC section 501(c)(3) include operating in a deteriorated or blighted area, providing assistance to a disadvantaged group, aiding businesses experiencing difficulties in obtaining conventional financing, or aiding businesses providing jobs and training to the unemployed or underemployed.

If it is determined that an organization does not qualify for exemption under IRC section 501(c)(3), consideration may be given to exemption under another subsection such as IRC section 501(c)(4) or 501(c)(6).
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Lesson 3
Low-Income, Elderly and Student Housing

Overview

Introduction
Many organizations conduct housing activities as an exempt activity. There are many ways that an organization which provides housing may qualify for exemption. This can be done by demonstrating that the organization serves a charitable purpose including:

- Relief of the poor and distressed
- Eliminating prejudice and discrimination
- Combating community deterioration
- Relief of the distress of the elderly or physically handicapped
- Lessening the burdens of government
- Lessening neighborhood tensions
- Advancing education

Common types of exempt housing organizations include low-income housing and elderly or handicapped housing organizations. This lesson discusses how such organizations may meet the requirements for exemption under IRC section 501(c)(3). If it is determined that an organization does not qualify for exemption under IRC section 501(c)(3), consideration may be given as to whether the organization furthers social welfare under IRC section 501(c)(4).

Organizations whose activities include the sale of low or moderate income housing units, down payment or foreclosure assistance, partnership agreements, or tax credits are higher graded cases and will be discussed in more advanced training.

Continued on next page
Overview, Continued

Objectives

At the end of this lesson you will be able to:

- Recognize types of housing organizations which qualify for exemption under IRC section 501(c)(3)
- Apply safe harbor provisions to low-income housing applicants
- List the identified special needs of the elderly
- Describe how a housing organization can meet the special needs of the elderly in order to qualify for exemption
- Analyze student housing organizations to determine whether they qualify for exemption under IRC section 501(c)(3)
- Identify common sources of private benefit or inurement in housing organizations
- Develop questions to determine the existence of private benefit or inurement

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Low-Income Housing

Introduction

The Service has long held that providing affordable, low-income housing is not, in and of itself, a charitable purpose under IRC section 501(c)(3). A housing organization must provide housing in a charitable manner to qualify for exemption. This can be done by serving charitable purposes including:

- Relief of the poor and distressed
- Eliminating prejudice and discrimination
- Combating community deterioration
- Relief of the distress of the elderly or physically handicapped
- Lessening the burdens of government
- Lessening neighborhood tensions

To obtain recognition of exemption, an organization providing low-income housing has been required to demonstrate, through facts and circumstances of its operations, that it served charitable purposes as defined in Treas. Reg. 1.501(c)(3)-1(d)(2).

Because relief of the poor and distressed is the primary purpose for which low-income housing organizations apply for exemption, this section will focus on determining whether an organization serves this charitable purpose.

Continued on next page
Rev. Proc. 96-32, 1996-20 IRB 14, provides guidance under which organizations that provide low-income housing will be considered charitable as described in IRC section 501(c)(3) because they relieve the poor and distressed.

The revenue procedure is significant for the following reasons:

• Its purpose is to expedite the consideration of applications for tax-exempt status filed by such organizations.

Organizations that have determination letters and have not materially changed their operations can continue to rely on their letters.

Rev. Proc 96-32 contains:

• A safe harbor that outlines the amount of a housing facility’s units that must be occupied by “poor and distressed” residents,

• A definition of “low-income,” and

• Criteria to consider in a facts and circumstances test.

It does not alter previous standards that have been applied to determine whether low-income housing organizations qualify for tax-exempt status under IRC section 501(c)(3).

Meeting the safe harbor guideline assures a housing organization of obtaining and maintaining exempt status for the purpose of relieving the poor and distressed. Not meeting the safe harbor guideline does not result in an automatic denial or revocation. If an organization does not meet safe harbor, it can still obtain and maintain exempt status for relieving the poor and distressed by meeting the facts and circumstances test.

Therefore, since it provides quantitative guidance for organizations who want to obtain and maintain their exempt status, most organizations will attempt to meet the safe harbor guideline. This applies to organizations which apply for exempt status after May 13, 1996, and to organizations that obtained exempt status prior to that date.
“Safe Harbor”

Explanation of the Safe Harbor

An organization will be considered charitable because it relieves the poor and distressed if it meets the following requirements:

- The units must be occupied by (as opposed to available for) a certain percentage of low- and very low-income residents, as explained below.

- The project is actually occupied by poor and distressed residents. Generally, a transition period of one year is provided in order to give the project time to secure qualified residents. See the Rev. Proc. for additional information on “reasonable” transition periods.

- The housing must be affordable to the charitable beneficiaries. Generally, rents are not more than 30% of residents’ incomes.

- If a project consists of multiple buildings and each building does not separately meet the requirements, then the buildings must share the same grounds. (This does not apply to scattered housing available exclusively to families with incomes at or below 80% of the area’s median family income.)

Composition of Residents

The first requirement provides that a certain percentage of residents must have incomes at the low-income level. Additionally, some of these residents must also be considered to have very low-income levels, as explained below:

<table>
<thead>
<tr>
<th>% of Units Occupied</th>
<th>Income Level of Resident</th>
</tr>
</thead>
<tbody>
<tr>
<td>75%</td>
<td>Low-income</td>
</tr>
</tbody>
</table>

Plus and Included in the Above is One of the following:

<table>
<thead>
<tr>
<th>% of Units Occupied</th>
<th>Income Level of Resident</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>Very low-income</td>
</tr>
<tr>
<td>40%</td>
<td>Does not exceed 120% of Very low-income</td>
</tr>
</tbody>
</table>

The last 25% may be occupied by residents of any income level.
“Safe Harbor,” Continued

Example

Assume that a facility has 100 units. In order to meet the safe harbor, the composition of residents could be as follows:

<table>
<thead>
<tr>
<th># of Units Occupied</th>
<th>Income Level of Resident</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>Low-income</td>
</tr>
<tr>
<td>20</td>
<td>Very low-income</td>
</tr>
<tr>
<td>25</td>
<td>Any</td>
</tr>
</tbody>
</table>

This facility meets the safe harbor because 75% of the units are occupied by low-income residents (55 + 20). Also, 20% (20) are occupied by very low-income residents. 25 units may then be occupied by residents of any income level.

Where to Find Income Statistics

The Department of Housing and Urban Development (HUD) provides income statistics for low-income and very low-income, as adjusted for family size. The median family income is calculated for a family of four. Low-income figures are 80% of the median and are adjusted for family size. Very low-income figures are 50% of the median and are also adjusted for family size. These statistics are prepared annually by city and county and are available from HUD (www.hud.gov or www.huduser.org).

Affordability Standard

The Department of Housing and Urban Development generally expects that residents qualifying for its programs will spend no more than 30% of their income on housing. This limit has been adopted by the Service as a general guideline. Compliance with other government programs, such as those involving low-income housing tax credits, may also be acceptable.

Continued on next page
“Safe Harbor,” Continued

Calculating the Affordability Standard

A simple example will illustrate how to calculate the affordability test. Organization L’s facility located in Marrow County, Ohio, offers only one-bedroom units. These units can be occupied by one or two persons. The maximum rent that could be charged for both low- and very low-income residents is calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Very Low-Income (50% of area’s median income)</th>
<th>Low-Income (80% of area’s median income)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income — One Person</td>
<td>$12,050</td>
<td>$19,250</td>
</tr>
<tr>
<td>Income — Two Persons</td>
<td>$13,750</td>
<td>$22,000</td>
</tr>
<tr>
<td>Average</td>
<td>$12,900</td>
<td>$20,625</td>
</tr>
<tr>
<td>30% divided by 12</td>
<td>$322.50</td>
<td>$515.63</td>
</tr>
<tr>
<td>Less Utility Allowance</td>
<td>&lt;$50.00&gt;</td>
<td>&lt;$50.00&gt;</td>
</tr>
<tr>
<td>Maximum Rent</td>
<td>$272.50</td>
<td>$465.63</td>
</tr>
</tbody>
</table>

Continued on next page
“Safe Harbor,” Continued

If the organization does not meet the safe harbor, then it must meet the facts and circumstances test. Rev. Proc. 96-32 provides facts and circumstances that demonstrate relief of the poor which may include, but are not limited to, the following:

1. A substantially greater percentage of residents than required by the safe harbor with incomes up to 120% of the area’s very low-income limit

2. Limited degree of deviation from the safe harbor percentages

3. Limitation of a resident’s portion of rent or mortgage payment to ensure that the housing is affordable to low-income and very low-income residents

4. Participation in a government housing program designed to provide affordable housing (although qualification under a government housing program does not necessarily qualify an organization for exemption)

5. Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization’s operations

6. The provision of additional social services affordable to the poor residents

7. Relationship with an existing 501(c)(3) organization active in low-income housing for at least five years if the existing organization demonstrates control

8. Acceptance of residents who, when considered individually, have unusual burdens such as extremely high medical costs which cause them to be in a condition similar to persons within the qualifying income limits in spite of their higher incomes

9. Participation in a homeownership program designed to provide homeownership opportunities for families that cannot otherwise afford to purchase safe and decent housing

10. Existence of affordability covenants or restrictions running with the property

Continued on next page
“Safe Harbor,” Continued

Other Considerations

In addition to the facts and circumstances identified in Rev. Proc 96-32, other factors may be considered such as local conditions that may result in higher housing costs where income levels have not increased in the same manner (such as areas with limited space available) or an increase in general living costs (such as rising fuel, food or transportation costs) which can cause those in need of housing to be unable to afford it. The key factor is determining whether the organization relieves the conditions of the poor and distressed.

What if the Organization Does Not Meet the Facts and Circumstances Test?

If the organization does not meet the facts and circumstances test, it means only that it cannot obtain or maintain exempt status for the purpose of relieving the poor and distressed. It can still qualify for exempt status by demonstrating that its charitable purpose is any of those set forth in IRC section 501(c)(3) or Treas. Reg. 1.501(c)(3)-1(d)(2). These purposes include, but are not limited to, those mentioned in the introduction to this section.

Moderate-Income Housing

Organizations which provide housing to moderate-income families rather than low-income families will generally not qualify for exemption for the charitable purpose of relieving the poor and distressed.

Rev. Rul. 70-585, 1970-2 C.B. 115, situation 4, describes an organization formed to provide moderate-income families with housing in a particular community. The organization in the situation was formed to build new housing facilities for the purpose of helping families secure decent, safe and sanitary housing at prices they can afford. The organization plans to erect housing that is to be rented at cost to moderate-income families. The organization is financed by mortgage money obtained under federal and state programs and by contributions from the general public.

The ruling concludes that since the organization’s program is not designed to provide relief to the poor or to carry out any other charitable purpose within the meaning of the regulations, it is not entitled to exemption under IRC section 501(c)(3).

Although this revenue ruling held that providing housing to moderate-income families was not an exempt activity, each application for exemption must be evaluated based on the particular facts and circumstances of the case to determine whether the organization serves a charitable purpose under IRC section 501(c)(3).
Serving Other Charitable Purposes

As previously stated, relief of the poor and distressed is just one charitable purpose for which a housing organization may qualify for exemption. Other charitable purposes and relevant guidance include:

**Combating community deterioration**
- Rev. Rul. 68-17
- Rev. Rul. 68-685
- Rev. Rul. 70-585 (situation 3)
- Rev. Rul. 76-147

**Eliminating prejudice and discrimination/ Lessening neighborhood tensions**
- Rev. Rul. 68-655
- Rev. Rul. 70-585 (situation 2)

**Relief of the distress of the elderly or physically handicapped**
- Rev. Rul. 72-124
- Rev. Rul. 79-18
- Rev. Rul. 79-19

**Lessening the burdens of government**
- Rev. Rul. 85-1
- Rev. Rul. 85-2

Additional discussion of housing as an exempt activity can be found in the 1994 EO CPE text “Low-Income Housing Update” and the 1996 text, “Recent Developments in Housing Regarding Qualification Standards and Partnership Issues.”

In addition to serving a charitable purpose under IRC section 501(c)(3), a low-income housing organization must also meet the other requirements of that section, including the prohibitions against inurement and private benefit which are discussed later in this lesson.
Housing for the Elderly

Introduction
Since the 1970s, the elderly have generally been recognized as a charitable class. Organizations (including housing organizations) that satisfy the needs of the elderly can be charitable as relieving the poor, distressed or underprivileged. The special needs of the elderly have been identified as:

- Housing
- Health care
- Financial security

When examining these organizations, your primary guidance will be:

- Rev. Rul. 72-124, 1972-1 CB 145
- Rev. Rul. 79-18, 1979-1 CB 194

Who Are “The Elderly”
Rev. Rul. 72-124 and 79-18 both pertain to organizations who admit residents who are at least 65 years of age. GCM 37101 (1977) allows exempt status for an organization whose residents are at least 62 years of age. Although GCMs are not cited as precedent, this one employs the same age restrictions defined in the National Housing Act and related legislation. Therefore, the Service generally uses the age of 62 as a cutoff to include individuals in a charitable class by reason of being elderly. Subsequently, in order to qualify for exemption as providing housing for “the elderly,” the facility must limit the age of residents to at least 62 years of age.

Types of Housing
The senior housing industry has grown substantially with the aging population of the U.S. Housing options for the elderly may include “seniors only” complexes, modular home communities, shared housing, assisted living, continuing care retirement communities, skilled nursing facilities, or Alzheimer’s facilities. Several of these types of senior housing organizations may apply for tax exemption under IRC section 501(c)(3). Applications from these organizations should be reviewed to determine whether they meet the special needs criteria discussed in this section.

Organizations could also apply for exemption as low-income housing (discussed previously), assisting the physically handicapped (Rev. Rul. 79-19, 1979-1, C.B. 195), or a hospice type facility (Rev. Rul. 79-17, 1979-1, C.B. 193).

Continued on next page
Housing for the Elderly, Continued

Need for Housing

The special need for housing will generally be satisfied if the organization provides residential facilities that are specifically designed to meet some combination of the physical, emotional, recreational, social, religious and similar needs of the elderly. Although a home for the elderly certainly does not have to provide all of these, some special aspects should be provided in order to distinguish the elderly housing facility from others.

Housing - Physical Needs

Physical impairments and weaknesses of the elderly require specially designed facilities to help them function effectively. Some specific additions to living areas that are mentioned in Rev. Rul. 79-18, 1979-1 C.B. 194, are:

- Grab bars by bathtubs and toilets
- Wide entrance-exit doorways
- Ramps and elevators for wheelchair use
- Floors designed to help prevent slips and falls
- Conveniently located electrical outlets and cabinets to avoid strenuous bending or stretching
- Windows at eye level for residents confined to wheelchairs
- Emergency 24-hour alarm system
- Fire-resistant construction

Continued on next page
Housing for the Elderly, Continued

Housing - Other Needs

Other supportive facilities which satisfy other needs are:

- Central dining room
- Chapel with a staff chaplain available for counseling
- Social-recreational program under the direction of a staff social director with on-site recreational facility
- Transportation for shopping trips and social events
- Laundry and housekeeping services

Need for Health Care

The organization is not required to actually operate a health unit or have paid medical staff to meet this condition. Health care needs are satisfied if the organization either directly provides some form of health care or maintains some continuing arrangement with other organizations or health personnel to maintain the physical, and if necessary, mental well-being of the residents. Some possibilities are:

- A location within close proximity of a hospital
- Transportation for residents to medical appointments
- Arrangements with other organizations to provide medical care for residents
- An employee on duty 24 hours a day who can give temporary aid in emergencies and contact professional help

Eviction for Health Reasons

Many facilities require that the residents be ambulatory. If a resident becomes bedridden, the organization does not jeopardize its exempt status if it requires the resident to leave. In most cases, they will ask a relative to come and get the person, or they will arrange to send them to a nursing home.
Housing for the Elderly, Continued

Need for Financial Security

There are three financial conditions that must be met by the organization in order to satisfy the elderly’s need for financial security:

• Rental charges must be set at a level within the financial reach of a significant segment of the community’s elderly population.

• The organization must be committed to operating at the lowest feasible cost.

• The organization must be committed to an established policy of maintaining in residence any persons who become unable to pay their regular charges.

Making part of a facility available at rates below its customary charges to persons of more limited means than its regular residents could be viewed as evidence that an organization is attempting to satisfy the need for financial security, provided that the organization fulfills the affordability condition regarding the provision of financial security.

Affordability

Affordability must be determined on a case by case (and community by community) basis. “Affordable” housing is generally determined by reviewing traditional housing costs (mortgage, interest, taxes and insurance). Additionally, an affordability analysis should include:

• The number of households aged 62 and above

• Definition of the “community” or “local market”

• The number of owner-occupied housing units

• The percentage of the elderly citizens within the defined community that are to be served by the housing project and can afford the units at the project

Note that the lavishness (or lack thereof) of the facility is not a determinative factor. The proper test is whether the various fees charged are low enough so that a significant portion of the elderly community can avail itself of the facility.

Continued on next page
Operating at Lowest Feasible Cost

This requirement generally means that a housing project must offer its services to the elderly persons of the community at the least possible expense.

A feasibility study is often conducted by an organization to determine the financial feasibility of a project along with the overall feasibility of the project. Preliminary budget items considered in the study may include site costs (acquisition and construction), various development and legal fees, financing costs, prefunded reserves, and an operational budget.

Reviewing these studies can provide a basis for determining whether the community operates at the “lowest feasible cost.” Also, the amount of any entrance, life care, founder’s or monthly fee charged should be considered in relation to all items of expense, including indebtedness and reserves, when determining lowest feasible cost.

Whether there could be less expensive methods to bring an organization to full-scale operation (such as advertising through church bulletins rather than more commercial advertising means or by seeking aid from other charitable organizations) is open to question and may not be available in certain circumstances.

The major factor that should distinguish a charitable home from a for-profit is the total dedication of the assets to the charitable work with no inurement.

Note: Availability to moderate or low-income individuals is not a necessary condition in satisfying the “lowest feasible cost” or “affordability” requirements. Rather, it is only a factor to consider in the determination of feasibility and affordability.
Established Maintenance Policy

The third condition of meeting the need for financial security is the need for an organization to be committed to an established policy of maintaining in residence any persons who become unable to pay their regular charges, through the organization’s own reserves or funding from private and governmental units or the general public.

While there is a requirement that the policy be established, it may or may not be advertised to the residents or potential residents. Additionally, there is no guidance on how the reserve fund should be established or how it should be funded. (Some states require funded reserves for senior communities)

The condition can also be met through a showing by the organization that they are committed to maintaining residents to the degree to which the organization is financially able. For example, a policy established by the organization of finding a place for residents with another suitable agency or organization when the residents can no longer pay the charge is sufficient to satisfy the criteria, without necessarily requiring the organization to directly maintain the resident.

However, if an organization established a written, stated policy of eviction of residents upon failure to pay the established fees or rent, regardless of any operational policies, the fact that the organization is afforded an opportunity and the right to evict residents who do not pay would preclude exemption of the organization for failure to meet the special need for financial security. A non-eviction policy statement by the organization would be necessary for additional consideration for exemption.

Housing for the Handicapped

Similar to organizations providing housing for the elderly, organizations that provide special housing for the physically handicapped may also qualify for exemption under IRC section 501(c)(3) by meeting the special needs of these individuals.

Rev. Rul. 79-19, 1979-1 C.B. 195, provides guidelines comparable to those set forth in Rev. Rul. 79-18, which provides a basis for exemption for organizations that provide housing to elderly persons.

Other 501(c)(3) Requirements

In addition to meeting the special needs of these populations, these housing organizations must also meet all the other requirements for exemption under IRC section 501(c)(3)
Student Housing

**Introduction**

Providing housing for students, absent special facts and circumstances, is a trade or business that is not charitable. An organization providing student housing may, however, qualify for exemption under IRC section 501(c)(3) if certain facts and circumstances are present. This section discusses revenue rulings which describe organizations that were found to be exempt under IRC section 501(c)(3).

**Rev. Rul. 67-274**

Rev. Rul. 64-274, 1964-2 C.B. 141, describes an organization that provides free housing, scholarships, and books to students who could not otherwise attend college because of lack of funds.

The corporation operates and maintains a group of dwellings where students are provided free housing facilities. The students selected are those with exceptional records of scholastic achievement but who, because of lack of funds, could not otherwise attend a college or university. Students residing in the houses are required to pay for their own food and share the expenses for utilities. The purpose of the latter requirement is to encourage conservation in the use of utilities rather than to aid in meeting the cost of the students' housing. In addition to housing facilities, the corporation furnishes, as a gift or as a loan without interest, funds for the purchase of books and instructional material necessary for the pursuit of the students' program of studies.

This organization was found to be exempt as it is engaged in activities to aid students in attaining an education, thereby furthering the charitable purpose of advancing education.

*Continued on next page*
Rev. Rul. 67-217, 1967-2 C.B. 181, describes an organization that was formed to provide housing and food service exclusively for students and faculty at a specific university, which lacked adequate facilities.

The facility was constructed near the university and was managed by a commercial firm in accordance with the university's rules. The facility was made available to students at rates comparable to those charged by the university for similar facilities. Support services were provided to supplement university activities. Income came from rents and food service charges and funds were expended for operating expenses and debt retirement. Any surplus was donated to the university. The university had an option to purchase the facility at any time for an amount equal to the outstanding indebtedness.

The Service held that, by providing a housing facility under the circumstances described, the organization is advancing education and qualified for exemption under IRC section 501(c)(3).

Rev. Rul. 76-336

The organization described in Rev. Rul. 76-336, 1976-2 C.B. 143, was formed by community leaders to provide housing for students of a particular college in response to studies by staff members of the college showing that the college lacked suitable housing to meet the need.

The college itself provided no housing because it was financially unable to do so. Many students, however, lived so far away that daily commuting was unreasonable. The housing facility was built adjacent to the college campus and available to students, first-come, first-served. The college and the organization consulted and cooperated to ensure the needs of the college and its students were served by the operation of the housing facility. Income came from rentals and contributions. Disbursements were for operating expenses and debt retirement.

Under these circumstances, the Service determined that the organization was advancing education by assisting the college, which was unable to provide adequate student housing, to fulfill its educational purposes, and aiding the students to attain an education.

Continued on next page
A close reading of Rev. Rul. 67-217 reveals ongoing cooperation between the university and the organization regarding both the need for the facility and the operation of the facility so as to serve the needs of the university. The ruling indicates that the facility was made available to students at the same price as other university housing. The ruling is silent, however, whether the organization operated below cost by reducing its charges to students through the use of contributions or university subsidies.

A fact that weighed heavily in the analysis of Rev. Rul. 76-336 was that the organization was created by community leaders after studies made by the President of the College and the community leaders showed insufficient affordable student housing. The organization was not controlled by the developers but by the community on behalf of the college. The college and the organization consulted and cooperated to serve the housing needs of the students.

The organization described in Rev. Rul. 76-336 also operated below cost. The housing site was provided by the city at a fraction of its market value and the city made substantial contributions of equipment and services. The housing was not bond-financed. The costs not covered by the affordable rents were offset by contributions from both individuals and the community.

The essential facts and circumstances in both Rev. Rul. 67-217 and Rev. Rul. 76-336 were community control, college involvement, and below cost operation.

Rev. Rul. 64-118, 1964-1 C.B. 182, holds that an organization whose primary activity is to furnish, on a rental basis, a chapter house to a fraternity does not qualify for exemption under section 501(c)(3) as an educational organization. However, a corporation, fund, or foundation so organized may, under proper circumstances, be classified as a club organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes and exempt under IRC section 501(c)(7). (Fraternity housing organizations are generally classified as lower graded cases.)

In addition to serving an exempt purpose, student housing organizations must meet all other requirements for exemption under the requested subsection.
Private Benefit and Inurement Issues

In addition to furthering an exempt purpose under IRC section 501(c)(3), housing organizations must meet all other requirements under the subsection including the prohibition on private benefit and inurement. Because of the large dollar amounts generally involved in housing development, these applications for exemption should be closely examined for potential private benefit and inurement. Areas of particular concern include:

- Location/Purchase of Facility
- Development and Construction
- Management of the Facility
Private Benefit and Inurement Issues, Continued

Sources of Information

(b) (7)(E)

Location

Most of the time, land (or developed real estate) will be obtained from an unrelated party at a fair price to the applicant. However, the purchase of the location/facility is an area where private benefit or inurement can be present. Situations with potential private benefit or inurement include:

- An individual or for-profit entity holds land or developed property for sale that has remained unsold (possibly due to poor location, unsuitability for development, a too high selling price, or need for substantial renovations). The owner forms an exempt organization and sells the property to the organization.

- An individual sells property to an organization because the property has no other valid or legitimate use that is marketable to a large segment of the business world. For example, a parcel of property located on a remote mountainside or out in the desert may create problems for a low-income housing project. Even if the price paid for the property is cheaper than could be obtained elsewhere, how will the exempt organization get people to live in such a remote location?

Even if sold to the organization at a very reasonable price, in these situations, the owner was still relieved of property that would otherwise not have sold.

Continued on next page
Questions for consideration include:

- (b) (7)(E)
Private Benefit and Inurement Issues, Continued

Development and Construction

(b) (7)(E)

Continued on next page
Questions for consideration include:

- Facility Management

Once the location has been determined and the housing has either been constructed or renovated, then the actual day-to-day operation of the facility will take place. The exempt organization may or may not actually manage the facility. In some cases, the applicant will hire a management company to do the job. If the organization will actively participate in the day-to-day operation of the organization, the usual issues regarding possible related party compensation should be considered. If a management company will run the facility, additional development may be required to determine whether any private benefit or inurement is present.

Some of the questions regarding the facility management of a housing organization can often be answered by reviewing any existing management contracts or agreements.

Continued on next page
## Questions for consideration include:

**Facility Management Questions**

- Low-Income, Elderly and Student Housing

- (b) (7)(E)
Summary

The Service has long held that providing affordable, low-income housing is not, in and of itself, a charitable purpose under IRC section 501(c)(3). Often, an organization providing low-income housing serves the charitable purpose of relieving the poor and distressed.

Rev. Proc 96-32 contains a “safe harbor” for low-income housing organizations that outlines criteria under which an organization will be considered as relieving the poor and distressed. (Although an organization may demonstrate that it meets the safe harbor guidelines, it must also meet all other requirements for exemption under IRC section 501(c)(3).)

Safe harbor requirements include that the units must be occupied by (as opposed to available for) a certain percentage of low- and very low-income residents; a transition period of one year (sometimes longer) is provided in order to give the project time to secure qualified residents; the housing must be affordable to the charitable beneficiaries; and if a project consists of multiple buildings and each building does not separately meet the requirements, then the buildings must share the same grounds.

Elderly housing organizations may qualify for exemption by meeting the special needs of the elderly, identified as housing, health care, and financial security.

Student housing organizations may qualify for exemption by advancing education. Factors for consideration include whether the organization provides housing to those who could not otherwise afford to attend college, demonstration of a close connection and cooperation with a specific college, community oversight, and operating below cost.

The potential for private benefit and inurement in housing operations is significant, especially given the high dollar amounts involved in many of these operations. Areas that should be reviewed for private benefit and inurement include the acquisition of the property, the development and construction of the property, and the day-to-day management of the facility.
Lesson 4

Tax Exempt Bond Financing

Overview

Introduction

Interest on bonds issued by a city, state or any other qualifying governmental entity is exempt from Federal income tax, providing the issuer complies with the requirements of the Internal Revenue Code. The IRC contains a large number of complex rules concerning tax exempt bonds. To understand these rules, it is helpful to separate them into general categories:

- IRC section 141 provides the rules for determining whether a bond is a governmental bond or a private activity bond.
- IRC section 142 provides the requirements for qualified exempt facility bonds.
- IRC section 143 provides a detailed set of requirements for qualified mortgage bonds and qualified veterans’ bonds.
- IRC section 144 provides detailed rules for qualified small issues bonds, qualified student loan bonds, and qualified redevelopment bonds.
- IRC section 145 provides rules for qualified IRC section 501(c)(3) bonds.
- IRC section 146 provides the rules for the statewide “volume cap” on qualified activity bond issues.
- IRC section 147 provides a number of special rules that apply to all types of private activity bonds, with certain exceptions.
- IRC section 148 provides a number of rules regarding arbitrage and exceptions thereto.
- IRC sections 149 and 150 provide a variety of miscellaneous rules and generally applicable definitions.

However, this lesson is primarily directed to qualified IRC section 501(c)(3) bonds as described under IRC section 145.

Continued on next page
Overview, Continued

Introduction (continued)

- Examples of projects completed through the use of bond proceeds include hospitals, schools, skilled nursing facilities, nursing homes, low-income housing, waste disposal systems and airports.

Objectives

At the end of this lesson, you will be able to:

- Define a qualified IRC section 501(c)(3) bond
- List the basic terms used to describe the parties involved in a basic loan transaction
- Identify factors indicating that a bond-financed project does not adversely affect an organization’s exempt status under IRC section 501(c)(3)
- Identify factors indicating that a bond-financed project may jeopardize the IRC section 501(c)(3) exemption of an organization
- Resolve potential private benefit issues present in cases involving bond financing
- Calculate degree of risk present in bond cases based on facts and circumstances specific to the cases

In This Lesson

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<td>Basic Loan Transaction</td>
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<td>4-15</td>
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<td>Exhibit 4-1: Risk Assessment Profile</td>
<td>4-17</td>
</tr>
</tbody>
</table>
Qualified IRC Section 501(c)(3) Bonds

Definition of Qualified 501(c)(3) Bonds
Qualified IRC section 501(c)(3) bonds are those bonds issued under the provisions of IRC section 145 to finance property owned by:

- An organization described under IRC section 501(c)(3) (an “exempt organization”)
- A governmental unit

Statutory Provisions
The specific requirements for qualified IRC section 501(c)(3) bonds are enumerated in IRC section 145.

- Treas. Reg. 1.145-2(a) provides that sections 1.141-0 through 1.141-15 of the regulations are applicable to bonds issued under IRC section 145(a).

- Other requirements applicable to qualified private activity bonds that are also applicable to qualified IRC section 501(c)(3) bonds are provided in IRC sections 146 through 150.

Use of Proceeds
As provided by IRC section 145(a), all of the net proceeds of qualified IRC section 501(c)(3) bonds (defined as bond proceeds less amounts in the reasonably required reserve fund) must be used to finance property owned by:

- An exempt organization, or
- A governmental unit

Unlike exempt facility and small issue bonds, as long as used in an exempt organization’s exempt purposes, proceeds of qualified IRC section 501(c)(3) bonds may be used to provide working capital or intangible property for an exempt organization. Note that certain arbitrage rules specifically apply to bonds issued to finance working capital. See Treas. Reg. 1.148-1(c)(4), 1.148-2(e)(3), 1.148-6(d)(3).

Continued on next page
Qualified IRC Section 501(c)(3) Bonds, Continued

Private Payment and Private Security

To be considered qualified IRC section 501(c)(3) bonds, no more than five percent of the payment of the debt service on the bonds may be directly or indirectly:

- Made from payments in respect to property, or borrowed money, used or to be used for a private business use, or
- Secured by an interest in property used or to be used by a private party, or in payments in respect to such property.

The security for and payment of debt service on the bonds is determined from the terms of the bond documents and any underlying arrangements.

Note

The rules regarding the private security and private payment tests are the same for qualified IRC section 501(c)(3) bonds as for governmental bonds and are described in Treas. Reg. 1.141-4.
Basic Loan Transaction

Typical Loan Scenario

For comparison to a bond-financed transaction, we’ll take a typical loan scenario. When you borrow money from a bank to purchase a house, the bank gives you the money, and in return you give the bank a document that is evidence of your promise to repay the amount borrowed plus interest. This document specifies the amount of the loan, the rate of interest, and the times you must make payments. You also give the bank the right to take your house if you fail to make the payment in a timely fashion. If the bank has doubts about your ability to pay, but still wants to loan you the money, you may have to find someone else to guarantee your payments. In addition, you may have to insure your payments.

Loan Structure Terminology

In this typical case:

- The bank is called the lender
- You are called the borrower
- The insurance company or person who guarantees your payments is known as the guarantor
- The document that sets forth your obligation is called a note (in this real estate example—a mortgage)
- The failure to pay the bank is called default
- The right of the bank to take your house on default is called foreclosure
- The house is your collateral

Continued on next page
Basic Loan Transaction, Continued

<table>
<thead>
<tr>
<th>Bond Structure Terminology</th>
<th>Tax exempt bonds arise from a similar structure. Generally, in the tax exempt markets, we use the underlined names:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Lender</td>
<td>a. Bondholder</td>
</tr>
<tr>
<td></td>
<td>b. Creditor</td>
</tr>
<tr>
<td></td>
<td>c. Investor</td>
</tr>
<tr>
<td></td>
<td>d. Obligee</td>
</tr>
<tr>
<td>• Borrower</td>
<td>a. Issuer</td>
</tr>
<tr>
<td></td>
<td>b. Debtor</td>
</tr>
<tr>
<td></td>
<td>c. Obligator</td>
</tr>
<tr>
<td>• Guarantor</td>
<td>a. Insurer</td>
</tr>
<tr>
<td></td>
<td>b. Letter of Credit Provider (LOC provider or LOC bank)</td>
</tr>
<tr>
<td></td>
<td>c. Credit Enhancer</td>
</tr>
<tr>
<td></td>
<td>d. Surety</td>
</tr>
<tr>
<td>• Note (if it is short-term) and Bond (if it is long-term) (Treas. Reg. 1.150-1(b))</td>
<td>a. Obligation (Treas. Reg. 1.150-1(b))</td>
</tr>
<tr>
<td></td>
<td>b. Debt Instrument</td>
</tr>
<tr>
<td></td>
<td>c. Evidence of Indebtedness</td>
</tr>
<tr>
<td></td>
<td>d. Debenture</td>
</tr>
<tr>
<td>• Collateral</td>
<td>a. Security</td>
</tr>
</tbody>
</table>
Tax Exempt Bond-Financed Transactions

Closely Scrutinize

Bondholders of tax exempt bonds are willing to accept lower interest rates to obtain income exempt from federal tax. Accordingly, the borrowing cost of IRC section 501(c)(3) organizations financing their activities with tax exempt bond proceeds is lower. While this benefit is conferred to encourage socially worthwhile projects, it also can attract private parties more motivated by the potential of increased profits. Therefore, the impact of a tax exempt bond-financed project on an organization’s exempt status under IRC section 501(c)(3) should be closely scrutinized. All the facts and circumstances must be available to determine whether impermissible private benefit or inurement exists in a particular tax exempt financing arrangement.

Facts and Circumstances

An application involving financing with tax exempt bonds cannot be accurately determined unless all the relevant facts related to the matter are uncovered, weighed, and analyzed. To accomplish this you must consider, at a minimum, the following general items:

- The composition of the board of directors
- The relationship of the parties to the arrangement
- The organization’s arrangement with other exempt organizations, governmental entities, banks or guarantors
- Facts surrounding the management of the facility
Identifying Favorable Transactions

Favorable Factors

Factors indicating that an organization’s bond-financed project does not adversely affect its exempt status under IRC section 501(c)(3) may include, among other items, the following:

- The organization has a governing board comprised of local, independent, civic leaders that broadly represents the community in which the bond-financed property is located.

- The organization is controlled by an established IRC section 501(c)(3) organization whose exempt purposes are also furthered by the bond-financed project.

- The organization was created by a local governmental entity to be the lessor in a lease back transaction in which the lessor issues bonds or certificates of participation.

- None of the sellers, developers, contractors, managers, or individuals connected with them were instrumental in the creation of the organization or exercise substantial influence over the affairs of the organization.

- There is a feasibility study that indicates the organization will be able to operate the project in a qualified IRC section 501(c)(3) manner.

- There is an appraisal of the bond-financed facility, which uses the income method, market method, and cost method of valuation to estimate the facility’s current business enterprise value.

- The organization plans to manage the bond-financed property itself, hire a related exempt organization that has experience managing a similar facility, or hire a manager through competitive bidding.
Identifying Potentially Adverse Transactions

**Unfavorable Factors**

Factors indicating that an organization’s bond-financed project may adversely affect the organization’s exemption under IRC section 501(c)(3) may include, among other items, the following:

- The governing board members are located throughout the country and have no discernable connection with each other or the community in which the bond facility is located.

- There is a for-profit developer, manager or other party engaged in various bond-financed projects throughout the country who created and controls the organization.

- There is a for-profit entity involved in the bond-financed project that loaned the organization funds or paid various costs incurred in the process of organizing the organization and pursuing tax exempt financing.

- There is a for-profit entity selling the bond-financed facility to the organization, recently purchased the facility, and is making a substantial profit on the sale.

- The for-profit seller has provided a portion of the financing for the project by purchasing a series of subordinate bonds.

- A bank lender or third party guarantor, such as a bond insurer or a letter of credit bank, has final authority over the organization’s budget and fees and has required the organization to maintain an unreasonable amount of cash on hand.

- The organization has entered into a management contract with a for-profit manager to operate the bond-financed facility that provides for the sharing of net profits or provides for penalties if the applicant terminates the contract.
Private Benefit

Private Use Prohibition

IRC section 145(a)(2) provides that for bonds to be considered qualified IRC section 501(c)(3) bonds, the bonds must NOT meet the private business use test and the private security and payment test, as specified in IRC section 141(b).

Not Considered Private Use

For purposes of applying the private business tests under IRC section 141, an exempt organization using facilities financed with qualified IRC section 501(c)(3) bonds is treated as a governmental unit. This means the use of the bond-financed facility by an exempt organization (in related activities), or by a governmental unit, is generally NOT considered private use.

Private Business Use Test

To be considered qualified IRC section 501(c)(3) bonds, no more than five percent of the net proceeds of the bond issue may be used for any private business use. This five percent refers to use by a private party other than an exempt organization or a governmental unit.

UBI

Use by an exempt organization, other than the borrower, which is unrelated trade or business use under IRC section 513, is considered private use.

Also, Treas. Reg. 1.145-2(c)(2) provides that issuance costs are included in this five percent private business use.

Example: 5% Private Business Use

Assume that charity A borrows $100M of bond proceeds from City B to build a hospital. The ownership and private business use tests are calculated as follows:

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$100M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve Fund</td>
<td>(10M)</td>
</tr>
<tr>
<td>Net Proceeds</td>
<td>$ 90M</td>
</tr>
<tr>
<td>$ x. 05</td>
<td>(Hospital must be 100 % owned by Charity A or City B)</td>
</tr>
<tr>
<td>$ 4.5M</td>
<td>(Can be used as “bad costs”)</td>
</tr>
<tr>
<td>(2M)</td>
<td>(2 % of $100M allocated to issuance costs)</td>
</tr>
<tr>
<td>$ 2.5M</td>
<td>(Remaining amounts permitted to be used for private use)</td>
</tr>
</tbody>
</table>

Continued on next page
**Private Benefit, Continued**

<table>
<thead>
<tr>
<th>Management Service Contracts Definition:</th>
<th>Contracts between an exempt organization and certain private parties pursuant to which the private parties provide services to the exempt organization may result in private business use. These contracts are known as “management contracts.”</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Examples: Management Contracts</strong></td>
<td>Treas. Reg. 1.141-3(b)(4)(ii) provides examples of management contracts. Each of the following is treated as a management contract.</td>
</tr>
<tr>
<td>• Management services for an entire hospital</td>
<td></td>
</tr>
<tr>
<td>• Management services for a specific department of a hospital</td>
<td></td>
</tr>
<tr>
<td>• Incentive payment for physician services to patients of a hospital</td>
<td></td>
</tr>
<tr>
<td><strong>Arrangements Generally not Treated as Management Contracts</strong></td>
<td>Certain arrangements are generally not treated as management contracts resulting in private business use. As provided in Treas. Reg. 1.141-3(b)(4)(iii) and section 2.01(7) of Rev. Proc. 97-13, 1997-1 C.B. 632, the following examples will not result in private business use. Contracts for:</td>
</tr>
<tr>
<td>• Janitorial services</td>
<td></td>
</tr>
<tr>
<td>• Office equipment repair</td>
<td></td>
</tr>
<tr>
<td>• Hospital billing</td>
<td></td>
</tr>
<tr>
<td><strong>Safe Harbors: Management Service Contracts</strong></td>
<td>The Service has provided safe harbors regarding management service contracts between a for-profit entity and an exempt organization where the service is provided in connection with a bond-financed facility.</td>
</tr>
</tbody>
</table>

*Continued on next page*
**Private Benefit, Continued**

<table>
<thead>
<tr>
<th>Research Agreements: Rev. Proc. 97-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certain agreements with respect to bond-financed facilities under which a private entity sponsors research by an exempt organization may result in private business use.</td>
</tr>
<tr>
<td>As provided by Treas. Reg. 1.141-3(b)(6), private business use occurs if the sponsor is treated as the lessee or owner of the bond-financed property for federal income tax purposes.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Safe Harbor: Research Agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rev. Proc. 97-14, 1997-1 C.B. 634, provides safe harbors for research agreements effective for any research agreement entered into on or after May 16, 1997.</td>
</tr>
</tbody>
</table>
Mixed Use and Multipurpose Facilities

Definition

Mixed or multipurpose facilities are facilities that have multiple users, such as an exempt organization and a private entity.

Allocations

A mixed use or multipurpose facility may be financed in part with qualified IRC section 501(c)(3) bonds. The portion that is bond-financed must be used by the exempt organization in its exempt purposes or by a governmental unit.

The portion used by the private entity must be financed with taxable financing or sources other than bond proceeds.

The allocations between the different users of the facility must be made in proportion to the benefits derived, directly or indirectly, by the various users of the facilities.

The allocations of the bond proceeds and other sources of funds, and the use of the facility by various parties must be reasonable and consistently applied.
Risk Assessment

Risk Assessment Profile Work Sheet

Subsequent to the review of the application and solicitation of any additional information, the specialist may complete the risk assessment profile work sheet. Even though it may be used as a work paper, if desired, our current procedures no longer require the completion of the Risk Assessment Profile (RAP) Work Sheet. See Exhibit 4-1. The risk assessment work sheet is mainly intended to determine the likelihood of private benefit.

In addition, past procedures required applicants to complete a bond questionnaire; this is also no longer required.

Profile Score

The profile score suggests whether the case may need to be coordinated with EO Technical (after discussing the issue with the group manager). The scores are as follows:

- (b) (7)(E)

   

TEB Division

The TE/GE Tax Exempt Bonds (TEB) Division routinely conducts examinations to ensure bond proceeds are not diverted away from their intended use. This oversight has been a significant factor in lessening EO Determination’s concerns regarding tax exempt bonds.

Historically, tax exempt bond cases were subject to mandatory review by Quality Assurance (QA). However, at the present time and primarily due to TEB activity, tax exempt bond cases are not subject to mandatory review by QA.
Summary

Qualified IRC section 501(c)(3) bonds are those bonds issued under the provisions of IRC section 145 to finance property owned by either an organization described under IRC section 501(c)(3) or a governmental unit. To be considered qualified IRC section 501(c)(3) bonds, no more than five percent of the payment of the debt service on the bonds may be directly or indirectly made from payments in respect to property or borrowed money, used or to be used for a private business use, or secured by an interest in property used or to be used by a private party, or in payments in respect to such property.

Although the terminology may differ, bond transactions in tax exempt markets mirror other basic loan transactions, such as when an individual borrows money from a bank to purchase a house. Bond transactions typically involve a bondholder, issuer, guarantor, bond, and collateral.

Factors indicating that an organization’s bond-financed project does not adversely affect its exempt status under IRC section 501(c)(3) may include having a governing board comprised of independent community leaders, being controlled by an established IRC section 501(c)(3) organization, and being created by a local governmental entity to be the lessor in a lease back transaction.

Factors indicating that a bond-financed project may jeopardize the IRC section 501(c)(3) organization’s exemption may include having board members located throughout the country with no discernable connection with each other or the community in which the bond facility is located, having a for-profit developer in control of the operations, or executing a management contract with a for-profit manager to operate the facility while sharing the net profits.

To be considered qualified IRC section 501(c)(3) bonds, no more than five percent of the net proceeds of the bond issue may be used for any private business use; otherwise, impermissible private benefit may result from the arrangement. Specialists must analyze all management contracts which could be used to creatively mask other sources of private benefit to private parties.

Although not a required workpaper, specialists may choose to complete a Risk Assessment Profile (RAP) Work Sheet to help quantify the likelihood of potential private benefit. Responses to a list of questions are used to calculate a profile score which serves as an indicator of the degree of risk present.
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Set forth below are responses to the questions contained in the Risk Assessment Profile Worksheet for exemption applications of organizations that intend to use tax exempt bond financing.

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IRS 00415
## Risk Assessment Profile, Continued

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### Tax Exempt Bond Financing

*4-18*

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Doc 2013-26066 (372 pgs)
### Risk Assessment Profile, Continued

**Total score for all of the above questions:**

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Lesson 5

Advanced Fundraising Issues

Overview

Introduction

Almost all organizations exempt under IRC section 501(c)(3) conduct some type of fundraising to finance their charitable activities. In fact, many exempt organizations list fundraising as their primary purpose. Fundraising activities can raise exemption issues as well as unrelated business income issues.

Some types of fundraising organizations (i.e., PTAs, PTOs, and booster clubs) have shown historically high levels of compliance with respect to tax exemption under IRC section 501(c)(3). Applications for exemption submitted by these organizations are Grade 11 cases. (Issues generally associated with these cases are not discussed in this training.) Applications from other types of organizations whose primary activity is fundraising (including via gaming) are generally more complex and, as such, are graded as Grade 12.

Additional issues arise regarding an organization that is involved with professional fundraisers. These arrangements are also considered Grade 12 cases.

With the widespread availability of the internet, many organizations use the internet as an integral part of their fundraising strategy. However, applications from organizations whose fundraising is conducted solely via the internet (auctions or professional fundraising arrangements) may give rise to new issues and interpretations of tax law. These applications are currently Grade 13 cases and reserved for EO Technical. This issue will not be discussed in this training.

Some fundraising issues have been introduced in previous training but are repeated here and expanded upon as they relate to higher graded cases.

Continued on next page
Overview, Continued

Objectives
At the end of this lesson you will be able to:

- Identify the exemption issues associated with fundraising as a primary activity
- Explain the commensurate test and determine when it is met
- Recognize the exemption issues associated with professional fundraising
- Recognize the exemption issues associated with gaming activities
- Distinguish between a fundraising organization qualified under IRC section 501(c)(3) and a feeder organization
- Determine whether fundraising income is subject to unrelated business income tax

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Fundraising as a Primary Activity

Introduction

Operation of an athletic, social, entertainment, or gambling event is a very attractive means of raising funds for IRC section 501(c)(3) purposes. Some of the more popular mediums include charity balls, benefit concerts, theater and movie premiers, antique shows, bingo, and various athletic events.

An annual event with a gate attraction provides a vehicle that naturally attracts community support and news media publicity. Such an event often requires large expenditures for the services of gate attractions and salaried fundraisers or coordinators. Many times, a new corporation is formed to conduct this activity for contract, liability, insurance or other purposes.

Other organizations may operate a trade or business for the purpose of raising funds to contribute to other IRC section 501(c)(3) organizations.

In both cases, and in many situations in between, the organization may itself qualify for exemption under IRC section 501(c)(3).

