Exempt Organizations
Determinations
CPE - 2012

Student Text

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IRS
Department of the Treasury
Internal Revenue Service

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Training 10038-002 (Rev. 6-2012)
The IRS Mission
Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

The Tax Exempt and Government Entities Mission
Provide customers top quality service by helping them understand and comply with the applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to
14 General Principles of Ethical Conduct for Federal Employees
5 C.F.R. § 2635.101(b)

1) Public service is a public trust, requiring employees to place loyalty to the Constitution, the laws and ethical principles above private gain.

2) Employees shall not hold financial interests that conflict with the conscientious performance of duty.

3) Employees shall not engage in financial transactions using nonpublic Government information or allow the improper use of such information to further any private interest.

4) An employee shall not, except as permitted by subpart B of the Standards of Ethical Conduct, solicit or accept any gift or other item of monetary value from any person or entity seeking official action from, doing business with, or conducting activities regulated by the employee’s agency, or whose interests may be substantially affected by the performance or nonperformance of the employee’s duties.

5) Employees shall put forth honest effort in the performance of their duties.

6) Employees shall not knowingly make unauthorized commitments or promises of any kind purporting to bind the Government.

7) Employees shall not use public office for private gain.

8) Employees shall act impartially and not give preferential treatment to any private organization or individual.

9) Employees shall protect and conserve Federal property and shall not use it for other than authorized activities.

10) Employees shall not engage in outside employment or activities, including seeking or negotiating for employment, that conflict with official Government duties and responsibilities.

11) Employees shall disclose waste, fraud, abuse, and corruption to appropriate authorities.

12) Employees shall satisfy in good faith their obligations as citizens, including all just financial obligations, especially those – such as Federal, State, or local taxes – that are imposed by law.

13) Employees shall adhere to all laws and regulations that provide equal opportunity for all Americans regardless of race, color, religion, sex, national origin, age, or handicap.

14) Employees shall endeavor to avoid any actions creating the appearance that they are violating the law or the above ethical standards. Whether particular circumstances create an appearance that the law or these standards have been violated shall be determined from the perspective of a reasonable person with knowledge of the relevant facts.
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Lesson 1

IRM Procedures
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Lesson 1 - IRM Procedures

Slide 1

CPE 2012

Procedures Updates

Slide 2

Objectives

By the end of this presentation:

- You will be familiar with the changes to the EO Determinations procedures
- You will be reminded of some procedures you may have forgotten

Slide 3

Status of IRMs

- 7.20.1 - Published September 2011, update in process
- 7.20.2 - Published May 2012
- 7.20.3 - Pending publication
- 7.20.4 - Draft under review
- Formalizing and publishing all forms and letters
Lesson 1 - IRM Procedures

Slide 4

7.20.1

Slide 5

Pending Updates
- Cases reserved for EO Technical
- No QA review required for cases reserved for EO Technical
- No ROO follow-up referral on withdrawn application
- Form 2848 Revised 10-2011

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7.20.2
Lesson 1 - IRM Procedures

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### 7.20.2 Major Topics
- Technical Screening
  - Initial screening, AP, IP
- General case processing
- Effective dates & EIN issues
- Adverse case processing
- Case file assembly
- Case closing procedures

Slide 8

### Of Note
- OUO Information
- Most forms
- Secondary screening categories
- Case Grading Matrix and CAG
- List of common forms and letters
- Effective as of XXXXXXXX XX, 2012

Slide 9

### Technical Screening
7.20.2.3 Includes:
- Initial Screening
- Accelerated Processing (AP)
- Intermediate Processing (IP)
Lesson 1 - IRM Procedures

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General Case Processing
- Consider the customer
- Actions must occur within 5 workdays
- Get the letter out

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Your Case is Assigned
- Enter case on Form 6490 (WebETS)
- Prepare CCR noting date case was assigned (automatic on TEDS)
- Take actions within 5 workdays

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Requesting Additional Information
- Get the letter out
- Don’t ask for things you don’t need
- Proofread your letters
- Consider the customer
- Don’t forget the AIS sheet (TEDS cases)
Lesson 1 - IRM Procedures

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**Requesting Additional Information**

- May be appropriate to call for information
- Standard response times
- Reminder – additional information letter still needs to go out within 5 workdays of case assignment

Slide 14

**Response Received**

- Document the date response is received on the CCR
- If complete, close case within 5 workdays
- If incomplete, issue Letter 2382 within 5 workdays

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**No Response After 21 Days**

- Follow-up the day following the response due date
- May grant 14 day extension
- If you reach them by phone, no need to send Letter 4423
Lesson 1 - IRM Procedures

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No Response After 35 Days

- Talk to your manager before granting any more extensions
- Suspend case once all reasonable extensions have been exhausted

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Suspense/FTE

- Call the applicant
- Prepare Form 14289, EDS Closing Worksheet – Letters 4587 and 1314
- Case to manager within 5 workdays
- All suspense cases to the Adjustments Unit
- Update WebETS - add 37 before the name e.g. 37 – EO Determinations Charity
- Post-suspense inquiries/extension requests

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Cases Sent to EODQA

- Cases sent to EODQA for Mandatory Review are sent in hard copy
- Complete case must be sent
- Cases with no appeal rights – keep orange folder
- Cases with appeal rights – no orange folder
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Effective Dates
- Auto Revocation effects
- Consult manager for effective date more than 27-months before postmark date
- Change in subsection – postmark date
  - Add addendum to letter

Slide 20
EINs
- Research EIN if necessary
- EIN Merger
- New EIN Required
- Ensure correct EIN listed in LINUS, TEDS, and EDS