Basis for Exemption

It is clearly established by law that an organization with the purpose of distributing funds to other charitable organizations recognized as exempt under IRC section 501(c)(3) may itself qualify for IRC section 501(c)(3) exemption (Rev. Rul. 67-149, 1967-1 C.B. 133).

If we determine that the fundraising activities of an organization do not constitute an unrelated trade or business and/or that its payments to charity are commensurate with revenue generated by fundraising, the organization will qualify for exempt status. However, issues arise when an organization uses most of its revenue to pay fundraising and administrative expenses while using a disproportionately small amount of its revenue for its exempt activities.

Continued on next page
Fundraising as a Primary Activity, Continued

Look to Purpose of Business Operation

Treas. Reg. 1.501(c)(3)-1(e)(1) states:

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part if its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

Factors to Consider

Some factors to consider in determining whether a particular activity is fundraising and should be granted exemption from Federal income tax are the following:

- Occasional activity of a nature not usually considered to be commercial
- Members volunteer substantial services, so far as practical under the circumstances
- Advertising in programs is of the type usually regarded as charitable contributions
- Merchandise which is donated or furnished at cost

(Note that tax exemption does not preclude the payment of reasonable rents, fees for professional services, and reimbursement of members for out-of-pocket expenses.)

Where an income-producing activity is conducted primarily in the manner set forth above, the Service takes the position that the activity is "fundraising." A determination as to whether an activity is the primary activity of the organization claiming exemption under IRC section 501(c)(3) depends upon all the facts and circumstances of a particular case. As a general rule, however, if an organization otherwise qualified under IRC section 501(c)(3), in fact, to be carrying on a charitable program reasonable commensurate with its fund raising activities, there appears to be no basis for holding that the primary activity of the organization is other than charitable.
Qualification under IRC section 501(c)(3)

An organization that raises funds either to distribute to other charities or for its own charitable program must meet the requirement that it engages primarily in activities that accomplish one or more exempt purposes (Treas. Reg. 1.501(c)(3)-1(c)(1)). Whether a fundraising organization’s activity may be said to accomplish an exempt purpose often centers on the issue of whether there has been a sufficient turnover of funds to charity.

The “commensurate test” was first presented in Rev. Rul. 64-182, 1964-1, C.B. 186. In this ruling, an organization derived its income principally from renting space in a commercial property that it owned and operated. It was held to be exempt under IRC section 501(c)(3) because its primary purpose was found to be raising funds for distribution for charitable purposes. The ruling states that an organization that distributes funds for charitable purposes in an amount commensurate to its resources would qualify for IRC section 501(c)(3) exemption.

Note: The commensurate test is generally only applicable to IRC section 501(c)(3). There is no analogous authority under IRC section 501(c)(4). Therefore, if an organization’s primary activity is that of a business, notwithstanding generation of a commensurate amount of income for social welfare use, it would be difficult to justify recognition under IRC section 501(c)(4).

While there is no specified payout percentage for “commensurate in scope,” distribution levels that are extremely low should invite close scrutiny.

The “commensurate test” requires that organizations have a charitable program that is both real and, taking the organization’s circumstances and financial resources into account, substantial. Therefore, an organization that raises funds for charitable purposes but consistently uses virtually all its income for administrative and promotional expenses with little or no distribution to charity cannot reasonably argue that its distributions are commensurate with its financial resources and capabilities.

Continued on next page
Pay Out Considerations

The “commensurate test” does not lend itself to rigid numerical distribution formulas – there is no fixed percentage of income that an organization must pay out for charitable purposes. The financial resources of any organization may be affected by such factors as start-up costs, overhead, scale of operations, whether labor is volunteer or salaried, phone or postal rates, etc. In each case, the particular facts and circumstances of the fundraising organization must be considered.

Accordingly, a low payout percentage does not automatically mandate the conclusion that the fundraising organization under consideration has a primary purpose that is not charitable. In each case, consideration should be given as to whether the failure to make real and substantial contributions for charitable purposes is due to a reasonable cause.

Examples of Non-Qualifying Organizations

- **Make a Joyful Noise v. Commissioner**, TCM 1989-4, detailed an exempt organization that had been conducting bingo games lost its state permit due to a change in state law. The organization began to lease its premises to other organizations and to participate in the operations of the bingo games, receiving a portion of the gross receipts. The court held that operating regularly scheduled bingo games on behalf of other exempt organizations was an unrelated trade or business. Because the organization could not demonstrate that it conducted any charitable activities, other than unfulfilled charitable objectives, the court upheld the Service’s revocation.

- **Help the Children, Inc. v. Commissioner**, 28 TC 1128 (1957), involved an organization engaged in operating bingo games. Its charitable function consisted of contributions to charitable institutions of amounts that were insubstantial (less than 1%) when compared to gross receipts from the bingo games. The court held that the organization did not qualify for exemption because it did not operate any charitable institutions and its principal activity was the profitable operation of bingo games on a commercial basis.

- PLR 9132005 (May 3, 1991) described an organization formed to conduct research on problems of sight and hearing. The organization held bingo games to raise money. Because its actual payments to charity were minimal (approximately 1%), the Service concluded that the organization was not carrying on a charitable program reasonably commensurate with its financial resources, and revoked its exempt status.

Continued on next page
Qualification under IRC section 501(c)(3), Continued

Commercial Type Activities as “Fundraisers”

Cases involving organizations operating a commercial type business with “profits” going to other IRC section 501(c)(3) organizations will generally not qualify for exemption under IRC section 501(c)(3). These cases should be discussed with the group manager.

Do Not Cite Commensurate Test as Basis for Exemption or Denial

Because of the lack of consistent application and interpretation in the courts, cases that are being denied should not reference Rev. Rul. 64-182, but, rather, should rely on other precedent.

Also, Rev. Rul. 64-182 should generally not be cited as the sole legal basis for a favorable determination.

Inurement

Based upon facts and circumstances, a fundraising organization may qualify for exempt status under IRC section 501(c)(3) even though the fundraising activity itself is not inherently charitable. However, even if an organization makes a real and substantial contribution to charity commensurate with its financial resources, a substantial private purpose may be still be found that will disqualify it from IRC section 501(c)(3) exemption.

For example, fundraising commissions may involve inurement or private benefit if the commissions are unreasonable or bear no relationship to the services performed. The burden would fall on the organization to establish the reasonableness of compensation and to establish that charitable assets were or are not diverted. (*Bubbling Well Church of Universal Love, Inc. v. Commissioner*, 74 T. 531 (1980); *People of God Community v. Commissioner*, 75 T.C. 127, 132 (1980))

*PLL Scholarship Fund v. Commissioner*, 82 TC 196 (1984), involved an organization which raised funds for charity by conducting bingo games in a bar owned by the organization’s directors. The Tax Court concluded that the organization could not qualify for exemption because it had the substantial private purpose of making food and beverage sales for the benefit of the bar’s owners.

Additional Resources

*Fundraising*, 1982 EO CPE Text, Topic L
*Update on Fundraising*, 1986 EO CPE Text, Topic G
*Special Emphasis Program - Charitable Fundraising*, 1989 EO CPE Text, Topic M
*Fundraising Update*, 1990 EO CPE Text, Topic K
Professional Fundraisers

Use of Professional Fundraisers

Many legitimate professional fundraising organizations provide useful services to exempt organizations helping them organize and conduct fundraising campaigns. Professional fundraisers offer expertise and efficiency to both newly created organizations, whose officers are unfamiliar with resources and methods for obtaining funds, and to established organizations that wish to expand their support base.

The use of professional fundraisers is an area of legitimate concern in processing applications for tax exempt status. Some fundraising arrangements unduly benefit the professional fundraiser, who may or may not be an “insider” with respect to the organization seeking exemption, while providing minimal amounts of income for actual charitable uses.

However, not all arrangements with professional fundraisers are “suspect.” Many legitimate fundraisers provide useful services to exempt organizations in helping them organize and conduct fundraising campaigns. Professional fundraisers offer expertise and efficiency to both newly created organizations whose officers are unfamiliar with resources and methods for obtaining funds and to established organizations that wish to expand their support bases.

Definition

The instructions to Form 990 define “professional fundraising services” as:

…services performed for the organization requiring the exercise of professional judgment or discretion consisting of planning, management, the preparation of materials (e.g., direct mail solicitation packages), the provision of advice and consulting regarding solicitation of contributions, and the direct solicitation of contributions.

Continued on next page
Professional Fundraisers, Continued

Control of Fundraising Process
To ensure that assets and fundraising receipts are used for IRC section 501(c)(3) purposes, the exempt organization should retain oversight and control of all fundraising activities, including those involving professional fundraisers. If the IRC section 501(c)(3) organization does not retain control, there is no assurance that assets are being used for appropriate purposes. (“Assets” include the name of the exempt organization as well as actual monetary or in kind receipts.) The organization should retain control over the general fundraising event or operation including but not limited to setting of event/ticket prices, approval of marketing/advertising campaigns, and accounting/bank account control.

Fundraiser Compensation
There are several methods for compensating professional fundraisers including flat or hourly fees for specific projects or events, percentage of receipts arrangements, etc. Generally, flat or hourly fees, if negotiated with an unrelated party in an arm’s length transaction, do not pose a problem when reviewing an application for exemption.

In any compensation arrangement, it is important to determine the justification for the arrangement. For example, is the arrangement an incentive to increase production or is the fundraiser attempting to share in the assets of the exempt organization? (Incentives to increase production are viewed more favorably than attempts to share in assets.)

Compensation as a percentage of receipts is discussed below. Other methods of compensation may require development based on the facts and circumstances of the case.
Percentage of receipts arrangements often require close scrutiny to ensure that prohibited private benefit or inurement is not present. In developing this issue, it is important to determine if the fundraiser will be compensated based upon a percentage of gross or net receipts.

The current Service position is that a percentage of gross receipts is a more favorable arrangement as the Code specifies that “no part of the net earnings [may] inure to the benefit of any private shareholder or individual” (emphasis added). In addition, fees based on gross income do not provide an incentive for compensated parties to cut costs (often to the detriment of the exempt organization) in order to maximize their share of receipts.

In some cases, an organization may set a reasonable cap to percentage of income compensation. It may also be appropriate for the specialist to suggest that such a policy be established and included in any fundraiser negotiations.

Generally, if an organization provides a reasonable cap on the maximum compensation and the agreement was negotiated at arm’s length, a percentage based compensation arrangement with a professional fundraiser will not constitute private benefit or inurement; however, each situation must be evaluated based on the specific facts and circumstances of the case.

Continued on next page
A common issue in applications from organizations who use professional fundraisers and/or whose primary activity is fundraising is the presence of private benefit or inurement.

One scenario involves a “charity” or “social welfare organization” that is created by officers or employees of a professional fundraiser. The new exempt organization then hires the fundraiser to conduct one or more solicitation campaigns. Many times the exempt organization receives little or nothing, while the fundraiser, and possibly other related corporations, end up making substantial profits.

Where the exempt organization and the fundraiser are related parties, an abuse may exist and the exempt organization may be serving private interests even though the fees the exempt organization pays the fundraiser are at the prevailing rates within the industry for similar services.

Similarly, where prevailing rates are paid and substantially all of the gross fundraising proceeds are retained by or paid to the fundraiser, but the exempt organization and the fundraiser cannot be shown to be related parties, an abuse situation may still be present. It may or may not be true that the exempt organization was created with the intent to benefit private interests, but in actual operation, the organization’s fundraising activities have done just that.

In both situations, any benefit to the public from the exempt organization’s activities will almost always be insubstantial, and, in some cases, nonexistent. This issue should be thoroughly developed when making a determination.

In processing an exemption application, it is important to get all of the facts before advising an applicant that its current or proposed use of a professional fundraiser may have an adverse effect on its qualifications for exemption. Requests for additional information should be customized to fit the situation presented.
The following are questions that may be used (or tailored to case facts) regarding the current or proposed use of professional fundraisers:

- Identify all the professional fundraising organizations and/or individual fundraisers you use or intend to use.

- How did you or will you determine which professional fundraisers to use? Please explain in detail.

- Do any of your organization’s directors or officers work for the professional fundraisers you use or will use? If yes, please provide a detailed explanation of the relationship(s).

  In addition, disclose any compensation, bonuses or benefits these individuals will receive through their professional fundraising efforts.

- Does or will anyone in the organization have ultimate control over the fundraising process (e.g., approval of scripts for advertisements, accounting controls, authority to set ticket prices, etc.)?

- How are the professional fundraisers compensated? Will you enter into agreements where the professional fundraiser will receive a stated percentage of all funds raised? Please explain.

- Have you already entered into any written or oral agreements with professional fundraisers? If so, submit copies of any written contacts or agreements or provide specific details of any oral agreements.

Continued on next page
Professional Fundraisers, Continued

Car, Truck and Boat Donations

A common use of professional fundraisers is for the execution of a car donation program. Often, a charity hires a private, for-profit entity to operate the program. The charity and the for-profit entity must establish an agency relationship that is valid under the applicable state law. Generally, an agency relationship will be established where the parties agree that the for-profit entity will act on the charity’s behalf and that the for-profit entity’s activities covered by the agreement are subject to the charity’s oversight. Accordingly, the charity should actively monitor program operations and have the right to review all contracts, establish rules of conduct, choose or change program operators, approve or change all advertising, and examine the program’s books and records.

If the charity follows these guidelines, the program should not have an adverse impact on the applicant’s tax exempt status or a donor’s deductibility.

However, if the charity grants a for-profit entity the right to use the charity’s name for the purpose of soliciting donations of used cars and the charity receives either a flat fee or a percentage of the sale of the cars to use for its exempt purposes, the program is not the charity’s program. In such a case, the donated vehicle would not be deductible by the donor. Misleading the public on the deductibility of donations in this scenario may lead to adverse tax consequences to both the charity and the for-profit entity.

Additional information on the operation of car (or other vehicle) donation programs can be found in IRS Publication 4302, *A Charity’s Guide to Car Donations.*

Continued on next page
While cases involving professional fundraising organizations are Grade 12 on the Case Assignment Guide, there are many instances when professional fundraising arrangements do not raise exemption issues and cases remain as Grade 11.

For example, many PTAs, PTOs, and youth sports organizations contract with professional fundraising companies that supply items such as wrapping paper, candy, and seasonal gift items to be sold by school students. The professional fundraiser generally keeps a percentage of the sales price and has similar contracts with numerous parent-teacher and youth sports organizations in several different states. In the absence of indications of “insider” benefit or other unusual circumstances, extensive questioning regarding professional fundraising arrangements by these types of organizations is seldom essential to the determination process.

Schedule G of the redesigned Form 990 requires an organization to report certain amounts of professional fundraising expenses, revenues from special events, and revenue from gaming activities.
Overview of Gaming as a Primary Activity

Introduction

Gaming has become a primary fund raising activity of many exempt organizations. The significant increase in the number of organizations that use this means to secure additional funds to support their activities is due, in part, to the number of states that have passed legislation making the conduct of certain types of gaming legal under state law.

Gaming includes (but is not limited to): bingo, pull tabs/instant bingo (including satellite and progressive bingo), Texas Hold-Em Poker and other card games, raffles, scratch-offs, charitable gaming tickets, casino and Las Vegas nights, and coin-operated gambling devices. Coin-operated gambling devices include slot machines, electronic video slot or line games (e.g., video poker, blackjack, keno, bingo, etc.).

Applications from organizations whose primary activity is gaming are assigned to a reserved inventory category. This section provides an overview of the issues related to gaming. Bingo has traditionally been the most common form of gaming encountered in EO applications and is the focus of this section. Additional information on gaming as a primary activity will be provided in future training.

Gaming Issues

The following are issues that a determination specialist will need to consider in any application seeking tax-exempt status in which an organization indicates that gaming is the sole means of fundraising or is a substantial part of their fundraising for "charitable" purposes:

- Substantial non-exempt activities
- Inurement and private benefit
- Related entities
- Legality of gaming activity
- UBI – “Unrelated Business Income”
- Liability for excise taxes
- Special filing requirements for charitable gaming

Continued on next page
Overview of Gaming as a Primary Activity, Continued

Substantial Non-Exempt Activities

If the organization’s gaming activity serves a non-exempt purpose and the non-exempt purpose is substantial, the organization is not exempt. The following court cases involved bingo as the primary activity of each organization. Each organization was found to have a substantial non-exempt purpose:

- *Make a Joyful Noise v. Commissioner*, TCM 1989-4

Identifying Inurement and Private Benefit in Gaming

Gaming activities conducted by exempt organizations should be closely reviewed for potential inurement and/or private benefit. Inurement and private benefit are most likely to occur in business transactions especially if entered into by related parties.

Transactions common to gaming that may have the potential for inurement and private benefit are the leasing of property/real estate, bingo equipment or other personal property, operation of concession stands and the purchasing of bingo supplies.

Each of these transactions should be reviewed for related entity involvement.

Illegal Gaming Activity

The Internal Revenue Service is not in a position of authority to declare acts illegal under any laws except those that are in violation of the Internal Revenue Code.

The best method to determine if an organization’s proposed gaming activities are legal under State or local law is to request a copy of the State or local law that provides for legal “charitable” gaming activities and describes how gaming activities must be carried out.

Compare the proposed activities of the applicant organization with the requirements of State or local law to assure that the proposed gaming activity is in conformity with that law.
Overview of Gaming as a Primary Activity, Continued

Illegal Gaming Activity (continued)

Before issuing a favorable ruling letter, it may be necessary to secure additional information from the organization to clarify any of its methods of operation that are not sufficiently clear on the application in order to make a sound judgment that the applicant organization is in compliance with State and local law.

If a State or local governmental unit has not taken action with respect to a purported illegal act, the Service generally may not declare the act illegal for purposes of denying exempt status or revoking a current exemption.

An organization whose gaming activity is illegal will most likely have other issues to consider, including private benefit, inurement, or a substantial non-exempt purpose. Therefore, any proposed denial of exempt status should address all issues fairly presented by the facts and circumstances.

Bingo Generally Excluded From UBI

IRC section 513(f) provides that the term “unrelated trade or business” does not include any trade or business that consists of conducting bingo games.

For purposes of Unrelated Business Income (UBI), the term “bingo game” means any game of bingo:

- In which usually (i) the wagers are placed (ii) the winners are determined, and (iii) the distribution of prizes or other property is made in the presence of all persons placing wagers in such game,
- The conducting of which is not an activity ordinarily carried out on a commercial basis, and
- The conducting of which does not violate any State or local law.

Wagering Taxes

Certain types of wagering income (except where specifically excluded) are subject to the Federal excise tax imposed on wagers provided for in IRC section 4401 as well as an annual occupational tax imposed on persons receiving wages under IRC section 4411. Common types of wagering subject to these taxes are pull tabs, instant bingo and raffles.

Generally, wagering income of organizations exempt under subsections other than 501(c)(3) is subject to these taxes. However, the specialist should review the exceptions to the taxes and the facts and circumstances of each case in order to educate the applicant organization on its filing requirements.

Continued on next page
In addition to filing any required excise tax forms, a tax exempt organization that is involved in charitable gaming may also be liable for filing additional tax and/or information returns with the Service. These include:

- Form W2-G, Certain Gambling Winnings
- Form 5754, Statement by Person(s) Receiving Gambling Winnings
- Form 945, Annual Return of Withheld Federal Income Tax

Most, if not all, applications involving charitable gaming as a substantial part of a fundraising activity will come from organizations seeking exemption under IRC section 501(c)(3).

However, many State and local laws provide for “charitable” gaming for organizations other than those exempt under IRC section 501(c)(3). The most common types of non-(c)(3) organizations that can legally engage in “charitable” gaming under most State and local laws are organizations described in IRC sections:

- 501(c)(4) Social Welfare Organizations
- 501(c)(8) and (10) Fraternal Organizations
- 501(c)(19) Veterans Organizations

In addition to the general development issues of these organizations, the gaming activities of non-(c)(3) organizations should be reviewed to ensure that the purposes of the applicant organization fall within the exempt purposes of the Code section under which recognition of tax exemption has been applied for and to ensure consideration of any possible tax and filing implications.

Additional Resources

- *Gaming Publication for Tax-Exempt Organizations*, IRS Publication 3079
- *Gambling Activities of Exempt Organization*, 1990 EO CPE Text, Topic M
- *Update on Gaming Activities*, 1996 EO CPE Text, Topic D
- *Fundraising*, 1982 EO CPE Text, Topic L
Fundraiser or Feeder?

**Feeder Organizations**

A “feeder organization” operates for the primary purpose of carrying on a trade or business for profit, the income from which is turned over or “fed” to an IRC section 501(c)(3) organization.

If an organization’s principal income-producing activity is the conduct of a trade or business, and it has no significant charitable activity other than the payment of its profits over to one or more exempt organizations, it is operated for the “primary purpose” of carrying on a trade or business for profit within the meaning of IRC section 502 and will not qualify for exemption under IRC section 501(c)(3).

Often, the activities of feeder organizations and exempt fundraising organizations are difficult to distinguish. The facts and circumstances of each application must be evaluated to make a correct determination.

**IRC Section 502**

IRC section 502 states that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under IRC section 501 on the ground that all of its profits are payable to one or more organizations exempt under IRC section 501.

Note: IRC section 501(c)(3) regulations allow an organization to operate a trade or business under certain circumstances. Other sections of the Code (such as IRC sections 501(c)(4) and (6)) do not have provisions for the operation of a trade or business as the primary activity. As such, IRC section 502 is not applicable to these subsections.

**Key Determining Factor**

The term “payable,” as it is used in IRC section 502, is a key factor in determining whether an organization is a feeder. Legislative history has shown that in order for an organization to be defined as a feeder, there must be a legal or practical obligation to turn over the profits to one or more exempt organizations.

As long as the organization has the discretion as to which charity or charities it will give profits, it is not a feeder under IRC section 502.
Fundraiser or Feeder? Continued

Feeder Exceptions
IRC section 502(b) provides that the term “trade or business” does not include:

- The receipt of rents that would be excluded from unrelated business taxable income under IRC section 512(b)(3)
- A trade or business in which substantially all labor is volunteer labor, or
- A trade or business of selling merchandise, substantially all of which has been donated to the organization

Therefore, an organization whose activities meet one of these exceptions is not considered to carry on a “trade or business” and may qualify for exemption under IRC section 501 provided it meets all other requirements of the requested subsection.

Citing IRC Section 502
If an organization that uses business profits to donate to IRC section 501(c)(3) organizations is not required to donate its proceeds to a specific IRC section 501(c)(3) organization, it is not a feeder organization as described in IRC section 502. Such organizations might not qualify for exemption based upon the other facts and circumstances, but IRC section 502 does not apply.

In such situations, IRC section 502 should not be cited as the primary basis for proposed adverse action where there is no commitment to pay over profits to one or more specifically designated exempt organizations. However, IRC section 502 and rulings and cases interpreting this Code section may possibly be useful to illustrate general Service position concerning commercial activities of exempt organizations even when there is no “feeder” situation.

Continued on next page
Other Feeder Issues

An organization which provides commercial services to other organizations (related or unrelated) may or may not be classified as a feeder based on the facts and circumstances of the situation. Because these types of organizations do not generally turn over the profits of the organization to an IRC section 501 organization, they are not discussed in this lesson.


Additional Resources

IRM 7.25.25, Feeder Organizations
Feeder Organizations under IRC 502, 1983 CPE Text, Topic F
Unrelated Business Income Issues

Income May Be Subject to UBIT

Although a fundraising organization may qualify for exemption, part of the income from the organization’s activities may be subject to unrelated business income tax. Treas. Reg. 1.513-1(a) states that:

…unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization …is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Treas. Reg. 1.513-1(c)(2) clarifies the term “regularly carried on” as an activity which is conducted with a frequency and continuity which would be similar to commercial activities pursued by a nonexempt organization.

The term “substantially related” requires an examination of how a business activity that generates the income helps an organization accomplish its exempt purpose. Treas. Reg. 1.513-1(d) states that to be substantially related:

- The conduct of the business activity must have a causal relationship to the achievement of exempt purposes.
- The conduct of the business activity must **contribute importantly** to the accomplishment of the organization’s exempt purposes to be substantially related. (See also IRC section 513(a))

Continued on next page
Unrelated Business Income Issues, Continued

Exclusions From UBI

IRC section 513(a) provides for specific exclusions when a trade or business will not be considered an unrelated business activity.

These exclusions are:

- Trade or business activities conducted by volunteer labor
- Trade or business conducted for the convenience of members
- Trade or business involving selling merchandise received by the organization through gift or contribution

All dividends, interest, annuities, payments with respect to securities loans, and other passive income from an exempt organization’s ordinary and routine investments are excluded in computing unrelated business taxable income.

And, in general, rents from real property (non-debt financed) are also excluded in computing unrelated business taxable income.

Filing Requirements

Generally, income from fundraising activities is excluded from UBI due to the exceptions noted above. However, if it is determined that the organization may be subject to UBIT, a Form 990-T filing requirement should be entered when closing the case.
Applicant Education

Deductibility to Contributors

Fundraising activities often give rise to questions of deductibility of contributions under IRC section 170. As a general rule, where a transaction involving a payment is in the form of a purchase of an item of value, the presumption arises that no gift has been made for charitable contribution purposes, the presumption being that the payment in such case is the purchase price. The Service has long been concerned that charities do not accurately inform their patrons of the extent to which contributions are deductible. Deductibility of car, truck, and boat contributions has also been an area of confusion and abuse.

Although this issue does not usually require development in the determinations process (except in determining the correct foundation classification), it is a topic on which the specialist may wish to educate the taxpayer.

Resources

The Service has published guidance for charitable organizations to make them aware of their responsibilities in this matter and to provide guidelines and examples for determining deductibility amounts.

Organizations can be referred to:

Rev. Proc. 90-12, 1990-1 C.B. 471
Charitable Contributions, IRS Publication 526
Special Emphasis Program – Charitable-Fundraising, 1989 EO CPE Text, Topic M
Fund-Raising Issues – Car Donation Programs, 2000 EO CPE Text, Topic T
A Charity’s Guide to Car Donations, IRS Publication 4302
A Donor’s Guide to Car Donations, IRS Publication 4303
www.irs.gov
Summary

It is clearly established by law that an organization with the purpose of distributing funds to other charitable organizations recognized as exempt under IRC section 501(c)(3) may itself qualify for IRC section 501(c)(3) exemption. This may include an organization that conducts an annual fundraising event such as a charity ball or celebrity golf tournament on behalf of a charity as well as an organization that operates a business with commensurate proceeds going to other IRC section 501(c)(3) organizations.

Rev. Rul. 64-182, 1964-1, C.B. 186, holds that an organization that derived its income principally from renting space in a commercial property that it owned and operated was exempt under IRC section 501(c)(3) because its primary purpose was found to be raising funds for distribution for charitable purposes. The ruling states that an organization that distributes funds for charitable purposes in an amount commensurate to its resources would qualify for IRC section 501(c)(3) exemption.

Many exempt organizations engage professional fundraising organizations to provide useful services in helping them organize and conduct fundraising campaigns.

Applications from organizations whose primary activity is gaming require additional scrutiny to ensure the organization is furthering an exempt purpose. These cases are a reserved inventory category.

All fundraising activities should be developed to the extent that the specialist can determine that there is a legitimate exempt purpose and that no inurement or substantial private benefit is present.

IRC section 502 states that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under IRC section 501 on the ground that all of its profits are payable to one or more organizations exempt under IRC section 501. An organization shall not be considered a feeder organization so long as the organization is not required to pay its profits to specified exempt organizations.

Although a fundraising organization may qualify for exemption, income from the organization’s activities may still be subject to unrelated business income tax. Appropriate filing requirements should be included at case closing.
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Lesson 6
For-Profit Relationships

Overview

Introduction

In the strictest sense, a case could be considered to be “for-profit related” if an applicant organization paid legal fees to a law firm owned by a member of its governing body. Or, you could classify a case as “for-profit related” if a large company started a foundation to facilitate charitable giving among its employees.

However, these arrangements are not the higher-graded “for-profit related” applications that require special attention and that are discussed in this lesson.

The “for-profit related” cases of concern involve contracts and agreements between the nonprofit applicant organization and a for-profit entity, significant financial transactions between the two, or situations where substantial services or products are provided from one to the other. Many times such services or products are inextricably tied to the nonprofit’s exempt purposes.

Continued on next page
Overview, Continued

Objectives
At the end of this lesson you will be able to:

- Identify for-profit relationships requiring further development
- List activities likely to involve for-profit relationships
- Analyze governing bodies of related entities to uncover controlling interests which may confer private benefit on related for-profits
- Create probing questions to discourage for-profit related organizations from offering vague answers to information requests
- Recognize sources of private benefit disguised in the terms and conditions of contracts/agreements between for-profits and nonprofits
- Define “qualitative” and “quantitative” private benefit incidental to overall public benefit

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For-Profit Relationships
6-2
Identifying For-Profit Relationships

Form 1023

Assuming the form is completed correctly, “for-profit related” issues may be revealed in Part V of Form 1023.

For example, line 7 of Part V asks if the applicant will sell or purchase goods or services from officers/directors; line 8 discusses leases, contracts, and loans between the applicant and the officers/directors, etc.

Case Grade

Because of the complexity of for-profit relationships, the required analysis and questioning of the applicant, and the lack of specific tax law on the subject, true “for-profit related” cases are Grade 12.

Although it is possible that such a case could contain all information necessary for a merit closure determination, the majority of these cases must be sent for further development.

Examples

Virtually any application for exemption may involve a for-profit relationship. The following are a few of the most commonly seen situations:

- Low-income housing with a related for-profit developer
- Scientific research organization with related-party contracts concerning ownership of research material
- A school which trains students to work at a related for-profit business
- Credit counseling organization with a related for-profit credit repair company
- Organization selling homes to low-income clients via realtors with a personal stake in the transactions
- Conservation easement organization with a related for-profit environmental consulting firm

(For more examples, refer to IRM 7.25.3.16.9)

Methods of identifying and analyzing for-profit relationships are best developed through illustrative examples. This lesson will demonstrate many of the issues encountered when dealing with for-profit relationships by means of three comprehensive examples.
Example 1: For the first example, consider an application from a “(b) (3) (A)” program.

Assume that all members of the board of directors of the nonprofit applicant are employees at a for-profit catering company supplying the food to the nonprofit. Also, the name of the nonprofit is very similar to the name of the for-profit company.

You may suspect that the owners of the for-profit started the nonprofit specifically to generate business for itself. Your suspicion may be elevated by the similar names of the two entities.

Control

One of your first steps in developing the case is to determine whether the nonprofit is being controlled by the for-profit. If not already provided ask for a full listing of the governing bodies of both the nonprofit and the for-profit.

Control by employees of the catering company does not necessarily mean that the owners themselves are in control, although the arrangement should still be investigated to find out if they are otherwise exercising indirect control. Depending on all the facts and circumstances involved, it may be appropriate to recommend that board members completely unaffiliated with the catering company be added to the governing board of the nonprofit.
Example 1: Continued

**Questioning Techniques**

Applications such as these rarely provide all the information required up front to make a determination on exempt status. You must be direct in your questioning technique to keep the applicant from offering vague answers that do not address the issues at hand.

“Probing” questions tend to yield more meaningful responses than “closed-ended” questions. You should ask for descriptions, explanations and details rather than questions that require only a “yes” or “no” response.

**Suggested Questions**

To determine whether the related company is the only company providing its services to the nonprofit, you might ask whether other companies provide services to the applicant, and if so, the names of the companies, what services they provide, and how they were selected.

To find out whether the nonprofit has any plans to utilize other catering companies at a later date, you may ask the applicant to describe any future plans it may have to utilize other companies. You may ask for a description of any active efforts to seek out services from other, more affordable companies.

To evaluate whether there are any unique qualities of the related catering company that make it more attractive than other companies, you may ask the nonprofit to describe the related company’s qualities, services, etc., and how those qualities/services compare to other catering companies in its geographic area.

You may ask if it took competitive bids from other companies. If so, you would ask for a detailed description of the selection process. The description should reveal how many bids were received, from whom, how did each compare, and what led to the final selection decision. If necessary, you could ask for copies of the quotes in order to establish the reasonableness of the food and service amounts.

*Continued on next page*
Example 1: Continued

**Extenuating Circumstances**

Often, an organization will utilize the services of a related provider as a matter of convenience with sincere plans to solicit other companies once its operations get off the ground.

Additionally, quoted prices may not necessarily reflect a reasonable price. The applicant may choose a higher-priced company because it offers better quality, more services, etc. Likewise, selecting the lowest-priced company does not necessarily prove reasonableness of pricing or the elimination of private benefit.

**Contracts & Agreements**

If the nonprofit entered into a written food service contract with the related for-profit catering company, secure a copy of the agreement for the file.

The prices established in the contract may be compared to any bids from other companies to establish fair market value. As stated earlier, factors such as quality and amount of services provided may justify selection over other price quotes. Furthermore, if the contract was negotiated as part of an arm’s length transaction, the fact that the applicant is dealing with a related party may be irrelevant.

**Percentage of Revenue**

If you suspect that the nonprofit was created for the specific benefit of the for-profit, you can evaluate the payments from the nonprofit against the total annual revenue of the for-profit company. For example, ask the applicant whether its payments to the for-profit are significant to the for-profit company’s overall operations (that is, what percentage of the for-profit company’s funds is received as a result of the contract).

You can also ask what percentage of the for-profit company’s time is devoted to fulfilling the contract of the nonprofit.

*Continued on next page*
Example 1: Nonprofits sometimes share resources with a for-profit. You may need to question the applicant to determine whether it shares a facility, management, or staff with the for-profit or any other organization or individual. If so, solicit details on the shared resources, and explanations of how space, services, staffing, and expenses (such as rent, utilities, maintenance, taxes, payroll, etc.) are allocated to determine if private benefit or inurement issues are present.

Other Considerations

The applicant organization may strengthen its argument for exemption if it is engaged in other exempt activities, for example, if the “(b) (3) (A)” program is just one of many activities.

Although not relevant to this example, sometimes you must gather details on services provided to the for-profit company by the nonprofit. When for-profit offers services to a nonprofit, you must ensure the nonprofit is paying at or below fair market value; similarly, when the nonprofit provides services to the for-profit, you must ensure the for-profit is not benefiting by paying less than fair market value.
Example 2: School with Management Company

Scenario
One of the most commonly seen for-profit relationships involves a situation where a private school contracts with a for-profit management company.

This situation is not limited to charter schools, but can involve any type of private school.

Control
When considering this type of application, your first task is to determine who is in control.

You should ensure the school’s governing board retains control of the applicant organization and continues to exercise its fiduciary responsibility. The school board should be independent of the management company and should conduct active oversight of school operations.

School Board
The school board should consist of members of the community or persons who are otherwise qualified to serve on a school board. The management company should not appoint the majority of the school board.

Regular board meetings (more than two times per year) help guarantee that the board maintains active oversight of school operations. The school board should have the ultimate authority over major school policies such as the budget. The board should have policies in place to ensure the fiscal health of the school, such as periodic reviews of financial statements or employment of an auditor independent of the management company.

Continued on next page
Example 2: School with Management Company, Continued

Management Company Selection

The management company should have been chosen via an arm’s length transaction. This could be evidenced by the consideration of multiple companies or the use of a competitive bidding process.

In order to determine whether the transaction was truly at arm’s length, consider the following factors:

- Was the transaction between related parties?
- Who signed the agreement?
- Who was involved in the decision-making process - interested parties or independent parties?
- Who set the terms of the agreement and how?
- What was the basis of the decision?

Compensation

Any fees paid to the management company must be reasonable and commensurate with services provided; this also holds true for any other salaries paid. A strong conflict of interest policy can safeguard against unreasonable compensation; however, you must ensure the policies were, in fact, followed. Unfortunately, many organizations simply adopt the standard conflict of interest policy located in the instructions to Form 1023 but do not actually follow the policy.

Continued on next page
Example 2: School with Management Company, Continued

Management Contracts

All contracts, especially the management contract, should show evidence of arm’s length negotiations. Be on the alert for contracts that unduly favor the management company. The length of the contract should enable the board to remain flexible in meeting its fiduciary responsibilities.

Personnel policies should be favorable to the school and not limit its ability to terminate the contract. Private benefit to the management company may result if shortfalls are deemed a loan financed by the management company payable upon termination of the agreement (as opposed to a contribution by the contracted company).

The contract should specify the provisions for terminating the contract and the procedures for evaluating when terms are in default. Term provisions that unreasonably restrict and limit the options of the school are evidence of private benefit (for example, lump sum penalty, loss of equipment, and other punitive measures).

There should not be a “non-compete” clause in the contract. In other words, if teachers were hired directly by the management company, the contract should not have a clause which stipulates that the school cannot hire them directly for a period of time after the contract is terminated.

Continued on next page
Example 2: School with Management Company, Continued

Contract Red Flags

Name Branding

Such “name branding” could place a contractual burden on the school that could deter it from terminating its relationship with the management company. These contractual provisions do not necessarily preclude exemption; however, having such provisions combined with other factors could be an indicator of private benefit which, if substantial, may preclude exemption.

Facility Issues

If the school is leasing its facility from the management company and not from the actual owner of the property, subleasing the property may be yet another opportunity for the management company to benefit from the arrangement. Sometimes, the related company is actually responsible for constructing the school facility and then either selling or leasing the facility to the school. This is yet another avenue for potential private benefit.

Ancillary Services

The management company may provide other services directly or through affiliates, such as capital loans, facility leasing/construction, technology contracting, furnishings, fixtures, textbooks and other curriculum, payroll, purchasing services, state testing and/or reporting services, etc.

You must ensure all services are provided at or below fair market value, and were the result of arm’s length negotiations by an independent board.

For-Profit Relationships

6-11
Example 3: Gymnastics Booster Club

Scenario
You frequently see applications from gymnastics booster clubs formed to support competitive youth teams that are affiliated with privately-owned for-profit gyms.

These booster clubs help raise funds to cover the costs of participation in local, state, regional and national competitions (meet fees, travel expenses, etc.). Due to the potential risk of private benefit to the owners of the for-profit gym facility, these applications must be carefully analyzed.

Board Composition
You can begin by analyzing the composition of the board of directors. It may be dominated by gym owners, or it may be composed of parents of the youth attending the gym.

Even if the board consists only of parents, you must proceed with caution; the owners may use other methods to exercise a substantial degree of control over the organization’s operations (e.g. requiring that all students/parents join the club and participate in fundraising, stipulating that funds be directed for specific purposes, etc.).

Facility
Since the teams almost always utilize the training facility of the for-profit enterprise, you should question any charges for using the space.

This could involve charges for the actual training floor, or maybe charges for the use of office space in the facility.

Training Equipment
If the booster club raises money to buy training equipment for the team, you should know whether it will be owned by or permanently installed in the for-profit gym.

Sometimes the equipment may be used by paying customers of the gym who are not part of the booster club.

Either situation could raise issues of private benefit/inurement to the gym owners.

Continued on next page
Example 3: Gymnastics Booster Club, Continued

**Fundraising**

Booster clubs have many options for raising funds such as car washes, candy sales and sale of ad space.

If the club is selling merchandise (T-Shirts, jackets, mugs, etc.), find out if the items bear the logo of the for-profit gym. If so, the club is benefiting the for-profit gym through free advertising.

**Incidental Benefits**

Remember that the nature of these booster clubs offers an inherent benefit to the for-profit gyms. When a team trains at a single for-profit facility, the gym’s reputation is enhanced and the public is encouraged to patronize the facility. Also, if the booster club’s name is similar to the name of the for-profit gym, such name affiliation can offer immediate name recognition.

However, these intangible benefits are typically incidental to the overall exempt purposes of the organization. In light of all facts and circumstances, such factors could be used to strengthen a denial but in and of themselves would not be detrimental to exemption.

**Other Booster Clubs**

The issues in this discussion are not common only to gymnastics booster clubs, but also to other types of booster clubs affiliated with particular for-profit businesses.

For example, issues may be found in booster clubs for cheerleading teams at for-profit gyms, dance clubs affiliated with commercial dance studios, hockey teams associated with commercial ice rinks, and music clubs affiliated with for-profit music studios, to name a few.

For a more detailed discussion of for-profit related booster clubs, refer to the 1993 CPE Article, “Athletic Booster Clubs: Are They Exempt?”
Qualitative and Quantitative Incidental Benefit

Incidental Private Benefit

*American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989), provides further insight into the nature of private benefit. True private benefit is any nonincidental benefit conferred on disinterested persons serving private interests.

In order for private benefit to be incidental, it must be “qualitatively” and “quantitatively” incidental. “Qualitatively incidental” means that the private benefit is a mere byproduct of the public benefit.

For the private benefit to be “quantitatively incidental,” it must be insubstantial in amount. If all of an organization’s business dealings are with a single entity, private benefit is more likely to be present. This explains why comparisons of the payments from the nonprofit to the total annual revenues of the for-profit company can provide insight into the level of private benefit.

Additional discussion and examples of qualitative and quantitative incidental private benefit can be found in the 1990 CPE article “Overview of Inurement/Private Benefit Issues in IRC 501(c)(3)”

Example

*International Postgraduate Medical Foundation v. Commissioner*, TCM 1989-36, gives an excellent example of an exempt travel program that was revoked.

The nonprofit contracted with a related for-profit travel company. The operations significantly increased the income of the for-profit, and no attempt was made to solicit competitive bids from other companies.
Additional Issues

Internet Research

A thorough review of all related websites is important when dealing with “for-profit related” cases to uncover additional issues, relationships, and other information not revealed in the application.

Reminder: if information obtained from the Internet is the basis for a determination or case development, the information must be shared with the applicant in order to make it part of the administrative record. Consequently, it cannot be used as the basis for a denial (or used by Appeals or the Tax Court) unless it is part of the administrative record.

For-Profit Successors

“For-profit successor” cases are classified as Grade 13 per the most recent revision of the Case Assignment Guide (CAG). This subject will be covered in detail in more advanced training.

Note: although they are technically for-profit successors, organizations that simply incorporate as for-profits in error, never conduct activities as for-profits and immediately reform as nonprofits are a Grade 11 issue.
“For-profit related” cases of concern involve contracts and agreements between a for-profit and a nonprofit, significant financial transactions between the two, or situations where services or products are provided between the two.

Applications typically at risk of containing potentially abusive for-profit relationships include low-income housing, scientific research, schools, and credit counseling. However, any type of activity may involve ties to for-profit companies.

If not already revealed in the application, the board composition of the nonprofit and related for-profit should be compared to determine whether the for-profit is controlling the operations of the nonprofit. Lack of control does not eliminate the risk of private benefit; however its presence is a strong indicator of abuse.

When composing information request letters, you should make a habit of asking for descriptions, explanations, and details rather than questions that require only a “yes” or “no” response. Such “probing” questions are direct, to the point, and keep the applicant from offering vague answers that do not address the issues at hand.

If not already provided, specialists should secure copies of all contracts and agreements referenced in the application as such contracts may reveal sources of private benefit not readily apparent in other supporting documents. This holds especially true for charter schools which have executed contracts with for-profit management companies.

In order for private benefit to be incidental to overall benefit to the public, it must be “qualitatively” and “quantitatively” incidental. “Qualitatively incidental” means that the private benefit is a mere byproduct of the public benefit. For the private benefit to be “quantitatively incidental,” it must be insubstantial in amount.
Lesson 7
Voter Education and Political Activities

Overview

Introduction

Organizations exempt under IRC section 501(c)(3) must not carry on propaganda or otherwise attempt to influence legislation (as a substantial part of their activities), or participate or intervene in any political campaign on behalf of any candidate for public office.

Prohibited political activities may be uncovered in virtually any type of application. Take for example an educational organization. The term “educational” includes the instruction of the public on subjects useful to the individual and beneficial to the community. What some organizations consider to be educating the public may in fact cross the line into political or legislative territory. The challenge in distinguishing legislative and political activities from mere efforts to enlighten the public is a very common problem.

Although seldom stated in their initial applications for exemption, churches and religious organizations frequently make the news for endorsing political candidates from the pulpit. Despite strict prohibitions on participating in political campaigns, many of these organizations attempt to emphasize separation of church and state issues by intervening in political campaigns.

Generally, exemption under IRC section 501(c)(3) is denied to organizations which are substantially engaged in attempting to influence legislation, or those which participate in or intervene in any political campaign on behalf of any candidate for public office. The prohibition on political activity is absolute, and can result in loss of exemption and/or imposition of IRC section 4955 tax. For these reasons, careful consideration must be given to any application from organizations requesting exemption for the purpose of promoting political issues.

Continued on next page
Overview, Continued

Objectives

At the end of this lesson you will be able to:

• Distinguish between educational objectives and partisan objectives

• Identify permissible “voter education” activities

• Determine whether candidate appearances endanger exemption by violating the prohibition on political activity

• Describe situations in which organizations may take positions on public policy issues without risking political campaign intervention

• Detect potential violations involving web sites created by organizations

• Identify excise taxes relating to political expenditures

• Determine when political activities of other IRC section 501(c) organizations are permissible

• Identify relationships between IRC section 501(c)(3) organizations and other related entities, such as IRC section 501(c)(4) organizations and political action committees

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Background

Revenue Act of 1954

Prior to 1954, there were no statutory provisions absolutely prohibiting IRC section 501(c)(3) organizations from engaging in political campaign activities. During Senate consideration of what became the Revenue Act of 1954, Lyndon Johnson, then Senate Minority Leader, added a floor amendment to provide that IRC section 501(c)(3) organizations may not "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." Johnson stated "... [t]his amendment seeks to extend the provisions of section 501 of the House bill, denying tax-exempt status to not only those people who influence legislation but also to those who intervene in any political campaign on behalf of any candidate for public office."

Why Johnson proposed the political campaign prohibition in the first place has been the subject of considerable interest. One theory is that Johnson recommended the amendment out of concern that an opponent, Dudley Dougherty, was using funds provided by a charitable organization to help finance his campaign in the 1954 Texas Senatorial Primary. Research into the true motives for the amendment persists to this day.

Action Organizations

If an organization exempt under IRC section 501(c)(3) engages in prohibited political activities, it becomes classified as an action organization and may be ineligible for further recognition under this subsection. Action organizations are organizations whose political (or lobbying) activities prevent them from being exempt under IRC section 501(c)(3).

One type of action organization is disqualified from IRC section 501(c)(3) exemption because its main or primary objective is gained only by legislation or a defeat of proposed legislation; the other, which is relevant to this lesson, 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.

Although an action organization cannot be exempt under IRC section 501(c)(3), it may qualify for exemption under IRC section 501(c)(4).
Revenue Ruling 2007-41

In Rev. Rul. 2007-41, 2007-25 I.R.B. 1421, the Service offered 21 situations illustrating the application of facts and circumstances in determining whether an IRC section 501(c)(3) organization participated in, or intervened in, any political campaign on behalf of, or in opposition to, any candidate for public office. In each situation, the ruling applies the pertinent tax law and regulations to reach a conclusion about whether prohibited political activity has occurred.

Organizations described in IRC section 501(c)(3) may encourage people to participate in the electoral process through voter registration drives conducted in a non-partisan manner, however any such activities conducted in a biased manner that favor or oppose the candidates are prohibited. The ruling gives an example of a qualifying and non-qualifying organization. The non-qualifying organization demonstrates bias by altering a phone script depending on the voter’s views on issues held by the candidates. Utilizing an alternate script that provides more information on the logistics of election day to people who agree with the organization’s viewpoint on an issue that divides the candidates in the upcoming election is a strong indication of bias.