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User Fees
- Ensure correct fee is paid
  - Get a LINUS print if necessary
  - Check the fields on EDS/TEDS
- If user fee field is I or U, contact Adjustments Unit
- User fee refunds
Lesson 1 - IRM Procedures

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Adverse Case Processing

- IRM 7.20.2.11
- Letter prepared within 10 workdays
- Must be sent to QA in hard copy

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Case File Assembly

- Refer to the IRM for specific assembly procedures
- If a case is not established in TEDS, no orange folder needed

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Case Closing

- CCR
- No 6038 Checkbox form required
- Turn the case in the SAME day
  - If are in a POD other than your manager, update and ship SAME day
- Cases returned by manager – take action within 5 workdays
Lesson 1 - IRM Procedures

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Forms and Letters

- List of common forms and letters
- All forms and letters have official numbers
- Check NERD on regular basis for most up-to-date version of forms and letters

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Other Misc Topics in 7.20.2

- Requesting Administrative File
- EO Returns Processing
- OARs and other TAS requests
- CAG and Case Grading Criteria Matrix

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Questions?
Lesson 2

IRC 509(a)(3)
Type I & II Supporting Organizations
Lesson 2

IRC 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).
Overview, Continued

Introduction (continued)

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.

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.

Continued on next page
Overview, Continued

References
Exhibit 1-1, IRC 509(a)(3) Type I and II Guide Sheets
Exhibit 1-2, IRC 509(a)(3) Type I and II Guide Sheet Explanations

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Guide Sheet Explanation................................................................. 2-5
Tests for Qualification as a Type I or Type II Supporting
Organization..................................................................................... 2-6
Organizations Requiring Heightened Scrutiny................................. 2-9
Summary.............................................................................................. 2-12
Exhibit 1-1......................................................................................... 2-13
Exhibit 1-2 ......................................................................................... 2-21
Guide Sheet for Type I and Type II Supporting Organizations and Guide Sheet Explanation

IRC 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 1) along with a detailed Guide Sheet Explanation keyed to specific questions in the Guide Sheet (Exhibit 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)

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).

Guide Sheet Part 1 IRM 7.20.7.2.1

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)

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)

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

Guide Sheet, Part 2 IRM 7.20.7.2.2
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.

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 IRM 7.20.7.2.3
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.

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).

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

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

<table>
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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

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<th>Potential Red Flags - Guide Sheet, Part 5</th>
<th>IRM 7.20.7.2.5.1</th>
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<tbody>
<tr>
<td>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.”</td>
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<table>
<thead>
<tr>
<th>Potential Private Benefit – Guide Sheet Part 5,</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>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.</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Guide Sheet Part 5, IRM 7.20.7.2.5.2(1), (2) and (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Questions in Part 5, Section I of the Guide Sheet (IRM 7.20.7.2.5.2(1)) is 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.</td>
</tr>
</tbody>
</table>

*Continued on next page*
Questions in Part 5, Section I of the Guide Sheet (IRM 7.20.7.2.5.2(1)) is 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.

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 cases, the Guide Sheet should follow Form 6038 and the Form 6038 attachment. For A cases, the Guide Sheet should follow the CCR.

Continued on next page
Organizations Requiring Heightened Scrutiny, Continued

**Determination Letters**

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

Paragraph 4 – Type I, “operated, supervised, or controlled by” its supported organization(s)

Paragraph 5 – 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 on the NERD Drive under Denials-Adverse Determinations/Denial-Adverse 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

<table>
<thead>
<tr>
<th>Summary</th>
<th>IRC 509(a)(3) Type I supporting organizations are operated, supervised, or controlled by one or more publicly supported organizations (“parent-child” relationship).</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>IRC 509(a)(3) Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations (“brother-sister relationship”).</td>
</tr>
<tr>
<td></td>
<td>IRC 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.</td>
</tr>
<tr>
<td></td>
<td>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.</td>
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<tr>
<td></td>
<td>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.</td>
</tr>
<tr>
<td></td>
<td>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.</td>
</tr>
</tbody>
</table>
Exhibit 1-1

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>A.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>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>
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<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>B.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>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>
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</tbody>
</table>

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<thead>
<tr>
<th>C.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>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>
</tbody>
</table>

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<tr>
<th>D.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>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>
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</tbody>
</table>

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<thead>
<tr>
<th>E.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>To meet the organizational test, there must be a “Yes” answer to E(1) and &quot;No” answers to E(2) and E(3)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>A.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the supporting organization claim to support an IRC 501(c)(4), (5) or (6) organization? If &quot;Yes”, proceed to questions B through E.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>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>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>C.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>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>
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</tbody>
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<thead>
<tr>
<th>D.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the supporting organization meet the Type I or Type II relationship requirement?</td>
<td></td>
<td></td>
</tr>
</tbody>
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<thead>
<tr>
<th>E.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the supporting organization have sufficient safeguards to ensure its support is used exclusively for charitable purposes?</td>
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Continued on next page
**Exhibit 1-1, Continued**

509(a)(3) Type 1 and Type II Supporting Organization Guide Sheet, IRM 7.20.7-1 (p.2)

**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><strong>A.</strong> 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)</td>
<td>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>
</tr>
<tr>
<td>A(2)</td>
<td>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>
</tr>
<tr>
<td>A(3)</td>
<td>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>
</tr>
<tr>
<td>A(4)</td>
<td>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>
</tr>
<tr>
<td><strong>B.</strong> 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 &quot;Yes&quot; answer to B(1), B(2) or B(3) below. If &quot;No&quot;, the organization must meet A above to meet the operational test.</td>
<td></td>
</tr>
<tr>
<td>B(1)</td>
<td>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.</td>
</tr>
<tr>
<td>B(2)</td>
<td>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</td>
</tr>
<tr>
<td>B(3)</td>
<td>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)?</td>
</tr>
</tbody>
</table>