Continued on next page
Revenue Ruling 2007-41, Continued

The ban on partisan activity for charities was never meant to restrict free expression by leaders speaking for themselves, as individuals, however it does not give leaders the right to express personal views at organizational functions or in their publications.

The ruling gives four examples illustrating four different situations. One points out that individuals who endorse candidates can be identified as leaders of a charity in a newspaper ad or other public announcement, as long as they clarify that titles and affiliations are provided for identification purposes only.

Another example demonstrates that a column in a charity’s newspaper endorsing a candidate violates the prohibition even if the writer is speaking as an individual and covering the cost of the space.

The third example states that the charity is not responsible for third-party newspaper reports about endorsements that identify a speaker in their organizational capacity if no organizational resources were used and the speaker did not personally identify himself as a representative of the organization.

The last example stresses that a board member should not make statements supporting or opposing candidates at official organizational meetings.
Candidate Appearances

Rev. Rul. 2007-41 proceeds to describe various situations involving candidate appearances at events sponsored by charitable organizations, either in their capacity as a candidate or as a regular citizen. The ruling clarifies that candidates, as members of the general public, may appear without an invitation at public events of their own free will.

The ruling lists three major factors to consider when inviting candidates to appear at meetings or other events. These are whether the group:

- Provides an equal opportunity for all candidates seeking the same office
- Indicates support or opposition to the candidate at the event or in public statements about it
- Allows political fundraising at the event

All facts and circumstances must be considered. For example, an organization that invites one candidate to speak at its well attended banquet, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely have violated the political campaign prohibition, even if the manner of presentation for both speakers is otherwise neutral.

Debates & Forums

When the organization hosts a debate or forum, several factors are considered in making a determination whether the event is “nonpartisan,” including whether:

- Questions are prepared and presented by an independent nonpartisan panel
- Topics cover a broad range of issues that the candidates would address if elected to the office sought and are of interest to the public
- All candidates have an equal chance to present their views
- Candidates are not asked to agree or disagree with positions of the organization
- Comments by the moderator are impartial

The examples in the ruling highlight the fact that a debate can move forward when one candidate declines to attend, as long as they were invited to the event. The speaking order should also be determined at random.

Continued on next page
Candidate Appearances, Continued

Candidate Appearances – Other Factors

Other situations arise in which a candidate may appear at an organization’s event in capacities other than as a candidate, such as because they:

- Currently hold, or formerly held, public office
- Are considered an expert in a non-political field
- Are a celebrity or have lead a distinguished military, legal, or public service career

The ruling reminds us to consider certain factors if they are publicly recognized by the organization, or invited to speak, such as whether:

- They are asked to speak solely for reasons other than candidacy for public office
- There is any mention of the election
- Any campaign activity occurs
- There is a nonpartisan atmosphere
- The sponsoring organization clearly indicates the capacity in which the candidate is appearing

Several illustrations are provided in the ruling, stressing that they may acknowledge the presence of an elected official at events if the election is not mentioned. However, partisan intervention has occurred if they link the official to a funding program of the organization, and promote their re-election to ensure their funding is continued.
Issue Advocacy vs. Political Campaign Intervention

Organizations exempt under IRC section 501(c)(3) frequently take positions on public policy issues that may divide candidates in an election for public office. However, this is an area where they may unintentionally, or intentionally, cross the line into partisan politics if they are encouraging an audience to vote for a specific candidate in favor of a certain policy issue. Organizations might be engaging in prohibited political activity even if the candidate is not explicitly identified, through other means such as referring to distinctive features of a candidate’s platform or his biography.

Rev. Rul. 2007-41 offers a list of factors to consider to determine whether issue advocacy results in partisan intervention in an election, such as whether:

- One or more candidates for public office are identified
- Statements express approval/disapproval of candidates’ positions and/or actions
- Statements are made close to election day
- Statements make reference to voting or the election
- Issues have been raised as those distinguishing candidates for a given office
- Communications are part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of the election
- The timing of the communication is related to a non-electoral event

Any communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election.

Continued on next page
Issue Advocacy vs. Political Campaign Intervention, Continued

**Issue Advocacy Examples**

Two of the three examples provided in the ruling for this topic have similar facts, but also distinguishing factors separating permissible issue advocacy from impermissible issue advocacy. Both basic situations involve these facts:

- An elected official in a position to act on pending legislation
- An elected official running for re-election
- A pending bill
- Shortly before the election, the organization makes a public communication (advertisement) about the bill that takes a position on the bill and refers to the elected official in a position to act
- The ad does not mention the election, a political party, or another candidate
- The ad has a call to action urging the public to contact the elected official
- The public official’s position on the issue differs from that of the organization

The distinguishing factors separating permissible from impermissible issue advocacy are whether:

- The ad states the elected official’s position on the issue
- The issue distinguishes the candidates in the campaign
- A vote on the bill has been scheduled
- The ad is part of an ongoing series of substantially similar advocacy communications about the same issue

These examples are a helpful starting point for guidance in distinguishing permissible from impermissible issue advocacy, but the sets of facts within applications for exemption will rarely be as clear and on-point as the examples in the ruling. Specialists must use their judgment and careful consideration to apply the rationales to real life examples.
Business Services and Websites

Rev. Rul. 2007-41 gives two examples of how offering business services to candidates on favorable terms not available to the general public may constitute intervention in partisan politics. For example, renting a dinner hall to a candidate’s party at a standard fee on equal terms to members of the general public is not political campaign intervention. However, an organization has intervened in a political campaign if it agrees to rent a mailing list to one campaign committee, but declines rental requests from the opposition.

Rev. Rul. 2007-41 – Web Sites

The last three examples provided in the ruling underscore the fact that web sites are treated the same as printed or oral material that is distributed to the public. An organization also has control over whether it establishes a link to another web site. Even if the organization has no control over the actual content of the linked site, they are responsible for the consequences of establishing and maintaining the link. Since the linked content may change over time, they may reduce the risk of political campaign intervention by continuously monitoring the linked content and adjusting the links accordingly.

This does not mean the organization cannot provide a link to a candidate’s website, but they must consider all facts and circumstances involved, such as:

- The context for the link
- Whether all candidates are represented
- Whether the link serves an exempt purpose

The directness of the links between the organization’s web site and the web page that contains material favoring or opposing a candidate (for example, how many “clicks” it takes to get from one point to another)
Business Services and Websites, Continued

Grade 13 Issues  Take note that applications involving “extensive use of the Internet” are Grade 13 cases as well as reserved for processing by EO Technical per IRM 7.20.1.3.4(13)e. The nature of “extensive use” is subject to interpretation; however, the mere fact that an organization creates a web site is not justification for transfer.
Educational vs. Political

Qualifying Organizations – Elevating Standards of Political Campaigns

In Rev. Rul. 76-456, 1976-2 C.B. 151, the Service approved standards of exemption under IRC section 501(c)(3) for an organization formed to elevate the standards of ethics and morality in the conduct of political campaigns.

The organization collected, collated, and disseminated, on a nonpartisan basis, information concerning general campaign practices, through the press, radio, television, mail, and public speeches.

It qualified as an educational organization because it instructed and encouraged the public about public campaigns, a subject useful to the individual and beneficial to the community.

A key fact in the decision was that the organization's activities were conducted on a nonpartisan basis.

Partisan Objectives

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), a school that trained individuals as campaign managers was denied exemption under IRC section 501(c)(3) because it operated for the substantial nonexempt purpose of benefiting Republican Party entities and candidates.

Although the school had a legitimate educational program, the Tax Court held that it conducted its educational activities with the partisan objective of benefiting Republican interests. The court noted that the school's partisan purpose distinguished its activities from the educational activities of the organization described in Rev. Rul. 76-456.
Voter Education

Rev. Rul. 78-248

Whether an organization is conducting voter education activities that qualify under IRC section 501(c)(3) depends upon all the facts and circumstances of each case.

For example, certain “voter education” activities, including preparation and distribution of voter guides conducted in a non-partisan manner, may not constitute prohibited political activities under IRC section 501(c)(3). Other so-called “voter education” activities may be proscribed by the statute.

Rev. Rul. 78-248, 1978-1 C.B. 154, provides examples of voter education activities that qualify as educational and those that constitute prohibited political activity within the meaning of IRC section 501(c)(3).

Continued on next page
Voter Education, Continued

Rev. Rul. 78-248
Qualifying Activities

The following are two examples of voter education activities conducted in a nonpartisan manner that are recognized as exempt under IRC section 501(c)(3):

Example 1: An organization annually prepares and makes generally available to the public a compilation of voting records of all members of Congress on major legislative issues involving a wide range of subjects. The publication contains no editorial opinion, and its contents and structure do not imply approval or disapproval of any members of Congress or their voting records.

The activity qualifies under IRC section 501(c)(3) because it contains:

• no editorial opinion

• no indication of approval or disapproval of any members of Congress

Example 2: An organization sends a questionnaire to all candidates for governor in State M. The questionnaire solicits a brief statement of each candidate's position on a wide variety of issues. All responses are published in a voters guide that it makes generally available to the public. The issues covered are selected by the organization solely on the basis of their importance and interest to the electorate as a whole. Neither the questionnaire nor the voters guide, in content or structure, evidences a bias or preference with respect to the views of any candidate or group of candidates.

The activity qualifies under IRC section 501(c)(3) because:

• the questionnaire is sent to all candidates

• the responses are published

• issues covered are selected by the organization solely on the basis of their importance and interest to the electorate as a whole

• neither the questionnaire nor the voters guide evidences a bias or preference in content or structure

Continued on next page

Voter Education and Political Activities
7-14
IRS 00474
The following are examples of voter education activities that are considered prohibited political activity within the meaning of IRC section 501(c)(3).

**Example 1:** An organization sends a questionnaire to candidates for major public offices and uses the responses to prepare a voters guide which is distributed during an election campaign. Some questions evidence a bias on certain issues.

The activity does not qualify under IRC section 501(c)(3) because, by using a questionnaire that contains questions that indicate a bias or preference, the organization is participating in a political campaign in contravention of the provisions of IRC section 501(c)(3) and is disqualified as exempt under that section.

**Example 2:** An organization publishes a voter's guide for its members and others concerned with land conservation issues. The guide is intended as a compilation of incumbents' voting records in selected land conservation issues of importance to the organization and is factual in nature. It contains no express statements in support of or in opposition to any candidate. The guide is widely distributed among the electorate during an election campaign.

The activity does not qualify under IRC section 501(c)(3) because:

- The guide is limited to issues that concern the organization.
- The organization does not make the guide generally available to the public but rather distributes it to their members and others concerned with land conservation.
- While the guide may provide the voting public with useful information, its emphasis on one area of concern indicates that its purpose is not non-partisan voter education. The organization is participating in a political campaign in contravention of the provisions of IRC section 501(c)(3) and, therefore, is disqualified as exempt under that section.

Take note that any voter education material prepared by a candidate, political party, or political action committee (PAC), may not be distributed by an organization exempt under IRC section 501(c)(3). Any such material is prepared and distributed solely for the purpose of improving or diminishing a candidate's prospects to be elected.
Distributing Information to the Public

Legislative and Judicial Reporting

Rev. Rul. 80-282, 1980-2 C.B. 178, found that an organization that monitors and reports on legislative, judicial, administrative, and other governmental activities considered by it to be of important social interest qualifies for recognition under IRC section 501(c)(3). The organization publishes a nonpartisan newsletter that consists of the voting records on selective issues together with the organization's own position.

Publication is usually after congressional adjournment and not geared to the timing of any election.

The Service considered the following factors as demonstrating the absence of political campaign activity:

- The voting records of all incumbents were presented
- Candidates for reelection were not identified
- No comment was made on an individual’s overall qualifications for public office
- No statements expressly or impliedly endorsing or rejecting any incumbent as a candidate for public office were offered
- No comparisons of incumbents with other candidates were made
- The organization pointed out the inherent limitations of judging the qualifications of an incumbent on the basis of certain selected votes, by stating the need to consider such unrecorded matters as performance on subcommittees and constituent service
- The organization did not widely distribute its compilation of incumbents’ voting records
- The publication was distributed to the organization’s normal readership (only a few thousand nationwide)
- No attempt was made to target the publication toward particular areas in which elections were occurring nor to time the date of publication to coincide with an election campaign

Continued on next page
**Legislative and Judicial Reporting (continued)**

The Service expressed its general view on this issue in General Counsel Memorandum (GCM) 38444. Generally, “in the absence of any expressions of endorsement for or opposition to candidates for public office, an organization may publish a newsletter containing voting records and its opinions on issues of interest to it provided that the voting records are not widely distributed to the general public during an election campaign or aimed, in view of all the facts and circumstances, towards affecting any particular elections.” Although GCMs are not to be cited as precedent, they may help gain insight into the Service position on a subject.

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**Public Forums**

In Rev. Rul. 86-95, 1986-2 C.B. 73, the Service determined that public forums, as described in the ruling, do not constitute participation or intervention in political campaigns within the meaning of IRC section 501(c)(3).

The organization in Rev. Rul. 86-95 sponsored public forums in congressional districts during congressional election campaigns. All legally qualified candidates for the House of Representatives from the districts in question were invited to participate. Questions to forum participants were prepared and presented by a nonpartisan, independent panel. All candidates were allowed an equal opportunity to present their views on each of the issues discussed.

The presentation of public forums or debates is a recognized method of educating the public. Providing a forum for candidates is not, in and of itself, prohibited political activity.

The activity qualifies under IRC section 501(c)(3) because:

- It was established that the purpose of the forums was to educate and inform voters.

- During the debate, no comments were made or questions asked that would imply approval or disapproval of any of the candidates. The forum provided fair and impartial treatment of candidates and did not promote or advance one candidate over another.
**Excise Taxes**

**IRC Section 4955**

IRC section 4955 imposes an excise tax on the political expenditures of IRC section 501(c)(3) organizations. It appears that Congress viewed these taxes to serve as a supplementary tax in addition to revocation in situations involving flagrant violations, when revocation alone would be an ineffective penalty.Secondarily, they enacted this Code section as an alternative to revocation in limited situations where the expenditures are small, the violation is unintentional, and the organization subsequently adopts procedures to ensure that similar expenditures will not be made in the future.

IRC section 4955(a)(1) provides for an initial tax on the organization of 10 percent of each political expenditure. IRC 4955(b)(1) imposes an additional tax on the organization of 100 percent of each political expenditure previously taxed and not corrected within the taxable period. There is no upper limit on the tax that can be levied on the organization.

**IRC Section 4945**

Under IRC section 4945(d)(2), amounts paid or incurred by a private foundation to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drives are taxable expenditures subject to tax under IRC section 4945, unless such amounts are paid or incurred by an organization described in IRC section 4945(f), described below.

The structure of IRC section 4955 was based upon the structure of IRC section 4945. That is, they both carry the same first and second tier excise tax structure (10 percent initial, 100 percent not corrected within taxable period.

To avoid duplicating excise taxes on political expenditures by private foundations, IRC section 4955(e) provides that if its taxes are imposed on a private foundation, the expenditure is not treated as a taxable expenditure under IRC section 4945.

A private foundation may distribute amounts for voter registration drives, or make grants for voter registration drives to other organizations, and the amounts will not be considered taxable expenditures, assuming the requirements of IRC section 4945(f) are met. These detailed requirements will not be discussed in this training, however ruling requests under IRC section 4945(f) are under the jurisdiction of EO Determinations. Organizations attempting to meet these requirements must seek advance approval in a manner similar to that of IRC section 4945(g).
Our discussion thus far has focused on organizations described in IRC section 501(c)(3), but as a reminder, other organizations described in IRC section 501(c) may generally make expenditures for political activities so long as such activities, in conjunction with any other non-qualifying activities, do not constitute the organization's primary activity (51%). Take note that there is no established method to determine this percentage. One method is simply to compare expenditures for non-qualifying activities to those of qualifying activities. However, this figure may prove unreliable for an organization using mainly volunteers to carry out their activities. An alternative method is to analyze the staff hours, both paid and volunteer, devoted to qualifying and non-qualifying activities.

However, an IRC section 501(c) organization that makes expenditures for political activities is subject to tax under IRC section 527(f). IRC section 527(f)(1) provides that the tax base is an amount equal to the lesser of (1) the organization's net investment income for the taxable year in which such expenditures are made, or (2) the aggregate amount of expenditures for exempt function activities (as defined in IRC section 527(e)(2)) during the year. Such tax on political expenditures would be computed on Form 1120-POL. This form must be filed by any tax exempt organization making political expenditures of more than $100 on behalf of or in opposition to a candidate seeking public office.

To avoid possible tax liability under IRC section 527(f), organizations might spin off political funds into a separate segregated fund, which would be subject to IRC section 527. Prior to the enactment of IRC section 527, there were no statutory provisions that dealt with the tax status of political organizations, such as political parties, campaign committees, and PACs (political action committees). But once Congress considered the issue, they decided not to tax them on income from contributions, dues, and fundraising income used for political campaign purposes.

TEGE does not have jurisdiction over IRC section 527 political organizations. The key to TEGE jurisdiction is the filing, or the responsibility of an IRC section 501(c) organization to file, a Form 1120-POL.

Continued on next page
Other Organizations, Continued

In some instances organizations exempt under IRC section 501(c) form separately organized political action committees (PACs). Even if the PAC is a separately organized entity, an organization exempt under IRC section 501(c)(3) may not establish a PAC to engage in political campaign activities. The fact that IRC section 527 imposes a tax on the exempt function income expenditures of other IRC section 501(c) organizations, and permits such organizations to establish separate segregated funds to engage in campaign activities, does not permit IRC section 501(c)(3) organizations to participate in political activities. Forming a PAC is considered engaging in political activity.

However, the directors of an IRC section 501(c)(3) organization may form a PAC in their own individual capacities unconnected with the charity itself. The directors are not prohibited from engaging in political activity simply because they are on the Board of the charity. The prohibition against political campaign activity does not prevent an organization's officials from being involved in a political campaign, so long as those officials do not in any way utilize the organization's financial resources, facilities, or personnel for such purposes. Whether the individuals are truly acting in their own capacity is another issue altogether.

Specialists may encounter multiple, interconnected, separately organized entities involved in various degrees of political activity. It is not uncommon to identify relationships between 501(c)(3)s, other 501(c) organizations, and IRC section 527 PACs. For example, an IRC section 501(c)(3) charity may establish an IRC section 501(c)(4) action organization, which in turn establishes a PAC. Such an arrangement may not jeopardize the exemption of the charity, provided that the 501(c)(3) and 501(c)(4) do not commingle their finances, conduct separate activities in furtherance of their own exempt purposes, and maintain and respect their own separate entities. Additionally, the 501(c)(3) may not earmark for political campaign activities any support it provides to the 501(c)(4). The Service must respect the separate legal status of entities established for a valid business purpose unless one organization is a sham or acting as a mere agent of the other.
## Sensitive Political Issues

**Promotional Material**

Preparers who submit applications involving sensitive political issues typically prefer to avoid undue scrutiny, thus it is likely that their activity narratives are vague and carefully-worded to reduce the likelihood of extensive development. Accordingly, specialists must ensure they obtain copies of all brochures, pamphlets, guides, etc., to find out how the organization presents itself to the public. If the organization has a website, a thorough review of the site and links to other websites is of the utmost importance.

**Mandatory Review**

Applications from organizations involved in sensitive political issues such as voter registration, voter guides, voter education, and voter polling, are subject to Mandatory Review by Quality Assurance. As of March 7, 2008, such issues are listed in IRM 7.20.5.4(3)x.

**Merit Screening**

In addition to being subject to Mandatory Review by Quality Assurance, such applications are also not appropriate for merit closure as part of the EO Determinations merit screening process. Refer to the December 19, 2007, Memorandum from the Director, Exempt Organizations Rulings and Agreements.

Applications from organizations involved in sensitive political issues such as voter registration, voter guides, voter education, and voter polling, should be assigned for full case development regardless of whether it appears the application is suitable for merit closure in screening. Such cases must be given special attention and must be treated consistently, as they tend to be high-profile cases subject to media attention, especially during election years.
Nominating Convention and Host Committees

Cases Reserved for EO Technical

Applications submitted under IRC sections 501(c)(3), 501(c)(4), or 501(c)(6) by nominating conventions, or nominating host committees, are reserved for processing by EO Technical per IRM 7.20.1.3.4(14).

A “nominating convention” refers to an organization that conducts a convention arranged by a political party where delegates select candidates for national, state, or local public offices.

A “nominating convention host committee” refers to an organization that encourages the selection of a particular location for a nominating convention arranged by a political party where candidates for national, state, or local public office are selected. A nominating host committee may also be involved in arranging hospitality events for delegates to a nominating convention, such as by offering a welcoming ceremony and informational services, or by otherwise providing support to facilitate a nominating convention.

More Information

For additional legal precedent relating to political activity of organizations exempt under IRC section 501(c)(3), refer to IRM 7.25.3.18 (Intervention in Political Campaigns).
Summary

Organizations exempt under IRC section 501(c)(3) must not carry on propaganda or otherwise attempt to influence legislation (as a substantial part of their activities), or participate or intervene in any political campaign on behalf of any candidate for public office. The prohibition on political activity is absolute, and can result in loss of exemption and/or imposition of IRC section 4955 tax.

Rev. Rul. 2007-41 is an excellent resource, providing multiple examples of acceptable and unacceptable political activities of IRC section 501(c)(3) organizations. The ruling discusses candidate appearances, debates and forums, issue advocacy, business activities, and web sites created by the applicants.

As a rule, organizations involved in permissible “voter education” activities convey no editorial opinion, no indication of approval or disapproval of any members of Congress, and no indication of bias or preference. Those crossing the line into partisan politics show evidence of bias or preference, or emphasis on one area concerning only issues important to a select group of people.

IRC section 4955 imposes an excise tax on the political expenditures of IRC section 501(c)(3) organizations. Under IRC section 4945(d)(2), amounts paid or incurred by a private foundation to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drives are taxable expenditures subject to tax under IRC section 4945, unless such amounts are paid or incurred by an organization described in IRC section 4945(f).

Restrictions on other IRC section 501(c) organizations pertaining to political activities are more lenient that those governing IRC section 501(c)(3). However, political activities may not constitute the organization's primary activity. Additionally, they may be liable for tax under IRC 527(f) for political expenditures.

An organization exempt under IRC section 501(c)(3) may not establish a PAC to engage in political campaign activities. However, the directors of an IRC section 501(c)(3) organization may form a PAC in their own individual capacities unconnected with the charity itself. Also, an IRC section 501(c)(3) charity may establish an IRC section 501(c)(4) action organization, which in turn may establish a PAC, as long as the 501(c)(3) does not earmark any support it provides to the 501(c)(4) for political campaign activities.

Voter Education and Political Activities
7-23
Lesson 8

509(a)(3) Type I and Type II Supporting Organizations

Overview

Introduction

Every organization described in IRC section 501(c)(3) is further classified under IRC section 509(a) as either 1) a private foundation, or 2) other than a private foundation if it qualifies for IRC section 509(a)(1), (2), (3), or (4). Organizations described in IRC section 501(c)(3) that meet the requirements of IRC section 509(a)(3) are commonly referred to as "supporting organizations."

Supporting organizations are public charities that carry out exempt purposes by supporting one or more other exempt organizations, usually other public charities. An IRC section 509(a)(3) supporting organization may also support an organization exempt under IRC section 501(c)(4), (5) or (6).

The key feature of a supporting organization is a strong relationship with an organization it supports. The strong relationship enables the supported organization to oversee the operations of the supporting organization.

In general, supporting organizations have been identified by the type of relationship they have with their supported organization. Under the Pension Protection Act of 2006 (PPA), supporting organizations are classified into Type I, Type II or Type III supporting organizations based on the three supporting organization relationships described in current regulations.

Type I supporting organizations are operated, supervised, or controlled by one or more publicly supported organizations ("parent-child" relationship)

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations ("brother-sister" relationship)

Type III supporting organizations are operated in connection with one or more publicly supported organizations.

Continued on next page
Overview, Continued

Introduction (continued)

An organization may request IRC section 509(a)(3) status when it initially files a Form 1023 application for IRC section 501(c)(3) exemption or, subsequently, may request a determination letter that changes its existing foundation status to IRC section 509(a)(3).

An overview of IRC section 509(a)(3) foundation classification is presented in Lesson 13, Section D, of Unit 1a. This lesson will focus on requests for classification as an IRC section 509(a)(3) Type I or Type II supporting organization. Requests for classification as a Type III supporting organization are a reserved inventory category and Grade 13 cases which will be covered in future training. Requests from non-exempt charitable trusts for classification as IRC section 509(a)(3) will also be covered in future training.

Objectives

At the end of this lesson you will be able to:

- Identify the four tests that are applied in determining if an organization qualifies for classification as an IRC section 509(a)(3) Type I or Type II supporting organization
- Determine if an organization meets the organizational test, operational test, control test, and relationship test for classification as an IRC section 509(a)(3) Type I or Type II
- Effectively utilize the IRC section 509(a)(3) Guide Sheet and Guide Sheet Explanation in making a determination that an organization qualifies for classification as an IRC section 509(a)(3) Type I or Type II supporting organization
- Recognize situations where heightened scrutiny is required in processing requests for classification as an IRC section 509(a)(3) Type I or Type II supporting organization

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509(a)(3) Type I and Type II Supporting Organizations are required to meet an organizational test, operational test, control test, and relationship test.

To assist in determining if an organization meets the requirements of these four tests, an IRC section 509(a)(3) Supporting Organization Guide Sheet for Type I and Type II supporting organizations was developed (Exhibit 8-1) along with a detailed Guide Sheet Explanation keyed to specific questions in the Guide Sheet (Exhibit 8-2). The Guide Sheet Explanation is designed to provide an overview of exempt organization tax law rules applicable to IRC section 509(a)(3) Type I and Type II supporting organizations.

The Guide Sheet and Guide Sheet Explanation can also be found in IRM 7.20.7.
Tests for Qualification as a Type I or Type II Supporting Organization

Organizational Test under IRC 509(a)(3)(A) Guide Sheet, Part 1

IRM 7.20.7.2.1

All organizations must meet an organizational test to qualify under IRC section 509(a)(3). The IRC section 509(a)(3) organizational test is in addition to the organizational test required for exemption under IRC section 501(c)(3). If an organization does not meet the organizational test for IRC section 509(a)(3), it will not qualify for classification under IRC section 509(a)(3).

Part 1, Section I of the Guide Sheet is used to determine if an organization supporting an IRC section 509(a)(1) or 509(a)(2) public charity meets the organizational test.

Part 1, Section II of the Guide Sheet is used to determine if an organization supporting an IRC section 501(c)(4), (5) or (6) organization meets the organizational test.

The Guide Sheet Explanation provides an overview of the organizational test for IRC section 509(a)(3) Type I and Type II supporting organization and describes the rationale behind questions in Part 1, Sections I and II.

Operational Test under IRC 509(a)(3)(A) Guide Sheet, Part 2

IRM 7.20.7.2.2

All organizations must meet an operational test to qualify under IRC section 509(a)(3). The IRC section 509(a)(3) operational test is in addition to the operational test required for exemption under IRC section 501(c)(3). If an organization does not meet the operational test for IRC section 509(a)(3), it will not qualify for classification under IRC section 509(a)(3).

Part 2 of the Guide Sheet solicits information to determine if an organization meets the operational test under IRC section 509(a)(3). The Guide Sheet Explanation provides an overview of the operational test for IRC section 509(a)(3) Type I and Type II supporting organization and describes the rationale behind questions in Part 2.

Continued on next page
Tests for Qualification as a Type I or Type II Supporting Organization, Continued

Control Test under IRC 509(a)(3)(c)

An IRC section 509(a)(3) organization cannot be controlled by disqualified persons.

Guide Sheet, Part 3

Part 3 of the Guide Sheet solicits information to determine if an organization meets the control test under IRC section 509(a)(3). The Guide Sheet Explanation provides an overview of the control test for IRC section 509(a)(3) Type I and Type II supporting organization and describes the rationale behind questions in Part 3.

IRM 7.20.7.2.3

Relationship Requirement Under IRC 509(a)(3)(B)

An organization must meet one of two relationships to qualify as a IRC section 509(a)(3) Type I or Type II supporting organization:

- A Type I supporting organization is “operated, supervised or controlled by” its supported organization(s). Treas. Reg. 1.509(a)-4(g)

Guide Sheet, Part 4

- A Type II supporting organization is “supervised or controlled in connection with” its supported organization(s). Treas. Reg. 1.509(a)-4(h)

IRM 7.20.7.2.4

Part 4, Section I of the Guide Sheet is used to determine if an organization meets the relationship requirement for a Type I supporting organization.

Part 4, Section II of the Guide Sheet is used to determine if an organization meets the relationship requirement for a Type II supporting organization.

The Guide Sheet Explanation provides an overview of the relationship tests for IRC section 509(a)(3) Type I and Type II supporting organization and describes the rationale behind questions in Part 3, Sections I and II.
# Organizations Requiring Heightened Scrutiny

## Potential Red Flags

**Guide Sheet, Part 5**

Part 5 of the Guide Sheet is designed to identify transactions, assets, and other situations that raise red flags because of concern that a supporting organization may be used to benefit private interests. The presence of one or more of the listed factors is not determinative. All facts and circumstances must be considered in determining whether an organization meets the requirements for tax exemption and/or supporting organization status.

Part 5 of the Guide Sheet Explanation provides examples of potential “red flags.”

## Potential Private Benefit

**Guide Sheet, Part 5**

Questions included in Part 5, Sections I, II and III of the Guide Sheet are intended to identify potential private benefit situations involving promoters, unreasonable compensation/loans, and closely held stock or non-liquid investments/assets that do not produce current income.

Questions in Part 5, Section I of the Guide Sheet (IRM 7.20.7.2.5.2(1)) are intended to assist in identifying potential promoters. For purposes of completing the Guide Sheet, the term “promoter” refers to a person who organizes or assists in the organization of a partnership trust, investment plan, or any other entity or arrangement that is to be sold to a third party. The concern is that the partnership, trust, etc. is designed to be used or is actually used by that third party to obtain tax benefits not allowable by the Internal Revenue Code.

Questions in Part 5, Section II of the Guide Sheet (IRM 7.20.7.2.5.2(2)) are intended to assist in identifying situations where there may be unreasonable compensation/loans present.

Questions in Part 5, Section III of the Guide Sheet (IRM 7.20.7.2.5.2(3)) are intended to assist in identifying situations where there may be closely held stock or non-liquid investments/assets that do not produce current income.
Case Processing Notes

Guide Sheet

The IRC 509(a)(3) Supporting Organizations Guide Sheet for Type I and Type II should be prepared for all requests for classification as an IRC section 509(a)(3) Type I or Type II supporting organization.

The Guide Sheet should be initialed and dated by the specialist in the upper right hand corner and placed in the left hand side of the case file. For I and S cases, the Guide Sheet should follow Form 6038 and the Form 6038 attachment. For A cases, the Guide Sheet should follow the CCR.

Determination Letters

EDS Letter 947 is used for a favorable determination on exemption and IRC section 509(a)(3) foundation status (I and S cases). EDS Letter 947 must include Paragraph 3088 to further classify the organization by “Type” using one of the two following variables

I – Type I, “operated, supervised, or controlled by” its supported organization(s)
II – Type II, “supervised or controlled in connection with” its supported organization(s).

A modified composed Letter 4425 is used for a favorable determination on a request for change in foundation classification to IRC section 509(a)(3) Type I or Type II. This letter is located in the Outlook Public Folders under “A Case Letters and Paragraphs.”

A composed letter 1079 is used for an adverse determination on an IRC section 509(a)(3) Type I or Type II foundation status. This letter is located in the Outlook Public Folders under Determination Specialist Tools/Letters and Paragraphs/Denial Letters. As in cases involving a denial of exemption, you are required to consult with your manager for concurrence before proceeding with an adverse foundation status determination. All adverse determinations are subject to Mandatory Review by Quality Assurance.
Summary

509(a)(3) Type I supporting organizations are operated, supervised, or controlled by one or more publicly supported organizations ("parent-child” relationship).

509(a)(3) Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations ("brother-sister relationship).

509(a)(3) Type I and Type II supporting organizations must meet an organizational test, an operational test, a control test, and a relationship test.

The IRC 509(a)(3) Supporting Organization Guide Sheet for Type I and Type II supporting organizations assists in determining if the four required tests are met.

The Guide Sheet Explanation, keyed to specific questions in the Guide Sheet, provides an overview of exempt organization tax law rules applicable to Type I and Type II supporting organizations.

Part 5 of the Guide Sheet Explanation provides examples of potential “red flags” that may identify potential private benefit situations including potential promoters, unreasonable compensation/loans, or closely held stock or non-liquid investments/assets that do not produce current income.
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**Exhibit 8-1**

509(a)(3) Type I and Type II Supporting Organization Guide Sheet, IRM 7.20.7

**PART 1: ORGANIZATIONAL TEST UNDER IRC 509(a)(3)(A)**

An organization must meet the organizational test to qualify under IRC 509(a)(3). If a supporting organization does not meet the Organizational Test, it is not qualified under IRC 509(a)(3). Special organizational test rules pertain to supporting organization that support IRC 501(c)(4), (5) or (6) organizations. Therefore, complete Section II below instead of Section I to demonstrate that an organization meets the organizational test where it seeks to qualify under 509(a)(3) because it is supporting an IRC 501(c)(4), (5) or (6) organization.

**Section I - Organizational Test for an organization supporting IRC 509(a)(1) or 509(a)(2) public charities**

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Is the supporting organization requesting classification as a Type I or II supporting organization? If &quot;No&quot;, refer case to 509(a)(3) Type III reserved inventory. If &quot;Yes&quot;, to satisfy the organizational test there must be a &quot;Yes&quot; answer to one of the questions B, C or D below. In addition, all three components of question E must be met.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Does the supporting organization's organizing document specify by name the IRC 509(a)(1) or (2) organization(s) it supports? See Form 1023, Schedule D, Section III.1.a. If &quot;Yes&quot;, skip to E below.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Does the supporting organization's organizing document identify the IRC 509(a)(1) or (2) organization(s) it supports by class or purpose? See Form 1023, Schedule D, Section III.1.a. If &quot;Yes&quot;, skip to E below.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Do the supporting organization and the supported organization(s) have a historic and continuing relationship such that there is a substantial identity of interests between the two organizations?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>E(1) Does the organization's organizing document limit its purposes to provide that it is organized, and at all times thereafter is operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified 509(a)(1) or (a)(2) organizations?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E(2) Does the organization's organizing document expressly empower it to engage in activities which are not in furtherance of the purposes stated in E(1) above?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E(3) Does the organization's organizing document expressly empower it to operate to support or benefit any organization not specified by name, purpose or class in its organizing document?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Section II - Organizational Test for an organization supporting IRC 501(c)(4), (5) or (6) organizations**

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Does the supporting organization claim to support an IRC 501(c)(4), (5) or (6) organization? If &quot;Yes&quot;, proceed to questions B through E.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Does the IRC 501(c)(4), (5) or (6) organization meet the public support tests of IRC 509(a)(2)?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Does the supporting organization meet the organizational test by stating in its organizing document that it will carry on exclusively charitable purposes, including religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals within the meaning of section 170(c)(2)?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Does the supporting organization meet the Type I or Type II relationship requirement?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Does the supporting organization have sufficient safeguards to ensure its support is used exclusively for charitable purposes?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### PART 2: OPERATIONAL TEST UNDER IRC 509(a)(3)(A)

An organization must meet the operational test to qualify under IRC 509(a)(3). If an organization does not meet the requirements of either A or B below or a combination of A and B below, it does not meet the operational test.

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Does the organization make payments to or for the use of the specified IRC 509(a)(1) or (2) organizations? To meet the operational test under this section, there must be a &quot;Yes&quot; answer to A(1), A(2), A(3) or A(4) below. If &quot;No&quot;, the organization must meet B below to meet the operational test.</td>
<td></td>
</tr>
<tr>
<td>A(1) Does the organization make payments only to or for the use of one or more specified IRC 509(a)(1) or (2) organizations? See Form 1023, Part VI.1.b.</td>
<td></td>
</tr>
<tr>
<td>A(2) Does the organization make payments to or for the use of individual members of the charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s)? See Form 1023, Part VI.1.a and Form 1023, Part VI.2</td>
<td></td>
</tr>
<tr>
<td>A(3) Does the organization make payments indirectly through another unrelated organization to or for the use of a member of a charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s), but only if the payments consists of a grant to an individual rather than to an organization?</td>
<td></td>
</tr>
<tr>
<td>A(4) Does the organization make payments to or for the use of another supporting organization that also supports or benefits the specified 509(a)(1) or (2) organization(s)?</td>
<td></td>
</tr>
</tbody>
</table>

| B. Does the organization provide services or facilities to or for the use of the specified IRC 509(a)(1) or (2) organization(s)? To meet the operational test under this section, there must be a "Yes" answer to B(1), B(2) or B(3) below. If "No", the organization must meet A above to meet the operational test. |
| B(1) Does the organization provide services or facilities only to or for the use of one or more specified IRC 509(a)(1) or (2) organization(s)? See Form 1023, Part VI.1.b. |
| B(2) Does the organization provide services or facilities to or for the use of individual members of the charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s)? See Form 1023, Part VI.1.a and Form 1023, Part VI.2 |
| B(3) Does the organization provide services or facilities to or for the use of another supporting organization that also supports or benefits the specified IRC 509(a)(1) or (2) organization(s)? |
### PART 3: CONTROL TEST UNDER IRC 509(a)(3)(C)

An IRC 509(a)(3) organization cannot be controlled by disqualified persons (other than foundation managers).

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A.</strong></td>
<td>Is the organization controlled directly or indirectly by disqualified persons because disqualified persons on the governing board can potentially aggregate their votes together to control the operations of the supporting organization? [&quot;No&quot; required] See Form 1023, Schedule D, Section IV.1.c.</td>
</tr>
<tr>
<td><strong>B.</strong></td>
<td>Is the organization controlled directly or indirectly by disqualified persons because disqualified persons on the governing board can potentially aggregate their votes together with other board members who provide personal services to the disqualified persons, such as legal, accounting, or investment advice, to control the operations of the supporting organization? [&quot;No&quot; required] See Form 1023, Schedule D, Section IV.1.b</td>
</tr>
<tr>
<td><strong>C.</strong></td>
<td>Do disqualified persons have the right to appoint the nominating committee or successor governing board members? [&quot;No&quot; required] See Form 1023, Schedule D, Section IV.1.a</td>
</tr>
<tr>
<td><strong>D.</strong></td>
<td>Is the organization controlled directly because the disqualified persons control the primary assets of the supporting organization’s activities? [&quot;No&quot; required]</td>
</tr>
<tr>
<td><strong>E.</strong></td>
<td>Is the organization controlled directly or indirectly by disqualified persons because disqualified persons have veto power over the supporting organization’s activities? [&quot;No&quot; required]</td>
</tr>
<tr>
<td><strong>F.</strong></td>
<td>Is the organization controlled directly because the disqualified persons control the primary assets of the supporting organization? [&quot;No&quot; required]</td>
</tr>
<tr>
<td><strong>G.</strong></td>
<td>Does a disqualified person own a general partnership interest in a limited partnership in which the supporting organization owns an interest?</td>
</tr>
<tr>
<td><strong>H.</strong></td>
<td>Does a disqualified person own an interest of 51% or more of the voting stock of a corporation in which the supporting organization is a stockholder?</td>
</tr>
<tr>
<td><strong>I.</strong></td>
<td>Does a disqualified person hold 51% or more control of a corporation through a voting trust or other voting arrangement in which the supporting organization is a stockholder?</td>
</tr>
<tr>
<td><strong>J.</strong></td>
<td>Does a disqualified person have a controlling interest in a limited liability corporation (LLC) in which the supporting organization has an interest?</td>
</tr>
<tr>
<td><strong>K.</strong></td>
<td>Does a disqualified person have an ownership interest in assets such as real estate, insurance, artwork, collectibles, intellectual property, promissory notes, or other assets in which the supporting organization also has an interest?</td>
</tr>
<tr>
<td><strong>L.</strong></td>
<td>Do donors or their family members have the right to provide advice to the supporting organization regarding investments or grant making?</td>
</tr>
<tr>
<td><strong>M.</strong></td>
<td>Taking into account all of the facts and circumstances, including information described in questions G through L, are disqualified persons in a position to directly or indirectly control the decisions made by the supporting organization?</td>
</tr>
</tbody>
</table>
**Exhibit 8-1**

509(a)(3) Type I and Type II Supporting Organization Guide Sheet, IRM 7.20.7-1 (p. 4)

### PART 4: RELATIONSHIP REQUIREMENT UNDER IRC 509(a)(3)(B)

An organization must meet either Section I below to qualify as a Type I Supporting Organization or Section II below to qualify as a Type II Supporting Organization.

#### Section I - Type I "Operated, Supervised or Controlled By"

<table>
<thead>
<tr>
<th>A.</th>
<th>Is the supporting organization seeking to meet the “operated, supervised or controlled by” relationship test with respect to one or more IRC 509(a)(1) or (2) organizations? If “Yes,” continue. If “No,” see Section II below or refer case to 509(a)(3) Type III reserve inventory.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.</td>
<td>Are a majority of the supporting organization’s officers, directors, or trustees appointed or elected by a supported organization’s officers, directors, trustees or membership? See Form 1023, Schedule D, Sec. II.1</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>C.</td>
<td>Does the supporting organization accept gifts or contributions from any person (other than a public charity described in IRC 509(a)(1), (2) or (4)) who directly or indirectly controls the governing body of a supported organization (alone, or together with family members or a 35% controlled organization)? If “No,” proceed to the next question. If “Yes,” the organization does not meet this requirement.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>D.</td>
<td>Does the supporting organization support organizations that are not organized in the United States? If “Yes,” proceed to the next questions. There must be a &quot;Yes&quot; answer to either D(1) or D(2), and a &quot;Yes&quot; to C(3) for the organization to qualify under IRC 509(a)(3). See Form 1023, Part VIII, 14a.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>D(1)</td>
<td>Is the foreign supported organization recognized by the IRS as exempt under IRC 501(c)(3) and a public charity under IRC 509(a)(1) or (2)? OR</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>D(2)</td>
<td>Is the foreign supported organization described in IRC 501(c)(3) and a public charity described under IRC 509(a)(1) or (2)?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>D(3)</td>
<td>Does the organization retain control and discretion over the funds distributed to the foreign organization? Please see RR 74-229, RR 66-79 and PLR 9651031 for more information regarding qualification and deductibility.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

#### Section II - Type II "Supervised or Controlled in Connection With"

<table>
<thead>
<tr>
<th>A.</th>
<th>Is the organization seeking to meet the “supervised or controlled in connection with” relationship test with respect to one or more IRC 509(a)(1) or (2) organizations? If “Yes,” continue. If “No,” see Section I above or refer case to 509(a)(3) Type III reserve inventory.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.</td>
<td>Is control or management of the supporting organization placed with the same persons that control or manage the supported organization? See Form 1023, Schedule D, Sec. II.2</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>C.</td>
<td>Does the organization support organizations that are not organized in the United States? If “Yes,” proceed to the next questions. There must be a &quot;Yes&quot; answer to either C(1) or C(2), and a &quot;Yes&quot; to C(3) for the organization to qualify under IRC 509(a)(3). See Form 1023, Part VIII, 14a.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>C(1)</td>
<td>Is the foreign supported organization recognized by the IRS as exempt under IRC 501(c)(3) and a public charity under IRC 509(a)(1) or (2)? OR</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>C(2)</td>
<td>Is the foreign supported organization described in IRC 501(c)(3) and a public charity described under IRC 509(a)(1) or (2)?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>C(3)</td>
<td>Does the organization retain control and discretion over the funds distributed to the foreign organization? Please see RR 74-229, RR 66-79 and PLR 9651031 for more information regarding qualification and deductibility.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
**Exhibit 8-1**

509(a)(3) Type I and Type II Supporting Organization Guide Sheet, IRM 7.20.7-1 (p.5)

**PART 5: ORGANIZATIONS REQUIRING HEIGHTENED SCRUTINY**
Most supporting organizations further legitimate charitable purposes. However, some taxpayers may seek to shield assets inappropriately through supporting organizations. This has resulted in the need for heightened scrutiny of supporting organizations generally to screen for those where there is a significant potential for abuse. The typical Type I or II supporting organization that supports a hospital, university, or other large charitable institution generally does not raise the private benefit concerns that require heightened scrutiny. The questions below are aimed at identifying situations that raise potential for impermissible private benefit. Additional questions needed to develop an issue should be tailored to the organization’s specific situation.

**Section I - Promoters**
For purposes of completing this guide sheet, a promoter is a person who organizes or assists in the organization of a partnership, trust, investment plan, or any other entity or arrangement that is to be sold to a third party and is designed to be used or is actually used by that third party to obtain tax benefits not allowable by the Internal Revenue Code.

| A. Are any promoters identified with the establishment or operation of the supporting organization? | Yes | No |
| B. Does the supporting organization benefit a list of more than five supported organizations? |

**Section II - Unreasonable Compensation/Loans**

| A. Are goods, services, or cash provided to donors or their family members or persons with whom they have business relationships? See Form 1023, Part V.7.a-b | Yes | No |
| B. Are the goods, services, or cash provided to donors or their family members or persons with whom they have business relationships part of reasonable compensation arrangements? See Form 1023, Part V.7.a-b |
| C. Are goods, services, or cash provided to officers, directors, or trustees? See Form 1023, Part V.7.a-b |
| D. Are the goods, services, or cash provided to officers, directors, or trustees part of reasonable compensation arrangements? See Form 1023, Part V.7.a-b |
| E. Are the goods, services, or cash provided to the five highest compensated employees or independent contractors part of reasonable compensation arrangements? F. 1023, Part V.7.a-b |
| F. Is there evidence of any loan activity? See Form 1023, Part V.8.a-f and Part IX. Balance Sheet |
| G. Are loans made to donors or their family members or persons with whom they have a business relationship, to officers, directors, or trustees, or to the five highest compensated employees or independent contractors? See Form 1023, Part V.8.a-f and 9a |
| H. Are the loans made to donors or their family members or persons with whom they have a business relationship, to officers, directors, or trustees, or to the five highest compensated employees or independent contractors part of reasonable compensation arrangements? See Form 1023, Part V.8 a-f and 9a |
### Section III - Closely Held Stock/Non-Liquid Investments/Assets That Do Not Produce Current Income

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Does the supporting organization hold closely held stock? See Form 1023, Part VIII.11 and Part IX, Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>Does the supporting organization hold an interest in a partnership or limited liability company in which the donor retains an interest as a general partner or member? See Form 1023, Part VIII.8 and Part IX, Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>Does the supporting organization own significant other investments ($100,000 or more) that are not explained in detail? See Form 1023, Part IX, Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>Does the supporting organization own significant land ($100,000 or more)? See Form 1023, Part VIII.11 and Part IX, Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>Does the supporting organization own significant other property ($100,000 or more) that does not produce current income? See Form 1023, Part VIII.10-11 and Part IX, Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>Does the supporting organization own life insurance on the donor’s life or the life of the donor’s family member? See Form 1023, Part IX, Balance Sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G</td>
<td>Does the supporting organization own more than 20% of the stock of a corporation, partnership interest, or beneficial interest of an estate? See Form 1023, Part VIII.8 and Part IX, Balance Sheet</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II,IRM 7.20.7.1

This Guide Sheet Explanation is designed to provide an overview of exempt organization tax law rules applicable to supporting organizations and to assist in preparation of the IRC 509(a)(3) Supporting Organizations Guide Sheet Type I and Type II. A separate explanation and guide sheet is available Type III supporting organizations.