Continued on next page
Exhibit 1-1, Continued

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

**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.”

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</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? See Form 1023, Schedule D, Section IV.1.c.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B.</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? See Form 1023, Schedule D, Section IV.1.b.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C.</td>
<td>Do disqualified persons have the right to appoint the nominating committee or successor governing board members? See Form 1023, Schedule D, Section IV.1.a.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D.</td>
<td>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?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E.</td>
<td>Is the organization controlled directly or indirectly by disqualified persons because disqualified persons have veto power over the supporting organization’s activities?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F.</td>
<td>Is the organization controlled directly because the disqualified persons control the primary assets of the supporting organization?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G.</td>
<td>Does a disqualified person own a general partnership interest in a limited partnership in which the supporting organization owns an interest?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H.</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>
<td></td>
<td></td>
</tr>
<tr>
<td>I.</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>
<td></td>
<td></td>
</tr>
<tr>
<td>J.</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>
<td></td>
<td></td>
</tr>
<tr>
<td>K.</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>
<td></td>
<td></td>
</tr>
<tr>
<td>L.</td>
<td>Do donors or their family members have the right to provide advice to the supporting organization regarding investments or grant making?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M.</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>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Continued on next page
Exhibit 1-1, Continued

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>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A.</strong> 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.</td>
<td></td>
</tr>
<tr>
<td><strong>B.</strong> 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></td>
</tr>
<tr>
<td><strong>C.</strong> 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></td>
</tr>
<tr>
<td><strong>D.</strong> 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 D(3) for the organization to qualify under IRC 509(a)(3). See Form 1023, Part VIII, 14a.</td>
<td></td>
</tr>
<tr>
<td><strong>D(1)</strong></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>
</tr>
<tr>
<td><strong>D(2)</strong></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>
</tr>
<tr>
<td><strong>D(3)</strong></td>
<td>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.</td>
</tr>
</tbody>
</table>

Continued on next page
### Section II - Type II "Supervised or Controlled in Connection With"

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>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.</td>
<td></td>
</tr>
<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></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></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></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></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 Rev. Ruls. 74-229 and 66-79 and PLR 9651031 for more information regarding qualification and deductibility.</td>
<td></td>
</tr>
</tbody>
</table>

*Continued on next page*
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, 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.

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>Are any promoters identified with the establishment or operation of the supporting organization?</td>
<td></td>
</tr>
<tr>
<td>B.</td>
<td>Does the supporting organization benefit a list of more than five supported organizations?</td>
<td></td>
</tr>
</tbody>
</table>

Section II - Unreasonable Compensation/Loans

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>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</td>
</tr>
<tr>
<td>B.</td>
<td>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</td>
</tr>
<tr>
<td>C.</td>
<td>Are goods, services, or cash provided to officers, directors, or trustees? See Form 1023, Part V.7.a-b</td>
</tr>
<tr>
<td>D.</td>
<td>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</td>
</tr>
<tr>
<td>E.</td>
<td>Are the goods, services, or cash provided to the five highest compensated employees or independent contractor’s part of reasonable compensation arrangements? See Form 1023, Part V.7.a-b</td>
</tr>
<tr>
<td>F.</td>
<td>Is there evidence of any loan activity? See Form 1023, Part V.8.a-f and Part IX. Balance Sheet</td>
</tr>
<tr>
<td>G.</td>
<td>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</td>
</tr>
<tr>
<td>H.</td>
<td>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 contractor’s part of reasonable compensation arrangements? See Form 1023, Part V.8 a-f and 9a</td>
</tr>
</tbody>
</table>

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**Exhibit 1-1, Continued**

509(a)(3) Type I and Type II Supporting Organization Guide Sheet, IRM 7.20.7-1 (p.6)

**Section III - Closely Held Stock/Non-Liquid Investments/Assets That Do Not Produce Current Income**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></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>
</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>
</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>
</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>
</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>
</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>
</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>
</tr>
</tbody>
</table>
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Exhibit 1-2

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 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.
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.
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.

Continued on next page
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?

Continued on next page
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.

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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 can not 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 can not
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.

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A supporting organization can help to ensure that payments made to an IRC 501(c)(4), (5) or (6) organization are used exclusively for charitable purposes by, for example, making restricted use grants limited to charitable purposes when distributing funds directly to an organization that does not qualify under IRC 501(c)(3).

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.

Note: 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)?

Note: The organization may also make payments to or for the use of a college or university described in IRC 511(a)(2)(B)

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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)?

Note: 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 descendent 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.

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Exhibit 1-2, Continued

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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?

Example 1: 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.

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Example 2: 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.

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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.

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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?

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.

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, 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 1 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 1 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.
Exhibit 1-2, Continued

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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 D(3) 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.

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Exhibit 1-2, Continued

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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.

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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.

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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.

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Exhibit 1-2, Continued

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.

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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?

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Exhibit 1-2, Continued

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?

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?

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Exhibit 1-2, Continued

Supporting Organizations Guide Sheet Explanation, Type I and Type II, IRM 7.20.7.2 (p.20)

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?
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Lesson 3

Sale of Housing
Lesson 3
Sale of Housing

Overview

Introduction

IRC 501(a) and (c)(3) provide for the exemption from federal income tax of those organizations that are organized and operated exclusively for charitable purposes. Reg. 1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in IRC 501(c)(3) in its generally accepted legal sense. Such term includes relief of the poor and distressed or of the underprivileged, and the promotion of social welfare by organizations designed to lessen neighborhood tensions; to eliminate prejudice and discrimination; or to combat community deterioration.

Providing housing is not an inherently charitable activity. Beneficiaries of the various housing acts enacted into law are not necessarily conducting a charitable activity as defined in the Internal Revenue Code and Regulations.

Nevertheless, 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:

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

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).

Continued on next page
Overview, Continued

Objectives

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

- Identify exempt purposes regarding housing organizations
- Analyze organizations involved in the sale of housing to determine whether they qualify for exemption under IRC section 501(c)(3)
- Identify common sources of private benefit or inurement regarding housing sales
- Develop questions to determine the existence of private benefit or inurement regarding housing sales

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# Relief of the Poor and Distressed

## Introduction

As mentioned, housing can serve a charitable purpose by relieving the poor and distressed, eliminating prejudice and discrimination, combating community deterioration, relieving the distress of the elderly or physically handicapped, lessening the burdens of government, lessening neighborhood tensions, or advancing education. We will briefly discuss each these methods.

## Information Needed

This is the most common purpose upon which housing organizations rely in applying for recognition of exemption. Generally, an organization seeking to qualify by relieving the poor and distressed is asked to supply information that shows, through the facts and circumstances of its operations, that it does in fact provide relief to a class of individuals that are poor and distressed.

## Examples of Organization

Rev. Rul. 67-138, 1967-1 C.B. 129, detailed an exempt nonprofit organization created to provide instruction and guidance to low income families in need of adequate housing and interested in building their own homes. The organization's activities, which were directed toward assisting low-income families obtain improved housing, including:

- Conducting a training course relative to various aspects of house building and homeownership,
- Coordinating and supervising joint construction endeavors,
- Purchasing building sites for resale at cost, and
- Lending aid in obtaining home construction loans.

No charge was made for any of these services. The organization was financed by public contributions and federal grants.

The exempt organization in Rev. Rul. 76-408, 1976-2 C.B. 145, provided interest-free home repair loans in a badly deteriorated urban residential area to low-income homeowners who were unable to obtain loans elsewhere.

*Continued on next page*
On October 16, 1992, the Service published the Safe Harbor Guideline for Low Income Housing to simplify the process for low-income housing organizations that clearly relieve the poor and distressed within the meaning of Reg. 1.501(c)(3)-1(d)(2). This Safe Harbor is detailed in Revenue Procedure 96-32, 1996-1 C.B. 717.

The safe harbor is merely an alternative method of demonstrating qualification for exemption under IRC 501(c)(3). Inability to meet the safe harbor provision for low income housing may never be used to deny exemption to an organization. Rather, failure to meet the safe harbor merely requires application of the facts and circumstances test to determine whether the organization is relieving the poor and distressed or is otherwise serving charitable purposes.

Such facts and circumstances include, but are not limited to:

- The percentage of poor residents,
- The provision of additional social services affordable to the poor residents,
- The 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,
- Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization's operations, and
- 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.
Combating Community Deterioration

Overview

Combating community deterioration often applies to low-income housing organizations because many low-income housing projects are located in deteriorated areas. The importance of this approach is that the economic composition of the occupants of a low-income housing project is generally not crucial to exemption. This should be of considerable interest to many housing organizations that are funded from programs that require economic mixes that do not meet the safe harbor mentioned in Rev. Proc. 96-32, supra.

Generally, organizations seeking to qualify by combating community deterioration are asked to supply information that the area in which they operate is designated by an appropriate governmental agency as blighted. However, combating community deterioration may be demonstrated by reference to all the surrounding facts and circumstances, not merely designation of blight.

Factors

The suggestion that deterioration can be demonstrated by facts and circumstances begs the question as to what factors are important. This is a factual analysis, which means that any fact that tends to demonstrate that an area is deteriorated will be considered. For example, situation 3 in Rev. Rul. 70-585, 1970-2 C.B. 115, relies, in part, on studies that demonstrate that the area is old and badly deteriorated as well as having a lower median income than the rest of the city.

However, the facts do not have to be limited to those that demonstrate that the area is already deteriorated. In Rev. Rul. 68-17, 1968-1 C.B. 247, an organization combats community deterioration in deteriorating neighborhoods. Accordingly, the facts, in addition to demonstrating actual deterioration, may include those that demonstrate the process of deterioration.

Similarly, in Rev. Rul. 68-655, 1968-2 C.B. 213, the activities of the organization do not demonstrate actual deterioration. In this ruling, the organization's activities that stabilize the neighborhoods combat the potential for community deterioration.
Eliminating Prejudice and Discrimination

Educating the Public

Rev. Rul. 68-655, supra, detailed a charitable organization that educated the public regarding integrated housing and conducted intensive neighborhood educational programs to prevent panic selling because of the introduction of a non-white resident into a formerly all-white neighborhood. It also counseled minority group residents about the problems of living in an integrated neighborhood and ways of minimizing potential tensions and misunderstandings and provided mortgage loans.

By educating the public about integrated housing and conducting intensive neighborhood educational programs, the organization was striving to eliminate prejudice and discrimination and to lessen neighborhood tensions. By making mortgage loans to families that could not obtain such loans commercially but that otherwise were considered desirable residents, the organization was trying to break down the barriers of prejudice and gain acceptance of integrated housing within the community.

It accomplished this same objective by purchasing homes and reselling or leasing them on an open occupancy basis to families that would be compatible with a neighborhood and would demonstrate the feasibility of integrated communities. By stabilizing the neighborhood, the organization was combating potential community deterioration.