OVERVIEW

Background
Every organization described in IRC 501(c)(3) is further classified under IRC 509(a) as either 1) a private foundation, or 2) other than a private foundation if it qualifies under IRC 509(a)(1), (2), (3), or (4).

Private foundations typically have a single major source of funding (usually gifts from one family or corporation rather than funding from many sources). Organizations that are qualified under IRC 509(a)(1) include churches, hospitals, qualified medical research organizations affiliated with hospitals, schools, colleges and universities, and organizations that have an active program of fundraising and receive contributions from many sources, including the general public, governmental agencies, corporations, private foundations or other public charities. Organizations qualified under IRC 509(a)(2) receive income from the conduct of activities in furtherance of the organization’s exempt purposes. Organizations qualified under IRC 509(a)(3) actively function in a supporting relationship to one or more IRC 509(a)(1) or (2) organizations.

An organization may request IRC 509(a)(3) status either 1) when it initially files a Form 1023 application for IRC 501(c)(3) exemption, or 2) subsequently, by requesting a determination letter that changes its existing foundation status. A nonexempt charitable trust described in IRC 4947(a)(1) may also request a determination that it is described in IRC 509(a)(3), even though it is has not been recognized as an IRC 501(c)(3) organization, pursuant to Revenue Procedure 72-50, 1972-2 I.R.B. 830. For information about Rev. Proc. 72-50, see FY 1980 Continuing Professional Education text entitled General Explanation of Trusts Subject to Section 4947 of the Internal Revenue Code.

The Pension Protection Act of 2006 (PPA of 2006) modified the statutory scheme applicable to supporting organizations to address concerns that some supporting organizations were being used to inappropriately benefit private interests. This guide sheet inquires about supporting organization arrangements that lend themselves to private benefit abuses, including situations where a supporting organization makes loans, grants, or compensation payments to or for the benefit of donors or donors’ families and businesses. The guide sheet also inquires about situations where the supporting organization is a recipient of closely held stock, personal residences, partnership interests, sole proprietorships, or insurance policies, as these asset types may be manipulated for the benefit of donors or donors’ families and businesses. In these circumstances, one needs to consider possible denial of IRC 501(c)(3) exemption, or possible denial of IRC 509(a)(3) supporting organization status.
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.1 (p.2)

Types
In general, supporting organizations have been identified by the type of relationship they have with their supported IRC 509(a)(1) or (2) organizations. Under the PPA of 2006, supporting organizations are classified into Type I, Type II, or Type III supporting organizations. The names are new, but they merely reflect the existing three relationships with supported organizations described in the current regulations. Type I supporting organizations are operated, supervised, or controlled by one or more IRC 509(a)(1) or (2) organizations. Type II supporting organizations are supervised or controlled in connection with one or more IRC 509(a)(1) or (2) organizations. Type III supporting organizations are operated in connection with one or more IRC 509(a)(1) or (2) organizations. The PPA of 2006 classifies Type III supporting organizations into the following two categories: Type III supporting organizations that are not functionally integrated or functionally integrated Type III supporting organizations.

Type III supporting organizations that are not functionally integrated are subject to excess business holding rules under IRC 4943 and must meet annual payout requirements. Further, private foundations are prohibited from treating grants made to Type III supporting organizations that are not functionally integrated as qualifying distributions under IRC 4942.

Functionally integrated Type III supporting organizations are not subject to excess business holding rules of IRC 4943, are not subject to annual payout requirements, and private foundations may treat grants to functionally integrated Type III supporting organizations as qualifying distributions under IRC 4942.

Until final guidance is issued that defines functionally integrated Type III supporting organizations as described in IRC 509(d) and 4943(f)(5)(B), the IRS is generally suspending the issuance of determination letters to this category of Type III organizations other than organizations that choose to meet the advance notice of proposed rulemaking. [See Advance Notice of Proposed Rulemaking (ANPRM), 72 Fed. Reg. 42335 (Aug. 2, 2007). This ANPRM is available from the IRS website at www.irs.gov under Charities and Nonprofits.]

The ANPRM sets forth criteria for qualifying as a functionally integrated Type III supporting organization. If a Type III supporting organization chooses to meet the ANPRM, IRS may issue a determination letter that classifies it as a functionally integrated Type III supporting organization. Of course, the organization would have to comply with the regulations that define functionally integrated Type III supporting organizations when they are finalized. If an organization chooses not to agree to comply with the ANPRM, it can qualify for a determination letter that classifies it as a Type III supporting organization without determining whether it is or is not functionally integrated. In this case, Notice 2006-109, 2006-51 I.R.B. 1121, provides rules on which private foundations can rely to ensure they are not making grants to Type III supporting organizations that are not functionally integrated. Finally, Announcement 2006-93, 2006-48 I.R.B.1017, provides for an expedited process whereby organizations that are classified as IRC 509(a)(3) supporting organizations may, if they qualify for the status, obtain a determination letter that modifies their foundation classification to IRC 509(a)(1) or (2).
A supporting organization must meet an organizational test that requires it to contain provisions in its organizational document (e.g. articles of incorporation, trust instrument, articles of association, or articles of organization) that limit its purposes to operate exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more IRC 509(a)(1) or (2) organizations. A supporting organization must also meet an operational test that requires it to engage solely in activities that support one or more publicly supported organizations. A supporting organization may not be controlled directly or indirectly by a disqualified person. Effective August 17, 2006 the PPA of 2006 provides that neither a Type I nor Type III supporting organization qualifies as a supporting organization if it accepts gifts from a person (other than a IRC 509(a)(1), (2), or (4) organization) that directly or indirectly controls (alone, or together with family members and 35 percent controlled organizations) the governing body of a supported organization.

A Type I supporting organization must be operated, supervised, or controlled by one or more publicly supported organizations. The relationship between the supported organization and the supporting organization is like a parent-subsidiary relationship. This relationship exists where one or more supported organizations (by their governing bodies, members of the governing bodies, officers acting in their official capacities, or their membership) elect or appoint a majority of the organization’s officers, directors, or trustees.

A Type II supporting organization must be supervised or controlled in connection with one or more publicly supported organizations. A Type II relationship is like a brother sister relationship. In a Type II relationship, the same persons control or manage both the supporting organization and the supported organization.
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p. 4)

SPECIFIC EXPLANATION KEYED TO GUIDE SHEET

PART I: ORGANIZATIONAL TEST UNDER IRC 509(a)(3)(A)

An organization must meet the organizational test to qualify under IRC 509(a)(3). If a supporting organization does not meet the Organizational Test, it is not qualified under IRC 509(a)(3). Special organizational test rules pertain to supporting organization that support IRC 501(c)(4), (5) or (6) organizations. Therefore, complete Section II below instead of Section I to demonstrate that an organization meets the organizational test where it seeks to qualify under 509(a)(3) because it is supporting an IRC 501(c)(4), (5) or (6) organization.

Section I – Organizational Test for an organization supporting IRC 509(a)(1) or 509(a)(2) public charities

A. Is the supporting organization requesting classification as a Type I or II supporting organization? If "No", refer case to 509(a)(3) Type III reserved inventory. If "Yes", to satisfy the organizational test there must be a "Yes" answer to one of the questions B, C or D below. In addition, all three components of question E must be met.

A Type I or II supporting organization’s organizing document must limit its purposes to supporting one or more IRC 509(a)(1) or (2) organizations. Although the organizing document may accomplish this limitation in a variety of ways, the organizing document may not contain any provisions that are inconsistent with its stated purpose of supporting the specified organization(s). For purposes of this guide sheet, the term “organizing document” means a trust instrument, corporate charter, articles of incorporation, articles of association, or other written instrument by which the organization is created under state law.

B through D - A supporting organization seeking to qualify as a Type I supporting organization (operated, supervised or controlled by relationship), or Type II supporting organization (supervised or controlled in connection with relationship) has three methods by which it may specify the publicly supported organization on whose behalf the organization is to be operated.

One method is to designate the supported organization by name in its organizing document. For example, X is an organization described in section 501(c)(3) which operates for the benefit of Y, an institution of higher learning that controls X and is a section 509(a)(1) organization. X’s articles will meet the organizational test if they provide for the giving of scholarships to enable students to attend Y.
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p.5)

Another method is to designate the supported organization by class or purpose instead of by name. For example, M is an organization described in section 501(c)(3) which was organized and operated by representatives of N church to run a home for the aged. M is controlled by N church, a section 509(a)(1) organization. Care of the sick and aged are long-standing temporal functions and purposes of organized religion. By operating a home for the aged, M is operating to support or benefit N church in carrying out one of its temporal purposes. Thus M’s articles will meet the organizational test if they require M to care for the aged since M is operating to support one of N church’s purposes (without designating N church by name). See section 1.509(a)-4(d) of the Income Tax Regulations.

The third method is by showing the existence of a historic and continuing relationship and, by reason of such relationship, there has developed a substantial identity of interests between such organizations. A disqualified person cannot have authority or discretion to designate beneficiaries other than those specified by name, class, or purpose in the organizing document. See Quarrie v. Commissioner, 70 T.C. 182 (1978).

B. Does the supporting organization’s organizing document specify by name the IRC 509(a)(1) or (2) organization(s) it supports? If “Yes,” skip to E below.

C. Does the supporting organization’s organizing document identify the IRC 509(a)(1) or (2) organization(s) it supports by class or purpose? If “Yes,” skip to E below.

D. Do the supporting organization and the supported organization(s) have a historic and continuing relationship such that there is a substantial identity of interests between the two organizations?

E. To meet the organizational test, there must be a “Yes” answer to E(1) and a “No” answer to E(2) and E(3).

E(1) through E(3) - A Type I (operated, supervised or controlled by) or Type II (supervised or controlled in connection with) supporting organization must contain provisions in its organizing document that limit its purposes to one or more purposes that are similar to, but no broader than, the purposes set forth in the governing instruments of its controlling IRC 509(a)(1) or (a)(2) organizations. In addition, the organizing document may not contain provisions that expressly empower it to (1) engage in activities that do not support its supported organizations, or (2) support organizations that are not specified by name, purpose, or class.

E(1) Does the organization’s organizing document limit its purposes to provide that it is organized, and at all times thereafter is operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified 509(a)(1) or (a)(2) organizations?
E(2) Does the organization’s organizing document expressly empower it to engage in activities which are not in furtherance of the purposes stated in (E)(1) above?

E(3) Does the organization’s organizing document expressly empower it to operate to support or benefit any organization not specified by name, purpose, or class in its organizing document?

Section II – Organizations Operating in Conjunction With Certain IRC 501(c)(4), (5) or (6) organizations

Special organizational test rules pertain to supporting organizations that support IRC 501(c)(4), (5) or (6) organizations. Therefore, complete this Section II rather than Section I to demonstrate that an organization meets the organizational test where it seeks to qualify under IRC 509(a)(3) because it is supporting an IRC 501(c)(4), (5) or (6) organization. For purposes of this guide sheet, the term “organizing document” means a trust instrument, corporate charter, articles of incorporation, articles of association, or other written instrument by which the organization is created under state law.

A. Does the supporting organization claim to support an IRC 501(c)(4), (5) or (6) organization? If “Yes,” proceed to questions B through E.

Questions A through D are directed to whether the supporting organization meets the IRC 509(a)(3) requirements where its supported organization is an IRC 501(c)(4), (5) or (6) organization. See Reg. 1.509(a)-4(c)(1).

B. Does the IRC 501(c)(4), (5) or (6) organization meet the public support tests of IRC 509(a)(2)?

A supporting organization may support an IRC 501(c)(4), (5) or (6) organization if such organization would be classified as an IRC 509(a)(2) public charity. In other words, if the IRC 501(c)(4), (5) or (6) organization was uprooted and transplanted in IRC 501(c)(3) soil, would it qualify under IRC 509(a)(2). Therefore, the IRC 501(c)(4), (5) or (6) organization must meet the support tests of 509(a)(2), namely that (1) more than one third of its support is derived from gifts, grants, contributions, or membership fees, or gross receipts from permitted sources, and (2) not more that one-third of its support is derived from the sum of its gross investment income and unrelated business taxable income less IRC 511 income taxes.
C. Does the supporting organization meet the organizational test by stating in its organizing document that it will carry on exclusively charitable purposes, which can include religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals within the meaning of IRC 170(c)(2)?

A supporting organization cannot state in its organizing document that it is organized and operated exclusively to support a named IRC 501(c)(4), (5) or (6) organization because this would fail the 501(c)(3) organizational test. In this circumstance, the supporting organization will meet the IRC 509(a)(3) organizational test by stating in its organizing document that it will carry on exclusively charitable purposes. These purposes can include one or more of the following purposes: religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals within the meaning of section 170(c)(2). This rule is further explained in Rev. Rul. 76-401, 1976-2 C. B. 175.

D. Does the supporting organization meet the Type I or II relationship requirement?

Because a supporting organization that is supporting an IRC 501(c)(4), (5) or (6) organization cannot name the organization that it is supporting in its organizing document, it cannot qualify as a Type III under the “operated in connection with” relationship. Therefore, the supporting organization must meet the Type I or Type II relationships by demonstrating either that the members of its governing board are appointed by the IRC 501(c)(4), (5) or (6) organization (Type I), or that a majority of its board are also members of the IRC 501(c)(4), (5) or (6) organization (Type II). This rule is also further explained in Rev. Rul. 76-401.

E. Does the supporting organization have sufficient safeguards to ensure its support is used exclusively for charitable purposes?

Question E is directed to whether the supporting organization meets the IRC 501(c)(3) requirement that it retain control and discretion over the use of its funds for its exempt purposes. Rev. Rul. 68-489, 1968-2 C.B. 210 discusses the control and discretion requirement when a charity distributes funds to an organization that is not qualified under IRC 501(c)(3).

For example, does the supporting have safeguards in place to ensure that any payments made to an IRC 501(c)(4), (5) or (6) organization are used exclusively in furtherance of the supporting organization’s charitable purposes? IRC 501(c)(4), (5) or (6) organizations, by their very nature, are not organized and operated for purposes that are exclusively charitable. Therefore, it is incumbent upon the supporting organization to ensure that payments given to IRC 501(c)(4), (5) or (6) organizations are used in furtherance of the supporting organization’s charitable purposes.

The payment cannot be used for political intervention and any payment made to the supported organization for lobbying expenditures must be attributed to the supporting organization’s lobbying limitation.
Therefore, it would be appropriate to inquire about what restrictions are placed on funds expended by an IRC 509(a)(3) organization that is organized and operated to support an IRC 501(c)(4), (5) or (6) organization, including (1) restrictions on the use of grants for exclusively charitable purposes, (2) reports regarding the use of grants, and (3) conditions on the use of funds that are not expended for the stated charitable purposes for which the grant was made.

PART 2: OPERATIONAL TEST UNDER IRC 509(a)(3)(A)

An organization must meet the operational test to qualify under IRC 509(a)(3). If an organization does not meet requirements of either A or B below or a combination of A and B below, it does not meet the operational test.

A. Does the organization make payments to or for the use of the specified IRC 509(a)(1) or (2) organization(s)? To meet the operational test under this section, there must be a “Yes” answer to A(1), A(2), A(3), or A(4) below. If “No,” the organization must meet B below to meet the operational test. The specified IRC 509(a)(1) or (2) organizations are those organizations that the supporting organization is organized and operated to support.

A(1) Does the organization make payments only to or for the use of one or more specified IRC 509(a)(1) or (2) organizations?

A(2) Does the organization make payments to or for the use of individual members of the charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s)?

A(3) Does the organization make payments indirectly through another unrelated organization to or for the use of a member of a charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s), but only if the payment constitutes a grant to an individual rather than a grant to an organization?

A(4) Does the organization make payments to or for the use of another supporting organization that also supports or benefits the specified IRC 509(a)(1) or (2) organization(s)?

The organization may also make payments to or for the use of a college or university described in IRC 511(a)(2)(B).
B. Does the organization provide services or facilities to or for the use of the specified IRC 509(a)(1) or (2) organization(s)? To meet the operational test under this section, there must be a “Yes” answer to B(1), B(2), or B(3) below. If “no,” the organization must meet A above to meet the operational test.

B(1) Does the organization provide services or facilities only to or for the use of one or more specified IRC 509(a)(1) or (2) organizations?

B(2) Does the organization provide services or facilities to or for the use of individual members of the charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s)?

B(3) Does the organization provide services or facilities to or for the use of another supporting organization that also supports or benefits the specified IRC 509(a)(1) or (2) organization(s)?

The organization may also provide services or facilities to or for the use of a college or university described in IRC 511(a)(2)(B).

PART 3: CONTROL TEST UNDER IRC 509(a)(3)(C)

An IRC 509(a)(3) organization cannot be controlled by disqualified persons (other than foundation managers). Questions A through F require a “No” answer. Questions G through L are facts and circumstances questions that require additional scrutiny if answered “Yes.”

Persons who are in a position of serving on the governing board of the supported organization may also be directors, trustees or officers of the supporting organization in order to improve the supporting organization’s operations and exercise appropriate supervision and control.

Disqualified persons may also serve on the governing board of the supporting organization. Disqualified persons consist of all the disqualified persons defined in IRC 4946, except foundation managers who are disqualified persons solely because of their status as foundation managers. Disqualified persons include (1) a substantial contributor; (2) foundation managers (officers, directors, trustees, and persons with similar powers); (3) an individual with 20% or more voting power of a corporation (or profits interest in a partnership or beneficial interest in a trust) that is a substantial contributor; (4) a lineal descendant or ancestor of a family member of the individuals above; or (5) a corporation, partnership, or trust in which persons described in 1-4 above own more than 35% of the profit interests. IRC 509(a)(1) or (2) organizations and foundation managers who are disqualified persons only as a result of being foundation managers are not treated as disqualified persons.
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p.10)

The presence of any disqualified persons (with the exceptions noted above) on a supporting organization’s governing body is cause for close examination of whether prohibited control is present. Although control is generally present where a disqualified person can aggregate a majority of the voting power, veto power also constitutes control. In addition, control by disqualified persons may be present even in the absence of a majority of the voting power or veto power if disqualified persons control decisions based on all of the facts and circumstances. See Reg. 1.509(a)-4(j) for rules regarding control by disqualified persons.

A. Is the organization controlled directly or indirectly by disqualified persons because disqualified persons on the governing board can potentially aggregate their votes together to control the operations of the supporting organization?

One example of impermissible control is where the board of directors consists of five directors, two are disqualified persons, two are appointed by the supported charity, and the final director is a so-called “independent” director appointed by the disqualified persons. Appointment of the fifth director by disqualified persons represents “indirect” control by disqualified persons.

B. Is the organization controlled directly or indirectly by disqualified persons because disqualified persons on the governing board can potentially aggregate their votes together with other board members who provide personal services to the disqualified persons, such as legal, accounting, or investment advice, to control the operations of the supporting organization?

An example of indirect control described in Rev. Rul. 80-207, 1980-2 C.B. 113 involves an IRC 501(c)(3) organization whose purpose is to make distributions to a university described in IRC 509(a)(1) and 170(b)(1)(A)(ii). The organization is controlled by a four member board of directors. One of these directors is a substantial contributor to the organization.

Two other directors are employees of a business corporation of which more than 35 percent of the voting power is owned by the substantial contributor. The remaining director is chosen by the university. None of the directors has a veto power over the organization’s actions. Reg. 1.509(a)-4(j) provides that all pertinent facts and circumstances will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization. One circumstance to be considered is whether a disqualified person is in a position to influence the decisions of members of the organization’s governing body who are not themselves disqualified persons. In this example, employees of a disqualified person are considered to be subject to the influence of a disqualified person in determining whether one or more disqualified persons control 50 percent or more of the voting power of an organization’s governing body. Since the organization was controlled by a disqualified person and the employees of a disqualified person, it was determined not to qualify as a supporting organization.
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p.11)

An analogous example of control is a four person board of directors made up of one disqualified person, two persons appointed by the supported charity, and a fifth director who is paid by the disqualified persons for accounting, legal, or investment advice apart from the affairs of the supporting organization. Since the disqualified person is in a position to influence the decisions of the fifth director, this factor would need to be taken into consideration as evidence of indirect control by the disqualified person.

C. Do disqualified persons have the right to appoint the nominating committee or successor governing board members?

Another way that control may be exercised indirectly by disqualified persons is where two disqualified persons on a five member board of directors are authorized to select all nominees for the fifth so-called “independent” director position. Even if the two charity appointed directors then appoint the fifth director from among the list of selected nominees, control over the board resides with the disqualified persons.

D. Is the organization controlled directly by disqualified persons because the disqualified persons either have 50% of the voting power on the governing board or a veto power over the supporting organization’s activities?

Voting power may also be maintained through voting rights. For example, a publicly supported organization may be entitled to appoint four out of five of the members of the board of directors. The fifth director must be a disqualified person. If the disqualified person has an 80 percent vote on all major decisions of the organization, voting power is retained through voting rights regardless of representation on the board of directors.

E. Is the organization controlled directly or indirectly by disqualified persons because disqualified persons have veto power over the supporting organization’s activities?

Reg. 1.509(a)-4(j) provides that a supporting organization will be considered to be controlled by one or more disqualified persons if a disqualified person has the right to exercise veto power over the action of the organization. A veto situation is also deemed to exist where a two member board of directors of a supporting organization is made up of one disqualified person board member and one appointed by the supported organization.
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p.12)

F. Is the organization controlled directly because the disqualified persons control the primary assets of the supporting organization?

If a disqualified person does not control the board but continues to control the supporting organization’s assets after the assets are transferred to the supporting organization, the disqualified person virtually controls the organization by control of the assets. This position is suggested in Reg. 1.509(a)-4(j). The following items G through K relate to various forms of control of the supporting organization’s assets by a disqualified person.

G. Does a disqualified person own a general partnership interest in a limited partnership in which the supporting organization owns an interest?

The general partner of a limited partnership generally is responsible for the management of the partnership and usually the general partner makes most or all important decisions for the partnership, including the distribution of income to partners. If a disqualified person holds a 1 percent general partnership interest and the supported organization holds a 99 percent limited partnership interest (in most cases received from the disqualified person), the disqualified person is able to control the partnership and thus control the supporting organization’s only or primary asset.

H. Does a disqualified person own an interest of 51% or more of the voting stock of a corporation in which the supporting organization is a stockholder?

If a disqualified person holds 85 percent of the stock of a closely-held corporation and transfers 5 percent of such stock to the supporting organization which constitutes the supporting organization’s only or primary asset, the 80 percent ownership of the corporation allows the disqualified person to effectively influence the economic rights associated with ownership of a minority interest in the corporation such as the five percent stock held by the supporting organization.

I. Does a disqualified person hold 51% or more control of a corporation through a voting trust or other voting arrangement in which the supporting organization is a stockholder?

Control of a closely held corporation may also be maintained through a voting trust or voting rights. Thus, if the supporting organization owns 90 percent of the stock of a closely held corporation and the disqualified person holds only five percent of the stock, the disqualified person may still be entitled to maintain voting control of such corporation through a voting trust arrangement or other voting rights.
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p.13)

J. Does a disqualified person have a controlling interest in a limited liability corporation (LLC) in which the supporting organization has an interest?

Control of a limited liability company may be maintained by a disqualified person in a manner similar to the corporate and partnership examples described above.

K. Does a disqualified person have an ownership interest in assets such as real estate, insurance, art work, collectibles, intellectual property, promissory notes, or other assets in which the supporting organization also has an interest?

A disqualified person may also maintain control of real property or tangible or intangible personal property through joint ownership arrangements. For real or tangible personal property, the control may also be facilitated by the possession of the property by the disqualified person through lease or custody arrangements. The real or personal property may also be used in the business of the disqualified person.

Also, consider a situation where the disqualified person donated a valuable collection of antique automobiles to a supporting organization, the collection is maintained in a warehouse at the country residence of the disqualified person, and the warehouse is leased to the supporting organization. In this situation, the disqualified person still controls the collection by controlling access.

L. Do donors or their family members have the right to provide advice to the supporting organization regarding investments or grant making?

(a) Consider what safeguards are in place to ensure that disqualified persons are not in control of investment or grant making decisions of the supporting organization. (b) For example, determine if there is an “advisory committee” or similar arrangement created in the trust agreement or other organizing documents conferring on the donor or members of the family the right to select grant recipients which must be accepted by the supporting organization.

M. Taking into account all of the facts and circumstances, including information described in questions G through L, are disqualified persons in a position to directly or indirectly control the decisions made by the supporting organization?

Consider any number of ways that the disqualified person may control the use or enjoyment of assets transferred to and held by the supporting organization.
PART 4: RELATIONSHIP REQUIREMENT UNDER IRC 509(a)(3)(B)

An organization must meet either Section I below to qualify as a Type I Supporting Organization or Section II below to qualify as a Type II Supporting Organization. The specific requirement for a Type I Supporting organization is contained in Reg. 1.509(a)-4(g). The specific requirement for a Type II Supporting Organization is contained in Reg. 1.509(a)-4(h).

Section I – Type I “Operated, Supervised or Controlled By”

A. Is the supporting organization seeking to meet the “operated, supervised or controlled by” relationship test with respect to one or more IRC 509(a)(1) or (2) organizations? If “No,” see Section II below or refer the case to 509(a)(3) Type III reserve inventory.

A Type I supporting organization is operated, supervised, or controlled by one or more public charities (supported organizations) described in IRC 509(a)(1) or (2). IRC 509(a)(3)(B)(i).

B. Are a majority of the supporting organization’s officers, directors, or trustees appointed or elected by a supported organization’s officers, directors, trustees or membership?

A supporting organization is operated, supervised, or controlled by an IRC 509(a)(1) or (2) organization if a majority of the supporting organization’s officers, directors or trustees are appointed or elected by a supported organization’s officers, directors or trustees or membership. This is similar to a parent/subsidiary relationship. IRC 509(a)(3)(B)(i) and Reg. 1.509(a)-4(g). These persons who are in a position of serving on the governing board of the supporting organization may also be directors, trustees or officers of the supported organization in order to improve the supporting organization’s operations and exercise appropriate supervision and control.

C. Does the supporting organization accept gifts or contributions from any person (other than a public charity described in IRC 509(a)(1), (2), or (4)) who directly or indirectly controls the governing body of a supported organization (alone, or together with family members or a 35% controlled organization)? If “No,” proceed to the next question. If “Yes,” the organization does not meet this requirement.

A supporting organization will fail to qualify as a Type I supporting organization if a donor to the supporting organization controls directly or indirectly an IRC 509(a)(1) or (2) supported organization that the Type I supporting organization supports. It will also fail to qualify if the organization accepts a gift or contribution from a member of that donor’s family (as defined in IRC 4958(f)(4)) or from the donor’s 35% controlled entity.
Direct or indirect control of a supported organization is determined through any combination of the donor, the donor’s family members, and the donor’s 35% controlled entity. See IRC 509(f)(2)(A)(i) and (f)(2)(B). This rule does not apply to donors that are themselves IRC 509(a)(1), (2) or (4) organizations.

D. Does the supporting organization support organizations that are not organized in the United States? If “No,” skip D(1), D(2), and D(3). If “Yes,” proceed to these questions. There must be a “Yes” answer to either D(1) or D(2), and a “Yes” to D3 for the organization to qualify under IRC 509(a)(3).

D(1) Is the foreign supported organization recognized by the IRS as exempt under IRC 501(c)(3) and a public charity under section 509(a)(1) or (2)? OR

D(2) Is the foreign supported organization described in IRC 501(c)(3) and a public charity described under IRC 509(a)(1) or (2)?

D(3) Does the organization retain control and discretion over the funds distributed to the foreign organization? See Rev. Ruls. 74-229 and 66-79 for more information regarding qualification and deductibility.

A Type I or Type II supporting organization is not specifically precluded from supporting a foreign charity unlike the way in which section 509(f)(1)(B) prohibits a Type III supporting organization from supporting foreign charities. However, all supporting organizations are limited to supporting only section 509(a)(1) or (2) public charities. If the foreign supported charity has received exemption from the Service under section 501(c)(3) as a 509(a)(1) or (2) public charity then such charity may be supported by a Type I or Type II supporting organization. Similarly, Rev. Rul. 74-229, 1974-1 C.B. 142 provides another avenue for a Type I or Type II supporting organization to support a foreign charity. Under Rev. Rul. 74-229, a Type I or Type II supporting organization may support a foreign charity if such charity is described in (but not exempt under) section 501(c)(3) and would meet the requirements of section 509(a)(1) or 509(a)(2) if it applied. In this circumstance, the supporting organization should be asked for information sufficient to demonstrate that the foreign charity would qualify under IRC 501(c)(3) and IRC 509(a)(1) or (2). Rev. Rul. 66-79 provides information regarding charitable contribution deductions when a domestic charitable organization is supporting a foreign charity. Also, see PLR 9651031 for an example of this situation.
Section II - Type II “Supervised or Controlled in Connection With”

A. Is the organization seeking to meet the “supervised or controlled in connection with” relationship test with respect to one or more IRC 509(a)(1) or (2) organizations? If “Yes,” continue. If “No,” see Section I above or refer case to 509(a)(3) Type III reserve inventory.

A Type II supporting organization is supervised or controlled in connection with one or more public charities (supported organizations) described in IRC 509(a)(1) or (2). IRC 509(a)(3)(B)(ii).

B. Is control or management of the supporting organization placed with the same persons that control or manage the supported organization?

A supporting organization is supervised or controlled in connection with an IRC 509(a)(1) or (2) organization if control or management of the supporting organization is placed with the same persons that control or manage the supported organization. An example is the presence of the same directors seated on the boards of both organizations. This is similar to a brother/sister relationship. IRC 509(A)(3)(B)(ii) and Reg. 1.509(a)- 4(h).

C. Does the supporting organization support organizations that are not organized in the United States? If “No,” skip C(1), C(2), and C(3). If “Yes,” proceed to these questions. There must be a “Yes” answer to either C(1) or C(2), and a “Yes” to C(3) for the organization to qualify under IRC 509(a)(3).

C(1) Is the foreign supported organization recognized by the IRS as exempt under IRC 501(c)(3) and a public charity under section 509(a)(1) or (2)? OR

C(2) Is the foreign supported organization described in IRC 501(c)(3) and a public charity described under IRC 509(a)(1) or (2)?

C(3) Does the organization retain control and discretion over the funds distributed to the foreign organization? See Rev. Ruls. 74-229 and 66-79 for more information regarding qualification and deductibility.
A Type I or Type II supporting organization is not specifically precluded from supporting a foreign charity unlike the way in which section 509(f)(1)(B) prohibits a Type III supporting organization from supporting foreign charities. However, all supporting organizations are limited to supporting only section 509(a)(1) or (2) public charities. If the foreign supported charity has received exemption from the Service under section 501(c)(3) as a 509(a)(1) or (2) public charity then such charity may be supported by a Type I or Type II supporting organization. Similarly, Rev. Rul. 74-229, 1974-1 C.B. 142 provides another avenue for a Type I or Type II supporting organization to support a foreign charity. Under Rev. Rul. 74-229, a Type I or Type II supporting organization may support a foreign charity if such charity is described in (but not exempt under) section 501(c)(3) and would meet the requirements of section 509(a)(1) or 509(a)(2) if it applied. In this circumstance, the supporting organization should be asked for information sufficient to demonstrate that the foreign charity would qualify under IRC 501(c)(3) and IRC 509(a)(1) or (2). Rev. Rul. 66-79 provides information regarding charitable contribution deductions when a domestic charitable organization is supporting a foreign charity. Also, see PLR 9651031 for an example of this situation.

PART 5: ORGANIZATION REQUIRING HEIGHTENED SCRUTINY

This PART 5 is designed to identify transactions, assets, and other situations that raise red flags because of concern that a supporting organization may be used to overly benefit private interests. The presence of one or more of the listed factors is not determinative. All facts and circumstances must be considered in determining whether an organization meets the requirements for tax exemption and/or supporting organization status.

Potential Red Flags

The following examples illustrate the types of transactions requiring heightened scrutiny.

1. A donor contributes cash to a supporting organization. The supporting organization “loans” the money back to the donor’s for-profit business. The supporting organization receives an unsecured promissory note for the loan and the donor takes a deduction for a contribution to the supporting organization.
In this example, there is no collateral on the loan other than a promise to pay which places the supported organization’s assets at risk. In addition, the donor is receiving impermissible private benefit that also amounts to inurement since the donor is an insider and because the loan is made to a for-profit business that is owned by the donor. **Much of the abuse in the supported organization area relates to unreasonable compensation and loans to disqualified persons, their family members, and their businesses.** Control is an important factor in determining whether an organization operates for the benefit of private interests. If disqualified persons have some position of substantial influence over the supporting organization, unreasonable compensation or loan activity may be present. See Best Lock Corporation v. Commissioner, 31 T.C. 620 (1959); Orange County Agricultural Society, Inc. v. Commissioner, 893 F.2d 529, 534 (2d Cir. 1990); and Lowry Hospital Association v. Commissioner, 66 T.C. 850 (1976).

2. A donor contributes cash to the supporting organization. No payments are scheduled or made to or on behalf of any publicly supported organizations. In this situation, the supporting organization has not demonstrated that it operates for IRC 501(c)(3) purposes or meets the IRC 509(a)(3) operational test. In addition, the donor may be in a position to exercise control over the supporting organization because after having taken a charitable contribution deduction, no distributions have either been made or are scheduled to be made to any supported organizations.

3. A donor contributes cash to the supporting organization. The supporting organization uses its assets to pay college tuition in the form of a “scholarship” to the donor’s child. In this situation, the donor receives a private benefit/inurement because the supporting organization’s assets are used to pay the school tuition of the donor’s child.

4. The donor makes a “contribution” of a historic façade easement to a supporting organization and takes a deduction.

In this situation, careful scrutiny is required to ensure that an inappropriate contribution deduction was obtained where local historic preservation laws already prohibit alteration of the home’s façade. In this situation, the contributed easement is superfluous to achieving a charitable purpose. Even if the façade could be altered, the deduction claimed for the easement contribution may far exceed the easement’s impact on the value of the property. (See IRM 7.20.6.2.1)

5. A donor contributes an interest in a partnership, or limited liability company, closely held business, real estate, intellectual property, art work, or conservation easements to a supporting organization.

In this situation, the assets may not be geared to generate significant income. Therefore, the payout by the Type III supporting organization that is not functionally integrated may not be sufficient to ensure attentiveness by the supported organization to the operations of the supporting organization(s). Thus, the supporting organization may fail the integral part test unless other facts and circumstances evidence attentiveness by the supported organization.
Further, a situation in which donor(s) contribute nonproductive assets to a Type III supporting organization that is not functionally integrated may raise concerns under IRC 501(3) regarding whether an organization is operated for a substantial nonexempt purpose as well as an issue under IRC 509(a)(3) regarding whether there is indirect control of the supporting organization by disqualified persons.

Most supporting organizations further legitimate charitable purposes. However, some taxpayers may seek to shield assets inappropriately through supporting organizations. This has resulted in the need for heightened scrutiny of supporting organizations generally to screen for those where there is a significant potential for abuse. The typical Type I or II supporting organization that supports a hospital, university, or other large charitable institution generally does not raise the private benefit concerns that require heightened scrutiny. The questions below are aimed at identifying situations that raise potential for impermissible private benefit. Additional questions needed to develop an issue should be tailored to the organization’s specific situation.

Section I – Potential Promoters

For purposes of completing this guide sheet, the term “promoter” refers to a person who organizes or assists in the organization of a partnership, trust, investment plan, or any other entity or arrangement that is to be sold to a third party. The concern is that the partnership, trust, etc., is designed to be used or is actually used by that third party to obtain tax benefits not allowable by the Internal Revenue Code.

A. Are any promoters identified with the establishment or operation of the supporting organization?

B. Does the supporting organization benefit a list of more than five supported organizations?

Section II - Unreasonable Compensation /Loans

A. Are goods, services, or cash provided to donors or their family members or persons with whom they have business relationships?

B. Are the goods, services, or cash provided to donors or their family members or persons with whom they have business relationships part of reasonable compensation arrangements?

C. Are goods, services, or cash provided to officers, directors, or trustees?

D. Are the goods, services, or cash provided to officers, directors, or trustees part of reasonable compensation arrangements?
Exhibit 8-2
Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p.20)

E. Are the goods, services or cash provided to the five highest compensated employees or independent contractors part of reasonable compensation arrangements?

F. Is there evidence of any loan activity?

G. Are loans made to donors or their family members or persons with whom they have a business relationship, to officers, directors, or trustees, or to the five highest compensated employees or independent contractors?

H. Are the loans made to donors or their family members or persons with whom they have a business relationship, to officers, directors, or trustees, or to the five highest compensated employees or independent contractors part of reasonable compensation arrangements?

Section III - Closely Held Stock/Non-liquid Investments/Assets That Do Not Produce Current Income

A. Does the supporting organization hold closely held stock?

B. Does the supporting organization hold an interest in a partnership or limited liability company in which the donor retains an interest as a general partner or member?

C. Does the supporting organization own significant other investments ($100,000 or more) that are not explained in detail?

D. Does the supporting organization own significant land ($100,000 or more)?

E. Does the supporting organization own significant other property ($100,000 or more) that does not produce current income?

F. Does the supporting organization own life insurance on the donor’s life or the life of the donor’s family member?

G. Does the supporting organization own more than 20% of the stock of a corporation, partnership interest, or beneficial interest of an estate?
Lesson 9

Miscellaneous Grade 12 Topics and Advanced Procedures

Overview

Introduction

At this point, this training has discussed several Grade 12 topics that are commonly seen in applications for exemption. This lesson will review Grade 12 topics that are less frequently seen. Some of these topics will be discussed in more depth while others are listed to assist specialists in making correct case grading assessments. Overview of Grade 12 issues that are reserved inventory categories will be presented in the next lesson.

In addition to reviewing these less seen topics, this lesson will discuss requesting technical advice and the use of closing agreements. These advanced procedures are included in this training as technical advice may be required due to the increasing complexity of higher graded issues and to promote awareness among determination specialists of a tool that may be used by EO Examinations or EO Technical to resolve tax liability issues.

Continued on next page
Overview

Objectives

At the end of this lesson you will be able to:

- Recognize Grade 12 school issues
- Distinguish between exempt and nonexempt consulting services
- Determine whether an organization qualifies for classification as an association of churches
- Describe the requirements for exemption under IRC section 501(e)
- Identify less seen Grade 12 issues when screening or working cases
- Define “technical advice” and determine its appropriate use
- Define “closing agreement” and identify its appropriate use

In This Lesson

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Advanced School Topics – Mississippi & Louisiana Schools

EO Technical
All private schools located in Mississippi and Louisiana must be coordinated with the appropriate EO Technical private school contact person(s). EO Technical maintains a database listing those schools with a known history of racial discrimination. If the applicant is on the list, EO Technical will request that the case be transferred to their office.

“Potentially” discriminatory private schools are also reserved for EO Technical per IRM 7.20.1.3.4(3). This designation is made based on consultations with the EO Technical function, as well as factors listed on the Private School Determination Checksheet.

Case Development
If EO Technical does not request the case, they will provide guidance to the specialist processing the application based on their analysis of the risk of discrimination. Newly formed schools generally receive less scrutiny than those formed at the time of public school desegregation. Research is required for those with an extensive operating history to determine whether they have a known tradition of discrimination.

Based on the facts and circumstances of the school and its history, requirements for documentation of adherence to some aspects of Rev. Proc. 75-50, 1975-2 C.B. 587, may be more extensive than others. For example, certain schools must demonstrate a proactive effort to recruit more minority students to atone for historical discrimination. The effective date of exemption becomes an issue when the school’s formation date precedes acts of discrimination.

The racial composition of the student body may also determine how much development is required. Those with a majority of minority students require less development than those where the racial composition of the student body does not reflect that of the local community and there are few minority students enrolled.

For more information concerning the meticulous recordkeeping requirements for private schools in Mississippi and Louisiana, refer to the article on “Private Schools” in the CPE for FY 2000. The article references Mississippi schools in particular, but the same rationale would also apply to those in Louisiana.
**Advanced School Topics – MS and LA Schools,** Continued

<table>
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<th>Mandatory Review</th>
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<td>All schools located in Mississippi and Louisiana are subject to QA Mandatory Review per IRM 7.20.5.4(3)a. Private elementary and secondary schools are subsequently sent to Post Review by EO Technical once processed at the QA level. Refer to IRM 7.21.3.8, Post Review of EO Determinations.</td>
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Advanced School Topics – Management Companies

Typically, school cases involving for-profit management companies are charter schools. Non-charter schools contracting with for-profit management companies are less common, yet possible. These cases would be Grade 12, also, because of related-party transactions or for-profit relationships. For an example of a school (charter or non-charter) related to a for-profit management company, refer to the “School with Management Company” example in the lesson on For-Profit Relationships in this Unit.

Please note that charter schools (with or without a management company) are currently a reserved inventory category.

Management Companies

Many charter school boards contract with management companies because the management companies bring skills in proposal and contract development, curriculum guidance, business/financial, and other skills that are often absent in a start-up charter school.

Management companies may be non-profit or for-profit organizations. The type of services provided varies from case to case as does the fee paid to the management company. The specialist should consider that a for-profit management company, by definition, is attempting to maximize profits for its owners or shareholders. The specialist should ensure that the school board remains in control of the school and continues to exercise its fiduciary responsibility.

“Charter Holders”

In some instances, charter schools contract for comprehensive services from management companies, engaging in little if no operational activity themselves. The Service has deemed these organizations to be “charter holders.” Charter holders are not schools, per se, since they are not delivering the educational activities necessary for school status. However, the charter holders may qualify as educational organizations because their activities are to maintain the charter school contract and oversee its subcontractor (the management company) to ensure the educational goals are met, which serves an educational purpose. Foundation status under IRC section 509(a)(2) is typically appropriate.
As previously stated, in some situations the management company may be a non-profit organization. These management companies may also apply for exemption. Under the rationale of Rev. Rul. 78-41, 1978-1 C.B. 148, a management company may qualify for exemption if it is an integral part of the charter schools to which it provides services. However, since its primary activity is the provision of management services, not the operation of a school, it may not qualify under IRC sections 509(a)(1) and 170(b)(1)(A)(ii).

A management company could qualify for exemption as an integral part if it performs essential services for the schools and the services, if performed by the schools themselves, would not be an unrelated trade or business. Additionally, the schools must exercise sufficient control and close supervision, based on all the facts and circumstances, to establish the equivalent of a parent and subsidiary relationship.

Facts and circumstances would include common control over the governing boards between the schools and the management company (structural control), as well as centralized authority over major financial decisions (financial control). See also Rev. Rul. 75-282, 1975-2 C.B. 201, and Treas. Regs. 1.502-1(b)(1) and (2).

If the organization does not control all of the charter schools that it is or will be operating, it may obtain exemption if it provides services at substantially below cost under the rationale of Rev. Ruls. 71-529, 1971-2 C.B. 234, and 72-369, 1972-2 C.B. 245. However, it is unusual for a non-profit management company to provide services at substantially below cost.

IRM Exhibit 7.20.4-13 contains a helpful Guidesheet that can be used in processing charter schools in general. The Guidesheet assists in identifying concerns pertaining to management companies and management agreements and also addresses situations in which the management company is the applicant.

The involvement of a management company increases the likelihood of prohibited private benefit or inurement. Accordingly, private and public schools “that engage services from a management services organization,” as well as those “that provide management services to one or more charter schools,” are subject to QA Mandatory Review per IRM 7.20.5.4(3)a.
Consulting Services

Providing Consulting Services

Consulting services as a permissible exempt activity depend on the type of services provided, since these services can vary from strictly educational and charitable to a commercial type activity. Therefore, a close review of the activities of the applicant organization is needed to identify the type of consulting services being provided in order to determine if the organization meets the operational test for exemption.

Impermissible Consulting Activities

Revenue Ruling 72-369, concerns an organization that was providing management and consulting services to IRC section 501(c)(3) organizations for a fee. It was advising organizations on operations, writing job descriptions and training manuals, and assisting in recruiting. The Service found that, even though the organization was providing the services at cost, these activities lacked the donative element necessary to be considered charitable. In addition, providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

These types of activities, in and of themselves, were determined not to be exclusively educational or charitable, but rather were commercial in nature and, therefore, did not qualify for exemption under IRC section 501(c)(3).

Permissible Consulting Activities

In some instances, organizations conducting consulting services are benefitting a charitable class or helping to educate an organization. Revenue Ruling 68-225, 1968-1 C.B. 283, concerns an organization that was formed to promote fair housing and assist minority groups. The organization began conducting consulting services for local businesses to help them secure housing for minority employees. This activity was found to further the organization’s educational and charitable purposes by promoting fair housing.

Revenue Ruling 71-529

Organizations which provide consulting type services that are substantially below cost, such as the organization described in Revenue Ruling 71-529, which provided investment services for exempt organizations at substantial savings, can qualify for exemption.
Convention or Association of Churches

Definition

A convention or association of churches is a type of religious organization generally referring to a cooperative undertaking by churches of the same denomination. It also applies to a cooperative undertaking by churches of differing denominations, assuming that the organization otherwise qualifies as a religious organization. Congress applied this designation to the organizational structure of congregational churches to accord them the comparable tax treatment granted to hierarchical churches.

As with churches, conventions and associations of churches are considered to be automatically exempt as public charities. However, if they wish to receive a determination letter, they must file Form 1023.

Like churches, conventions or associations of churches are classified as public charities under IRC sections 509(a)(1) and 170(b)(1)(A)(i) and, as such, are not required to file annual information returns.

Rev. Rul. 74-224

Rev. Rul. 74-224, 1974-1 C.B. 61, grants exemption to an organization under IRC section 170(b)(1)(A)(i) as an “association of churches.” The organization in question was recognized as exempt under IRC section 501(c)(3) and was created to act as the coordinating agency for its member churches for the purposes of developing the spirit of Christian fellowship and cooperative mission among the denominations and churches in a particular geographical area and to promote through cooperative effort the spiritual, moral, social, and civic welfare of the area. Activities of the organization included provision of clergymen at hospitals and college campuses, pastoral counseling, coordinated religious education programs and facilities, and coordinated efforts to aid the poor. Membership was comprised of Catholic and Protestant churches of various denominations. The governing board of the organization in question consisted of two voting members from each church.

The ruling goes on to state that although the term “convention or association of churches” has a historical meaning generally referring to a cooperative undertaking by churches of the same denomination, nothing in the legislative or religious history of the term prevents its application to a cooperative undertaking by churches of differing denominations, assuming such convention or association otherwise qualifies for recognition of exemption as an organization described in IRC section 501(c)(3).

Continued on next page
Convention or Association of Churches, Continued

PPA 2006
The Pension Protection Act of 2006 further provided that any organization which is otherwise a convention or association of churches shall not fail to so qualify merely because the membership of such organization includes individuals as well as churches or because individuals have voting rights in such.