Housing Units

Situation 2 in Rev. Rul. 70-585, supra, details an organization formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open occupancy basis. It constructed new housing that was available to members of minority groups with low and moderate income who were unable to obtain adequate housing because of local discrimination. These housing units were so located as to help reduce racial and ethnic imbalances in the community. They were sold at or below cost to low or moderate income families or rented, with options to purchase, to families who could not afford to purchase. Preference was to be given to families previously located in ghetto areas.

Continued on next page
The organization also informed the public regarding integrated housing as a means of minimizing potential misunderstanding and stabilizing integrated neighborhoods. It was financed by contributions from the general public and by funds obtained under Federal and State housing programs. As the organization's activities were designed to eliminate prejudice and discrimination and to lessen neighborhood tensions, it was engaged in charitable activities within the meaning of section 501 (c) (3) of the Code.
Relief for Elderly or Physically Handicapped

Overview

Rev. Rul. 72-124, 1972-1 C.B. 145, sets forth requirements that homes for the aged must meet in order to qualify for exemption under section 501(c)(3). The Revenue Ruling makes clear that a home for the aged may be deemed "charitable" if it meets the special needs of the elderly such as the need for health care, financial security, and residential facilities designed to meet specific physical, social, and recreational requirements of the elderly. Such a home need not provide direct financial assistance to the elderly in order to be "charitable," since poverty is only one form of distress to which the elderly as a class are particularly susceptible.

Rev. Rul. 79-19, 1979-1 C.B. 195, detailed a charitable nonprofit organization that provided specially designed housing to physically handicapped persons at the lowest feasible cost and maintained in residence those tenants who subsequently become unable to pay its monthly fees.

Lessening the Burdens of Government

Rev. Rul. 85-2, 1985-1 C.B. 178, holds that an organization formed to train and provide legal services to volunteer guardians ad litem who represent abused and neglected children before a juvenile court that requires their appointment qualifies for exemption under section 501(c)(3).

The criteria set out in the ruling for determining whether an organization's activities are lessening the burdens of government are: first, whether the governmental unit considers the organization's activities to be its burden; and second, whether these activities actually lessen the burden of the governmental unit.

An activity is a burden of the government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. Whether the organization is actually lessening the burdens of government is determined by considering all of the relevant facts and circumstances. A favorable working relationship between the government and the organization is strong evidence that the organization is actually “lessening” the burdens of the government.
For Additional Information

Additional discussion of housing as an exempt activity can be found in the following:

1979 EO CPE text, “Rental Housing For The Elderly under IRC 501(c)(3)”
1985 EO CPE text, “Housing For Senior Citizens”
1992 EO CPE text, “Low-Income Housing as a Charitable Activity”
1994 EO CPE text, “Low-Income Housing Update”
1996 EO CPE text, “Recent Developments in Housing Regarding Qualification Standards and Partnership Issues.”
2001 EO CPE text, “College Housing”
2003 EO CPE text, “Housing Partnership Agreements”
Sale of Housing

Overview

Providing housing is not an inherently charitable activity. Therefore, the basis for exemption must be an established charitable purpose.

An applicant that is involved in selling housing has the burden of proof to establish that it is operated exclusively for charitable purposes. All facts and circumstances must be considered in making your determination. Rev. Rul. 70-585, supra, and Rev. Proc. 96-32, supra, provide guidance to consider when developing the issue of home sales.

Rev. Rul. 70-585, supra

Situation 1 in Rev. Rul. 70-585, supra, detailed an organization that was formed to develop a program for new home construction and the renovation of existing homes for sale to low income families on long-term, low-payment plans. It purchased homes for renovation and lots for building new homes throughout the city in which it was located. It built new homes for sale to low income families who qualified for loans under a federal housing program and who could not obtain financing through conventional channels. It also aided financially those families eligible for the loans that did not have the necessary down payment. Rehabilitated homes were made available to families who could not qualify for any type of mortgage loan. The cost of these homes was recovered, if possible, through very small periodic payments. The organization derived its operating funds through federal loans and contributions from the general public. Where possible, renovations were made with volunteer help.

By providing homes for low income families who otherwise could not afford them, the organization described in Rev. Rul. 70-585, supra, situation 1, was relieving the poor and distressed and was held to be organized and operated exclusively for charitable purposes.

Continued on next page
Sale of Housing, Continued

**Rev. Proc. 96-32, supra**

Most of the low-income housing projects involve housing units, like apartments. Regardless, selling individual homes can serve exclusively charitable purposes. However, applying the safe harbor described in Rev. Proc. 96-32, supra, may be difficult. The procedure does provide some guidance specifically for homeownership programs. The procedure states that, among other requirements, the housing must be affordable to the charitable beneficiaries.

In section 3.01(3) the procedure indicates that in “the case of homeownership programs, this requirement will ordinarily be satisfied by the adoption of a mortgage policy that complies with government-imposed mortgage limitations or otherwise makes the initial and continuing costs of purchasing a home affordable to low and very low-income residents.” (Note that this is demonstrated in Rev. Rul. 70-585, supra, situation 1)

Rev. Proc. 96-32, supra, also addresses the fact that individual homes are not usually built on common ground. In section 3.01(4) the procedure indicates that units located at “scattered sites in the community” should be provided “exclusively to families with income at or below 80% of the area’s median income.” Generally, an income at or below 80% of an area’s median income would limit services to “low-income” families or individuals only.
Common Private Benefit Problems

The following are common issues to consider regarding housing sales.

An exempt organization selling homes must do so in a non-commercial manner. Determining whether an activity serves a commercial purpose requires considering all facts and circumstances. The following five factors are especially important:

- The manner in which the activities are conducted,
- The degree the activities are carried on with a “commercial hue,”
- Competition with commercial firms,
- The existence and amount of annual or accumulated profits, and
- How the organization sets its prices or fees (are they at or below cost, or at a substantial markup?).

In *Airlie Foundation v. Commissioner*, 283 F. Supp. 2d 58 (D.D.C., 2003), the court relied on the “commerciality” doctrine in applying the operational test. Because of the commercial manner in which this organization conducted its activities, the court found that it was operated for a nonexempt commercial purpose, rather than for an exempt purpose. The court stated that among the major factors courts have considered in assessing commerciality are competition with for-profit commercial entities; extent and degree of below-cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, *inter alia*, whether the organization uses commercial promotional methods (e.g., advertising) and the extent to which the organization receives charitable donations.

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The organization must prove that any benefit to a third party is insubstantial and incidental. Section 1.501(c)(3)-1(d)(1)(ii) of the regulations assigns the burden of proof to an applicant organization to show that it serves a public rather than a private interest and, specifically, 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 a substantial non-exempt purpose is established, exemption can be denied. In *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

Even if a benefit to a third party appears reasonable, the specialist should fully develop the issue to ensure that exclusively charitable purposes are served. In *Church by Mail*, 765 F. 2d 1387 (9th Cir. 1985), affg. TCM 1984-349, the Tax Court concluded that the extent of the integration between the operations of a non-profit entity and related for-profit entities controlled by the non-profit’s directors precluded exemption.

Furthermore, the Tax Court found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers. The 9th Circuit Court of Appeals, in affirming the Tax Court’s decision, stated that “the critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church”.

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# Common Private Benefit Problems, Continued

The following are some possible questions to use when developing applications containing the issue of housing sales.

List each past or present board member, officer, key employee, and members of their families who:

- Has served on the board of any organization with whom you do business
- Has an ownership interest in any for-profit entity that does business with you. For each, identify each entity, the ownership interest and the nature of the business relationship
- Has previously conducted similar activities for any for-profit entity
- Will be a paid employee of the organization. Indicate their duties and compensation.

Regarding your housing sales:

- What percentage of the properties does your organization anticipate selling to (i) very-low income individuals, (ii) low-income individuals, (iii) moderate income individuals, and (iv) others on an annual basis?
- How do you define very-low income? low-income? moderate-income?
- Who may receive your service? In other words, what is the selection criteria and process of the beneficiaries? Please be specific with actual numbers with reliable income data (ex., data from Departments of US Human and Health Services, HUD) that identify the very low-income, low-income, moderate-income and median income levels in the area where you are going to conduct your activities.
- Does your organization conduct your housing program under the auspices of a government, a governmental unit, or a governmental housing program? If so, explain and submit all relevant information that describes the program. Include any and all agreements between your organization and the government or the governmental unit.

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Continued on next page
Possible Questions (continued)

- Are you required to have tax exemption under section 501(c)(3) of the IRC in order to participate in a governmental program? If yes, explain.

- Does a government or the governmental unit have the authority to appoint one or more of your organization’s directors or officers? If so, explain and provide evidence of such authority.

- To date, has your organization sold or is in the process of selling any of its properties? If so, submit actual copies of all documents relating to the acquisition, renovation, and sale of the properties. If actual copies are not available, submit draft copies.

- Explain how your organization determines the selling price of each property. Please be specific and provide examples.

- Has your organization entered into any written or oral agreements with lending institutions, such as banks or mortgage brokers, that it will refer individuals? If so, explain, identify the parties involved, indicate how each institution was selected and submit copies of all agreements. If written agreements do not exist, outline the provisions of the oral agreements.

- Does your organization require that an individual secure or participate in a specific loan program in order to purchase one of its properties? If so, explain.

- If your organization does not require that an individual secure or participate in a specific loan program, what type of financing does your organization anticipate that an individual will utilize to purchase one of its properties?

- For each property you have sold, identify the type of financing used, that the buyer secured or will secure to purchase the property.

- Will your organization provide any type of financing to the individual when purchasing one of its properties? If so, explain and submit representative copies of all information relating to the financing provided by the organization.

- Submit representative copies of all contracts that the organization uses to purchase and sell its properties.

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**Possible Questions (continued)**

- Does the organization offer any assistance to an individual when purchasing one of its properties, such as down payment assistance or closing cost assistance? If so, explain.

- Does the organization offer any programs to an individual to ensure that he is able to continually maintain and afford the purchased property? If so, describe the programs offered and submit any literature or instructional material that is given to the individual. Additionally, state the duration of the program.

- Has the organization entered into any written or oral agreements with any real estate companies in which it will purchase and sell its properties? If so, explain, identify the parties involved, indicate how each company was selected and submit copies of all agreements. If written agreements do not exist, outline the provisions of the oral agreements.

- Has the organization entered into any written or oral agreements with contractors to do the renovations? If so, explain, identify the parties involved, and submit copies of all agreements. If written agreements do not exist, outline the provisions of the oral agreements.

- Also, how will, does, and did the organization select these specific contractors (realtors, developers, builders, lenders)? If the organization has not selected contractors, outline the criteria a contractor must satisfy in order to be utilized by the organization.
Rev. Proc. 70-585

Class Discussion

Rev. Rul. 70-585, supra, holds that nonprofit housing organizations created to aid low and moderate-income families by lessening neighborhood tensions, eliminating prejudice and discrimination, and combating community deterioration may qualify for exemption under IRC 501(c)(3). The revenue ruling discusses four different situations involving organizations which provide low-income housing as their charitable purpose.

Situation 1 describes an organization which was formed to develop a program for new home construction and the renovation of existing homes for sale to low-income families on long-term, low payment plans. The organization purchases and renovates existing homes as well as builds new homes for sale to low-income families who qualify for loans under a federal housing program. The ruling holds that by providing homes for low-income families who could not otherwise afford them, the organization is relieving the poor and distressed; therefore, it is organized and operated exclusively for charitable purposes.