IRM
IRM 7.26.2.2.6 and 7.26.2.2.4 provide additional guidance.
IRC Section 501(e) - Cooperative Hospital Service Organizations

Description

Treas. Reg. 1.501(e)-1(a) describes a cooperative hospital service organization as an organization that provides, on a cooperative basis, specific services enumerated in IRC section 501(e) to two or more hospitals exempt under IRC section 501(c)(3). Services may include:

- data processing
- purchasing (including the purchasing of insurance on a group basis)
- warehousing
- billing and collection (including the purchasing of patron accounts receivable on a recourse basis)
- food
- clinical
- industrial engineering
- laboratory
- printing
- communications
- record center
- personnel services (including selection, testing, training, and education of personnel)

It also provides that IRC section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization.

Continued on next page
From 1950 to 1968, the Service had refused to recognize these organizations as exempt under IRC section 501(c)(3) because they were determined to be “feeder organizations” within the meaning of IRC section 502.

The American Hospital Association (AHA) lobbied for a specific exemption to ensure that these organizations, particularly cooperative laundry associations, would be treated as organizations described in IRC section 501(c)(3). The AHA's general contention was that such organizations not only increase the efficiency and services of hospitals, but also enable hospitals to offer services at lower costs to the community; its most particular interest was to secure exempt status for hospital laundry cooperatives.

AHA's lobbying effort was successful. Congress agreed, and IRC section 501(e) was enacted in the Revenue and Expenditure Control Act of 1968. Curiously, while Congress adopted AHA's general position and rationale, it specifically omitted hospital laundry services from the statute's purview based on counter-pressure from commercial laundry interests.

Laundry services were deliberately omitted from the statutorily enumerated list and, specifically, were refused inclusion in that list. This interpretation of the statute was confirmed by the Supreme Court in *HCSC-Laundry v. U.S.*, 450 U.S. 1, (1981). A prior interpretation concluding that IRC section 501(e) was not the exclusive means by which such cooperative hospital service organizations could obtain exempt status (*Chart, Inc. v. U.S.*, 491 F. Supp. 10 (U.S.D.C. 1979)) was overruled.

Continued on next page
In order to qualify for IRC section 501(e) status, an organization must meet the following requirements:

- **Member (Patron) Hospital Requirement**: Each of its member hospitals (referred to in the regulations as patron-hospitals) must itself be exempt under IRC section 501(c)(3); must be a constituent part of such an exempt organization and be able to qualify for IRC section 501(c)(3) status but for its constituent part status; or be owned and operated by the United States, a State, the District of Columbia, a possession of the United States or a political subdivision, agency or instrumentality of such a governmental unit (Treas. Reg. 1.501(e)-1(d)(1)).

- **Allocation-Payover Requirement**: It must either allocate or pay over all of its net earnings, no less frequently than within 8 1/2 months of the end of its taxable year, to its patrons (i.e., its member hospitals) on the basis of services performed for them. An allocation will be considered sufficient if it consists of bookkeeping entries and written notice to the patron-hospitals, and retention of net earnings may be based on the reasonably anticipated needs of the organization (Treas. Reg. 1.501(e)-1(b)(1)).

- **Capital Stock-Limitations Requirement**: Although it may be a non-stock organization (such as an association rather than a corporation), if it is a capital stock corporation, the stock must be owned entirely by its members. The organization, however, cannot pay dividends on its capital stock (Treas. Reg. 1.501(e)-1(b)(5)).

- **Income Limitation Requirement**: It may, in addition to net earnings, receive membership dues and related membership assessment fees, gifts, grants and income from non-patronage sources such as investment of retained earnings. However, such an organization cannot be exempt if it engages in any business other than that of providing the specified services for the specified patron-hospitals. Thus, it generally cannot have unrelated business taxable income as defined in IRC section 512, although it may earn certain interest, annuities, royalties, and rents which are excluded from unrelated business taxable income because of the modifications contained in IRC section 512(b)(1), 512(b)(2) or 512(b)(3). It may, however, have debt-financed income which is treated as unrelated business taxable income solely because of the applicability of IRC section 514 (Treas. Reg. 1.501(e)-1(b)(4)).
Exemption Requirements, (continued)

- **Enumerated Activity Requirement**: It may perform only activities specifically mentioned in the statute. These activities are data processing, purchasing (including the purchasing of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, education of personnel) services and factoring accounts receivable. (Note that laundry services are NOT included.) Furthermore, an IRC section 501(e) organization cannot (a) engage in unrelated trade or business (although it may receive passive income from investments and income that is unrelated only because it is debt-financed income under IRC section 514); (b) establish for-profit subsidiaries; or (c) sell services to other than patron-hospitals (Treas. Reg. 1.501(e)-1(c)(1)).

- **Prohibition on Services to Other Organizations**: It may not perform any service for any other organization. For example, a cooperative hospital service organization is not exempt if it performs services for convalescent homes for children or the aged, vocational training facilities for the handicapped, educational institutions which do not provide hospital care in their facilities, and proprietary (for-profit) hospitals. However, the provision of the specified services between or among cooperative hospital service organizations meeting the requirements of IRC section 501(e) and the regulations thereunder is permissible. It is also permissible for IRC section 501(e) organizations to provide the specified services to entities which are not patron-hospitals, but only if such services are de minimis and are mandated by a governmental unit as, for example, a condition for licensing. (Treas. Reg. 1.501(e)-1(d)(3)).

*Continued on next page*
In *HCSC-Laundry v. U.S.*, 450 U.S. 1 (1981) the Supreme Court considered the case of a cooperative laundry organization that served tax exempt organizations. The issue was whether the organization, which was not described in IRC section 501(e) because laundry service is not one of the enumerated activities, could nevertheless qualify for exemption as a charitable organization described in IRC section 501(c)(3). The Court decided as follows:

In view of all this, it seems to us beyond dispute that subsection (e)(1)(A) of section 501, despite the seemingly broad language of subsection (c)(3), specifies the types of hospital service organizations that are encompassed within the scope of section 501 as charitable organizations. Inasmuch as laundry service was deliberately omitted from the statutory list and, indeed, specifically was refused inclusion in that list, it inevitably follows that petitioner is not entitled to tax-exempt status. The Congress easily can change the statute whenever it is so inclined. Consequently, the enumerated activity requirement is to be observed strictly -- the activity of billing and collection, for example, does not encompass factoring accounts receivable.

Applications from cooperative hospital service organizations for activities not specifically enumerated under IRC section 501(e) are reserved for EO Technical (IRM 7.20.1.3.4). Cases to be sent to EO Technical are subject to mandatory review before transfer of the case (IRM 7.20.5.4).

Additional information on cooperative hospital service organizations can be found in IRM 7.25.24
Less Seen Grade 12 Issues

Introduction

There are several issues that are rarely seen that are included and graded in the current Case Assignment Guide (CAG). It is important to be aware of these issues in order to properly grade cases in screening or to upgrade cases as new issues are identified during the development process. Correct case grading ensures that cases are worked by specialists with the appropriate level of experience and that staffing resources are properly allocated.

This section is intended to assist specialists in correctly identifying less seen Grade 12 activities and Grade 12 topics not specifically covered elsewhere in this training. Because some of these issues are rarely seen, issue identification and development are not discussed here. However, applicable tax law references from the current CAG are listed for convenience. It may be necessary to discuss an assigned case with the specialist’s manager if applicable legal precedent is unclear or unavailable. As always, the current list of topics reserved for EO Technical or subject to mandatory review should be checked for possible processing requirements.

| Arts, Culture & Humanities | • Producing Films – Rev. Ruls. 75-471 and 76-4  
| | • Radio and Television Broadcasting – Rev. Rul. 66-220 |
| Environment | • Conservation, Environmental Protection, Historic Preservation (no easements or land acquisition) – Rev. Rul. 76-204 |
| Health Care | • Specialized Care for the Elderly – Rev. Rul. 69-545 |
| Crime and Legal Related | • Prepaid Legal Services Plan Under IRC Section 501(c)(20) – Treasury Decision 8073 |
| Employment | • Association of Employers – Rev. Ruls. 70-31 and 82-138 |
| Public Safety, Disaster Preparedness & Relief | • Testing for Public Safety – Rev. Ruls. 78-426 and 65-61 |

Continued on next page
## Less Seen Grade 12 Issues

### Human Services
- Loans or Credit Reporting – Rev. Rul. 68-265 (Note: Cases involving credit counseling are Grade 13 and a reserved inventory topic.)

### Civil Rights, Social Action & Advocacy
- Other Civil Rights Activities – Rev. Rul. 72-228
- Propose, Support or Oppose Legislation – Section 501(h); Rev. Ruls. 76-147, 61-177, 70-449 and 67-293
- Provide Facilities or Services for Political Campaign Activities – Rev. Ruls. 74-574, 72-512 and 72-513; Treas. Reg. 1.501(c)(3)-1(c)(3)(iii)

### Community Improvement & capacity Building
- Regulating Business – Rev. Rul. 70-187

### Philanthropy, Volunteerism & Grantmaking Foundations
- Endowment Fund or Financial Services – Rev. Rul. 69-528

### Public & Societal Benefit
- Consumer Interest Group – Rev. Rul. 78-50
- Traffic or Tariff Bureau – Rev. Ruls. 67-393 and 68-264

### Miscellaneous
- Indians (Tribes, Cultures, etc.) – Rev. Rul. 77-272; Rev. Procs. 83-87, 84-36 and 84-37

*Miscellaneous Grade 12 Topics and Advanced Procedures*  
9-16
Advanced Procedures - Technical Advice

Introduction

As organizations find more creative and unique ways of furthering their exempt purposes, it becomes difficult in some situations to determine if an organization meets exemption or foundation classification requirements.

As determination specialists, we must use all tools and resources available when clarification or interpretation of the law is required or in situations where there is no applicable legal precedent.

This section explains under what circumstances Technical Advice may be requested from EO Technical in resolving complex issues for which there is lack of precedent. The following section explains under what circumstances Closing Agreements are used by EO Examinations and EO Technical to resolve tax liability issues.

Technical Advice Defined

“Technical advice” is advice or guidance in the form of a memorandum furnished by the Exempt Organizations Technical Office (EO Technical) in response to a request from an EO Examinations Area manager, the Manager of EO Determinations, or an Appeals Area Director submitted in accordance with the provisions of Rev. Proc. 2009-5 (updated annually). Special procedures for technical advice requests regarding IRC section 521 Farmers’ Cooperatives are set forth in Section 4.02 of Rev. Proc. 2009-5.

Technical advice can be issued in response to any technical or procedural question that develops on the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, notices, or other published precedent to a specific set of facts. A request for technical advice may be initiated by a taxpayer, and a taxpayer has the right to request technical advice when informed of a proposed denial of exemption.

Requests for technical advice on EO Determinations matters are subject to mandatory review by Exempt Organizations Division of Quality Assurance (EOQDA).

Continued on next page
Under What Proceedings Can Technical Advice be Requested?

Technical advice can be requested regarding:

- A request for a determination letter
- Examination of a taxpayer’s return
- Consideration of taxpayer’s claim for refund or credit
- Any other matter involving a specific case under the jurisdiction of EO Examinations or EO Determinations

Rev. Proc. 2009-5, Section 4.04

While technical advice may be requested on any technical or procedural question that cannot be resolved on the basis of law, regulations, or a clearly applicable revenue ruling or other published precedent, technical advice must be requested on the following matters:

- Requests for IRC section 7805(b) tax relief are mandatory TAMS for all exempt organization matters
- Cases concerning qualification for exemption or foundation status for which there is no published precedent or for which there is reason to believe that non-uniformity exists.

Procedures


Additional Resources

Additional information on requesting technical advice is found in the following IRMs:

- IRM 7.1.2, EO Administrative Procedures – Introduction
- IRM 7.1.4, Exempt Organizations Technical Advice Procedures
- IRM 4.75.21, EO Special Examination Procedures
**Advanced Procedures – Closing Agreements**

**Authority**

Tax-exempt organizations may want to enter into a closing agreement to resolve tax liability issues and close tax years (not determination cases) with finality. While EO Determinations does not have authority to enter into closing agreements, the purpose of discussing this topic in this lesson is to promote awareness among determination specialists of how this tool may be used by EO Examinations or EO Technical to resolve tax liability issues.

Under IRC section 7121, the Commissioner may enter into and approve a written closing agreement with any person relating to the liability of the person in respect to any internal revenue tax for any taxable period ending prior or subsequent to the date of such agreement.

Treas. Reg. 301.7121-1(a) provides further, that a closing agreement may be entered into in any case in which:

- There appears to be an advantage in having the case permanently and conclusively closed, or
- If good and sufficient reasons are shown by the taxpayer for desiring a closing agreement, and
- It is determined by the Commissioner that the United States will sustain no disadvantage through consummation of such an agreement.

**Purpose**

Closing agreements may be used to resolve tax issues under EO jurisdiction. For example, closing agreements may be considered:

- In conjunction with or in lieu of revocation of tax-exempt status for an organization, or
- To resolve specific tax issues giving rise to unrelated business taxable income, employment tax, excise tax, filing penalties and other issues.

*Continued on next page*
Advanced Procedures – Closing Agreements, Continued

Guidelines

- The closing agreement must be fair, impartial, objective, and consistent.

- Closing agreements should be used judiciously to resolve matters that cannot be resolved through normal compliance processing procedures and to encourage future voluntary compliance.

- Closing agreements should not be used in a manner that infringes on the settlement authority of Appeals, nor to merely to allow a taxpayer to reduce the amount of a tax or penalty.

- Closing agreements should not be used to circumvent Chapter 42 provisions, IRC sections 4911, 4912, 4955, and 4958 excise taxes, or abatement of first and second tier taxes in certain cases.

Closing Agreement Procedures

IRM 4.75.25, Exempt Organizations Closing Agreements, sets forth procedures for processing closing agreements.

Also see Rev. Proc. 68-16, 1968-1 C.B. 770.
Summary

All private schools located in Mississippi and Louisiana must be coordinated with the appropriate EO Technical private school contact person. Based on the facts and circumstances of the school and its history, requirements for documentation of adherence to some aspects of Rev. Proc. 75-50 may be more extensive than others.

Typically, school cases involving for-profit management companies are charter schools. Many charter school boards contract with management companies because the management companies bring skills in proposal and contract development, curriculum guidance, business/financial, and other skills that are often absent in a start-up charter school. Management companies may be non-profit or for-profit organizations. Nonprofit management companies may also apply for exemption.

Consulting services as a permissible exempt activity depend on the type of services provided, since these services can vary from strictly educational and charitable to a commercial type activity. In some instances, organizations conducting consulting services are benefitting a charitable class or helping to educate an organization. However, providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

A convention or association of churches is a type of religious organization generally referring to a cooperative undertaking by churches of the same denomination. It also applies to a cooperative undertaking by churches of differing denominations, assuming that the organization otherwise qualifies as a religious organization. As with churches, conventions and associations of churches are considered to be automatically exempt as public charities. However, if they wish to receive a determination letter, they must file Form 1023. Like churches, conventions or associations of churches are classified as public charities under IRC sections 509(a)(1) and 170(b)(1)(A)(i) and, as such, are not required to file annual information returns.

Treas. Reg. 1.501(e)-1(a) describes a cooperative hospital service organization as an organization that provides, on a cooperative basis, specific services enumerated in IRC section 501(e) to two or more hospitals exempt under IRC section 501(c)(3). Allowable services include food services, printing, data processing, billing and purchasing.

Continued on next page
Summary, Continued

There are several issues that are rarely seen that are included and graded in the current Case Assignment Guide (CAG). It is important to be aware of these issues in order to properly grade cases in screening or to upgrade cases as new issues are identified during the development process. Correct case grading ensures that cases are worked by specialists with the appropriate level of experience and that staffing resources are properly allocated.

Technical advice is requested from EO Technical when tax law clarification is required or an issue is identified that lacks legal precedent. Technical advice can be requested regarding a request for a determination letter, examination of a taxpayer’s return, and any other matter involving a specific case or taxpayer. Procedures for requesting technical advice are set forth in Rev. Proc. 2009-5, updated annually, and IRM 7.1.2, IRM 7.1.4, and IRM 4.75.21. Requests for technical assistance are subject to mandatory review by EOQDA.

EO Examinations and EO Technical have authority to enter into closing agreements to resolve tax liability issues. Closing agreements close tax years, not determination cases. Closing agreements are appropriate when there appears to be an advantage in having the case permanently and conclusively closed, and it is determined that the U.S. will sustain no disadvantage through such an agreement. IRM 4.75.25 sets forth procedures for processing closing agreements.
Overview

Introduction

Voluntary Employees' Beneficiary Associations (VEBAs) are membership organizations, separate from the employer, that provide their members with health and welfare and other benefits. Such organizations may qualify for exemption under IRC section 501(c)(9).

Applications from VEBAs that have 20 or fewer members are at risk of being used to provide impermissible deferred compensation benefits or other forms of prohibited inurement, particularly when a small business or a key employee effective controls the VEBA. These cases are subject to mandatory review by Quality Assurance (IRM 70.20.5.3).

A Supplemental Unemployment Benefits Trust (SUB Trust) is an employee welfare benefit fund created to provide the employee with supplemental wage compensation during times of unemployment. The compensation benefits paid are designed to supplement the state unemployment benefits being received by the employee member. Such organizations may qualify for exemption under IRC section 501(c)(17).

Because these issues are reserved inventory categories, this lesson is intended to provide an overview of the requirements and prohibitions under IRC section 501(c)(9) and 501(c)(17) and the issues that may be present in such cases.

Applications for exemption under IRC section 501(c)(9) and 501(c)(17) are Grade 12 cases and are a reserved inventory category.

Continued on next page
**Overview, continued**

**Objectives**

At the end of this lesson, you will be able to:

- Distinguish between a plan and a VEBA
- Identify VEBA requirements for exemption
- List permissible and nonqualifying benefits for VEBAs
- Describe examples of prohibited inurement in a VEBA
- Recognize discriminatory VEBA benefits
- Recognize the requirements for exemption under IRC section 501(c)(17)
- Identify permissible and nonpermissible benefits under IRC section 501(c)(17)
- Determine whether the benefits provided to employees are discriminatory under IRC section 501(c)(17)
- Determine if there are prohibited transactions under IRC section 501(c)(17)

**In This Lesson**

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The predecessors of IRC 501(c)(9) were sections 103(16) of the Revenue Act of 1928 and 101(16) of the Internal Revenue Code of 1939. The law, prior to the Tax Reform Act of 1969 required that 85 percent or more of the income of VEBAs be derived from amounts collected from members and, as added with retroactive effect by the Revenue Act of 1942, amounts contributed by employers. With the imposition of the tax on unrelated business income on all VEBAs, Congress concluded that the 85 percent test was no longer necessary for tax-exempt status of IRC 501(c)(9) organizations and eliminated the requirement.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress lowered the limits on amounts that could be contributed to qualified pension plans and limited the benefits that could be paid out of the plans. As a result of these restrictions, some tax practitioners began recommending that employers use VEBAs and other nonpension employee benefit organizations in order to obtain tax sheltering advantages similar to those that had existed with pension plans before 1982, but with fewer restrictions.

Because Congress recognized that a potential for abuse existed, provisions of the Deficit Reduction Act of 1984 (Public Law 98–369) were enacted to provide restrictions upon employee welfare benefit plans, including VEBAs. These provisions included new nondiscrimination rules and mandatory filing requirements.

Treas. Reg. 1.501(c)(9)-1 provides that in order to qualify as a Veba, an organization must be an association of employees, membership must be voluntary, only the specified benefits can be provided, and there must not be any inurement.

A comparison of these requirements to the facts and circumstances of each entity will determine if that entity qualifies for exemption under IRC section 501(c)(9).

A Veba may be organized as a trust, corporation or an association. VEBAs created by reason of collective bargaining agreements tend to be formed as trusts. VEBAs created by employers are generally organized as corporations or trusts. Associations (though uncommon) are generally governed under the same rules as corporations.
Plan vs. VEBA

When reviewing an application for exemption under IRC section 501(c)(9), it is important to distinguish between an employer's welfare benefit "plan" and a VEBA through which the plan may be funded. A specialist must ensure that the VEBA documents are secured and reviewed rather than the “plan” documents.

A Welfare Benefit Plan (“plan”) is a program of benefits promised to employees.

- It is normally embodied in a written plan document
- Title I of the Employee Retirement Income Security Act (ERISA) requires, in most cases, the employer prepare a “summary plan description” explaining the essential features of the plan and to furnish a copy of this summary plan description to each employee.

A VEBA is the entity that actually pays for the benefits described in one or more of plans. An employer may decide to fund some, or all, of the benefits under its plan(s) through a VEBA. Some characteristics are:

- A VEBA’s governing instrument will set forth the types of benefits to be provided
- A VEBA may provide benefits for more than one plan, e.g., a medical plan and a disability plan
- A VEBA may be self-insured and provide the benefits directly or may pay an insurance company to provide the benefit
VEBA Requirements

Must be an Association of Employees

A VEBA must be a membership organization, and the members must have some kind of employment related common bond.

The word "members" is synonymous with people. An association or corporation cannot be a member. In Bricklayers Benefit Plans of Delaware Valley, Inc. v. Commissioner, 81 TC 735, the Court found that pooled fund arrangements consisted of entities which could not be considered an "association of employees."

The word "employees" is plural, so the membership number has to be more than one (Rev. Rul. 85-199, 1985 2 C.B. 163). “Employees” as defined in Treas. Reg. 1.509(c)(9)-2(b) and IRC section 3121(d) may include surviving spouses and dependents (if designated members of VEBA), retirees and individuals who previously qualified as an employee/member of the VEBA.

The employees must have an employment-related common bond (see Treas. Reg. 1.501(c)(9)-2(a)). This includes membership defined by reference to a common employer, affiliated employers, a labor union with one or more collective bargaining agreements or employers in the same line of business in the same geographic locale.

Voluntary Membership

Treas. Reg. 1.501(c)(9)-2(c)(2) requires that membership in a VEBA be voluntary. It provides that membership is voluntary if an affirmative act is required by an employee to become a member rather than the designation as a member due to employee status.

This regulation provides, however, that membership will be considered voluntary even if membership is required of all employees, provided that the employees do not incur a detriment as a result of membership. An example of such a detriment is a deduction from the employee’s pay to finance the benefit.

- Likewise, membership will not be considered involuntary if it is required as a result of a collective bargaining agreement or as an incident of membership in a labor organization.
- As a practical matter, there are very few VEBA applicants that will fail on the grounds that they are not voluntary. Most employer-sponsored VEBAs do not finance benefits through deductions from employees' salaries.

Continued on next page
VEBA Requirements, Continued

Control by Membership

Treas. Reg. 1.501(c)(9)-2(c)(3) requires that a VEBA must be controlled either:

- by its membership;
- by independent trustee(s) (such as a bank); or
- by trustees or other fiduciaries, at least some of whom are designated by, or on behalf of, the membership. (Whether such control by or on behalf of the membership exists is determined with regard to the facts and circumstances of each case.)

A fiduciary intermediary such as a bank, acting in a fiduciary capacity, generally will be considered an independent trustee. A VEBA will also be considered to be controlled by independent trustees if it is an "employee welfare benefit plan" as defined in Section 3(l) of the Employee Retirement Income Security Act of 1974 (ERISA) and, as such, is subject to the requirements of Parts 1 and 4 of Subtitle B, Title I of ERISA.
Permissible VEBA Benefits

Permissible Benefits

IRC section 501(c)(9) states that a voluntary employees' beneficiary association may provide life, sick, accident, or other benefits to its members. The permissible benefits mentioned in IRC section 501(c)(9) have very broad descriptions but they also have some restrictive characteristics.

- The permissible benefits are generally provided as a result of an unpredictable event, i.e., sickness, death, and disability.

- Treas. Regs. 1.501(c)(9)-3(d)(1) and (2) indicate that the benefit should be of a type that safeguards or improves the health of a member or member's dependent or protects against a contingency that interrupts or impairs a member's earning power.

Permissible benefits should possess the characteristics previously mentioned and should be provided for the purposes described in Treas. Reg. 1.501(c)(9)-3(d).

Examples of qualifying benefits include:

- Term life insurance
- Group whole life insurance (as defined in IRC section 79)
- Accidental Death and Dismemberment (AD&D)
- Medical and/or dental benefits
- Disability benefits (both long and short term)
- Vacation pay and/or vacation facilities
- Education or training benefits or courses for members
- Temporary living expense loans and grants in times of disaster
- Recreational Expenses
- Child-care
- Job Readjustment Allowances
- Income Maintenance Payments in Times of Economic
- Any other benefit meeting the criteria of Treas. Reg. 1.501(c)(9)-3(b), (c), (d), or (e)
Non-Qualifying VEBA Benefits

Treas. Reg. 1.501(c)(9)-3(f) provides that all benefits not described in regulation 1.501(c)(9)-3(b), (c), (d), or (e) are nonqualifying benefits. Several nonqualifying benefits are listed in the regulation and below.

Some of the characteristics of nonqualifying benefits are:

- Benefit becomes payable by reason of a passage of time
- The benefit has a value greater than the lower of the cost of the benefit to the VEBA or FMV
- A benefit that supplements a retirement benefit or other sources of passive income.

Examples of nonqualifying benefits under Treas. Reg. 1.501(c)(9)-3(f) are:

- Whole Life Insurance (nonqualifying under IRC 79)
- Accident Insurance on Property and/or homeowner’s insurance
- Commuting Expenses
- Malpractice Insurance
- Loans (other than in times of distress)
- Pensions or annuities payable at retirement
- Stock bonus or profit-sharing plans
- Any other deferred compensation benefits
- Dependent's Education (noncollectively bargained-plans)
- Supplemental Retirement Benefits
Prohibited Inurement for VEBAs

Inurement

A VEBA that provides permissible benefits to its employee members will be exempt if no part of its net earnings inures (other than through such payments) to the benefit of any private shareholder or individual.

Issues of inurement in favor of officers, shareholders, and highly compensated employees may arise. Analysis of the facts and circumstances in the case will determine if inurement is present that will result in denial of exemption.

Examples of inurement:

- The disposition of property to, or the performance of services for, a person for less than the greater of fair market value or cost (including indirect costs) to the organization, other than as a qualifying benefit.

- The payment of unreasonable compensation to the trustees or employees of the organization.

- The purchase of insurance or services for amounts in excess of fair market value from a company in which one or more of the organization's trustees, officers, or fiduciaries, has an interest.

- The payment of disproportionate benefits to highly compensated personnel in relation to benefits received by other members.
VEBA Non-Discrimination Rules

In general, the final regulations under IRC section 501(c)(9) prohibit a VEBA from establishing criteria for eligibility for membership or benefits that favor officers, shareholders, or highly compensated personnel of an employer by either limiting benefits to these individuals or by providing disproportionate benefits to them in relation to benefits provided to other members of the VEBA. IRC section 505(b)(1) bars discriminatory classifications and discriminatory benefits in favor of highly compensated individuals.

IRM 7.25.9.3 lists safe harbor guidelines which allow for the processing of VEBA applications without waiting for the publication of regulations under IRC section 505(b). These guidelines apply to certain benefits covered by IRC section 505(b), which include life, disability, severance, insured medical unemployment compensation, and vacation/sick leave benefits.

A VEBA that otherwise meets all of the other requirements of IRC section 501(c)(9) but does not meet the nondiscrimination guidelines will be given the opportunity to amend its plan to conform to the nondiscrimination safe harbor guidelines for each benefit.

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The safe harbor guidelines are divided into two major categories:

- Rules for income replacement benefits
- Rules for non-income replacement benefits

Examples of income replacement benefits include life insurance, severance benefits and sick or vacation pay. Non-income replacement benefits include any benefit that is not a substitute for wages during a period of interruption or impairment of earning power (e.g., health and accident benefits, vacation facilities, education and training expense benefits, etc.).

The Uniform to Compensation Rule: An income replacement benefit will not be considered discriminatory merely because the benefit bears a uniform relationship to compensation pursuant to IRC section 505(b)(1). Income replacement benefits are usually provided as a fraction or multiple of employees' compensation. Guidelines can generally be met through a ratio test, proportionality test, and best benefit test. Specific benefits may dictate which test is applied. Safe harbor guidelines for income replacement benefits can be found in IRM 7.25.9.3.2 through 7.25.9.3.4.

The non-discrimination safe harbor guidelines for non-income replacement benefits require that benefits be offered to participants in equal amounts and under equal eligibility requirements, terms and conditions, and without regard to salary level, position, or ownership interest in the employer.
Collectively Bargained VEBAs and Additional Information

Collectively Bargained VEBAs

Treas. Reg. 1.419A-2T, Q and A(2) defines a collectively bargained welfare benefit fund as follows:

- A fund that is maintained pursuant to an agreement which the Secretary of Labor determines to be a collective bargaining agreement, and
- Only if the benefits provided through the fund were the subject of arms-length negotiations between employee representatives and one or more employers, and
- If such agreement between employee representatives and one or more employers satisfies section 7701(a)(46) of the Code (limitation of less than half of the members can be owners or employers)
- At least 50% of the members eligible to receive benefits are covered by the collective bargaining agreement.

The advantages of being a collectively bargained Veba are as follows:

- The nondiscrimination rules of IRC section 505 do not apply
- Can provide additional benefits including educational or training benefits for dependents of members; personal legal service benefits (other than through an IRC section 501(c)(20) organization); workers' compensation

Application for Exemption

IRC section 505(c) requires all IRC section 501(c)(9) organizations to file a Form 1024 in order to be recognized as exempt. Organizations must apply for exemption within 15 months from the end of the month in which the organization was formed to qualify for exemption as of the date of formation.

Organizations that do not meet the timely filing requirement may be recognized as exempt from the date of application or request relief from the timely filing requirement under Treas. Reg. 301.9100-3.

Additional Resources

- IRM 7.20.4, Special Determination Issues, VEBA Reference Guide
- IRM 7.25.9, Voluntary Employees Beneficiary Associations
- EO 1999 CPE text, Voluntary Employees’ Beneficiary Associations
- EP1999 CPE text, VEBA Awareness

IRC Section 501(c)(9) VEBAs and
IRC Section 501(c)(17) Supplemental Unemployment Benefit Trusts
10-A-12
A Supplemental Unemployment Benefits Trust (SUB Trust) is an employee welfare benefit fund created to provide the employee with supplemental wage compensation during times of unemployment.

The compensation benefits paid are designed to supplement the state unemployment benefits being received by the employee member in order to approximate the employee member’s normal wages.

Generally, SUB Trusts can qualify and apply for exemption as a VEBA described in IRC section 501(c)(9) or as a SUB under IRC section 501(c)(17).

SUB Trusts may also qualify as a union described in IRC section 501(c)(5), providing the trust is collectively bargained and is partially funded by the employee or union or both. SUB Trusts are generally funded by employers and there is substantial doubt and very little published precedent as to whether employer funds can be used to finance employee benefits of a union. IRC section 501(c)(5) applications of this type should be worked in conjunction with the EO Technical.

Treas. Reg. 1.501(c)(17)-1 provides that in order to qualify as a SUB the organization must have the following qualifications:

- The organization must be a valid trust existing under local law as evidenced by an executed written document.

- The trust is part of a written plan established and maintained by the employer, his/her employees or both, solely for the purpose of providing supplemental unemployment compensation benefits.

- The plan provides that the corpus and the income of the trust cannot be used for or diverted to any purpose other than the providing of supplemental unemployment compensation benefits.

- The trust is part of a plan whose eligibility conditions and benefits do not discriminate in favor of shareholders, officers or highly compensated employees.

Continued on next page
IRC Section 501(c)(17) – Supplemental Unemployment Benefit Trusts, Continued

Qualification under IRC Section 501(c)(17) (continued)

- Benefits are to be determined by objective standards and not determined solely in the discretion of the trustees.

- The trust does not engage in any prohibited transactions as defined in IRC section 503.

A comparison of the Treas. Reg. 1.501(c)(17)-1 requirements to the facts and circumstances of each entity will determine if that entity qualifies as a SUB Trust.

General Characteristics

Historically, almost all SUB Trusts have been collectively bargained welfare benefit funds not subject to the discrimination rules of IRC section 505(b) and the Unrelated Business Taxable Income rules of IRC section 512(a)(3).

A SUB Trust is the entity that actually pays benefits described in one or more of the welfare benefit plan or plans. The SUB Trust’s instrument will set forth the types of benefits to be provided. The SUB Trust may be self-insured and provide the benefits directly or may pay an insurance company to provide the benefits.

The permissible benefits mentioned in IRC section 501(c)(17) have very narrow descriptions and restrictive characteristics.

- The permissible benefits are generally provided as a result of an employee’s involuntary separation from his employer because of a reduction in force, the discontinuance of a plant or operation, a shortened workweek, or other similar conditions.

- The benefits may be paid to an employee while separated from the employer even if the separation is temporary.

- Generally, the benefits provided are cash, but if other than cash, property or services at current FMV rates.

Treas. Reg. 1.501(c)(17)-1(b) (1) (ii) indicates that the benefits should be of a type that arises solely because of the involuntary separation from the employment of the employer. Sick and accident benefits qualify as long as these benefits are subordinate to the supplemental unemployment benefits.
IRC Section 501(c)(17) Benefit Issues

Subordinate Benefits

Treas. Reg. 1. 501(c)(17)-1(b)(5) indicates that the determination of whether a sick or accident benefit is subordinate to the separation benefits is a question to be decided based on all the facts and circumstances.

Factors to consider include:

- Amount of funding given for each type of benefit
- Amount and number of payments made for each type of benefit.

The specialist must ensure that the individuals eligible to receive the subordinated benefits are receiving the primary benefits.

Subordinated benefits should not be provided to employees who have not suffered an involuntary permanent or temporary separation from the employer. The subordinated benefits also may not discriminate in favor of the highly compensated employees on the basis of employee classification. However, sick and accident benefits need not be provided for all employees eligible for the receipt of separation benefits.

Benefit Restrictions

Treas. Reg. 1.501(c)(17)-2(a) provides that a SUB trust may not provide death, vacation, or retirement benefits.

Treas. Reg. 1.501(c)(17)-1(a)(4) indicates that if the Plan which established the SUB Trust provides for the payment of any benefits other than supplemental unemployment compensation benefits, then the trust will not qualify for exemption as an organization described in IRC section 501(c)(17).

Severance pay is not a restricted benefit as long as it is identical to supplemental unemployment compensation benefits.
IRC Section 501(c)(17) Non-Discrimination Rules

IRC sections 501(c)(17)(A)(ii) and (iii) indicate that an organization will qualify as an organization described in IRC section 501(c)(17) if the classification of employees to whom the supplemental unemployment compensation benefits are to be paid does not discriminate in favor of highly compensated employees as defined in IRC section 414(q).

The general non-discrimination rule cited in IRC section 501(c)(17)(A) applies only to supplemental unemployment compensation benefits.

According to the provisions of IRC section 501(c)(17)(C) the non-discrimination requirements of IRC section 501(c)(17)(A) are satisfied for the year if on one day in each quarter the plan satisfies the nondiscrimination requirements of IRC section 501(c)(17)(A).

Different employee classifications can have different eligibility requirements for supplemental unemployment compensation benefits as long as the eligibility requirements do not discriminate in favor of the highly compensated employees.

Exceptions to the general rule are listed in IRC sections 501(c)(17)(A) and (B).
IRC Section 501(c)(17) Prohibited Transactions and Additional Information

Prohibited Transactions

Prohibited transactions are described in IRC section 503(b) as transactions in which the trust:

1. lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to

2. pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to

3. makes any part of its services available on a preferential basis to

4. makes any substantial purchases of securities or any other property, for more than adequate consideration in money or money’s worth, from

5. sells any substantial part of its securities or other property, for less than an adequate consideration in money or money’s worth, to, or

6. engages in any other transaction which results in a substantial diversion of its income or corpus, to

the creator of such trust; a person who has made a substantial contribution to such trust, a member of a family of an individual who is the creator of such trust, or who has made a substantial contribution to such trust, or a corporation controlled by such creator or person through ownership, directly or indirectly, of 50% or more of the total combined voting power of all classes of stock entitled to vote or 50% or more of the total value of all classes of stock of the corporation.

Application for Exemption

IRC section 505(c) requires all IRC section 501(c)(17) organizations to file a Form 1024 in order to be recognized as exempt. IRC section 501(c)(17) organizations are subject to timely filing requirements in the same manner as VEBAs.

Additional Information

Additional information on IRC section 501(c)(17) SUB Trusts can be found in IRM 7.25.17.
Summary

Voluntary Employees' Beneficiary Associations (VEBAs) are membership organizations, separate from the employer, that provide their members with health and welfare and other benefits. Such organizations may qualify for exemption under IRC section 501(c)(9).

A VEBA is the entity that actually pays for the benefits described in one or more of welfare benefit plan or plans. An employer may decide to fund some, or all, of the benefits under its plan(s) through a VEBA.

IRC section 501(c)(9) states that a voluntary employees' beneficiary association may provide life, sick, accident, or other benefits to its members. The permissible benefits mentioned in IRC section 501(c)(9) have very broad descriptions but they are also subject to some restrictive characteristics.

A VEBA must be a membership organization, and the members must have some kind of employment related common bond. Membership must be voluntary. No net earnings of the organization may inure to the benefit of any private shareholder or individual. There are also nondiscrimination rules that must be followed in order to qualify for exemption.

A Supplemental Unemployment Benefits Trust (SUB Trust) is an employee welfare benefit fund created to provide the employee with supplemental wage compensation during times of unemployment. The compensation benefits paid are designed to supplement the state unemployment benefits being received by the employee member. Such organizations may qualify for exemption under IRC section 501(c)(17).
Lesson 10B
Introduction to Limited Liability Companies (LLCs)

Overview

Introduction

LLCs are a hybrid of partnerships and corporations. All LLCs have the corporate characteristic of limited liability for all members; however, unlike general or limited partnerships, all members may participate in governing and managing the LLC.

The entity is separate from its owners. It owns property, incurs debts, enters into contracts, and can sue or be sued.

LLCs are referred to in some states as "limited liability corporations." They are sometimes abbreviated as "LC" rather than "LLC." Professional firms sometimes use the abbreviation of "PLLC" or "PLC."

LLCs are distinct from limited liability partnerships ("LLPs"), sometimes known as registered limited liability partnerships ("RLLPs"), which are not to be confused with limited partnerships.

Objectives

At the end of this lesson you will be able to:

- Define a LLC
- Identify a LLC
- Identify exemption issues involving LLCs

In This Lesson

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<td>Development of LLC Exemption Issues</td>
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<tr>
<td>Exhibit 10B-1: Announcement 99-102</td>
<td>10B-11</td>
</tr>
</tbody>
</table>
Limited Liability Companies: In General

A domestic LLC will generally have:

- Articles of Organization and
- An Operating Agreement (some states refer to it as “regulations”)

The Articles of Organization are filed with the appropriate state authority that creates the entity under the laws of a particular state.

Usually only a minimal amount of information is required to be in the articles, such as the LLC’s name, address, and registered agent.

Note: The laws governing LLCs can vary widely from state to state.

The operating agreement is executed between the members and is not usually filed with the state.

The operating agreement governs the relationship between the members and the LLC, and the relationship among the members.

The operating agreement orders the LLC’s affairs and the manner in which business will be conducted.

Each state sets specific naming requirements.

The name of the entity must include language that puts the public on notice that there is limited liability, such as "Limited," or "LLC." Generally, states will reject articles of organization of entities that do not contain “LLC” in the name of the entity.
Limited Liability Companies: In General, Continued

Members

Most states allow an LLC to have a single member, though some states require an LLC to have two or more members. There is no upper limit on the number of members.

There are no restrictions on the types of members (may be individuals, corporations, partnerships, or other LLCs).

Each member owns one or more interests in the LLC.

Because state laws generally provide LLC members with ownership rights in the assets of the LLC, the Service is concerned that allowing non-exempt members would result in potential inurement problems. Thus, the LLC cannot have private shareholders or individuals as members.

Where one or more private shareholders or individuals have been identified in the articles of organization or similar organizing document, this issue should be resolved before consideration of any other issues regarding satisfaction of the organizational or operational tests. For those instances where private shareholders or individuals have been identified in the articles of organization, the issue may be resolved as follows: 1) private shareholders or individuals may forfeit their interests and be replaced by one or more 501(c)(3) organizations and/or governmental units or 2) dissolution of the LLC and reformation as a corporation, unincorporated association, or trust formed to meet the requirements of section 501(c)(3).

In instances where the organization dissolves the LLC and reforms as a corporation, unincorporated association, or trust, the case should be developed by the agent using procedures customary for corporations, unincorporated associations, or trusts. Such cases are not transferred to the LLC specialty group. In instances where private shareholders or individuals forfeit their interests and are replaced by one or more 501(c)(3) organizations, the case should be transferred to the LLC specialty group.

It should be noted, however, that the presence of solely charitable members does not ensure that the organization will be operated exclusively for charitable purposes and regular development of the activities of the organization are required to ensure that the organization is engaged in one or more purposes described in section 501(c)(3).
### Limited Liability Companies: In General, Continued

<table>
<thead>
<tr>
<th>Dissolution</th>
<th>Death, retirement, resignation, expulsion, or bankruptcy of any member generally results in dissolution unless remaining members agree to continue the business.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer of Member Interests</td>
<td>Unanimous or majority consent of all members may be required before a member can transfer an interest in an LLC.</td>
</tr>
</tbody>
</table>
| Managing Member | The Articles of Organization or Operating Agreement of an LLC may indicate the presence of a managing member who is designated by the members to act on their behalf.  
A managing member’s role is similar to that of a general partner in a partnership. A manager of an LLC need not be a member in some states, but the members must agree to the manager’s designation and specific responsibilities.  
In some states, LLCs are required to include a statement about any manager(s) of the entity in the registration papers filed with the state. |
| Investor Member | References to investor members in the Articles of Organization or Operating Agreement may indicate the presence of members who have agreed to a restrictive role in managing the LLC.  
Investor members can have roles similar to limited partners in a partnership. |
| Board of Governors | Some states require an elected board of governors, although the members still retain some rights to the management of the LLC. |
| Advantages | The major advantages of an LLC are:  
- Limited liability for all of its members, like a corporation  
- Possible pass-through tax treatment like a partnership, without any of the restrictions that an S corporation has, and  
- Overall flexible management structure and ownership |
Determining Entity Status for Federal Tax Purposes

**Separate Entity**
An organization that is recognized, for federal tax purposes, as a separate entity is either:

- A Trust or
- A Business Entity, unless the Internal Revenue Code provides for special treatment for the entity

**Trusts**
Treas. Reg. § 301.7701-4 defines a trust.

**Corporations**
Certain business entities are deemed to always be corporations according to Treas. Reg. § 301.7701-2:

- Entities described as corporations under federal or state law
- Joint-stock companies
- Insurance companies
- Certain banks
- Government-owned business entities that are not integral parts of the state
- Organizations treated as corporations under special Code provisions
- Certain business entities formed in certain foreign countries and U.S. possessions. Reg. 301.7701-2(b)

**“Check the Box” Business Entity**
The "check the box" regulations at Reg. 301.7701-1 (T.D. 8697, 1997-1 C.B. 215, 61 F.R. 66584), effective January 1, 1997, allow certain organizations to choose treatment as a **partnership, corporation, or disregarded entity** for federal tax purposes.

An LLC is one such "check the box" organization.

A clarification of the proper entity status may be needed before any other LLC issues can be developed.

*Continued on next page*
Determining Entity Status for Federal Tax Purposes, Continued

At Least Two Members

In general, eligible “check the box” entities with at least two members, can be classified as:

- A Partnership, or
- An Association (taxable as a corporation per Reg. § 301.7701-3)

Single Member

In general, an eligible “check the box” entity with a single member, can be classified as:

- An Association (taxable as a corporation per Reg. § 301.7701-3) or
- Disregarded as a Separate Entity (treated as a branch or division of the member and included in the member’s annual information return)

Default Classification

By default, a domestic eligible entity with two or more members is generally a partnership, and a domestic eligible entity with a single member is disregarded as a separate entity (treated as a branch or division of the single member and included in the member’s annual information return).

Disregarded Entity Status

Announcement 99-102 (Exhibit 7-1) clarified that an LLC wholly owned by a single member may be disregarded as an entity separate from the owner for federal tax purposes.

The Announcement specifically referred to a situation where the single exempt member [exempt under IRC 501(a)] of a disregarded LLC could treat the operations and finances of the LLC as its own for tax and information reporting purposes.

There would be no need to file an application for exempt status for the LLC since the LLC would be treated as a branch or division of the single exempt member and included in the member’s annual information return.

The new Form 990 (Part IX) solicits information relating specifically to disregarded entities.

Introduction to Limited Liability Companies (LLCs)

10B-6
Development of LLC Exemption Issues

**LLC Applicant for Tax Exempt Status**

By virtue of Treas. Reg. § 301.7701-3(c)(1)(v)(A), all LLC applicants for tax exempt status are treated as associations.

The 2001 Exempt Organizations CPE text provides guidance for when an LLC can qualify for exemption under 501(c)(3) (other than as a disregarded entity with a sole exempt organization owner).

The guidance provided can also be applied to requests for tax exempt status under section 501(c)(4) of the Code. For sections other than 501(c)(3) or 501(c)(4), the issues should be coordinated with EO Technical. In addition, coordination with EO Technical for any unprecedented issues involving LLC applicants is recommended.

**12 Conditions for 501(c)(3)**

The Service will recognize the 501(c)(3) exemption of an LLC that otherwise qualifies for exemption if it satisfies each of the 12 conditions below. The conditions are designed to ensure that the organization is organized and will be operated exclusively for exempt purposes, and to preclude inurement of net earnings to private shareholders or individuals.

1. The organizational documents must include a specific statement limiting the LLC’s activities to one or more exempt purposes.

2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.

3. The organizational language must require that the LLC’s members be section 501(c)(3) organizations or governmental units or wholly owned instrumentalities of a state or political subdivision thereof (“governmental units or instrumentalities”).

4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a section 501(c)(3) organization or governmental unit or instrumentality.

5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether directly or indirectly) any nonmember other than a section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value.

Continued on next page
12 Conditions for 501(c)(3) (continued)

6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.

7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with section 501(c)(3).

8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.

9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in section 501(c)(3) or governmental units or instrumentalities.

10. The organizational language must contain an acceptable contingency plan in the event one or more members ceases at any time to be an organization described in section 501(c)(3) or a governmental unit or instrumentality.

11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.

12. The LLC must represent that all its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

In some states, the Articles of Organization appear to be the controlling document while in others the Operational Agreement seems to control.

For administrative convenience, the Service requires that both the Articles of Organization and the Operating Agreement separately comply with the 11 conditions above (the 12th condition is met in a separate written statement from the organization).

Continued on next page
Further State Statute Problems

A few states may prohibit the inclusion of any information in the Articles of Organization other than certain specified items (e.g., name, address, whether the members manage the organization). For those states, the 11 provisions set forth above may be included in the Operating Agreement only, so long as there are no conflicting provisions in the Articles of Organization.

Other state statute problems pertain to:

- Purposes
- Dissolution provisions

Becoming familiar with the respective state statutes is particularly important when working an application from an exempt LLC.

Purposes

Some states (e.g. California, Indiana, Iowa, Maryland, Minnesota, New York, North Dakota, Rhode Island, Texas, Utah, and Virginia) and the District of Columbia appear to require that an LLC be formed for a business purpose. In such states, it is questionable whether an LLC may be formed as a 501(c)(3) charitable organization.

However, absent state case law to the contrary, the Service is willing to recognize exemption based on the LLC’s representation that its charitable status is permitted under state law, and that the provisions set forth above are enforceable.

Dissolution Provisions

The cy pres doctrine may not be relied upon to meet the organizational test for a 501(c)(3).
Development of LLC Exemption Issues, Continued

Disregarded Entity, Not Activity

While an LLC may be disregarded as a separate entity, it should not be disregarded as an activity.

Whenever an exempt organization references involvement with an LLC or the intent to establish an LLC, the governing documents and information regarding the LLC's activities and finances should be obtained and reviewed.

The presence of solely charitable members does not ensure the LLC will be operated for exclusively charitable purposes.

See Rev. Rul. 72-369, 1972-2 C.B. 245 that describes an organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations that was not exempt under IRC 501(c)(3).

Unrelated business activities and related party transactions of a disregarded entity may adversely affect the exempt status of an exempt owner.

Special care should be taken to insure that disregarded LLCs are not used as a device to thwart the various rules governing exempt organizations.

Employment Tax Issues

Currently, disregarded entities are still allowed to choose between regarded or disregarded status for employment tax purposes.

Partnership Issues

When an exempt organization refers to the following in the Articles of Organization, Operating Agreement, or activity description, consideration should be given for transfer of the case to a grade 13 agent for possible development of a partnership issue:

- Investor members
- Tax credits
- Syndication, Syndicators, etc.

Additional Resources

IRM 7.20.4-12, Limited Liability Company Reference Guide Sheet and Guide Sheet Instructions

2001 CPE Text, Topic B, Limited Liability Companies as Exempt Organizations
Announcement 99-102

Changes to the Instructions to Forms 990, 990-EZ, 990-T, and 990-PF to clarify reporting by organizations of activities of entities disregarded as separate from the organization for federal tax purposes.


October 25, 1999

[1]

On January 13, 1997, final regulations under section 7701 of the Internal Revenue Code pertaining to the classification of certain business organizations under an elective regime were published in the Federal Register. See 26 C.F.R. 301.7701-1 et seq. These regulations provide that an entity wholly owned by a single owner may be disregarded as an entity separate from the owner. When an entity is disregarded as separate from its owner its operations are treated as a branch or division of the owner. Therefore, an owner that is exempt from taxation under section 501(a) of the Internal Revenue Code must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return. Accordingly, the instructions to the 1999 Forms 990, 990-EZ, 990-T, and 990-PF will be modified.

The principal authors of this announcement are Lynn Kawecki and Marvin Friedlander. For further information regarding this notice contact Mr. Kawecki at (202) 622-7922 or Mr. Friedlander at (202) 622-8715 (not toll free numbers).
Lesson 10
Section C

Overview of Foreign Organizations

Overview

Introduction
An organization formed under foreign law may qualify as an exempt organization under IRC section 501(a), providing that it meets the tests for exemption under that section. However, certain subparagraphs of IRC section 501(c) limit their description to domestic entities.

Applications from foreign organizations are a reserved inventory category. This lesson will provide a general overview of the requirements for exemption of foreign organizations and the issues related to these applications.

Objectives
At the end of this lesson you will be able to:

- Distinguish between a “domestic” and a “foreign” organization
- Describe the application process for foreign organizations
- Identify the requirements for exemption of foreign organizations
- Apply the contribution rules applicable to foreign organizations
- Identify the special provisions for organizations organized and operated in U.S. territories
- Determine the effect tax treaties may have on foreign organizations

Continued on next page
Overview, Continued

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Overview of Foreign Organizations
10-C-2
Definitions and General Rules

**Domestic**

IRC section 7701(a)(4) provides that the term “domestic” means created or organized in the United States or under the law of the United States or of any State, when applied to a corporation or partnership.

**Foreign**

IRC section 7701(a)(5) states that the term “foreign” when applied to a corporation or partnership means a corporation or partnership that is not domestic.

Therefore, the definition of a foreign organization generally means that the organization is not organized under United States law.

**Foreign Trust**

IRC section 7701(a)(31)(B) defines a foreign trust to be one not described in IRC section 7701(a)(30)(E).

IRC section 7701(a)(30)(E) describes a trust as a “United States person” if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons (as defined in IRC section 7701(a)(30)) have the authority to control all substantial decisions of the trust.

**U.S. Territories**

As a general rule, charitable entities created in U. S. territories are not treated as domestic organizations.

The term “United States” includes only the 50 States and the District of Columbia.
Entities Created in U.S. By Foreign Organizations

Establishment and control of a domestic organization by foreign persons (corporations, trusts, or individuals) does not make an organization that was created or organized in the United States a foreign organization.

Example

A corporation organized in Delaware by a French school was found to be a domestic organization (Bilingual Montessori School of Paris, Inc. v. Commissioner, 75 T.C. 480 (1980)).

Applications such as these require special attention to the “discretion and control” of funds used in foreign countries as the nature of the disbursements may affect the issue of deductibility of contributions to the organization. This topic has been addressed in previous training.

IRC Section 501(a) Exemption

An organization formed under foreign law may qualify for exemption under IRC section 501(a). (Rev. Rul. 66-177, 1966-1 C.B. 132)

Foreign organizations cannot qualify for exemption under IRC sections 501(c)(1), (c)(19), (c)(20), (c)(21), (c)(22), (c)(23), (c)(26), and (c)(27) because these Code sections only describe domestic entities.

A nonexempt foreign organization is treated as a foreign taxpayer subject to the tax provisions of IRC sections 871, 881, 1441, and/or 1442.

Case Handling

Applications from organizations not organized under United States law are currently reserved for Group 7821 in Cincinnati. Additionally, with the exception of U.S. territories, all other applications from organizations not organized under United States law are subject to QA Mandatory Review per IRM 7.20.5.4(3)m.

Overview of Foreign Organizations

10-C-4
Application Process

Filing Provisions

Unless excepted by provisions of a tax treaty, a foreign organization seeking exemption must file an application:

- Form 1023 if seeking exemption under IRC section 501(c)(3)
- Form 1024 if seeking exemption under most other Code sections

Special Requirements

Special requirements include:

- Application for exemption under a Code section for which no form is provided must contain sufficient information to demonstrate qualification under that section.
- All documents submitted with an exemption application must be written in English or accompanied by an English translation.
- All financial information must be submitted in U.S. dollars.
- A conversion rate is required if dollar amounts are converted from foreign currency.

508(a) Timely Filing

A foreign organization is subject to the same timely filing notice rule of IRC section 508(a) as a domestic organization. (Treas. Reg. 1.508-1(a)(2)(vi))

IRC section 508(a) applies only to organizations seeking exemption under IRC section 501(c)(3).

A similar timely filing notice rule applies under IRC section 505 to organizations seeking exemption under IRC section 501(c)(9). These filing requirements are similar to those applied under IRC section 508(a).

Continued on next page
Exemption Requirements

General Rule
To qualify for exemption, a foreign organization must show that it meets the requirements of that particular subsection in the same manner as a domestic organization.

Organizational Test
A foreign organization that applies for exemption under IRC section 501(c)(3) must have the proper organizational language required under Treas. Reg. 1.501(c)(3)-1(b) in its governing document. However, specific citation of the U.S. Internal Revenue Code section is not required.

If the foreign organization claims that the terms of the purpose clause in its organizing document have a meaning different from the generally accepted meaning in the U.S., they must establish such meaning by clear and convincing reference to relevant court decisions or other evidence of applicable law of the foreign country in which the organization is created.

Foreign organizations cannot argue that their local law obtains the same result irrespective of inclusion of a proper dissolution clause.

Exception
If the foreign organization would have to incur significant delay or expense to obtain judicial approval of an amendment to their organizing document, they should be afforded an opportunity to demonstrate that under the foreign law assets are appropriately dedicated.

IRC Section 508(e) Requirements
Foreign private foundation applicants that receive more than 15% of support from U.S. sources (not including investment income) are subject to the governing provisions of IRC section 508(e)(1). (IRC section 4948(b))

No foreign government, including Canada, has enacted a provision for satisfying the governing language requirement under IRC section 508(e), and, therefore, the governing instrument must include the IRC section 508(e) provisions.

Continued on next page
Exemption Requirements, Continued

**Operational Test**

A foreign organization that applies for exemption under IRC section 501(c)(3) must meet the operational test in the same manner as U.S. entities. Impermissible private benefit or inurement may prohibit exemption under this subsection.

**Example 1**

Q & A

Q. A local custom provides that the foreign IRC section 501(c)(3) applicant will give money to needy relatives of the founder’s family using separate money not received for charitable purposes from the U.S. Will exemption be denied?

A. Reliance on local law or custom as to what constitutes a charitable operation will not prevent an inquiry into whether private benefit or inurement is involved. Exemption may be denied under IRC section 501(c)(3) on the grounds of inurement, serving a private interest, and/or failing to serve charitable purposes.

**Example 2**

Q & A

Q. What if the applicant were to use the funds only for charitable purposes?

A. The applicant would still have to account for its funds by establishing that it retains discretion and control over the use of the funds by maintaining the types of records required by Rev. Rul. 56-304, 1956-2 C.B. 306, and Rev. Rul. 68-489, 1968-2 C.B. 210.

**Supporting a Foreign Government**

Supporting a foreign government is not a recognized charitable purpose since foreign governments engage in many kinds of activities.

**Political Activity**

Foreign organizations seeking exemption under IRC section 501(c)(3) are prohibited from engaging in political activity in the same manner as U.S. entities seeking exemption under that subsection.

Continued on next page
### Lobbying

Engaging in substantial legislative action is a basis for denial of exemption under IRC section 501(c)(3).

Rev. Rul. 73-440, 1973-2 C.B. 177, concludes that the term “legislation” includes foreign as well as domestic laws for purposes of the IRC section 501(c)(3) lobbying restrictions.

A foreign charity can make an election under IRC section 501(h) to come within the lobbying limits set forth in IRC section 4911.

### Special Consideration - Foreign Lobbying

In foreign countries with an authoritarian or theocratic regime where the legislative process may lack the integrity of democratic governments, it may be improper to characterize various types of resolutions or edicts as “legislation” as defined in Treas. Reg. 1.501(c)(3)-1(c)(3)(ii) and Treas. Reg. 56.4911-2(d).

### Private Schools


### Exception for Foreign Schools

In certain situations, a foreign school may demonstrate that the racial discrimination information is impossible to collect because collecting it would be illegal under foreign law or else impractical under its circumstances. If so, it may provide specific evidence, such as a copy of the relevant law or regulation and an English translation thereof, and the Service may waive as much of the information required by Rev. Proc. 75-50 as is based upon such evidence.

### Activities Contrary to Public Policy

The conduct of illegal activities contrary to clearly defined public policy will jeopardize IRC section 501(c)(3) exemption irrespective of where the activity is conducted. (Rev Rul. 80-278, 1980-2 C.B. 175, and Rev. Rul. 75-384, 1975-2 C.B. 204)
# General Contribution Rules

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General Rule</strong></td>
<td>A charitable deduction is allowed under IRC section 170(c)(2)(A) only if made to an organization created or organized in the United States or in any territory thereof or under the law of the United States, any State, the District of Columbia, or any territory of the United States.</td>
</tr>
<tr>
<td><strong>Exception for Tax Treaty</strong></td>
<td>Certain tax treaties allow for cross-border charitable contributions. Generally, the deduction for charitable contributions is limited to the applicable percentage of the taxpayer’s income received in the foreign country.</td>
</tr>
<tr>
<td><strong>Implemented Tax Treaty</strong></td>
<td>Currently there is only one implemented tax treaty which is with Canada. Charitable contributions to Canadian charities are tax deductible to the extent allowed by law even though the charitable organization has not applied for recognition of exemption in the United States.</td>
</tr>
<tr>
<td><strong>Non-Implemented Tax Treaty</strong></td>
<td>Charitable contributions made to charitable organizations located in a country with a tax treaty with the United States which has not been fully implemented are limited to the provisions in that tax treaty. Charitable contributions are limited to those charitable organizations that have established their exemption with the United States.</td>
</tr>
<tr>
<td><strong>Estate and Gift Tax Contributions</strong></td>
<td>Bequests to charitable foreign organizations are deductible in computing the taxable estate of a deceased resident or citizen of the United States for United States estate tax purposes under Treas. Reg. 20.2055-1(a). Gifts of property to foreign charitable organizations are deductible in computing the United States gift tax of a resident or citizen of the United States under Treas. Reg. 25.2522(a)-1(a).</td>
</tr>
</tbody>
</table>
Form 1023 Special Contribution Provisions

Disclosure Statement Required

A foreign organization must acknowledge in its Form 1023 application that contributions to it are not deductible under IRC section 170.

Organizations from Tax Treaty Countries

Charitable organizations located in a country that has a tax treaty with the United States that allows cross-border charitable contributions should include a statement in its Form 1023 application that contributions to it are governed by the relevant treaty.

If the application does not make the statement on the application, one should be secured.

The charitable organization should supply a copy of its exemption certificate from its country to establish that it is qualified to receive deductible contributions under IRC section 170.

Applicable Favorable Pattern Paragraphs

If the appropriate statement is included in the application or secured from the organization, an appropriate pattern paragraph(s) would be included in a favorable ruling letter as follows:

- Deductibility paragraph for IRC section 501(c)(3) Canadian colleges and universities

- Deductibility paragraph for all other IRC section 501(c)(3) Canadian organizations

- Deductibility paragraph for IRC section 501(c)(3) foreign organizations other than Canadian organizations

Failure to Provide Statement

Failure to provide an appropriate statement will require that the tax deductibility of contributions be denied whether or not exemption is recognized.

The closing letter should include the protest, conference, and declaratory judgment rights afforded under IRC section 7428.
United States Territories

United States territories include:

- Puerto Rico
- U.S. Virgin Islands
- Guam
- American Samoa
- Commonwealth of Northern Mariana Islands
- Marshall Islands
- Federated States of Micronesia

(IRC sections 7651, 7654(b)(2), and 7701(d))

Tax Treatment

Organizations formed in U.S. territories are not treated as domestic organizations since IRC section 7701(a)(9) defines the United States as including only the 50 States and the District of Columbia.

Special Provisions

U.S. territories may be treated as domestic organizations for these specific purposes:

- Contributions to such organizations are tax deductible under IRC section 170(c)(2).
- Organizations created in U.S. territories utilize United States social security and employment tax systems.
- The general rules applicable to filing Forms 990, 990-EZ, 990-N and 990-PF apply.

UBI

Organizations in U.S. territories are taxed only on their U.S. source unrelated business income. (IRC section 512(a)(2))
## Tax Treaties

<table>
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<tr>
<th>Introduction</th>
<th>As a general rule, the Service does not recognize determinations made by a foreign government that an organization is an exempt entity unless a tax treaty allows for such recognition.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notice 99-47 Exemption Provisions</td>
<td>Tax exempt organizations that are organized under the laws of either the U.S. or Canada will automatically receive recognition of exemption without application in the other country.</td>
</tr>
<tr>
<td></td>
<td>A Canadian registered charity will automatically be recognized as tax exempt by the Service without the need to apply for exemption.</td>
</tr>
<tr>
<td></td>
<td>U.S. organizations must be recognized as exempt under IRC section 501(c)(3) to qualify for automatic recognition by the Canada Revenue Agency.</td>
</tr>
<tr>
<td>Notice 99-47 Contribution Provision</td>
<td>The following are the contribution provisions of Notice 99-47:</td>
</tr>
<tr>
<td></td>
<td>- A U.S. donor can make a tax-deductible donation to a Canadian registered charity, limited to 30% or 50% of the donor’s Canadian-source income.</td>
</tr>
<tr>
<td></td>
<td>- Donors may carry forward excess contributions and deduct them in subsequent tax years, subject to the same limitation.</td>
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<tr>
<td></td>
<td>- If the recipient is a Canadian college or university at which the donor or a member of the donor’s family is or was enrolled, the donor may deduct such contributions from other than Canadian source income, but subject to the 30% or 50% limitation.</td>
</tr>
<tr>
<td></td>
<td>- Although a Canadian registered charity is not required to apply for exemption, a donor will be required to show that the organization is a Canadian registered charity.</td>
</tr>
<tr>
<td></td>
<td>- Although automatically exempt, a Canadian registered charity is presumed to be a private foundation under U.S. law and a U.S. donor will be subject to a 30% deduction limitation for the contribution.</td>
</tr>
</tbody>
</table>

*Continued on next page*
Tax Treaties, Continued

Classification as Public Charity

A Canadian registered charity that seeks recognition as a public charity must provide sufficient information to show that it qualifies for public charity classification.

Qualifying publicly supported Canadian registered charities will be listed in Publication 78 as a foreign organization and will be eligible to receive contributions deductible up to 50% of the donor’s Canadian source income.

If a qualifying Canadian registered charity submits information and it is determined that it is a private foundation, the charity will be listed in Publication 78, but deductible contributions will be limited to 30% of the donor’s Canadian source income.

Requesting Recognition under 501(c)(4)

A religious, scientific, literary, educational, or charitable organization formed in Canada that has received a Form T2051 (Notice of Registration) from the Canada Revenue Agency and whose registration has not been revoked may apply for recognition as a social welfare organization under IRC section 501(c)(4) without completing all parts of Form 1024. Such an organization must complete only Part I and the signature portion of Form 1024. For more information, refer to the Instructions for Form 1024, page 2, "Special Rule for Certain Canadian Organizations."

Additional Information

For more information, refer to the 2001 EO CPE text, Exemption of Canadian Charities Under the United States-Canada Income Tax Treaty.

Other Treaties

Treaties negotiated between the United States and a foreign country are subject to ratification and implementation before becoming effective. (Rev. Rul. 83-144, 1983-2 C.B. 295)

For a list of countries that have tax treaties with the U.S. and a brief summary of these treaties, refer to the IRS website at:

## Final Items

| Further Guidance | Refer to IRM 7.20.4.5 (*Foreign Applications*) for a summary of the case processing procedures for foreign organizations. |
| Foreign Contacts  | When corresponding by mail with foreign applicants, be sure to follow your local procedures for ensuring adequate postage is used on the mailings. Additionally, be aware that only certain telephone and fax lines are equipped to handle calls to foreign countries. |

*Overview of Foreign Organizations*

10-C-14
A “foreign” organization is generally defined as an organization that is not organized under United States law. This includes organizations organized in U.S. territories. Organizations formed under foreign law may qualify for exemption under IRC section 501(a) but are precluded from exemption under certain subsections of IRC section 501(c).

The application process and exemption requirements for foreign organizations are substantially the same as for domestic organizations. However, special filing requirements and other special provisions may be applicable.

In general, contributions to organizations formed under foreign law are not tax deductible by the donor. Exceptions to this rule include deductibility of contributions to organizations formed in U.S. territories and deductibility provisions within tax treaties. Organizations may be required to include specific acknowledgements in their applications for exemption regarding deductibility. In addition, appropriate language should be included in determination letters issued to such organizations regarding the deductibility of contributions.

As a general rule, the Service does not recognize determinations made by a foreign government that an organization is an exempt entity unless a tax treaty allows for such recognition. Currently, the only tax treaty which allows such recognition is with Canada.

Applications from organizations not organized under United States law are currently reserved for Group 7821 in Cincinnati.
Overview of IRC Section 501(d)

Overview

Introduction
IRC section 501(d) provides exemption for religious or apostolic associations or corporations.

Applications for exemption under this Code section are a reserved inventory category.

Additional information on exemption under IRC section 501(d) can be found in IRM 7.25.23.

Objectives
At the end of this lesson you will be able to:

- Identify organizations that qualify for exemption under IRC section 501(d)

In This Lesson
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Background and Requirements for Exemption

Legislative History

The provisions contained in IRC section 501(d) date back to the Revenue Act of 1936 and were added to the law for the following reasons:

"It has been brought to the attention of the committee that certain religious and apostolic associations and corporation, such as the House of David and the Shakers, have been taxed as corporations, and that since their rules prevent their members from being holders of property in an individual capacity, the corporations would be subject to the undistributed-profits tax. These organizations have a small agricultural or other business. The effect of the proposed amendment is to exempt these corporations from the normal corporation tax and the undistributed-profits tax,* if their members take up their shares of the corporations' income on their own individual returns. It is believed that this provision will give them relief, and their members will be subjected to a fair tax." 80 Cong. Rec. 9074 (1936)

* Now called Accumulated Earnings Tax (IRC sections 531-537)

Requirements for Exemption

IRC section 501(d) provides exemption for a religious or apostolic association or corporation if:

- it has a common or community treasury, even if it engages in business for the common benefit of its members; and
- the members include in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for the year

Any amount included in the gross income of a member is to be treated as a dividend received.
General Characteristics

In general, the type of organization exempt under IRC section 501(d) is one:

- Organized for the purpose of operating a communal religious community
- Where the members live a communal life
- Following the tenets and teachings of the organization

All of the organization's property is owned in community and, each member, upon leaving the organization, is entitled to no part of the community assets.

The activities often consist of farming and manufacturing.

The income of the organization goes into a community treasury and is used to defray operating expenses and the cost of supporting and maintaining the members and their families. (Rev. Rul. 57-574, 1957-2 C.B. 161)
### Relevant Tax Law

#### Related Rulings

In *Kleinsasser v. United States*, 707 F. 2d 1024 (1983), the 9th Circuit Court of Appeals commented:

> The only requirements for the exemption are that there be a common treasury, that the members of the organization include pro-rata shares when reporting taxable income, and implicitly, that the organization have a religious or apostolic character. Once this requirement of form is fulfilled, the exempt organization is unlimited as to function.

In Rev. Rul. 78-100, 1978-1 C.B. 162, an organization was created to promote the tenets and practices of a particular church, did not conduct any business activity, and was supported by wages earned by members from outside employment. The organization did not qualify for exemption under 501(d) of the Code since it was supported by wages from outside employment and not an internally operated business.

In *Twin Oaks Community, Inc. v. Commissioner*, 87 T.C. 1233 (1986), the Tax Court rejected the Service position that the requirement for a common treasury meant that members must take a vow of poverty and irrevocably contribute all of their property to the organization. The court held that a community treasury exists when all income internally generated by the community operated business and all income derived by the organization from its property is placed in a common fund and used for the maintenance and support of its members, with all members having an equal undivided interest in the fund, but no right to claim title to any part of it.

*Peggy Lou Riker and Freda H. Grassmee v. Commissioner*, 244 F.2d 220 (1957), involved a member of a church owned a restaurant which she managed as a church project. The gross receipts were turned over to the church and the church paid all expenses. The court held that where the taxpayer operated a restaurant as a private business for profit and donated the entire profits to a church and its committee and the committee was a part and parcel of the church and the church itself was engaged in commercial activities and not devoted exclusively to religious matters, contributions by taxpayer were not deductible from the taxpayer's income taxes on the ground that the church or the committee qualified as a religious organization.

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*Continued on next page*
Filing Requirements

**Requesting Exemption**

An organization requesting exemption under IRC section 501(d) does not file Form 1023 or Form 1024. Any form of written application is acceptable and must include the specific information noted in Rev. Proc. 72-5, 1972-1 C.B. 709.

**Filing Requirements**

Under Treas. Reg. 1.6033-2(e) and the filing instructions for Form 1065, an IRC section 501(d) organization is required to file a partnership return on Form 1065. As required by IRC section 501(d), members report their pro rata share of the organization's income as a dividend on their individual tax returns.

IRC section 501(d) organizations are required to have their annual Form 1065 return available for public inspection for three years after the due date of Form 1065.
Summary

IRC section 501(d) provides exemption for a religious or apostolic association or corporation if it has a common or community treasury (even if it engages in business for the common benefit of its members) and the members include in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for the year.
Lesson 11

Overview of Grade 13 Case Topics

Overview

Introduction
Specialists will routinely encounter Grade 13 issues when reviewing cases which have been previously marked as Grade 12. It is also important for specialists to know the difference between Grade 12 and Grade 13 cases when screening cases as part of the technical screening program. This lesson will provide a broad overview of some of the more common Grade 13 issues.

Objectives
At the end of this lesson, you will be able to apply the various requirements which the following organizations must meet to qualify for tax exempt status:

- Hospitals
- Organizations Involved in Medical Research
- Organizations Involved in Scientific Research
- Instrumentalities
- Organizations Selling Homes to Low/Moderate Income Individuals
- For-Profit Successors
- Organizations Involved in Public Policy Issues
- Public Interest Law Firms
- Previously Revoked Organizations

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# Overview, Continued

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<td>Previously Revoked Organizations</td>
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<tr>
<td>Summary</td>
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</tr>
</tbody>
</table>
Hospitals

Introduction

By “hospitals,” we are referring to organizations classified under IRC section 170(b)(1)(A)(iii) as hospitals. “Health clinics” and “rural medical facilities” are subsets of the “Health Care” category and were reclassified as Grade 11 issues under the most recent revision of the Case Assignment Guide (CAG).

Community Benefit Standard

Under Rev. Rul. 69-545, 1969-2 C.B. 117, a hospital must meet a community benefit standard to be exempt as an organization described in IRC section 501(c)(3). Organizations promoting health may be charitable provided they are not operated in a proprietary manner and the class of beneficiaries is sufficiently large and indeterminate to benefit the public as a whole.

Prior to Rev. Rul. 69-545, tax exempt hospitals were required by Rev. Rul. 56-185, 1956-1 C.B. 202, to admit and treat patients who were unable to pay, either without charge or at rates below cost. This requirement was referred to as the “financial ability standard” because this uncompensated care had to be provided to the extent of the hospital’s financial ability.

Rev. Rul. 69-545 modified Rev. Rul. 56-185 by removing the financial ability standard and substituting a new test known as the “community benefit standard.” The community benefit standard, which remains the standard applied by the Service today, focuses on a number of factors indicating that the operation of the hospital benefits the community as a whole. The redesigned Form 990 released in December 2008 contains a schedule emphasizing adherence to this test. Schedule H to Form 990 (Hospitals) attempts to gather sufficient evidence to quantify the community benefit standard for a hospital.

Continued on next page
Hospitals, Continued

Factors to Consider

To determine whether a hospital meets the standard, the following factors should be considered:

- Does the hospital have a governing board, community board, board of trustees, or board of directors composed of prominent civic leaders rather than hospital administrators, physicians, etc.?

- If the organization is part of a multi-entity hospital system, do the minutes reflect corporate separateness?

- Is admission to the medical staff open to all qualified physicians in the area, consistent with the size and nature of the facilities?

- Does it operate a full-time emergency room open to everyone, regardless of his or her ability to pay? (Rev. Rul. 83-157, 1983-2 C.B. 94, in some situations, allows hospitals not to operate an emergency room.)

- Does it provide non-emergency care to everyone in the community who is able to pay either privately or through third parties including Medicare and Medicaid?

- Does it serve a broad cross-section of the community through research or charity care (as defined in Rev. Rul. 56-185)?

Continued on next page
The regulations do not contain a short, simple definition of a hospital. Instead, they give examples of organizations that are hospitals and those that are not.

The Service released an Executive Summary of its Hospital Study in February of 2009. The report underscored the fact that the community benefit and reasonable compensation standards for hospitals have proved difficult to administer. The report condensed the findings of responses to questionnaires sent to a sample of more than 500 nonprofit hospitals. To obtain information about community benefit practices and reporting, the questionnaire requested information regarding the hospital’s patient mix, emergency room, board of directors, medical staff privileges, and programs such as medical research, professional education and training, uncompensated care, and community programs.

The Service released extensive data and statistics on its findings relating to hospital expenditures for varying categories and sizes of hospitals but declined to revise or quantify the degree of community benefit required for a hospital to maintain its exempt status. Such lack of precise standards further justifies the need for these applications to be worked by Grade 13 specialists.

Certain hospital issues subject an application to mandatory review by Quality Assurance. Refer to IRM 7.20.5.4(3)e, which lists, among others, health care organizations that are integrated delivery systems, hospitals at which physician practices or physician facilities (e.g., MRI, ambulatory surgery center, etc.) have been purchased or where compensation is based on net profits or earnings, hospital management service organizations, etc.

Continued on next page
Hospitals, Continued

EO Technical

Certain applications involving hospitals are reserved for EO Technical. For example: applications for hospitals and health care providers not clearly covered by Rev. Rul. 69-545, including hospitals participating in whole hospital joint ventures described in Rev. Rul. 98-15, faculty group practice organizations, physician-hospital organizations, individual practice associations, and corporate practice of medicine (IRM 7.20.1.3.4(3)). Additionally, applications from cooperative hospital service organizations for activities not specifically enumerated under IRC section 501(e) are reserved for EO Technical (IRM 7.20.1.3.4(10)).

Another recent development in healthcare involves promoting the use of electronic patient records as a means to improve the delivery of healthcare services and patient outcomes. Two initiatives include regional health information organizations (RHIOs) and electronic health record (EHR) systems. Some of these organizations are created and affiliated with hospitals. The IRS Memorandum from Joe Urban dated March 22, 2006, mandates EO Technical transfer for applications involving electronic patient records, so be aware of hospital applications involving this issue.

Further Guidance

For more information on hospitals classified under IRC section 170(b)(1)(A)(iii), refer to IRM 7.26.2.4, Hospitals and Medical Research Organizations, the Health Care Providers Reference Guide Exhibit in IRM 7.20.4-9, as well as the 2004 EO CPE article entitled Health Care Provider Reference Guide.

Overview of Grade 13 Case Topics

11-6
## Medical Research

<table>
<thead>
<tr>
<th>Introduction</th>
<th>Historically, hospitals have conducted medical research activities and other hospital service activities necessary for the efficient operation of the hospital system. These activities can be conducted under the umbrella of the exempt hospital entity or as separate entities within the hospital system.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition</td>
<td>The description of a medical research organization is found in Treas. Reg. 1.170A-9(d)(2)(i) and states, in part, “An organization qualifies as a medical research organization if the principal purpose or functions of such organization are medical research and if it is directly engaged in the continuous active conduct of medical research in conjunction with a hospital.”</td>
</tr>
<tr>
<td>Active Involvement</td>
<td>According to Treas. Reg. 1.170A-9(d)(2)(v), to satisfy the “Operational Test” for a medical research organization, the organization must be primarily engaged directly in the continuous active conduct of medical research. The best evidence of an organization being primarily engaged directly in the continuous active conduct of medical research is when the organization either devotes a substantial part of its assets to, or expends a significant percentage of its endowment for, such purposes.</td>
</tr>
<tr>
<td>Medical Research in Conjunction with a Hospital</td>
<td>According to Treas. Reg. 1.170A-9(d)(2)(vii), an organization need not be formally affiliated with a hospital to be considered primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital. But, in any event, there must be a joint effort on the part of the research organization and the hospital pursuant to an understanding that the two organizations will maintain continuing close cooperation in the active conduct of medical research.</td>
</tr>
<tr>
<td>Active Medical Research</td>
<td>Engaging directly in the continuous active conduct of medical research does not include the disbursing of funds to other organizations for the conduct of research by them or the extending of grants or scholarships to others. Therefore, if an organization’s primary purpose is to disburse funds to other organizations for the conduct of research by them or to extend grants or scholarships to others, it is not primarily engaged directly in the continuous active conduct of medical research.</td>
</tr>
</tbody>
</table>
Scientific Research

Introduction
The issues pertaining to scientific research are similar to those encountered in applications involving medical research. However, organizations involved in scientific research are typically not affiliated with hospitals. They may be affiliated with other for profit companies or private interests. Since these private interests are more likely to be present in these types of applications, the risk of private benefit or inurement is normally greater.

Research in the Public Interest
Treas. Reg. 1.501(c)(3)-1(d)(5)(iii) holds the following to be research carried on in the public interest if:

- The results of the research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis.
- Such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or
- Such research is directed toward benefiting the public.

Examples of Activities Benefiting the Public
The following are cited as examples of activities that benefit the public:

- Scientific research carried on for the purpose of aiding the scientific education of college or university students.
- Scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade-publication, or in any other form that is available to the interested public.
- Scientific research carried on for the purpose of discovering a cure for a disease.
- Scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.

Continued on next page
Scientific Research, Continued

Treas. Reg. 1.501(c)(3)-1(d)(5)(ii) holds:

“Scientific research does not include activities of a type ordinarily carried on as 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, etc.”

Companies already get a tax benefit from writing off such costs as research and development, which should eliminate the need for such activities to be spun off into a tax exempt organization.

Treas. Reg. 1.501(c)(3)-1(d)(5)(iii), supra, holds that scientific research will be held to be carried on in the public interest if the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis.

If a sponsor pays for the research, receives the right to the results, and retains all ownership rights in any patents resulting from work on the project, the activities may still come within the scope of IRC section 501(c)(3) assuming certain factors. The results of research, including all relevant information, must be generally published in such form as to be available to the interested public either currently, as developments in the research warrant, or within a reasonably short time after completion of the project.

However, where publication is significantly delayed (for business reasons) beyond the time necessary to register a patent or copyright, research income may constitute UBI or else prohibit exemption under IRC section 501(c)(3).
Instrumentalities

Introduction
A wholly owned state or municipal instrumentality that is a separate entity and is organized and operated exclusively for purposes described in IRC section 501(c)(3) may qualify for exemption under this paragraph.

General Requirements
Qualifying organizations must meet the following requirements:

- Operated for exempt purposes
- Separately organized entity
- Organizational test
- Not operated as an integral part of government
- Limited regulatory or enforcement powers

Governmental Units
Organizations described in IRC sections 509(a)(1) and 170(b)(1)(A)(v) include a governmental unit such as 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 (governmental units referred to in IRC section 170(c)(1)). Such organizations ordinarily would not qualify under IRC section 501(c)(3) since their purposes are clearly not exclusively those described in IRC section 501(c)(3).

Integral Part
Rev. Rul. 60-384, 1960-2 C.B. 172, reiterated that a state or municipality itself would not qualify as an organization described in IRC section 501(c)(3) since its purposes are clearly not exclusively those described in IRC section 501(c)(3).

This revenue ruling further established that an organization that is operated as an integral part of a state or municipal government is not eligible for IRC section 501(c)(3) exemption, even if it is separately established and it satisfies the organizational test. Such an organization is treated the same as the government of which it is a part and, therefore, does not qualify as an IRC section 501(c)(3) organization.

Continued on next page
### Instrumentalities

#### Regulatory or Enforcement Powers

Rev. Rul. 60-384 provides that even though a wholly owned state or municipal instrumentality may be a separately organized entity, it is not entitled to exemption if it is clothed with powers other than those described in IRC section 501(c)(3).

Three generally acknowledged sovereign powers by which the government exercises its authority are:

- the power to tax
- the power of eminent domain
- police power

#### Form 990 Filing Exception

Treas. Reg. 1.6033-2(g)(1)(vi) provides that governmental units and affiliates of governmental units are not required to file Form 990. Rev. Proc. 95-48, 1995-2 C.B. 418, defines organizations that may be treated as governmental units and those which may be treated as organizations affiliated with government units.

#### Further Guidance

The Exhibit IRM 7.20.4-10 offers a reference guide and an accompanying guide sheet that will assist in processing organizations closely affiliated with State or Indian Tribal Governments. The guide sheet will also help determine whether an organization is excepted from filing Form 990 under Rev. Proc. 95-48.

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*Overview of Grade 13 Case Topics*

11-11

IRS 00605
## Sale of Homes (Low/Moderate Income Housing)

### Introduction
This training has already covered the rental of low or moderate income housing. However, low/moderate income housing involving the sale of homes is a higher-graded issue.

### Private Benefit/Inurement
Applications involving the sale of homes have been upgraded due to the increased risk of private benefit or inurement to individuals or related companies. Rental housing projects may involve related contractors or construction firms, but organizations selling homes may be furthering the interests of real estate companies or individuals looking to “flip” homes, especially in an economy with rampant home foreclosures.

The specialist must also differentiate the home sale activity from that of a commercial operation. All facts and circumstances must be considered.

### Safe Harbor
**not Applicable**
Unlike applications involving rental housing, the safe harbor is not a valid means of justifying exemption for applications involving home sales. Rev. Proc. 96-32, 1996-1 C.B. 717, states that if a project consists of multiple buildings and each building does not separately meet the safe harbor requirements, then the buildings must share the same grounds. Organizations selling homes typically sell homes in scattered locations, rather than in a single neighborhood area. Rev. Proc. 96-32 states that this requirement does not apply to organizations providing individual homes located at sites dispersed throughout the community.

### Facts and Circumstances
The lesson in this training dedicated to low-income housing already discussed the various facts and circumstances that may demonstrate the relief of the poor. Common issues generally considered in applications involving the sale of homes include how down payments on the homes are determined, how the final sales prices of the homes are calculated, whether the organization employs restrictive covenants to prevent quick resale, how any gains generated on property sales are utilized, how mortgage payments are made affordable to the buyers, etc.

Example 3 in Sec. 5.01 of Rev. Proc. 96-32 presents an illustration of an organization assisting individuals who cannot afford to purchase housing without outside assistance.

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*Overview of Grade 13 Case Topics*

11-12
For-Profit Successors

Introduction
This training has already covered applications involving for-profit relationships. However, applications involving bona fide successors to for-profit organizations are now Grade 13 per the CAG. They are typically easy to identify because successors to for-profits are required to complete Schedule G to Form 1023.

Nature of Transition
The nature of the for-profit to nonprofit transition depends on the state law in effect. In some states, the for-profit corporation may be simply converted to a nonprofit. The nonprofit is still the same entity, although with a different form. In other states, it may be required to start a new corporation. The for-profit corporation and the subsequent nonprofit are two distinct entities. If the for-profit corporation was not dissolved, the specialist must find out whether the two organizations will have a continuing relationship.

Case Development
The first step in analyzing the application of a for-profit successor is to determine if its activities qualify for exemption. Typically, the organization is conducting an activity that is prevalent in the business sector, but can also qualify as an exempt organization. For example, a school or daycare.

Next, the specialist should analyze the motives for converting to a nonprofit. The composition of the board of directors is a critical element. The applicant should reveal the owners of the predecessor organization on line 4 of Schedule G; these names must be compared to those on the governing body of the nonprofit. Although conflict of interest policies are preferred for all applications, adopted policies are even more encouraged for successors to for-profit organizations.

Gathering Data
One reason these applications are higher-graded is that advanced investigative techniques must often be utilized to review the financials of the for-profit predecessor to uncover potential ulterior motives for forming the nonprofit. For example, there are situations where an organization may form a nonprofit simply because it was incurring losses as a for-profit. The organization may be trying to transfer liabilities to the nonprofit. If there is a transfer of assets, the nonprofit should generally pay at or below fair market value for all assets. Financial data relating to the for-profit predecessor is not always provided up front; it is not uncommon to request the historical financial data of the predecessor.

Overview of Grade 13 Case Topics
11-13
Public Policy Issues

Introduction
Lesson 1 of Unit 1b already provided a detailed discussion of legislative activities conducted by IRC section 501(c)(3) organizations. It covered the definition of lobbying, action organizations, the substantial part test, and the expenditure test under IRC section 501(h). Closely intertwined is the treatment of sensitive public policy issues, which were reclassified as Grade 13 in the most recent CAG. These cases are typically high profile in addition to being sensitive issues.

Issue Listing
The most common issues encountered in this category, which are individually named in the CAG, are:

- Birth Control Methods
- Sex Education in Public Schools
- Population Control
- Legalized Abortion
- Location of Highway Transportation System
- Ecology and Conservation
- Protection of Consumer Interests
- Medical Care Service Welfare System
- Urban Renewal
- Firearms Control
- National Defense Policy
- Weapons Systems
- Government Spending
- Taxes or Tax Exemption
- Separation of Church and State
- Government Aid to Parochial Schools
- U.S. Foreign Policy / Military Involvement

Continued on next page
Public Policy Issues, Continued

Issue Listing (continued)

Common issues (continued):

• Pacifism and Peace
• Economic and Political System of U.S.
• Anti-Communism
• Right to Work
• Zoning or Rezoning
• Rights of Criminal Defendants
• Capital Punishment
• Stricter Law Enforcement
• Racial Integration
• Use of Intoxicating Beverage / Drugs or Narcotics / Tobacco
• Prohibition of Erotica
• Gay and Lesbian Rights

Education vs. Advocacy

In addition to involving legislative issues, these cases also routinely involve the “education vs. advocacy” principles of Rev. Proc. 86-43, 1986-2 C.B. 729. Organizations may advocate 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.

They may not present viewpoints unsupported by facts, distort the facts, use inflammatory and disparaging terms, or present information without considering the background of their intended audience.

Mandatory Review

Be aware that some of these cases are subject to mandatory review by Quality Assurance per IRM 7.20.5.4(3)d., if they are “impact cases.” Such cases have a controversial issue involved or involve situations where the outcome of the case may cause widespread adverse publicity for the Service. For example, applications involving radical environmental causes.
Public Interest Law Firm

Introduction

Unit 1a discussed legal assistance as a charitable activity, describing organizations providing free legal advice to indigent persons, or even providing such services to the “poor and distressed” at a fee based on their ability to pay. Other litigation activities may be able to qualify as charitable, such as those conducted by public interest law firms.

These firms are specifically formed to engage in litigation, not for individual persons, but for widespread public good in some chosen area of public interest. For example, the preservation of the environment or protection of consumer interests.

Public Interest Criteria

To qualify for exemption, public interest law firms must adhere to the following:

- The litigation must be designed to present a position on behalf of the public at large on matters of public interest
- The organization cannot achieve its objectives by illegal activity or through a program of disruption of the judicial system
- The organization cannot violate any canons of legal ethics

Public Control

To ensure that public interests, not private interests, are being served:

- The organization should be controlled by a public board, not employees or persons who litigate on behalf of the organization
- The physical office space should not create identification or confusion with a private law firm
- Deductions for cost of litigation should not be arranged for the private benefit of the donor
- Reimbursements should only be accepted from clients or opposing parties for direct out-of-pocket expenses incurred in the litigation

Continued on next page
Rev. Proc. 92-59, 1992-2 C.B. 411, sets forth other generally accepted guidelines for public interest law firms. For example, with respect to fees received, the organization may not consider the likelihood or probability of a fee (court awarded or client paid), in the selection of cases. The expectation of fees for services might influence which cases are accepted.

Take note that the guidelines established in the Rev. Proc. are not inflexible; based on the facts and circumstances of the particular program, adherence to the guidelines is not required in certain respects.
# Previously Revoked Organizations

## Introduction
When the exemption of an organization is revoked, and they subsequently reapply for recognition of exemption, special consideration must be given to the new application. These requests are handled by Grade 13 specialists.

## Research
The specialist should always secure the research for the initial application, as well as any further documentation concerning the reason for the revocation itself.

## Coordination with Exam
It is not uncommon to coordinate case processing with the EO Exam agent responsible for revoking the exemption. The organization may be encouraged to reapply under a different subsection by EO Exam. In these situations it is very important to communicate with the EO Exam agent to ensure consistent treatment and learn the history of the revocation.

## Effective Date
Research and coordination with EO Exam are both critical to determine the correct effective date of exemption, if approval is recommended. Granting an effective date predating a date already established by EO Exam may jeopardize their interests.

## Special Rules
Any organization whose exemption under IRC section 501(c)(3) is revoked as an action organization during an examination for engaging in substantial legislative activity or intervention in political campaigns cannot reapply and receive exemption under IRC section 501(c)(4). Refer to IRC section 504.

## Mandatory Review
Applications from previously revoked organizations are subject to mandatory review by Quality Assurance per IRM 7.20.5.4(3)g.
Summary

Specialists will routinely encounter Grade 13 issues in screening and when reviewing cases which have been previously marked as Grade 12. A basic understanding of Grade 13 topics is important in recognizing and determining a correct case grading and providing a starting point when working a Grade 13 issue as a developmental case.

A hospital must meet the community benefit standard to be exempt as an organization described in IRC section 501(c)(3). The community benefit standard is based on Rev. Rul. 69-545. This standard, which remains the standard applied by the Service today, focuses on a number of factors indicating that the operation of the hospital benefits the community as a whole.

An organization qualifies as a medical research organization if the principal purpose or functions of such organization are medical research and if it is directly engaged in the continuous active conduct of medical research in conjunction with a hospital. Engaging directly in the continuous active conduct of medical research does not include the disbursing of funds to other organizations for the conduct of research by them or the extending of grants or scholarships to others.

Scientific research is considered to be carried on in the public interest if the results of the research are made available to the public on a nondiscriminatory basis, such research is performed for the United States (or any of its agencies or instrumentalities, or for a State or political subdivision thereof), and if such research is directed toward benefiting the public.

A wholly owned state or municipal instrumentality that is a separate entity and is organized and operated exclusively for purposes described in IRC section 501(c)(3) may qualify for exemption under this paragraph. Qualifying organizations must be operated for exempt purposes, separately organized entities, meet the organizational test, not be operated as an integral part of government, and have limited regulatory or enforcement powers.

Organizations involved in the sale of homes must be differentiated from organizations involved in commercial operations. Unlike applications involving rental housing, the safe harbor is not a valid means of justifying exemption for applications involving home sales.

Continued on next page
For-profit successors must be scrutinized to uncover any potential benefit to the predecessor organization. Investigative techniques must be utilized to review the financials of the for-profit predecessor and uncover potential ulterior motives for forming the nonprofit.

Applications involving potentially controversial public policy issues are typically high profile in addition to being sensitive issues. Frequently encountered issues within this category include abortion, firearms control, and foreign policy, to name a few. In addition to involving legislative issues, these cases also routinely involve the “education vs. advocacy” principles of Rev. Proc. 86-43.

Public interest law firms are specifically formed to engage in litigation, not for individual persons, but for widespread public good in some chosen area of public interest. To qualify for exemption, the litigation must be designed to present a position on behalf of the public at large on matters of public interest, the organization cannot achieve its objectives by illegal activity or through a program of disruption of the judicial system, and they cannot violate any canons of legal ethics. Rev. Proc. 92-59 sets forth other generally accepted guidelines for public interest law firms.

When the exemption of an organization is revoked and they subsequently reapply for recognition of exemption, special consideration must be given to the new application. It is not uncommon to coordinate case processing with the EO Exam agent responsible for revoking the exemption. Granting an effective date predating a date already established by EO Exam may jeopardize their interests.
Lesson 12
Section A

Overview of Donor Advised Funds

Overview

Introduction

Form 1023, page 6, Part VIII “Your Specific Activities” asks:

Do you or will you maintain separate accounts for any contributor under which the contributor has the right to advise on the use or distribution of funds? Answer “Yes” if the donor may provide advice on the types of investments, distributions from the types of investments, or the distribution from the donor’s contribution account. If “Yes”, describe this program, including the type of advice that may be provided and submit copies of any written materials provided to donors.

This question on the application is intended to identify donor advised funds. However, many applicants check this box but do not maintain true donor advised funds as defined in the Code. This lesson will provide an overview of donor advised funds so that applications are correctly identified and routed to the appropriate group.

Applications for exemption from donor advised funds Grade 13 cases and are a reserved inventory category.