Situation 2 describes an organization formed to eliminate prejudice and discrimination. The organization constructs new housing for sale to minority groups with low and moderate-income levels who are unable to obtain adequate housing because of local discrimination. The housing units are located to help reduce racial and ethnic imbalances in the community and are sold at or below cost, or rented with an option to purchase, to minority families who cannot presently afford to purchase a home.

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The ruling holds that the organization's activities are designed to eliminate prejudice and discrimination and to lessen neighborhood tensions within the meaning of IRC 501(c)(3) and should be recognized as exempt under that section.

Situation 3 involves an organization formed to formulate plans for the renewal and rehabilitation of a particular area in a city as a residential community. Studies of the area showed that the median income in the area is lower than that in other sections of the city and the housing located in the area is generally old and badly deteriorated. The organization coordinated its efforts with the local redevelopment authority and developed an overall plan for the rehabilitation of the area. As part of the renewal project, it purchased an apartment house that it plans to rehabilitate and rent at cost to low and moderate-income families. The ruling holds that since the organization's purposes and activities combat community deterioration by assisting in the rehabilitation of an old and run-down residential area, they are charitable within the meaning of IRC 501(c)(3).

Situation 4 of the revenue ruling discusses 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 to 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 situation 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 501(c)(3).
Summary

IRC 501(c)(3) provides for the exemption from federal income tax of those organizations that are organized and operated exclusively for charitable purposes. Reg. 1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in IRC 501(c)(3) in its generally accepted legal sense.

Providing housing is not an inherently charitable activity. However, housing can serve a charitable purpose by relieving the poor and distressed, eliminating prejudice and discrimination, combating community deterioration, relieving the distress of the elderly or physically handicapped, lessening the burdens of government, lessening neighborhood tensions, or advancing education.

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

If an organization claims that it is promoting social welfare within the meaning of Reg. 1.501(c)(3)-1(d)(2), it must submit sufficient evidence to establish that, in fact, the conditions that it seeks to alleviate (community deterioration, prejudice, discrimination) do exist and that its activities are likely to alleviate such problems.
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Lesson 4

Lessening Neighborhood Tensions
Lesson 4

Lessening Neighborhood Tensions

Overview

Introduction

This lesson details the requirements for classification as an organization exempt under section IRC 501(c)(3) which is organized and operated to lessen neighborhood tensions.

Treasury Regulations section 1.501(c)(3)-1(d)(2) provides that lessening neighborhood tensions 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 neighborhood tensions is based on facts and circumstances.

While “lessening neighborhood tensions” is a separately stated charitable purpose under Reg. 1.501(c)(3)-1(d)(2), such purpose is generally regarded as accomplished where the organization also eliminates prejudice and discrimination or accomplishes other social welfare goals. No Revenue Ruling finds an organization exempt under section 501(c)(3) solely on the ground of lessening neighborhood tensions. The phrase, if not the concept, may have originated with the 501(c)(3) regulations issued in 1959. See G.C.M. 33906 (Aug. 7, 1968).

The charitable purposes listed in section 1.501(c)(3)-1(d)(2) of the Treasury Regulations are particularly relevant to modern urban problems such as poverty, racial discrimination, and urban decay.

All organizations exempt under section 501(c)(3) of the Code, including organizations claiming to lessen neighborhood tensions, are subject to the prohibition on inurement and private benefit.

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

After completing this lesson, you will be able to:

• Identify IRC section 501(c)(3) activities conducted by organizations in support of lessening neighborhood tensions

• Determine whether an organization formed to lessen neighborhood tensions qualifies for exemption under IRC section 501(c)(3).

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Charitable Defined

“Charitable” and “Educational” Defined

Common to all definitions of charity is the concept of broad public benefit. This public benefit is brought about either by financially supporting the activities of one of the particular charities or by conferring direct benefits on the community at large.

Section 501(c)(3) of the Code provides for exemption from Federal income tax of organizations organized and operated exclusively for charitable or educational purposes.

Section 1.501(c)(3)-1(d)(2) of the Treasury Regulations defines “charitable” to include the promotion of social welfare by organizations designed to lessen neighborhood tensions; eliminate prejudice and discrimination; defend human and civil rights secured by law; and combat community deterioration and juvenile delinquency.

Section 1.501(c)(3)-1(d)(3) of the regulations defines the term "educational" as including the instruction of the public on subjects useful to the individual and beneficial to the community.

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The group of individuals that may properly receive assistance from a charitable organization is called a charitable class. A charitable class must be large or indefinite enough that providing aid to members of the class benefits the community as a whole. In general, a charitable class may consist of any of the following groups of individuals:

- **Poor**: Persons who are at or below federal poverty guidelines
- **Elderly**: Persons over 62 years of age
- **Handicapped**: Persons afflicted with a physical or mental handicap
- **Distressed**: For example, individuals who have suffered from a disaster
- **Children**: Under the age of 18
- **Broad Group** of individuals, such as the residents of a town, sufficiently broad that the organization may be said to benefit the community.
Community Benefit

Another important factor to consider is whether the organization’s activities designed to lessen neighborhood tensions provide a community-wide benefit, rather than a personal benefit.

Remember, all organizations exempt under section 501(c)(3) of the Code, including organizations claiming to lessen neighborhood tensions, are subject to the prohibition on inurement and private benefit.

If it is determined that an applicant organization’s community-wide benefit does not meet the requirements for exemption under section 501(c)(3) of the Code, consideration may be given to exemption under IRC section 501(c)(4) or 501(c)(6).