Objectives

At the end of this lesson you will be able to:

- Identify a donor advised fund
- List the parties involved in donor advised funds
- Recognize issues associated with donor advised funds

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**Overview, Continued**

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*Overview of Donor Advised Funds*

12-A-2
Donor Advised Funds

Background

Donor advised funds (DAFs) have been part of charity for nearly a century, and have long been a staple of community foundations. Prior to the Pension Protection Act of 2006 (Pub. L. No. 109-208), the term “donor advised fund” was not defined in the Code or Regulations, but it was understood to include arrangements by which some charitable organizations (including community foundations) established separate funds or accounts to receive contributions from donors. Donor-advised fund arrangements were comparable to component funds maintained by certain community trusts.

In general, contributions to a DAF are treated as contributions to a public charity, thus providing donors some advantages over private foundations. For example, donors may claim a higher charitable contribution deduction (up to 50% of adjusted gross income (AGI) to a public charity vs. 30% to a private foundation), and donor-advised funds are not subject to the Chapter 42 restrictions that apply to private foundations, such as the IRC section 4941 self-dealing rules and the IRC section 4942 annual payout requirements. Other advantages touted by promotional literature include estate planning benefits, donor anonymity, lower start-up costs, and lower expenses in connection with legal, administrative, and accounting services to establish and maintain donor-advised fund accounts as compared to private foundations.

The Service has been concerned that some donors or related parties are exerting excess control or receiving undue benefits from a donor-advised fund.

Pension Protection Act

The Pension Protection Act (PPA) of 2006 (Pub. L. 109-280) requires the IRS to study the advantages and disadvantages of donor advised funds and supporting organizations as well as payout requirements that should apply to them. The Pension Protection Act also enacted several provisions intended to improve the accountability of donor-advised funds including the imposition of several excise taxes.

Continued on next page
Donor Advised Funds, Continued

**Definition**

Under IRC section 4966(d)(2), a donor advised fund is defined as a fund or account owned and controlled by a sponsoring organization, which is separately identified by reference to contributions of the donor or donors, and the donor expects to have advisory privileges over the distributions and investments of the assets.

A sponsoring organization is defined under IRC section 4966(d)(1) as a section 170(c) organization that is not a governmental organization (reference in sections 170(c)(1) and (2)(A)) or a private foundation and maintains one or more donor-advised funds.

**Excise Taxes**

IRC section 4966 imposes a 20% excise tax on taxable distributions made by a sponsoring organization. In addition, a 5% excise tax applies to a fund manager who makes a taxable distribution knowing that it is a taxable distribution.

IRC section 4967 applies a 125% excise tax on a donor, donor advisor, or related person who gives advice to have a sponsoring organization make a distribution from a donor-advised fund, which results in such person receiving, directly or indirectly, a more than incidental benefit as a result of such distribution. The tax does not apply if a tax has already been imposed with respect to such distribution under IRC section 4958. In addition, a 10% excise tax applies to a fund manager who makes a taxable distribution knowing that it is a taxable distribution.

IRC section 4943(e) applies the taxes on excess business holdings applicable to private foundations to donor-advised funds. The tax is equal to 10% of the value of the excess business holdings. If the excess business holdings are not disposed of within a specified time period, an additional tax of 200% of the excess holdings is imposed. The rule applies to taxable years beginning after August 17, 2006.

Under the provision, any grant, loan, compensation, or other similar payment from a donor-advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related to a donor or donor advisor is automatically treated as an excess benefit transaction under IRC section 4958, with the entire amount paid to any such person treated as the amount of the excess benefit. IRC section 4958(c)(2).

Additional information on excise taxes can be found in IRM 7.20.8.3.
A fund must possess the following three characteristics to be a DAF:

- It must be separately identified with reference to the contribution of donor or donors;
- It must be owned and controlled by a sponsoring organization; and
- The donor or a person appointed by the donor must have, or must reasonably expect to have, the privilege of providing advice with respect to the fund’s investments or distributions.

If any one of these characteristics is absent, the fund is not a DAF.

Examples of separate identifications include naming the fund after a donor or persons related to the donor or tracking contributions to the fund with respect to the specific donor or donors on the organization’s books.

Funds that attract contributions from several donors are not donor advised as long as the fund is not tracked with reference to the gift of any particular donor. A fund that is tracked by the gift of a particular donor is a donor advised fund if the donor reasonably expects to provide advice about the fund’s investments or distributions even if the fund agreement restricts grants to a particular purpose such as supporting the arts or improving the environment.

Continued on next page
Identifying a Donor Advised Fund, Continued

DAF Examples

The most common type of DAF is a Community Foundation. The primary purpose of a community foundation is to provide charitable support to their local charities. They do this by building endowments with contributions from local residents, and administer them for the benefit of their communities. They also administer non-endowment funds. These foundations do not themselves hold the funds; rather, they are held in and managed by banks and trust companies within the community.

A Community Foundation offers many attractions to donors. They provide professional investment management of charitable contributions. Donors contributing to these foundations generally receive the maximum charitable deduction allowed because most community foundations are publicly supported within the meaning of IRC section 170(b)(1)(A).

Several commercial entities now offer national programs featuring donor designated and donor directed charitable funds. The charitable fund is a pooled fund with a separate irrevocable account balance maintained for each donor. The fund claims ownership over the assets. In some cases the bylaws permit the commercial entity to have two of the five board members. The other three members are selected by the sponsoring organization. These types of cases are potentially abusive and should be brought to the attention of your manager or the project coordinator.

Generally Identified within Form 1023 Narrative

Organizations that are maintaining DAF will give a detailed description of the activity and are often grant making organizations.

An organization that does not submit a narrative to Form 1023, Part VIII, item 4e is almost never maintaining a DAF especially if they are conducting an exempt activity. If a screener comes across such a case do not send it to DAF inventory.

Donor Control Not Allowed

In donor directed funds, donors have an interest in continuing control over the use of their contributions. In such an arrangement, the donor has a continuing right to designate the charitable recipient of the donated funds’ income or principle. The donor reserves this right expressly (as in the instrument of transfer) or by implied agreement. This type of donor control is not permissible.

Overview of Donor Advised Funds

12-A-6
Identifying a Donor Advised Fund, Continued

Scholarship Funds

A scholarship fund is not a DAF, even if the donor or fund advisor is a member of the selection committee, if it meets the following tests:

- The sponsoring organization appoints all of the members of the committee and the donor’s advice is given solely as a member of the committee;
- The donor, and the parties related to the donor, do not control the committee directly or indirectly; and
- All grants are awarded on an objective and nondiscriminatory basis using a procedure that has been approved in advance by the board of directors of the sponsoring organization and the procedure is designed to ensure that all such grants meet the requirement of paragraphs (1)(2), or (3) of section 4945.

False Positives

Many organizations indicate on their applications for exemption that they will maintain separate contributor accounts. Based on the narratives attached to the application, the majority of these organizations intend to allow donors to select a particular purpose or area of interest for the use of their donations. Organizations such as these and others who do not operate programs with the specific characteristics discussed above are not to be considered “donor advised funds.”

For example, a donor would like to create a restricted fund to protect the environment. Apart from specifying the fund’s purpose in the gift agreement, the donor will not provide advice about the fund’s investments or distributions nor will they appoint anyone else to do so. This would not be considered a DAF. Legal restrictions, such as a designated purpose, are not advice and will not make the fund a DAF. Also, a fund is not a DAF if the donor only recommends individuals to be on the advisory committee and the individuals that he recommends are expertise in that particular area of interest. For example, a donor who creates a fund that will benefit art organizations and he recommends individuals with expertise in the arts.

These cases can be worked as part of the screening process or in general inventory and should be graded according to the primary activity of the organization.
DAF Parties and Their Responsibilities

Once the specialist has determined that the organization will be operating a DAF, it is important to know the four parties (the donors, the sponsoring organization, the investment manager, and the recipient charity) that make up the DAF and each of their responsibilities.

The **Donor** makes an irrevocable and unconditional contribution of cash, marketable securities or other assets to the sponsoring organization to establish an individual donor-advised fund. At the time of the gift, the donor relinquishes all legal control over how the contributed funds are invested and distributed. Upon establishing the fund, the donor may “advise” the sponsoring organization with respect to the charitable distributions from the fund and general investment matters.

The **Sponsoring Organization** is an organization exempt from tax under IRC section 501(c)(3). This organization maintains the individual donor-advised funds. The assets contributed to each fund are added to the sponsoring organization’s pooled investments, but a separate fund or account is created by each donor. The fund serves as an internal bookkeeping mechanism for the organization. The sponsoring organization will often be the applicant that has filed the Form 1023 application.

The **Investment Manager** advises the sponsoring organization on how best to invest the “fund” assets. The manager may be a large brokerage house or a small investment adviser. The organization and the manager usually enter into contract for the provision or services in exchange for the payment of certain fees and charges.

The **Recipient Charity** is an organization that is exempt from tax under IRC section 501(c)(3) and is classified as a public charity under IRC section 509(a)(1), (2), or (3). At any time, the donor may “recommend” that all or a portion of the assets in the donor’s named account be granted to the recipient charitable organization.
## DAF Exemption Issues

### Exemption Issues

Although donors or their advisors may provide advice or recommendations with regard to fund distributions and investments, to be consistent with exemption under IRC 501(c)(3), the charities maintaining the funds must have the ultimate authority over how the assets in the funds are invested and distributed. If a donor or his advisor continues to exercise control over amounts contributed, it might be found that sponsoring charities do not have legal ownership and control of the assets following the contribution. (In the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor).

### Some Issues of Concern

The Service has been concerned that some donors or related parties are exerting excess control or receiving undue benefits from a donor-advised fund. For example, some donors to donor-advised funds participate in schemes that allow them to regain assets they contribute to their donor advised funds such as through “educational” loans to family members or by paying travel expenses that are not substantially related to a charitable purpose.

For exemption purposes, the concern is whether the sponsoring organization has sufficient procedures and governance to ensure that the assets in its donor advised funds accomplish charitable purposes, are used exclusively for charitable purposes, and not for an impermissible private benefit. For example, does the sponsoring organization allow donors to place limitations on the amounts that may be distributed from funds? These types of limitations may indicate that the assets in the account are not being used primarily to accomplish charitable purposes.

If donors have placed a material restriction on amounts transferred to a donor advised fund, the sponsoring organization may be receiving donors’ assets in trust rather than as the owner. Amounts received in trust would not qualify as public support for purposes of qualifying as a publicly supported organization under IRC sections 509(a)(1)/170(b)(1)(A)(vi) or IRC 509(a)(2).

*Continued on next page*
DAF Exemption Issues, Continued

Guide Sheet

The Donor-Advised Funds Guide Sheet, available in IRM 7.20.8, is designed to assist in the processing of Form 1023 applications for recognition of exemption under IRC 501(c)(3) filed by sponsoring organizations that maintain donor-advised funds. The guide sheet assumes that an organization is otherwise qualified as an exempt organization and focuses on issues that are of special concern for a sponsoring organization.

Additional Information

Notice 2006-109, 2006-51 I.R.B. 1121, provides interim guidance regarding certain requirements enacted as part of the Pension Protection Act of 2006 (PPA) that affect donor-advised funds. Notice 2006-109 excludes certain employer-sponsored disaster relief funds from the definition of donor-advised fund, and clarifies how the Internal Revenue Service will apply the new IRC section 4966 excise taxes with respect to payments made pursuant to education grants awarded prior to the date of enactment of the PPA.

Additional information and guidance can be found in IRM 7.20.8, Donor-Advised Fund Guide Sheet.

As previously noted, donor advised funds are a reserved inventory category. If a specialist determines that a case involves a donor advised fund, discuss the case with your manager regarding transfer of the case to the designated group.

Overview of Donor Advised Funds

12-A-10
Summary

Donor advised funds (DAFs) have been part of charity for nearly a century, and have long been a staple of community foundations. The Pension Protection Act of 2006 requires the IRS to study the advantages and disadvantages of donor advised funds and supporting organizations as well as payout requirements that should apply to them. The Pension Protection Act also enacted several provisions intended to improve the accountability of donor-advised funds including the imposition of several excise taxes.

A fund must possess the following three characteristics to be a DAF:

- It must be separately identified with reference to the contribution of donor or donors;
- It must be owned and controlled by a sponsoring organization; and
- The donor or a person appointed by the donor must have, or must reasonably expect to have, the privilege of providing advice with respect to the fund’s investments or distributions.

If any one of these characteristics is absent, the fund is not a DAF.

The four parties that make up a DAF are the donors, the sponsoring organization, the investment manager, and the recipient charity.

Donor advised funds give rise to complex exemption issues which is reflected in the assigned case grade of Grade 13. In addition, these cases are reserved as a specialized inventory category and are currently worked within EO Determinations Group 7828.
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Overview of IRC Section 509(a)(3) Type III Supporting Organizations and IRC Section 4947(a) Trusts

Overview

Introduction

In general, supporting organizations have been identified by the type of relationship they have with their supported IRC section 509(a)(1) or (2) organizations. Under the Pension Protection Act of 2006, supporting organizations are classified into Type I, Type II or Type III supporting organizations. Type I supporting organizations are operated, supervised, or controlled by one or more IRC section 509(a)(1) or (2) organizations. Type II supporting organizations are supervised or controlled in connection with one or more IRC section 509(a)(1) or (2) organizations. Type III supporting organizations are operated in connection with one or more IRC section 509(a)(1) or (2) organizations.

Type III supporting organizations are divided into the following two categories: Type III supporting organizations that are not functionally integrated and functionally integrated Type III supporting organizations.

Type I and Type II supporting organizations were discussed in Lesson 8. Because of the complex issues involved in determining qualification as a Type III supporting organization, these cases are graded as Grade 13 cases and are a reserved inventory category. This overview of Type III organizations will assist specialists in correctly identifying Type III requests and the primary issues involved with these cases. Detailed information will be presented in more advanced training.

Trusts that are not exempt under IRC section 501(a) can obtain many of the tax benefits held by organizations that are exempt under IRC section 501(c)(3). IRC section 4947 was enacted to prevent certain charitable trusts from escaping private foundation requirements, restrictions, and excise taxes imposed by the Tax Reform Act of 1969.

Continued on next page
Overview

Introduction (continued)
Although IRC section 4947(a)(1) and 4947(a)(2) trusts are Grade 12 issues, most EO Determinations letter requests from these trusts are for classification as IRC section 509(a)(3) Type III supporting organizations. As such, these cases are classified as Grade 13 and are a reserved inventory category. This lesson contains an overview of IRC section 4947(a) trust to familiarize specialists with these types of trusts and trust terms that may be encountered in processing determination letter requests. Detailed information will be presented in more advanced training.

Objectives
At the end of this lesson you will be able to:

- Distinguish between a Type III functionally integrated and non-functionally integrated supporting organization
- Name the four tests a supporting organizations must meet for classification under IRC section 509(a)(3) Type III
- Describe the two relationship sub-tests that Type III organizations must meet
- Identify IRC section 4947(a)(1) and 4947(a)(2) trusts

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Overview of IRC section 509(a)(3) Type III Supporting Organizations and IRC Section 4947(a) Trusts
12-B-2
Type III Supporting Organizations

Background
An organization may request IRC 509(a)(3) status either 1) when it initially files a Form 1023 application for IRC 501(c)(3) exemption, or 2) subsequently, by requesting a determination letter that changes its existing foundation status.

A nonexempt charitable trust described in IRC 4947(a)(1) may also request a determination that it is described in IRC 509(a)(3), even though it is has not been recognized as an IRC 501(c)(3) organization, pursuant to Rev. Proc. 72-50, 1972-2 I.R.B. 830. For information about Rev. Proc. 72-50, see FY 1980 EO CPE Text, General Explanation of Trusts Subject to Section 4947 of the Internal Revenue Code.

Type III Supporting Organizations
Type III supporting organizations are “operated in connection with” one or more IRC 509(a)(1) or (2) organizations. The PPA of 2006 classifies Type III supporting organizations into the following two categories: non-functionally integrated or functionally integrated.

Information on Type III organizations can be found in IRM 7.20.7, IRC section 509(a)(3) Supporting Organization Guide Sheet and Guide Sheet Explanation.

Functionally Integrated vs. Non-Functionally Integrated
A Type III non-functionally integrated supporting organization must pay substantially all (85%) of its adjusted net income to or for the use of at least one of the supported organization(s) and the payments are sufficient to warrant the attentiveness of at least one of the supported organization(s).

A Type III functionally integrated supporting organization is one that actually engages in activities which benefit the publicly supported organizations as opposed to simply making grants to supported organizations.

Continued on next page
Type III Supporting Organizations, Continued

Most supporting organizations further legitimate charitable purposes. However, as with Type I and Type II supporting organizations, some organizations which request classification as a Type III supporting organization may be set up to inappropriately shield assets. Situations that should be closely scrutinized include:

- A balance sheet that lists notes payable as part of the assets
- Financial data that shows no disbursements to the supported organization
- Contribution of an interest in a partnership, limited liability company, closely held stock, real estate, or some other non-liquid asset
Type III Supporting Organization Tests

Four Tests

A Type III supporting organization must meet the four following tests:

Organizational Test under IRC section 509(a)(3)(A)
It must be organized exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations described in IRC section 509(a)(1) or 509(a)(2).

Operational Test under IRC section 509(a)(3)(A)
It must be operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations described in IRC section 509(a)(1) or 509(a)(2).

Disqualified Person Control Test under IRC section 509(a)(3)(C)
It must not be controlled directly or indirectly by one or more disqualified persons (as defined in IRC 4946) other than foundation managers and other than one or more organization described in IRC section 509(a)(1) or 509(a)(2).

Relationship Test under IRC section 509(a)(3)(B)
It must be operated, supervised, or controlled by or in connection with one or more organizations described IRC section 509(a)(1) or 509(a)(2).

Continued on next page
### Organizational Test

A Type III supporting organization’s organizing document must limit its purposes to supporting one or more IRC section 509(a)(1) or (2) organizations that are specified by name. Unlike Type I and Type II organizations, a Type III supporting organization cannot qualify by supporting an IRC section 501(c)(4), (5) or (6) organization. In addition, Type III supporting organizations can only support organizations organized in the United States.

In situations where there has been an historic relationship between the supporting organization and the publicly supported organization and where, by reason of such relationship, a substantial identity of interests has been developed between the organizations, the identity of the supporting organization need not be specified.

In addition, its organizational document may not contain any provisions that are inconsistent with its stated purpose of supporting the specified organization(s).

A thorough review of the organizational test is found at IRM 7.20.4.1.

### Operational Test

The supporting organization must make payments to or for the use of the specified IRC 509(a)(1) or (2) organization(s) and/or the organization must provide services or facilities to or for the use of the specified IRC 509(a)(1) or (2) organization(s). A thorough review of the operational test is found at IRM 7.20.4.2.

### Control Test

An IRC 509(a)(3) organization cannot be controlled by disqualified persons (other than foundation managers). There are numerous factors to consider when determining whether disqualified persons control the organization. A thorough review of the control test is found at IRM 7.20.4.3.

### Relationship Test

To meet the relationship test, a type III “operated in connection with” supporting organization must meet a responsiveness test and an integral part test. A thorough review of the relationship test is found at IRM 7.20.4.4.
Type III Responsiveness Test

Responsiveness Test

The responsiveness test requires that a supporting organization and its supported organizations must have at least one officer, director or trustee in common or such individual(s) must maintain a close and continuous working relationship between the two organizations, such that the supported organizations have a significant voice in the investment policies and operations of the supporting organization, including in the timing and manner by which it makes grants and selects grant recipients.

Close and Continuous Working Relationship

The organization may pass the responsiveness test if the officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization. This provision is intended for situations where there is an historic and continuing relationship between the supporting and a supported organization such that there is a substantial identity of interests between the two organizations.

This relationship determination would be based on all the pertinent facts and circumstances, including the length and nature of the relationship; the number of other supported organizations the supporting organization supports; the percentage of support contributed by the supporting organization to the supported organization’s total support; evidence of actual attentiveness; and a substantial identity of interests between the supporting organizations and its supported organizations.
Type III Integral Part Test

**Payout/Responsiveness Not Functionally Integrated**

To pass the integral part test for an organization that is not functionally integrated, the amount of income the supporting organization provides to the supported organization must be sufficient to ensure that the supported organization is attentive to the operations of the supporting organization.

The “payout/responsiveness” part requires that the supporting organization make payments of substantially all its income to or for the use of one or more publicly supported organizations and such support must be sufficiently significant in relation to the supported organization’s programs to insure its attentiveness to the supported organization.

The PPA of 2006 will change the payout requirement in a manner to be determined by the IRS and Treasury in future guidance. Pending issuance of such guidance, these organizations must meet the “payout/responsiveness” requirements of current regulations.

**“But For” Test**

To pass the integral part test for a functionally integrated, the supporting organization must engage in activities to perform the functions of or to carry out the purposes of one or more of the supported organizations that the supported organization would otherwise have to perform but for the supporting organization. This is referred to as the “but for” test. Making cash distributions to a supported organization will not satisfy this prong of the integral part test.
Introduction

Trusts that have not applied for or received a determination of tax exempt status under IRC section 501(a) can nonetheless obtain many of the tax benefits held by organizations that are exempt under IRC section 501(c)(3). IRC section 4947 provisions are designed to prevent “non-exempt” charitable trusts from escaping private foundation provisions of the Tax Reform Act of 1969. Without IRC 4947 it would be possible to set up a trust essentially like a private foundation and, at the same time, avoid all the private foundation excise taxes.

IRC section 4947(a)(1) non-exempt charitable trusts have exclusively charitable interests and beneficiaries. IRC section 4947(a)(2) split-interest trusts have charitable and non-charitable interests and beneficiaries.

Characteristics:

IRC 4947(a)(1) Charitable Trust

A non-exempt charitable trust (NECT) described under IRC section 4947(a)(1) is treated as a 501(c)(3) organization for certain purposes; however, it does not need to complete a Form 1023 application. IRC section 4947(a)(1) treats a trust as described in IRC 501(c)(3) if all of the following conditions are met:

1. the trust is not exempt under IRC 501(a),
2. all interests/beneficiaries are charitable, and
3. a charitable deduction was allowed to the donor(s) for contributions to the trust.

There are differences between the taxation of non-exempt charitable trusts and organizations exempt under IRC section 501(c)(3). If a nonexempt charitable trust pays or uses all of its income for charitable purposes, there will be no taxable income because of the unlimited charitable deduction accorded trusts under IRC section 642(c). However, failure to use all income for charitable purposes (including allowable expenses) may result in tax.

Continued on next page
A trust described in 4947(a)(1) may be treated as a public charity or private foundation. Generally, IRC section 4947(a)(1) provides that the private foundation provisions apply to non-exempt trusts in the same manner as they apply to exempt private foundations. Revenue Procedure 72-50 established guidelines for how an IRC section 4947(a)(1) trust may request a determination from the Service that is it described under IRC section 509(a)(3) even though it has neither obtained nor seeks exemption under IRC section 501(c)(3).

In the past, NECTs have typically requested public charity treatment by requesting a determination that they are a 509(a)(3) Type III supporting organization “operated in connection with” their supported organization(s). Provisions of the Pension Protection Act of 2006, make it more difficult for an NECT to meet the “responsiveness” test for a 509(a)(3) Type III supporting organization. A NECT may also meet the requirements of a Type I or Type II supporting organization.

A request submitted by a NECT for a determination of IRC section 509(a)(3) status is established as an “A” case on EDS. A user fee is not required.
Characteristics and Types:  
4947(a)(2) Split Interest Trust

A split-interest trust described in IRC section 4947(a)(2) is treated as an IRC section 501(c)(3) organization for certain purposes; however, it should not complete a Form 1023 application. A split-interest trust is treated as a private foundation if it has the following three characteristics:

1. the trust is not exempt under IRC section 501(a)
2. the trust’s income and assets are not completely devoted to charitable purposes described in IRC section 170(c)(2)(B), and
3. there are amounts in trust for which a charitable deduction was allowed.

Common Types of Split Interest Trusts

There are three common types of split interest trusts.

Pooled income described in IRC section 642(c)(5)

Pooled income funds are created and maintained by an organization described in IRC section 509(a)(1). Pooled income funds accept gifts where income is to be paid to an individual for life and where all remaining interests are given to the organization maintaining the pooled income funds.

Charitable remainder trusts described in IRC section 664

Charitable remainder trusts described in IRC section 664 also involve trusts where income is given to individuals and all remaining interests (the remainder) are devoted to charitable purposes. There are two varieties: charitable remainder annuity trusts and charitable remainder unitrusts.

Charitable lead trust

Charitable lead trusts pay out their income interests in the form of an annuity or unitrust. The remainder interests involve private beneficiaries and at least a portion of the income interest must be devoted to charitable purposes.

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In considering application of the private foundation provisions to split interest trusts that are treated as if they were private foundations, it is necessary to consider each particular private foundation Code section. IRC section 4947(a)(2) specifies those private foundation provisions that are applicable to split interest trust.

- IRC section 4947(a)(2)(A) limits application of the foundation excise tax provisions so that they do not apply to amounts paid to beneficiaries unless a charitable deduction was allowed.

- IRC section 4947(a)(2)(B) treats segregated amounts as separate trusts.

- IRC section 4947(a)(2)(C) prevents application of the private foundation provisions to amounts transferred in trust prior to May 2, 1969.

In general Chapter 42 taxes apply except IRC 4940 and 4942. IRC 4940 and 4942 apply to a segregated amount as meant in IRC 4947(a)(2)(B) because a wholly charitable segregated amount is treated as a separate trust described in IRC 4947(a)(1) for purposes of IRC 4947.

### IRC Section 4947(a)(2) Filing Requirements

Form 5227, Split Interest Trust Information Return, is required for all split interest trusts treated as private foundations.

Form 1041, Fiduciary Income Tax Return, is required for all split interest trusts.

Form 1041-A, Fiduciary Income Tax Return, is required for a split interest trust described in IRC 4947(a)(2) that claims a charitable or other deduction under IRC 642(c) unless the trust is required to distribute its income currently or is a charitable trust described in IRC 4947(a)(1).

Form 4720 is required if there is a liability for any of the Chapter 42 excise taxes.
Type III supporting organizations are “operated in connection with” one or more IRC 509(a)(1) or (2) organizations. The PPA of 2006 classifies Type III supporting organizations into the following two categories: non-functionally integrated or functionally integrated.

A Type III non-functionally integrated supporting organization must pay substantially all (85%) of its adjusted net income to or for the use of at least one of the supported organization(s) and the payments are sufficient to warrant the attentiveness of at least one of the supported organization(s).

A Type III functionally integrated supporting organization is one that actually engages in activities which benefit the publicly supported organizations as opposed to simply making grants to supported organizations.

Type III organizations must meet the four tests required of all IRC section 509(a)(3) supporting organizations. The relationship test is met through a responsiveness test and an integral part test which are specific to Type III organizations.

Trusts that are not exempt under IRC section 501(a) can obtain many of the tax benefits held by organizations that are exempt under IRC section 501(c)(3). IRC 4947 was enacted to prevent certain charitable trusts from escaping private foundation requirements and restrictions imposed by the Tax Reform Act of 1969.

Trusts covered under IRC 4947(a)(1), known as non-exempt charitable trusts (NECT’s), have only charitable interests and beneficiaries. An NECT described under section 4947(a)(1) of the Code is treated as a 501(c)(3) organization, however, it does not need to complete a Form 1023 application. An NECT may request a determination that it is described in IRC section 509(a)(3), even though it has not been recognized as an IRC section 501(c)(3) organization. Generally, these requests are for Type III classification.

Trusts covered under IRC section 4947(a)(2) are split interest trusts that have both charitable and non-charitable interests and beneficiaries. Common types of split-interest trusts include pooled income funds, charitable remainder trusts, and charitable lead trusts. IRC sections 4947(a)(2)(A), (B), and (C) set forth private foundation excise tax provisions applicable to IRC section 4947(a)(2) trusts.
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Overview of Conservation Easements

Overview

Introduction

Conservation easements are binding legal restrictions placed on the use and development of property such as parks, wetlands, farmland, forested land, scenic areas, historic lands, or historic structures.

A conservation easement is a recorded agreement between a property owner and the holder of the easement which describes the restrictions and allowed uses of the property to ensure that conservation values are protected.

IRC 170(h) provides for a charitable deduction for contributions of conservation easements if the donor meets all of the statutory and regulatory requirements.

The value of the easement is determined based on a qualified appraisal as defined in the regulations. In order to claim a deduction, there must be a reduction in the property value due to the granting of the conservation easement. If there is no loss in value, no deduction is allowed.

Some conservation easements do not qualify for a charitable contribution deduction because legal requirements are not met. On the other hand, some conservation easements do meet legal requirements but the value of the donation is not properly determined.

The IRS has seen abuses of tax provision related to conservation easements. In some cases taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for easements. In other cases, taxpayers claim deductions when they are not entitled to any deduction at all. Also, taxpayers have sometimes used or developed these properties in a manner inconsistent with section 501(c)(3) of the Code. In other cases, the charity has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement’s restrictions.

Continued on next page
Introduction (continued)

Another problem arises in connection with historic easements, particularly façade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the façade of a historic structure and give an easement to this effect to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. A taxpayer cannot give up a right that he or she does not have.

Objectives

At the end of this lesson you will be able to:

- Define “conservation easement” and “façade easement”
- Explain what “qualified conservation contribution” means
- Understand how to determine the value of a conservation easement
- Explain the roles and responsibilities of the recipient 501(c)(3) organization
- Identify exemption issues related to conservation easements

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Conservation Easement Definitions

What is a conservation easement?
A conservation easement is a legal deed restriction that limits real estate development and certain other activities on a property. The landowner who gives up these development rights continues to privately own and manage the land after the easement is donated to a qualified recipient charity or governmental agency for the purpose of conservation. A conservation easement donation is unlike a fee-simple property donation where the qualified charity or governmental agency becomes owner of the property. A conservation easement donation is not a donation of the title or ownership of the property but rather a donation that legally restricts the right to future development (both residential and commercial) on the property in perpetuity. Thus an easement does not grant ownership nor does it absolve the private property owner from traditional owner responsibilities, i.e., property tax, upkeep, maintenance, or improvements.

What is a Façade Easement?
Historic façade easements are deed restrictions in which the property owner agrees not to alter the exterior of a structure to preserve its historic value in perpetuity.

What is a Qualified Conservation Donation?
On the Federal level, the Tax Treatment Extension Act of 1980 substantially modified IRC 170 to provide a charitable deduction for conservation contributions made to qualified organizations which are established to preserve specified types of properties. For purposes of IRC 170((f)(3)(B)(iii), the term “qualified conservation contribution” means a contribution of:

(a) qualified real property interest to

(b) a qualified organization

(c) exclusively for conservation purposes.
Conservation Easement Definitions, continued

What Is a Qualified Real Property Interest?

IRC 170(h)(2) states that a qualified real property interest means:

• The entire interest of the donor other than a qualified mineral interest,
• a remainder interest, and
• a restriction (granted in perpetuity) on the use which may be made of the real property.

What Is a Qualified Organization?

Under Section IRC 170(h)(3), a “qualified organization means an IRC 501(c)(3) organization classified under IRC 509(a)(1) & 170(b)(1)(A)(vi), IRC 509(a)(1) & 170(b)(1)(A)(v), IRC 509(a)(2) or a Type I section 509(a)(3) supporting organization.

Private foundations, private operating foundations, and Type II and Type III 509(a)(3) supporting organizations are not qualified organizations for purposes of IRC 170(h)(3).
Conservation Easement Definitions, continued

What Are Conservation Purposes?

IRC 170(h)(4)(A) states that “conservation purpose” means:

- preservation of land for outdoor recreation or education
- protection of natural habitat
- preservation of open space for scenic enjoyment
- preservation of open space pursuant to a clearly delineated governmental conservation policy
- preservation of an historically important land area or a certified historic structure
How is the Value of a Conservation Easement Contribution Determined?

Value of Contribution

The value of the conservation easement contribution under IRC 170 is the fair market value (FMV) of the perpetual conservation restriction at the time of the contribution [Reg. 1.170A-14(h)(3)].

If no substantial record of market-place sales is available to use, the value of the conservation easement generally is the difference between the value of the land if it were developable and the decrease in value once the easement is placed.

When a Charitable Deduction is Not Allowed

A charitable deduction for a conservation easement contribution is not allowed in the following circumstances:

- Reg. 1.170A-14(h)(3)(ii) provides that no deduction is allowable if the donation of a conservation easement has no material effect on the value of real property or enhances rather than reduces the value of the real property.

- No deduction is allowable if the donor reasonably can expect to receive financial or economic benefits greater than those that will inure to the general public as a result of the easement donation.

- A charitable deduction is disallowed in situations where local ordinances require the donor to set aside certain lands in a conservation trust as a prerequisite to development approval.

- Easements granted as a condition of subdivision development approval are generally not deductible due to the lack of charitable intent.

- Easements granted as a condition of permit approval under the clean Water Act or the operation of a conservation baking program may also lack the requisite charitable intent to be tax deductible.
Benefits to Donors of Conservation Easements

Possible Benefits

In addition to being able to privately own and manage the land, the donor of a conservation easement may receive significant state and Federal tax advantages. The donor may take a charitable deduction on his/her Federal income tax return, and some states offer income and property tax incentives as well as tax credits for contribution of conservation easements.
Role and Responsibilities of Recipient 501(c)(3) Organization

Monitoring and enforcement

Upon receipt of donation of a conservation easement, the recipient charitable organization becomes the overseer and enforcer of the easement agreement to assure that the property is permanently preserved for conservation purposes for the benefit of the public. If the property owner violates the easement agreement, it is the responsibility of the recipient charitable organization to seek remedy of the violation and ensure that the property owner restores the property as stated in the conservation easement agreement/contract.

Verification

The applicant organization prior to accepting the conservation easement donation should:

- establish policies and procedures for accepting conservation or façade easements and make such policies and procedures known to the public
- request a certified appraisal prepared by a qualified appraiser to determine the FMV of the easement donation
- perform a baseline study to verify that the property meets one or more the conservation purposes as set forth in IRC 170(h)(4)(A) and
- maintain a registry of all its conservation easements including copies of legal deeds of easement.

Continued on next page
Role and Responsibilities of Recipient 501(c)(3) Organization, continued

Review

The specialist should request that the applicant submit a copy of the conservation easement donation agreement. The specialist reviewing the application should ensure that the agreement does not allow a use of the property that is inconsistent with the conservation purposes of the easement.

For example, in the case of an easement property in which the mineral rights are retained by the donor, a provision in the easement which permits the surface mining of oil and minerals on the property constitutes “inconsistent use” of the property. Since surface mining has the potential to destroy the ecological, environmental and/or historical values of the property, it is inconsistent with the conservation purpose of the easement. The specialist should also ensure that any facade easement for a registered historic district building created after July 25, 2006 includes preservation of the “entire exterior” of the building and that the applicant organization does not plan to make improvements to the property that benefits the private property owner.

Commitment and resources

The applicant organization must also have both the commitment and the resources to monitor and enforce the easement. The applicant needs to show that it will have a qualified board of directors who have the ability and experience to monitor the property year after year. It needs to demonstrate that it will visit the property, at least once a year, to verify that the owner has not violated the easement agreement. The applicant should show that it has proper procedures to enforce the agreement in the event of an easement violation and that it has sufficient funds to pursue violations including possible legal actions. The determination specialist should question the level of the organization’s commitment and resources if it reports very little revenues and states that everything will be done by volunteers.
## Common Issues in Conservation Easement Cases

### Inurement/ Private Benefit

As with many applications for exemption under section 501(c)(3) of the Code, the most common issue encountered with conservation easement relates to potential inurement to insiders of the organization or impermissible private benefit.

### Donor Sits on Board

Situations in which the donor of a conservation easement is also an officer or board member of the recipient exempt organization present potential inurement issues. Because the role of the recipient charity is oversight and enforcement of the easement donation agreement, a donor who also serves as an officer/board member of the recipient charity is overseeing his/her own property. In some cases the donor may agree to step down from a position of power with the recipient charity or agree to abstain from voting on issues related to the easement. In any event, the determination specialist must ensure the applicant organization has proper procedures to prevent inurement.

### Donors are Business Partners, Neighbors, and/or Friends of Officer/Board Member

In situations where an officer or director of the applicant organization has business partners, neighbors, and/or friends that have donated a conservation easement to the organization, there is a potential private benefit issue. In addition, a potential private benefit issue is present if the donor’s lawyers, accountants, or land developers have positions of power with the applicant organization.

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Inurement/private benefit issues are also present if the applicant organization pays for restoration services on the donated conservation easement property. In some instances, an applicant organization has expertise on restoration and will undertake restoration of a historic property or help to clean up a river bank area on a property with an easement donation. The specialist must remember that an easement does not grant ownership nor does it absolve the property owner from traditional owner responsibilities, i.e., property tax, upkeep, maintenance, or improvements. Thus, the applicant organization should not pay for property tax, upkeep, maintenance or capital improvements on the property subject to the easement. The private property owner must pay for those services and improvements. If the applicant organization was to pay for such costs, it would constitute private benefit to the donor/private owner of the property.

An area of concern in reviewing conservation easement applications relates to appraisals which are:

- based on unrealistic assumptions about the highest and best use of the land,
- based on an assumption that all assets are already in place,
- conducted without regard to current zoning law or
- conducted pursuant to inadequate professional standards.
Notice 2004-41

What is Notice 2004-41?

Notice 2004-41 warns taxpayers that the Service is looking closely at improperly claimed charitable deductions for contribution easement contributions and that, in addition to disallowing the deduction, penalties and excise taxes may be imposed.

The Notice also indicates that the Service may challenge the tax-exempt status of a charitable organization that participates in transactions arising from improper deductions taken as part of the contribution of a conservation easement on the basis that a tax-exempt organization that allows this to happen is operated for a substantial non-exempt purpose.
Summary

Conservation easements are binding legal restrictions placed on the use and development of property such as parks, wetlands, farmland, forested land, scenic areas, historic lands, or historic structures. A conservation easement donation is not a donation of the title or ownership of the property but rather a donation that legally restricts the right to future development (both residential and commercial) on the property in perpetuity.

IRC 170(f)(3)(B)(iii) defines the term “qualified conservation contribution” as a contribution of (a) qualified real property interest to (b) a qualified organization (c) exclusively for charitable purposes.

The value of the conservation easement contribution under IRC 170 is the fair market value (FMV) of the perpetual conservation restriction at the time of the contribution.

Upon receipt of a donation of a conservation easement, the recipient charitable organization becomes the overseer and enforcer of the easement agreement to assure that the property is permanently preserved for conservation purposes for the benefit of the public. The recipient charitable organization must have both the commitment and the resources to monitor and enforce the easement.

Common issues for development in conservation easement applications relate to potential inurement and or private benefit by donors and/or board members, potential for capital improvements to privately owned property, inflated appraisals of the value of the contribution.

Notice 2004-41 warns taxpayers that the Service is looking closely at improperly claimed charitable deductions for contribution easement contributions and that, in addition to disallowing the deduction, penalties and excise taxes may be imposed.
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Overview

Introduction

The Internal Revenue Service first addressed credit counseling organizations when they began appearing in the marketplace in the 1960's. Revenue Ruling 65-299 provided an example of a credit counseling organization that qualified for exemption under IRC 501(c)(4). Revenue Ruling 69-441 provided an example of a credit counseling organization that qualified for exemption under IRC 501(c)(3).

Relying on these rulings, the IRS later notified the Consumer Credit Counseling Service and credit counseling agencies that all credit counseling agencies determined to be exempt under IRC 501(c)(3) would be reclassified as exempt under IRC 501(c)(4). The result was two declaratory judgment cases in which the courts found that these credit counseling agencies qualified for exemption under IRC 501(c)(3).


In recent years, changes in Federal and state law, including adoption of the Credit Repair Organization Act of 1997 (CROA), have altered the credit counseling industry dramatically. Organizations primarily offering credit counseling as a commercial-type service sought to be classified as tax-exempt organizations so that they could charge service fees under exceptions to Federal and state laws available only to tax-exempt charities. As a result, the IRS found that many credit counseling organizations operating as tax-exempt charities are primarily sellers of debt-reduction plans, motivated by profit, and offer little or no counseling or education. In many cases, the credit counseling organization also serves the private interests of related for-profit businesses, officers and directors.

Continued on next page
Overview of Credit Counseling Organizations, continued

Introduction (continued)

The need to closely scrutinize these organizations increased with the implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). This new law requires nonprofit budget and credit counseling organizations to receive certification through the U.S. Trustee Program before providing bankruptcy counseling.

In response to these developments, the IRS initiated a comprehensive, multi-faceted strategy which includes:

- a widespread outreach program to alert the industry and general public to problems in the sector, and

- a compliance program encompassing both an aggressive examination program to halt abuses within the credit counseling industry and a rigorous determination process to prevent abusive organizations from receiving tax exemption.

The recent sub-prime lending crisis and the collapse of the housing market, has triggered many exemption applications from organizations offering some form of Foreclosure Assistance. This activity is similar to Credit Counseling and will be included in this overview.

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How to Identify Credit Counseling Organizations

The majority of potential credit counseling applications are identified during the screening process. The screeners have been trained to identify applications from organizations which indicate involvement in the following activities:

- Debt Consolidation
- Debt Repayment
- Debt Relief
- Debt Management
- Financial Management
- Financial Literacy
- Financial Education
- Money Management
- Budgeting Classes
- Home Ownership Classes
- Credit Repair
- Credit Counseling
- Creditor Negotiations
- Bankruptcy Counseling
- Bankruptcy Certification
- Bankruptcy Assistance
- Foreclosure Counseling

This list is a guide and is not necessarily all-inclusive. If activities such as these are discovered at any time during the processing of an application, the application must be returned to the Credit Counseling reserved inventory to be worked by a specialist who has been properly trained in these issues.

Once the application has been designated as a potential credit counseling organization, it is subject to a second screening process. During this process, a specialist in the designated credit counseling group reviews the application to determine if the credit counseling activities are potentially abusive. If the organization is involved in potentially abusive activities such as credit repair, bankruptcy certification or debt management plans, the application is returned to the credit counseling reserved inventory to be fully developed by a trained specialist. However, if the organization is involved in purely educational activities and the application requires only minor development; it may be worked through an accelerated processing program.
Financial Literacy Organizations

The majority of the applications that are identified as potential credit counseling organizations can be classified as financial literacy organizations. These are organizations that offer purely educational classes, workshops, seminars or counseling sessions aimed at educating individuals about banking, credit cards, financial management and budgeting. These organizations do not offer to repair their client's credit; they do not offer payment plans or debt management plans; and they do not offer bankruptcy certifications.

Organizations that offer financial literacy education may also be involved in a variety of other activities. Many are involved in other outreach and life skills training activities, transitional housing, or other charitable and educational activities.

These organizations can often be identified by the presence of such terms as:

- Financial Management
- Financial Literacy
- Financial Education
- Money Management Classes
- Budgeting Classes
- Home Ownership Classes
- Banking Skills

Although the credit counseling activities of these organizations are usually purely educational in nature, the activities must be sufficiently developed to ensure this. In addition, the specialist must ensure that any private benefit concerns have been resolved. The types of questions to be asked should focus on what the financial literacy activity involves - such as descriptions of the classes taught, copies of materials used, information regarding the class instructors, and details regarding whether the organization will refer participants to other services.

Organizations that offer purely educational financial literacy training can qualify for exemption under IRC 501(c)(3). If the organization has shown that their activities are exclusively educational and/or charitable; and if they have resolved any private benefit or inurement concerns, their application can be recommended for approval.

Continued on next page
When closing financial literacy applications, ensure that the correct NTEE Code is assigned. The NTEE code should reflect the organization's primary activity. If the organization's primary activity is the provision of financial literacy training, the correct NTEE Code is P51 - Financial Counseling. If the organization is only involved in financial literacy education as a secondary purpose, the NTEE Code should reflect their primary activity.

All credit counseling cases that are closed must be routed through the manager of the designated credit counseling group for review and signature.
Potentially Abusive Credit Counseling Organizations

Introduction

A small percentage of the applications that are identified as potential credit counseling organizations fall into the category of potentially abusive organizations. These include organizations that offer debt management or debt repayment plans (DMP); organizations that claim to be able to repair an individual’s credit history; and those that offer bankruptcy counseling and certification.

These organizations can often be identified by the presence of such terms as:

- Debt Consolidation
- Debt Repayment
- Debt Relief
- Debt Management
- Credit Repair
- Credit Counseling
- Creditor Negotiations
- Bankruptcy Certification
- Bankruptcy Counseling
- Bankruptcy Assistance

These organizations often exhibit a high potential for private benefit and/or inurement, including relationships with for-profit companies, a resemblance to commercial operations, etc.

Continued on next page
Potentially Abusive Credit Counseling Organizations, Continued

Debt Management Plans (DMPs)

Organizations that provide credit counseling may provide clients with options or suggestions for reducing debt and managing their finances. One of these options may be a Debt Management Plan (DMP), also know as a debt repayment plan or debt consolidation.

The credit counseling organization will consolidate some or all of the client's existing bills into one monthly payment. The organization may work with the client's creditors to negotiate more favorable terms; and they often only accept specific unsecured debts, such as credit card debts, as part of the payment plan. The client pays an initial fee for the set-up of the DMP which is sometimes equal to the first month's payment. Going forward, the client pays the monthly payment directly to the organization or to a payment processing company. This payment often includes a monthly fee and/or a "voluntary contribution". Fees are regulated by state laws. The credit counseling organization or payment processing company then makes payments to the client's creditors. In return, the creditors pay a "fair share contribution" to the organization.

Organizations that offer DMPs may qualify for exemption under IRC 501(c)(3). The organization must show that they have an educational methodology, and that they are not operating in a commercial manner. They must also ensure that there is no inurement or excessive private benefit.

Credit Repair Organizations

Organizations that offer credit counseling may also offer to repair a client's credit. These organizations claim that they can remove incorrect or negative items from an individual's credit report; and they often require the payment of a very high fee.

Alternatively, many financial literacy organizations also educate individuals about credit repair. They teach individuals how to read their credit report, show them how to identify incorrect items, and inform them about their rights. These organizations may also show the individuals how to write letters to their creditors or credit reporting agencies disputing items on their credit report. However, these organizations do not claim to repair an individual's credit for them; and they do not charge a separate fee to do so.

Continued on next page

Overview of Credit Counseling Organizations
12-D-7

IRS 00661
### Credit Repair Organizations (continued)

Organizations that educate individuals by teaching them how to identify and correct errors on their credit report may qualify for exemption under IRC 501(c)(3). The organization must show that they are purely educational in nature, and that they are not operating in a commercial manner. They must also ensure that there is no inurement or excessive private benefit. On the other hand, organizations that charge substantial fees to repair an individual's credit by removing negative or incorrect items, will not usually qualify for exemption. The service they provide is not charitable, and they do not limit their services to a charitable class of people.

### Bankruptcy Counseling Organizations

Organizations that offer credit counseling may also offer bankruptcy counseling as required as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. This law requires individuals pursuing debt relief through bankruptcy filing to seek pre-bankruptcy counseling and pre-discharge debtor education. The US Trustee Program at the Department of Justice approves credit counseling organizations who wish to provide this counseling and education. However, it is critical to ensure that an organization offering bankruptcy counseling is doing so in a manner that demonstrates an educational methodology rather than a commercial purpose.

Organizations that offer bankruptcy counseling may qualify for exemption under IRC 501(c)(3). The organization must show that they are purely educational in nature, and that they are not operating in a commercial manner. They must also ensure that there is no inurement or excessive private benefit. On the other hand, organizations that are operating in a commercial manner and are not following an educational methodology may not qualify for exemption.
Potentially Abusive Credit Counseling Organizations, Continued

Foreclosure Assistance Organizations

This activity is similar to Credit Counseling in that it can be conducted in a variety of ways. Activities of foreclosure assistance organizations include educational workshops, one-on-one counseling, providing grants to homeowners, negotiating with lenders, mortgage/loss mitigation, purchasing and renting homes, etc. Similar to Credit Counseling, Foreclosure Assistance can be exclusively charitable and educational. However, many organizations conduct their activities in a commercial manner. Also, often times there are related for-profit entities and strong potential for private benefit and inurement.

Foreclosure Assistance is a grade 13 issue. Applications from organizations involved with Foreclosure Assistance are screened to a reserved inventory and are currently being worked in group 7827. At closing, they are subject to mandatory review by EO Determinations Quality Assurance.

When developing Foreclosure Assistance cases, questions should be asked to determine whether the organization is exclusively educational and charitable, or operating in a commercial manner. Things to consider include eligibility requirements, fees charged, whether the information is actually educational, etc. Additionally, all private benefit and inurement issues must be addressed, especially with related for-profit entities.

Counsel is currently considering the effects of IRC section 501(q) as it relates to Foreclosure Assistance, specifically, whether or not it is permissible for an organization to negotiate directly with lenders on their clients’ behalf.
Additional Resources


Credit Counseling Organizations, 2004 CPE Text
Summary

In recent years IRS has found that many credit counseling organizations operating as tax-exempt charities are primarily sellers of debt-reduction plans, motivated by profit, and offer little or no counseling or education. In many cases, the credit counseling organization also serves the primary interests of related for-profit businesses, officers and directors. In response to these developments, the IRS initiated a widespread outreach program to alert the industry and general public to problems in this sector and initiated a compliance program to halt abuses within the credit counseling industry.

Organizations that offer purely educational financial literacy training can qualify for exemption under IRC 501(c)(3) if the organization can demonstrate that their activities are exclusively educational and/or charitable.

Potentially abusive credit counseling agencies include organizations that offer debt management or debt repayment plans, organizations that claim to be able to repair an individual’s credit history, and those that offer bankruptcy counseling and certification.

Similar to credit counseling organizations, foreclosure assistance organizations may conduct activities that are exclusively charitable and educational and qualify for exemption under IRC 501(c)(3). However, many foreclosure assistance organizations conduct their activities in a commercial manner, are related to for-profit entities, and present significant inurement/private benefit issues.
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Lesson 12  
Section E  
Down Payment Assistance Programs

Overview

Introduction
Many consider home ownership to be a basic part of the American dream. One of the basic provisions of section 501(c)(3) is to serve a charitable class, including the poor and needy, the handicapped and elderly, and those who are otherwise disadvantaged.

Traditionally, down payment assistance programs operated by tax-exempt organizations provided cash assistance to low-income homebuyers who could not afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage. Funds for these programs typically came from government agencies or from a charitable organization’s public funds.

Increasingly, the IRS has found that organizations claiming to be charities are participating in seller-financed down payment assistance programs that are operated to benefit sellers. Such organizations are not operated exclusively for exempt purposes and, therefore, do not qualify for exemption under IRC 501(c)(3).

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Potential Issues for Home Buyers

Potential home buyers may have problems getting their own home due to several factors, including:

- a lack of personal funds for making the necessary down payment,
- an inability to get a job with sufficient earning power to make monthly payments on a home, or
- an inability to find a house in an affordable price range in a safe neighborhood,

In order to qualify for most traditional loans and many governmental and charitably funded loans and programs, home buyers are usually required to have a down payment equivalent to 5-10 percent of the purchase price of the home.

Many buyers may be able to make the projected monthly mortgage payment but do not have the ability to save enough funds to make the needed down payment. Failure to make an adequate down payment can result in higher monthly mortgage payments, a higher interest rate on the mortgage, and a possible need for additional costly mortgage insurance payments. In many cases the lack of an adequate down payment is an obstacle that prevents many individuals from ever purchasing a home.
Types of Down Payment Assistance Programs

Many organizations, in conjunction with their other housing and economic development programs, have developed a wide variety of down payment assistance programs. For example, in recent years, applications for IRC 501(c)(3) have been submitted by small builders and rehabbers proposing to provide rehabilitated housing for low and moderate-income families.

Activities may be vague as described by the applicant. Upon development of the case, the determinations specialist may discover programs that involve:

- giving potential home buyers the necessary funds to make their down payment
- starting potential home buyers on a regimented savings plan or budget to help them save their own down payment
- educating potential home buyers on available sources to obtain funds that they can use to their down payment or
- getting potential home buyers involved in a seller-financed down payment assistance program

Revenue Ruling 2006-27

Down payment assistance programs can qualify as tax-exempt charitable and educational organizations under IRC 501(c)(3) when properly structured and operated. Revenue Ruling 2006-27 provides a detailed discussion of the guidelines to be utilized in reviewing applications for exemption from organizations conducting down payment assistance activities. The Revenue Ruling includes two examples that meet—and one example that fails to meet—the tests for exemption.

Revenue Ruling 2006-27 makes it clear that seller-funded programs are not charities because they do not meet the requirements of IRC 501(c)(3). Increasingly, the IRS has found that organizations claiming to be charities are being used to funnel down-payment assistance from sellers to buyers through self-serving, circular-financing arrangements. In a typical scheme, there is a direct correlation between the amount of the down payment assistance provided to the buyer and the payment received from the seller.
Application Issues

Applications that do not involve seller-financed down payment assistance programs do not require any special handling and are not reserved for a specified group or designated specialists. These applications require the specialist to follow the basic requirements for determining exemption under IRC 501(c)(3) by considering the following:

- Is the applicant operated and organized exclusively for 501(c)(3) purposes?
- How does the applicant insure that it is serving a charitable class?
- What specifically does the applicant do to serve this charitable class?
- Is there any private benefit or inurement?

As stated previously, applications involving seller-financed down payment assistance are reserved for EO Group 7827 in Cincinnati. If a specialist determines that they have one of these cases, they should obtain the concurrence of their manager, make an appropriate entry on the case chronology, and return the case to centralized processing with a request that the case be assigned to the reserved inventory for Group 7827.

However before doing this, the specialist should determine if the case is truly involved with a seller-financed down payment assistance program. This can be difficult, sometimes due to the fact that such a program may be only a small portion of the numerous activities conducted by an applicant and may be mentioned only in passing.

Continued on the next page
Application Issues, continued

Identifying Seller-Financed Down Payment Assistance Programs

Some general characteristics or examples of applications involving seller-financed down payment assistance include:

- Small builder/rehabber or real estate professional looking for exemption under section 501(c)(3)

- Vague activities but generally include rehabbing residential buildings in “run-down” or inner city areas for low to moderate-income families

- Officers may not necessarily be involved in the construction work

- Applicant may claim they are lessening the burdens of the government

- Applicant may say they are providing classes for first time homebuyer

- Related board members are drawing salaries

- Limited financial data is presented that is missing key elements such as the cost of rehabilitation

- Down payment assistance is provided to low and moderate income individuals and families

- Home buyers typically use a conventional FHA mortgage

- Rehabbers may say they will buy foreclosed properties from HUD or VA

- Local realtors are often involved behind the scenes in promoting a national down payment assistance program, locating potential buyers for FHA mortgages, etc.

Continued on next page
Identifying Seller-Financed Down Payment Assistance Programs

Characteristics

Some general characteristics of national organizations with down-payment assistance programs include:

- Currently exempt under section 501(c)(3)
- Fairly new organizations
- Extensive advertising over the internet
- May require home buyers to take first-time home buyers classes
- May require home warranties over and above the FHA requirements
- May have related 501(c)(3) organizations that conduct charitable activities
- May have related for-profit businesses
- A rehabber may pay a fee to the national organization that gives a smaller gift to the homebuyer for the down payment. The remaining funds stay within the national organization.
- Independent realtors often play a key role
- Website may suggest that the donor/seller may take at least part of the down payment assistance as a chartable contribution

Continued on next page
### Characteristics (continued)

Seller-financed down payment assistance programs are usually carried out by an organization working with local realtors and other members of the community. It is carried out by locating a home seller who may:

- Already have their home on the market
- Agree to pay all or a portion of the closing fees, usually paid by the buyer, in an attempt to lessen the cost to the buyer and help expedite the sale from the seller’s perspective

Closing costs usually paid by the buyer may include, but are not limited to:

- Title fees
- Title insurance
- Appraisal fees
- Deed recording
- Other processing and transaction fees
Summary

Down payment assistance programs provide cash to low-income homebuyers who cannot afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage for purchase of a home. Traditionally, funds for these programs have come from government agencies or various charitable organizations.

Since the IRS has found that many organizations claiming to be charities are participating in seller-financed down payment assistance programs operated to benefit sellers, applications for exemption from organizations participating in down payment assistance programs are closely scrutinized.

Down payment assistance programs can qualify as tax-exempt charitable and education organizations under IRC 501(c)(3) when properly structured and operated. Revenue Ruling 2006-27 provides a detailed discussion of the guidelines utilized in reviewing applications from organizations involved in down-payment assistance programs. The Revenue Ruling includes two examples that meet—and one example that fails to meet—the tests for exemption.
Lesson 12
Section F

Overview of IRC Section 521
Farmers’ Cooperatives

Overview

Introduction

This lesson provides an overview of organizations that may qualify as Farmers’ Cooperatives exempt under IRC section 521. It is not intended to be a comprehensive review of IRC section 521 requirements and/or case development. Farmers’ cooperatives are Grade 13 cases and are a reserved inventory category.

Objectives

At the end of this lesson the you will be able to:

• Define an exempt farmers’ cooperative

• Determine whether an organization is organized and operated on a cooperative basis

• List advantages and disadvantages to exemption under IRC section 521

In This Lesson

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Farmers’ Cooperatives - Background and Definition

Introduction

Certain farmers’ cooperatives have been exempted from Federal income tax since 1921 in order to improve the economic position of farmers. Organizations requesting exemption under IRC section 521 do so by submitting Form 1028, Application for Recognition of Exemption Under Section 521 of the Internal Revenue Code. These applications are Grade 13 cases and are currently a reserved inventory category. These cases are subject to mandatory review by Quality Assurance per IRM 7.20.5.3.

What is a Cooperative?

A cooperative is a membership organization that is owned and operated for its member/patrons for the purpose of providing goods and services and distributes the net profits from its business activities back to its member/patrons on the basis of the business each member/patron conducted with the cooperative.

Definition of an Exempt Farmers’ Cooperative

The definition of an exempt farmers’ cooperative can be found in IRC section 521(b) which states in part as follows:

The farmers’ cooperatives exempt from taxation to the extent provided in subsection (a) are farmers’, fruit growers’, or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

Effectively, IRC section 521 allows a single-tax treatment. The cooperative is not taxed, and the cooperative member/producer is taxed on the income received.

IRC 1381 states that all corporations operating on a cooperative basis are subject to tax under Subchapter T.

Overview of IRC Section 521 – Farmers’ Cooperatives

12-F-2
Organizational Requirements

**Definition of Farming**

Webster’s Unabridged Dictionary defines a farmer as “one who cultivates a farm.” The trade or business of farming is defined in Treas. Reg. 48.6420-4(b), in part, as follows:

A person will be considered to be engaged in the trade or business of farming if the person cultivates, operates, or manages a farm for gain or profit, either as an owner or a tenant. A person engaged in forestry or the growing of timber is not thereby engaged in the trade or business of farming.

Treas. Reg. 48.6420-4(c) also goes on to define a “farm.” A definition of farming can also be found in IRC 464(e)(1).

**Organizational Requirements**

IRC section 521(b) requires that a farmers' cooperative association be "organized and operated on a cooperative basis." Generally, an organization is operated on a cooperative basis within the meaning of IRC section 521 if it allocates net profits to patrons on the basis of the business done with or for such patrons.

In order to support that an IRC section 521 cooperative is organized on a cooperative basis, the language in the organizational documents has but one purpose, to provide safeguards to insure that **all patrons are treated equally** whereby the organization is operated to return net profits from operations to its patrons on the basis of business done with or for such patrons and is not engaged in business on its own behalf.

The Articles of Incorporation, bylaws, or written contract (i.e. membership agreement) **must** include a pre-existing valid enforceable written obligation that the cooperative will pay to each patron their portion of net earnings based upon the quantity or value of business done with or for such patron.

Whether an organization is organized and operated on a cooperative basis cannot be determined solely by a review of its articles of incorporation. An association that is confined to cooperative selling for the benefit of its patrons, but which has additional charter powers, may nevertheless be exempt. (Revenue Ruling 68-496, 1968-2 C.B. 251). Also, an association’s articles need not provide for equal dividends between members and nonmembers, if its business is solely with members. (Eugene Fruit Growers Ass’n v. Commissioner, 37 B.T.A. 993 (1938)).

*Overview of IRC Section 521 – Farmers’ Cooperatives*

12-F-3
Operational Requirements

In order to operate on a cooperative basis for purposes of IRC section 521, an exempt farmers’ cooperative must:

- Allocate net profits to its patrons on the basis of the business done with or for such patrons
- Perform a marketing or purchasing function (or both) for its patrons
- Establish that it has no taxable income for its own account other than that reflected in an authorized reserve or surplus or business with the government.

In order to operate on a cooperative basis for purposes of IRC section 521, an exempt farmers’ cooperative must not:

- With certain exceptions, market the goods of nonproducers. (IRC section 521(b)(1))
- Purchase supplies and equipment for nonmember/nonproducers in excess of 15% of the value of all purchases. (IRC section 521(b)(4))
- Market the goods of nonmembers in a value that exceeds the value of the goods marketed for members
- Purchase supplies and equipment for nonmembers in a value that exceeds the value of the goods purchased for members
- Pay patronage dividends allocable to one patron to a different patron e.g., nonmembers’ patronage dividends paid to member patrons

An exempt farmers’ cooperative performs two basic activities for its members:

- Marketing of crops (including packing, crating, shipping, storing, etc.)
- Purchasing of supplies

An exempt farmers’ cooperative is also allowed to conduct business with or for the U.S. Government or any of its agencies. (IRC section 512(b)(5))

Overview of IRC Section 521 – Farmers’ Cooperatives
12-F-4
## Additional Information Related to Farmers’ Cooperatives

### Advantage and Disadvantage of Exempt Farmers’ Cooperative

**Advantage:** An exempt farmers’ cooperative has an advantage over a nonexempt cooperative in that, if the exempt farmers’ cooperative follows the provisions of IRC section 521 and Subchapter T, there is a single tax treatment. Either the exempt farmers’ cooperative or its patrons will pay income tax, but not both. A nonexempt cooperative will pay income tax on the net profits from all nonpatronage-sourced income and so will its shareholder (usually its patrons/members) when they receive ordinary dividends.

**Disadvantage:** An exempt farmers’ cooperative is restricted from conducting activities on its own behalf which can be very lucrative and profitable for nonexempt cooperatives and their shareholders.

### Filing Requirements

Prior to January 1, 2007, an exempt farmers’ cooperative filed Form 990-C. Since that time, it files Form 1120-C.

Generally, exempt farmers’ cooperatives may not file a consolidated return.

Patronage dividend distributions are reported on Form 1099PATR.

### IRC Section 501(c)(16) Exempt Crop Financing Organizations

Crop financing organizations are entities formed to provide financing to farmers to cultivate their crops and livestock.

A crop financing organization must be organized by a farmers’ cooperative exempt under IRC section 521 or the members of a farmers’ cooperative exempt under IRC section 521. It must also operate in conjunction with the exempt cooperative.

**Example:**

In order to pay back the loan from the crop financing organization, the exempt farmers' cooperative withholds $1 from the sales proceeds of each crate of members' produce that is sold. This dollar is remitted to the crop financing organization on behalf of the farmer member.

### Additional Information

Additional information on farmers’ cooperatives will be provided in future training. More information on qualification under IRC section 521 can also be found in IRM 4.44.1.

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*Overview of IRC Section 521 – Farmers’ Cooperatives*  
*12-F-5*
Summary

IRC section 521 exempts farmers’ cooperative from Federal income tax. A cooperative is a membership organization that is owned and operated for its member/patrons for the purpose of providing goods and services and distributes the net profits from its business activities back to its member/patrons on the basis of the business each member/patron conducted with the cooperative.

Generally, an organization is operated on a cooperative basis within the meaning of IRC section 521 if it allocates net profits to patrons on the basis of the business done with or for such patrons.

In order to operate on a cooperative basis for purposes of IRC section 521, an exempt farmers’ cooperative must allocate net profits to its patrons on the basis of the business done with or for such patrons; perform a marketing or purchasing function for its patrons; and establish that it has no taxable income for its own account other than that reflected in an authorized reserve or surplus or business with the government.

An advantage of exemption under IRC section 521 includes a single tax treatment of income to members rather than to the cooperative in addition to the members’ income. Disadvantages of treatment under this section include the restriction from conducting activities on its own behalf which can be very lucrative and profitable for nonexempt cooperatives and their shareholders.
Lesson 12
Section G

Overview of Low-Income Housing Tax Credit
Limited Partnerships

Overview

Introduction

The use of partnerships has become an extremely popular device for funding low-income housing projects. This has been driven by the drying up of public funds for housing and the economic potential that encourages private investors to invest in low-income housing projects qualifying for tax credits under IRC section 42.

The economic goals of the private investors are strikingly different from, and often in conflict with, the charitable goals of exempt organizations in providing low-income housing. Partnership agreements attempt to satisfy the interests of both the exempt organizations and the investors.

Objectives

At the end of this lesson you will be able to:

- Identify criteria for qualification for low-income housing tax credits
- Identify issues related to low-income housing tax credits

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Overview of Low-Income Housing Tax Credit Limited Partnerships
12-G-1

IRS 00681
Applications Involving Low-Income Housing Tax Credits

LIHTC Qualification Criteria

Low-Income Housing Tax Credit (LIHTC) qualification criteria are the same for both for profit and nonprofit housing entities. However, IRC section 42 states a preference for allocating credits to a qualified nonprofit organization.

The criteria for a qualified nonprofit organization are:

- The organization must have IRC section 501(c)(3) or 501(c)(4) exemption
- May not be affiliated with or controlled by a for-profit organization
- Must have an exempt purpose to foster low-income housing

Therefore, applicants involved in LIHTC may submit either Form 1023 or 1024.

Agreement Analysis

A limited liability company (LLC), which is treated as a partnership for federal income tax purposes, has been increasingly used for LIHTC partnership arrangements. The analysis of the arrangement is the same whether the low-income housing partnership is a limited partnership (LP) or an LLC.

The partnership agreement or the operating agreement must be scrutinized to determine whether the exempt organization faces potential conflicts between furthering its charitable purpose(s) and furthering the interests of the limited partners or members. The agreement must also be analyzed as to whether it exposes the exempt organization’s charitable assets to possible risk.

Application Processing

Applications involved in LIHTC are Grade 13 cases and are currently a reserved inventory category. These applications are subject to Mandatory Review by EO Determinations Quality Assurance.
Issues Related to Low-Income Housing Tax Credits

Agreement Provisions

Like any housing application, an applicant involved in LIHTC must be organized and operated exclusively for purposes within IRC section 501(c)(3) or (c)(4) according to the requested subsection and no net earnings may inure to the benefit of any private individual.

In LIHTC partnerships, the investors contribute the money, and, thus, they generally dictate the terms of the agreement. Some important provisions in the agreements are the purpose of the business; the contribution amounts; the allocation of profits, losses and tax credits; the distributions; the powers, rights and duties of the general partner; the powers, rights and duties of the limited partners; the transfer rights and obligation; and the dissolution.

Impermissible Benefit

Guarantees, indemnifications, and return of capital provisions, among others, may lead to impermissible benefits to the investors. Such provisions require a careful analysis because they could reveal that the exempt general partner does not have effective control over the partnership or that the partnership could further a non-exempt purpose for the benefit of the investors.

It is essential that the exempt partner is able to ensure that its charitable assets are not at risk, that its charitable goals are furthered, and that no more than incidental benefit is afforded the for profit partners.

IRS Issued Memoranda

Prior to April 25, 2006, the Service required all applications involved in LIHTC to have executed an amended and restated limited partnership agreement or operating agreement (also referred to as the “final agreement”).

On June 25, 2006, the Service issued a Memorandum allowing applicants involved in LIHTC to submit representations that the final agreement will contain provisions that further a charitable purpose, put the exempt partner in control of the partnership, and not indemnify the investors at the expense of the exempt partner.

On July 30, 2007, the Service issued a second Memorandum superseding the Memorandum of June 25, 2006. The second Memorandum provides clarification in that the applicant must identify a specific proposed housing project, and it removes the condition that a final agreement must be submitted to the Service upon execution.
Summary

Partnership agreements attempt to satisfy the interests of both exempt organizations and investors in low-income housing projects even though the goals of private investors are often different from the goals of exempt organizations involved in low-income housing projects.

Low-Income Housing Tax Credit (LIHTC) qualification criteria are the same for both for-profit and non-profit housing entities. However, IRC section 42 states a preference for allocating credits to a qualified non-profit organization.

In LIHTC partnerships, the investors contribute money to the project and, therefore, generally dictate the terms of the agreement. The determination specialist must scrutinize the partnership agreement to determine whether the agreement presents a potential for conflict between the charitable goals of the exempt organization and the private interests of the limited partners or members. The agreement must also be analyzed as to whether it exposes the exempt organization’s charitable assets to possible risk.

Applications involved in low-income housing tax credits are Grade 13 cases and currently a reserved inventory category.
Lesson 13

Less Frequently Seen Subsections

Overview

Introduction

There are several types of organizations described under IRC section 501(c) which are seldom seen in EO Determinations. This lesson will provide a broad overview of the requirements for exempt status under less frequently seen subsections of IRC section 501(c).

Objectives

At the end of this lesson, you will be able to apply the various requirements which the following organizations must meet to qualify for tax exempt status:

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**IRC Section 501(c)(1) - Corporations Organized Under Act of Congress**

**Introduction**

IRC section 501(c)(1) exempts from Federal income tax corporations organized under an Act of Congress. To qualify for exemption under this section, the corporation must:

- Be an instrumentality of the United States **AND**
- Its exemption must be specifically authorized by Congress in the manner required by IRC section 501(c)(1)

**Before DEFRA (Deficit Reduction Act of 1984)**

Before enactment of the Tax Reform Act of 1984 [part of the Deficit Reduction Act of 1984 (DEFRA), Public Law 98-369], IRC section 501(c)(1) required that a corporation's federal tax exemption be authorized in the Act creating the corporation. The corporation would remain exempt only as long as its exemption was consistent with the supplements and amendments to the original Act. For corporations that obtained their exempt status before July 18, 1984, these requirements remain in effect.

**After DEFRA**

With the Deficit Reduction Act of 1984, the grant of tax exemption to an organization in its authorizing legislation is no longer sufficient for IRC section 501(c)(1) status:

- Unless an organization was exempt under its organizing Act, as amended and supplemented, before July 18, 1984, it can only qualify for IRC section 501(c)(1) exemption if the exemption is specifically provided for in the Internal Revenue Code or in a non-Code provision of a revenue Act.

- Congress enacted IRC section 501(l) in which corporations receiving IRC section 501(c)(1) exemption may be listed. Thus, all new IRC section 501(c)(1) organizations must be referred to by name as exempt within the Code or a revenue Act.

*Continued on next page*
Federal Credit Unions

Federal credit unions, organized and operated under the Federal Credit Union Act, as amended, have been held to be instrumentalities of the United States and therefore entitled to exemption as organizations described in IRC section 501(c)(1).

Credit unions are cooperative organizations that provide savings and lending services to their members. Each member must buy a share in the organization. The membership must consist of a group of persons having a common bond of occupation or association or to groups within a well-defined neighborhood community, or rural district. After provision for the required reserves, the board of directors may declare a dividend to be paid to members from the remaining earnings. Credit unions exempt under IRC section 501(c)(14) are discussed later in this lesson.

Federal credit unions are included in a group exemption letter or supplements thereto issued to the National Credit Union Administration, an independent government agency, or its predecessor bureaus.

If an application for exemption is received from a federal credit union, the organization should be advised that the matter is, or will be, taken care of by the National Credit Union Administration in connection with submission of its annual list of changes for its group ruling.

Federal Land Bank Associations

Federal Land Bank Association(s) (formerly National Farm Loan Associations) are exempt under IRC section 501(c)(1) pursuant to the Federal Farm Loan Act. These organizations are cooperative organizations that serve as screening agents for mortgage loans granted by the federal land banks. The members of the associations are borrowers or potential borrowers on mortgages from the federal land banks.

Continued on next page
Additional Examples of IRC section 501(c)(1) Organizations

Other examples of IRC section 501(c)(1) organizations include:

- Federal Deposit Insurance Corporation (FDIC)
- Federal National Mortgage Association
- Federal Reserve Banks
- Federal Savings and Loan Insurance Corporation (FSLIC)
- Public Housing Administration

IRC section 501(l) lists:

- The Central Liquidity Facility
- The Resolution Trust Corporation
- The Resolution Funding Corporation

<table>
<thead>
<tr>
<th>No Application Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 501(c)(1) organizations do not need to file exemption applications. There is no form to apply for exemption under IRC section 501(c)(1).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No Annual Return Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 501(c)(1) organizations are excepted from annual information return requirements. (See Treas. Reg. 1.6033-2(g)(1)(ii) and Rev. Rul. 89-94, 1989-2 C.B. 233.) Wholly-owned subsidiaries of these organizations are also excepted from annual information return requirements under IRC section 6033(a)(2)(C)(vi).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deductibility of Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions to IRC section 501(c)(1) organizations made exclusively for public purposes are deductible to the donor as provided by IRC section 170(c)(1).</td>
</tr>
</tbody>
</table>
IRC Section 501(c)(1) - Corporations Organized Under Act of Congress, Continued

<table>
<thead>
<tr>
<th>Exemption Under Other Subsections</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 501(c)(1) refers only to instrumentalities of the United States Government. Federal as well as state and local governmental instrumentalities, governmental units, etc. may, in some situations, be exempt under IRC section 501(c)(3) if they do not meet the IRC section 501(c)(1) requirements.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Case Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>As IRC section 501(c)(1) organizations are not required to submit applications for exemption, there is no specific case grade assigned. However, like organizations which may submit applications for exemption (non-federal credit unions and instrumentalities exempt under IRC section 501(c)(3)) are generally graded as Grade 13 cases. The specialist should refer to the current CAG for correct grading and assignment.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IRM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional information on this subsection can be found in IRM 7.25.1.4.3.</td>
</tr>
</tbody>
</table>
IRC Section 501(c)(11) - Teachers' Retirement Fund Associations

Statutory Provisions

IRC section 501(c)(11) provides exemption from Federal income tax for teachers' retirement fund associations of a purely local character, if:

- No part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and

- The income consists solely of amounts received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect of investments.

No regulations have been issued under IRC section 501(c)(11) nor have any rulings or court decisions been published under this provision.

Membership

While IRC section 501(c)(11) provides for exemption for "teachers' retirement fund associations," the reference is considered to be descriptive only, and should not be construed as prohibiting the inclusion of other school employees as members of the fund. However, the membership of other employees should be incidental.

Purely Local in Character

The phrase "of a purely local character" has the same meaning for the purpose of this section as it has for the purposes of IRC section 501(c)(12), relating to benevolent life insurance associations.

- Treas. Reg. 1.501(c)(12)-1(b) states that an organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions.

- If the activities of an organization are limited only by the borders of a state, it cannot be considered to be purely local in character.

Continued on next page
Inherent in the exempt function of IRC section 501(c)(11) organizations and in the nature of retirement funds or pensions is the requirement that payments be made to members of the association. The payment of retirement benefits of the association to members or surviving spouses does not constitute inurement.

Application for Exemption

There is no prescribed form on which organizations apply for exemption under IRC section 501(c)(11). Any form of written application is acceptable as long as it shows:

- The character of the organization
- Its purposes and activities
- The source of its receipts and the disposition thereof
- Whether any of its income may be credited to surplus or may inure to the benefit of any private shareholder or individual
- Any other information that may affect its right to exemption

An organization must also submit (in duplicate):

- Copies of its articles of incorporation or other enabling instrument
- Its by-laws or other governing regulations
- Its latest financial statements showing its assets, liabilities, receipts and disbursements

(See Treas. Reg. 1.501(a)-1(a)(3))

Case Grade

IRC section (c)(11) is not listed in the current CAG. If assigned, correct case grading should be discussed with the group manager.

IRM

Additional information on this subsection can be found in IRM 7.25.11.
IRC Section 501(c)(14) - State Chartered Credit Unions, Mutual Reserve Funds

Credit Union Statute and Regulations

IRC section 501(c)(14) provides exemption from Federal income tax for credit unions:

- without capital stock,
- which are organized and operated for mutual purposes, and
- without profit.

Federal credit unions organized and operated in accordance with the Federal Credit Union Act, as amended, have been held to be instrumentalities of the United States. As discussed earlier in this lesson, they are exempt under IRC section 501(c)(1) and not this subsection.

State Law

IRC section 501(c)(14) does not define "credit union" except that it is an organization without capital stock and must be organized for "mutual purposes without profit." Treas. Reg. 1.501(c)(14)-1 merely adds that the credit unions contemplated by this section are other than Federal credit unions.

However, based on a detailed analysis of the legislative history of IRC section 501(c)(14)(A), the Service has concluded that it was the intention of Congress to exempt under this provision only those organizations chartered as credit unions under the laws of their home states. Thus, state law determines whether organizations are credit unions for purposes of exemption from Federal income tax under IRC section 501(c)(14)(A). (See also Rev. Rul. 69-282, 1969-1 C.B. 155)

Continued on next page
IRC Section 501(c)(14) - State Chartered Credit Unions, Mutual Reserve Funds, Continued

Characteristics

Although the credit union statutes of no two states are precisely identical, many are patterned roughly after an early Act of the Massachusetts legislature, approved May 20, 1915, and all have certain characteristics in common. The 1915 Massachusetts Act provides that the words "credit union" are reserved to associations organized in accordance with the Act which provides that:

- Organizations incorporated under the laws dealing with credit unions are subject to the supervision of the State Banking Commissioner.

- Credit unions are authorized to receive the savings of members either as a deposit or as payment for shares.

- The bylaws prescribe the conditions of membership, the par value of shares of stock, and the maximum number of shares which may be held by one member. They also designate the conditions under which shares may be paid in, transferred or withdrawn, and the conditions under which deposits may be received and withdrawn.

Additional Requirement Created by IRC Section 501(c)(14)

To qualify as a credit union exempt from Federal income tax under IRC section 501(c)(14)(A), a credit union must:

- Be chartered under the state credit union law

- Have the above-defined characteristics

- Operate without profit and for the mutual benefit of its members


Continued on next page

Less Frequently Seen Subsections

13-10

IRS 00694
Other Common Characteristics

Only members may subscribe for shares of stock, yet a member might be merely a depositor instead of a shareholder. Shareholding is not an essential prerequisite for membership but simply an attribute of membership. Each shareholder is entitled to one vote, regardless of the number of shares owned.

Loans are made only to members of the credit union. Applications for loans must be made in writing to the credit committee, and the member applying for a loan must state the purpose for which it is desired. No loan shall be made unless the credit committee is satisfied that it promises to benefit the borrower. Loans of small amounts are made and are repayable in installments. Prompt payment of obligations is a fundamental requirement of these associations.

While members may subscribe for shares of capital stock, no stock certificates are issued. The Attorney General of the United States has ruled that the term "capital stock" as used in connection with credit unions is in no sense similar to the accepted business meaning of that term, which Congress doubtless had in mind when it restricted exemption to organizations "without capital stock." While a credit union pays dividends on shares of stock, this is in reality the same as paying interest on deposits, 31 Opinions of Attorneys General, 176 (1916-1919).
IRC Section 501(c)(14) - State Chartered Credit Unions, Mutual Reserve Funds, Continued

**Mutual Reserve Funds**

IRC section 501(c)(14) also exempts from federal income tax corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit to provide reserve funds for, and insurance of, shares or deposits in:

a. domestic building and loan associations,
b. cooperative banks without capital stock organized and operated for mutual purposes without profit,
c. mutual savings banks not having capital stock represented by shares, or
d. mutual savings banks described in IRC section 591(b).

IRC section 501(c)(14) further provides exemption for corporations or associations organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in a., b., or c. of the preceding paragraph. These organizations are exempt, however, only if 85 percent or more of the income is attributable to providing such reserve funds and to investments.

- Organizations described in this paragraph are exempt only for years ending after February 2, 1966, Sec. 3, Public Law 89-352, 1966-1 C.B. 375.

The significant differences in paragraph (1) and paragraph (2) above are, paragraph (2) does not require an organization to insure shares or deposits in its member organizations and does not contain a specific restriction against issuance of capital stock. On the other hand, paragraph (2) contains an income percentage restriction clause not present in paragraph (1). To avoid conflicts, the Code provides that the provisions of paragraph (2) are not applicable to organizations meeting the requirements of paragraph (1), IRC section 501(c)(14)(C).

For taxable years beginning after February 2, 1966, organizations described in paragraph (1) and (2), above, are subject to the tax imposed by IRC section 511(a) on unrelated business income.

*Continued on next page*
IRC Section 501(c)(14) - State Chartered Credit Unions, Mutual Reserve Funds, Continued

<table>
<thead>
<tr>
<th>Application for Exemption</th>
<th>There is no application form for use in applying for exemption under IRC section 501(c)(14). Any form of written application is acceptable as long as it shows:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• The state and date of incorporation</td>
</tr>
<tr>
<td></td>
<td>• That the state credit union law with respect to loans, investments, and dividends, if any, is being complied with</td>
</tr>
<tr>
<td></td>
<td>(See Treas. Reg. 1.501(a)-1(a)(3))</td>
</tr>
<tr>
<td></td>
<td>When properly filled out, the form titled Claim for Exemption from Federal Income Tax, supplied by the Credit Union National Association, is acceptable as an application. (See Rev. Proc. 56-2, 1956-1 C.B. 1017)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Applicants</th>
<th>The applications of any other organization claiming exemption under IRC section 501(c)(14) must show:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• The character of the organization</td>
</tr>
<tr>
<td></td>
<td>• Its purposes and activities</td>
</tr>
<tr>
<td></td>
<td>• The source of its receipts and the disposition thereof</td>
</tr>
<tr>
<td></td>
<td>• Whether any of its income may be credited to surplus or may inure to the benefit of any private shareholder or individual</td>
</tr>
<tr>
<td></td>
<td>• Any other information that may affect its right to exemption</td>
</tr>
</tbody>
</table>

| All Applicants            | The organization must submit copies of its articles of incorporation or other enabling instrument, its by-laws or other governing regulations, and its latest financial statements showing its assets, liabilities, and disbursements. (See Treas. Reg. Section 1.501(a)-1(a)(3)) |

| Reserved for EO Technical | Applications for exemption under IRC section 501(c)(14) are Grade 13 cases and are reserved for EO Technical.                                                                            |

| IRM                       | Additional information on this subsection can be found in IRM 7.25.14.                                                                                                           |

Less Frequently Seen Subsections
13-13
IRC Section 501(c)(18) - Employee Funded Pension Trusts (Created Before June 25, 1959)

Statute Requirements
IRC section 501(c)(18) provides for the exemption of employee trusts created before June 25, 1959. The trusts must form part of a pension plan funded only by contributions of employees. In addition:

- It must be impossible for any part of the corpus or income to be used for, or diverted to, any purpose other than providing plan benefits and meeting reasonable administrative expenses, prior to the satisfaction of all liabilities with respect to the employees under the plan.

- The trust must not be discriminatory in favor of officers, shareholders, supervisors, or highly compensated employees.

Treasury Regulations
Treas. Reg. 1.501(c)(18)-1(a) provides, in part, that IRC section 501(c)(18) trusts must also meet following additional requirements:

- The trust must be valid under local law

- The trust must be evidenced by an executed written document

- The trust must be funded solely from contributions of employees who are members of the plan

- The trust must have been created before June 25, 1959

- The trust must provide solely for the payment of pension or retirement benefits to its beneficiaries

Application for Exemption
There is no prescribed form on which organizations apply for exemption under IRC section 501(c)(18). Any form of written application is acceptable. (See Treas. Reg. 1.501(a)-1(a)(3))

Case Grade
IRC section (c)(18) is not listed in the current CAG. If assigned, correct case grading should be discussed with the group manager.
IRC Section 501(c)(21) - Black Lung Benefit Trusts

Introduction
IRC section 501(c)(21) (Public Law 95-488) was added by the Black Lung Benefit Revenue Act of 1977. IRC section 501(c)(21) provides exemption to qualifying black lung benefit trusts created and funded by coal mine operators to provide miners with benefits to cover disability or death from black lung disease.

Liability of Coal Mine Operators
The Federal Coal Mine and Safety Act of 1969 (Public Law 91-173) established a requirement that operators of coal mines pay benefits to miners that have contracted black lung disease.

An operator could satisfy its liability through the purchase of insurance or by qualifying as a self-insurer.

Employers Other Than Coal Mine Operators
In addition to coal mine operators, The Black Lung Benefits Revenue Act established liability on coal mine construction and transportation employers for workers exposed to coal dust. Such an employer may be able to establish a trust in the same way as coal mine operators.

Application to Nuclear Plants
The Deficit Reduction Act of 1984 (Public Law 98-369) imposes the rules of IRC section 501(c)(21) to Nuclear Decommissioning Trust Funds described in IRC section 468A(e).

Liability Under State Law
Employers liable under state law for claims for black lung disability or death benefits may also establish a trust under IRC section 501(c)(21). For example, worker's compensation laws may impose this liability; however, liability arising under a state statute must be for or with respect to a claim for compensation for death or disability due to black lung disease. Black lung disease is defined as a chronic dust disease of the lung arising out of coal mine employment.

Insurance Companies
A trust established by an insurance company is not described in IRC section 501(c)(21) because its liability arises from a contractual obligation rather than the operation of a mine.

Continued on next page
### Exemption Requirements

To qualify under IRC section 501(c)(21), a trust must be created or organized in the United States and established pursuant to a written instrument. The Trust's terms must provide that no part of its assets may be used for or diverted to any purpose not specified in IRC section 501(c)(21)(A).

A trust must also be irrevocable and have no right or possibility of reversion of the corpus or income to the coal mine operator or other creator liable for the payment of black lung benefits, except that the creator may recover excess contributions.

### Permitted Activities

#### Payment of Benefits

A coal mine operator may establish a trust to pay all or part of the operator's liability. The trust may pay the benefits directly to the beneficiaries or purchase insurance exclusively covering liability for black lung benefits.

#### Payment of Related Fees

Administrative and incidental costs of the trust may be paid out of its assets. Such costs may include any excise tax imposed on a taxable expenditure and reasonable expenses arising in connection with a claim against the trust for liability for a taxable expenditure.

#### Payment of Trustee Liability Insurance

A trust may purchase insurance covering the liability of a trustee for excise taxes to the extent that the cost of the insurance together with any other compensation to the trustee is reasonable. A trust may also indemnify a trustee for reasonable expenses arising from a successful defense in an administrative proceeding involving excise taxes. This indemnification is also subject to reasonable compensation limitations.
Permitted Activities (continued)

**Investment of Trust Assets**

A trust may invest its assets, but only to the extent that they exceed current year obligations. These investments must be limited to:

- Public debt securities of the United States (obligations guaranteed as to principal and interest by the United States)
- Obligations of a state or local government which are not in default as to principal and interest or
- Time-demand deposits in a bank or an insured credit union in the United States

**Investment of Trust Assets - Self-Dealing**

If a bank or credit union is a trustee of the trust or a disqualified person, deposits or investments in that bank or credit union would constitute an act of self-dealing under IRC section 4951. This differs from the private foundation area, in which Treas. Reg. 53.4941(2)-2(c)(4) would allow private foundations to invest its assets in a bank that was a disqualified person.

**Payment of Certain Excise Taxes Not Permitted**

Excise taxes imposed on the trustee or other disqualified person for acts of self-dealing or making excess contributions cannot be covered by the trust.

**Excise Taxes**

The Black Lung Benefits Revenue Act imposes excise taxes on certain acts of self-dealing (IRC section 4951) and taxable expenditures (IRC section 4952). These excise taxes are similar to those imposed on private foundations for self-dealing and taxable expenditures. Thus, the regulations under IRC sections 4941, 4945 and 4946 generally apply to IRC sections 4951 and 4952. The excise tax on self-dealing also applies to the Nuclear Decommissioning Trusts.

Continued on next page

Less Frequently Seen Subsections

13-17
### IRC Section 501(c)(21) - Black Lung Benefit Trusts, Continued

<table>
<thead>
<tr>
<th><strong>Application for Exemption</strong></th>
<th>There is no application form for use in applying for exemption under IRC section 501(c)(21). Any form of written application is acceptable. (See Treas. Reg. 1.501(a)-1(a)(3))</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Form 990-BL</strong></td>
<td>Tax-exempt black lung benefit trusts described in IRC section 501(c)(21) must file an annual information return, Form 990-BL, unless its normal annual gross receipts are not more than $25,000. A trust that normally has gross receipts of $25,000 or less must file an annual electronic notice (990-N).</td>
</tr>
<tr>
<td><strong>Schedule A</strong></td>
<td>Schedule A of Form 990-BL must be filed to report any initial excise taxes imposed under IRC section 4951 or 4952.</td>
</tr>
<tr>
<td><strong>Case Grade</strong></td>
<td>IRC section (c)(21) is not listed in the current CAG. If assigned, correct case grading should be discussed with the group manager.</td>
</tr>
<tr>
<td><strong>IRM</strong></td>
<td>Additional information on this subsection can be found in IRM 7.25.22.</td>
</tr>
</tbody>
</table>
### IRC Section 501(c)(23) - Veterans Organizations (Created Before 1880)

<table>
<thead>
<tr>
<th><strong>Qualification for Exemption</strong></th>
<th>IRC section 501(c)(23) provides exemption for veterans’ associations:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• organized prior to 1880</td>
</tr>
<tr>
<td></td>
<td>• more than 75 percent of whose members are past or present members of the armed forces, their spouses, or dependents; and</td>
</tr>
<tr>
<td></td>
<td>• the principal purpose of which is to provide insurance and other benefits to veterans or their dependents</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Created in 1982</strong></th>
<th>IRC section 501(c)(23) was created in 1982 by Public Law 97-248. This legislation was proposed on behalf of two organizations:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• The Army Mutual Aid Association</td>
</tr>
<tr>
<td></td>
<td>• The Navy Mutual Aid Association</td>
</tr>
</tbody>
</table>

| **Broader Than (c)(19)** | IRC section 501(c)(23) is broader than IRC section 501(c)(19) in that the membership requirements are more lenient. |

| **Application for Exemption** | There is no application form for use in applying for exemption under IRC section 501(c)(23). Any form of written application is acceptable. (See Treas. Reg. 1.501(a)-1(a)(3)) |

| **Case Grade** | IRC section (c)(23) is not listed in the current CAG. If assigned, correct case grading should be discussed with the group manager. |

| **IRM** | Additional information on this subsection can be found in IRM 7.25.19.9. |

*Less Frequently Seen Subsections*

13-19
IRC section 501(f) - Cooperative Service Organizations of Operating Educational Organizations

IRC section 501(f) indicates that if an organization is:

1. organized and operated solely to hold, commingle, and collectively invest and reinvest (including arranging for supervising the performance by independent contractors of investment services related thereto) in stocks and securities, the moneys contributed thereto by each of the members of such organization, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members,

2. organized and controlled by one or more of such members, and

3. comprised solely of members that are organizations described in clause (ii) or (iv) of IRC section 170(b)(1)(A):
   - which are exempt from taxation under subsection (a), or
   - the income of which is excluded from taxation under IRC section 115(a).

then such organization shall be treated as an organization organized and operated exclusively for charitable purposes.

Continued on next page
### IRC section 501(f) - Cooperative Service Organizations of Operating Educational Organizations, Continued

<table>
<thead>
<tr>
<th>Purpose and Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Like IRC sections 501(e), (g), and (k), IRC section 501(f) provides a special exception for organizations that might otherwise be barred from exemption under IRC section 501(c)(3). It provides a narrowly drawn exception to the Service position that a mutual investment fund for charitable organizations does not qualify for exemption under IRC section 501(c)(3) where services are not provided substantially below cost.</td>
</tr>
</tbody>
</table>

IRC section 501(f) affects cooperative service organizations formed and controlled by schools or organizations operated for the benefit of certain state and municipal colleges and universities for the collective investment for their funds in stocks and securities.

An organization described in IRC 501(f) is treated as organized and operated exclusively for charitable purposes. If it meets the other requirements of IRC section 501(c)(3), it is exempt under that subsection.

Congress did not intend for IRC section 501(f) to apply to any organization formed to promote the furnishing of investment services by private interests even though these services might be available only to educational institutions.

For example: If a private brokerage house were to initiate formation of a cooperative investment organization to drum up business, the organization would not qualify under IRC section 501(f), even if membership were limited to schools.


<table>
<thead>
<tr>
<th>Application for Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cooperative service organizations of operating educational organizations requesting exemption under IRC section 501(f) for organizations must complete and submit Form 1023.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Case Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 501(f) is not listed in the current CAG. If assigned, correct case grading should be discussed with the group manager.</td>
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</table>

<table>
<thead>
<tr>
<th>IRM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional information on this subsection can be found in IRM 7.25.3.7.6.1.</td>
</tr>
</tbody>
</table>

*Less Frequently Seen Subsections* 13-21
Summary

IRC section 501(c)(1) exempts corporations organized under an Act of Congress. To qualify under this section, the corporation must be an instrumentality of the United States and its exemption must be specifically authorized by Congress in the manner required by IRC section 501(c)(1).

IRC section 501(c)(11) provides exemption for teachers' retirement fund associations of a purely local character, if no part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and the income consists solely of amounts received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect of investments.

IRC section 501(c)(14) provides exemption for state chartered credit unions and mutual reserve funds. These cases are reserved for EO Technical.

IRC section 501(c)(18) provides for the exemption of employee trusts created before June 25, 1959. The trusts must form part of a pension plan funded only by contributions of employees.

IRC section 501(c)(21) provides exemption to qualifying black lung benefit trusts created and funded by coal mine operators to provide miners with benefits to cover disability or death from black lung disease.

IRC section 501(c)(23) provides exemption for veterans’ associations organized prior to 1880, more than 75 percent of whose members are past or present members of the armed forces, their spouses, or dependents; and the principal purpose of which is to provide insurance and other benefits to veterans or their dependents.

IRC section 501(f) indicates that if an organization is organized and operated solely to hold, commingle, and collectively invest and reinvest in stocks and securities, the moneys contributed thereto by each of the members of such organization, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members, organized and controlled by one or more such members, and comprised solely of members that are organizations described in clause (ii) or (iv) of IRC section 170(b)(1)(A) which are exempt from taxation under subsection (a), or the income of which is excluded from taxation under IRC section 115(a), then such organization shall be treated as an organization organized and operated exclusively for charitable purposes.