Revenue Ruling 78-85 describes an organization which meets this community-wide benefit standard under section 501(c)(3), while Revenue Ruling 75-286 describes an organization which is more appropriately classified as exempt under section 501(c)(4).

Revenue Ruling 78-85

Revenue Ruling 78-85, 1978-1 C.B. 150 holds that an organization formed by the citizens of a community to maintain a public park in the center of the city that was open to the public and commonly used by the residents of the city is exempt under IRC section 501(c)(3).

- The organization was formed by residents of a city to cooperate with municipal authorities in preserving, beautifying, and maintaining a public park located within the center of the city.
- The park is located in a heavily trafficked, easily accessible section of the city and is surrounded by high rise apartments, hotels, office buildings, and commercial establishments.
- The park and its facilities are open to the general public and are commonly used by citizens of the entire city.
- Membership in the organization is also open to the general public.

Continued on next page
Community Benefit, Continued

**Revenue Ruling 75-286**

Revenue Ruling 75-286, 1975-2 C.B. 210 provides that nonprofit an organization with membership limited to the residents and business operators within a city block and formed to preserve and beautify the public areas in the block, thereby benefiting the community as a whole as well as enhancing the members' property rights, will not qualify for exemption under section 501(c)(3) of Code but may qualify under section 501(c)(4).

- The organization was formed by the residents of a city block to preserve and beautify that block, to improve all public facilities within the block, and to prevent physical deterioration of the block.

- Much of the public area improved by the organization is part of the public roadway lying between the sidewalk and the street in front of private property owned by members of the organization.

- Membership in the organization is restricted to residents of the block and those owning property or operating businesses there.

- The organization's activities promote social welfare because they beautify and preserve public property in cooperation with the local government. Although these activities are limited to a particular block, the community as a whole benefits from them.
Housing Assistance

Overview

Many organizations are formed to conduct housing assistance programs for the purpose of achieving the larger goal of lessening neighborhood tensions within the impacted community.

Revenue Rulings

Revenue Rulings 70-585 (Situation 2) and 2006-27 and Rev. Proc. 96-32 describe charitable organizations under section 501(c)(3) of the Code which lessen neighborhood tensions by providing housing assistance to low and moderate income individuals.

Revenue Ruling 70-585

Situation 2 of Revenue Ruling 70-585, 1970-2 CB 115 provides that an organization formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open occupancy basis may qualify for exemption under section 501(c)(3) of the Code.

- By constructing new housing available to members of minority groups with low and moderate income who are unable to obtain adequate housing because of local discrimination, the organization helped reduce racial and ethnic imbalances in the community.
- By informing the public regarding integrated housing, the organization minimized potential misunderstanding and stabilizing integrated neighborhoods.

Continued on next page
Housing Assistance, Continued

Revenue Procedure 96-32

- Rev. Proc. 96-32 indicated that an organization that provides housing may qualify under section 501(c)(3) by lessening community tensions
- Such organizations may work to reduce overcrowding in lower income areas in which ethnic or racial tensions are high.

Revenue Ruling 2006-27

See also Rev. Rul. 2006-27 (organization that provides down payment assistance to home buyers may qualify under section 501(c)(3) under appropriate circumstances.)
Economic Development

Overview

Many organizations attempt to lessen neighborhood tensions by conducting economic development activities designed to benefit the community as a whole by providing business assistance and facilitating additional employment opportunities.

Revenue Rulings

Revenue Rulings 74-587, 76-419, and 81-284 describe charitable organizations under section 501(c)(3) of the Code which lessen neighborhood tensions by providing economic development opportunities.

Revenue Ruling 74-587

Revenue Ruling 74-587, 1974-2 C.B. 162 provides that an organization formed to relieve poverty, eliminate prejudice, reduce neighborhood tensions, and combat community deterioration through a program of financial assistance in the form of low-cost or long-term loans to, or the purchase of equity interests in, various business enterprises in economically depressed areas is exempt under section 501(c)(3) of the Code.

- The organization devotes its resources to programs designed to stimulate economic development in high density urban areas inhabited mainly by low-income minority or other disadvantaged groups.

- Its program of aiding minority-owned businesses promotes the social welfare of the community, since it helps to lessen prejudice and discrimination against minority groups by demonstrating that the disadvantaged residents of an impoverished area can operate businesses successfully if given the opportunity and proper guidance.

- It lessens neighborhood tensions and dissatisfaction arising from the lack of employment opportunities by assisting local businesses that will provide a means of livelihood and expanded job opportunities for unemployed or underemployed area residents.

Continued on next page
Revenue Ruling 76-419

Revenue Ruling 76-419, 1976-2 CB 146 provided that a nonprofit organization that purchased blighted land in an economically depressed community, converted the land into an industrial park, and encouraged industrial enterprises to locate new facilities in the park in order to provide employment opportunities for low income residents of the area, was operated exclusively for charitable purposes and qualifies for exemption under section 501(c)(3) of the Code.

- The organization's objectives were the relief of conditions of poverty, dependency, chronic unemployment, and underemployment, and the reduction of community tensions in an economically depressed community.
- The organization's activities to relieved poverty and lessened neighborhood tensions caused by the lack of jobs and job opportunities in the area, combating community deterioration by establishing new businesses, rehabilitating existing ones, eliminating conditions of blight, and lessening prejudice and discrimination against minorities.

Revenue Ruling 81-284

Revenue Ruling 81-284, 1981-2 CB 130 provides that an organization formed to relieve poverty, eliminate prejudice and discrimination, reduce neighborhood tensions, and combat community deterioration may qualify for exemption under section 501(c)(3) of the Code.

- The organization provided low-cost or long-term loans to businesses not able to obtain funds from conventional commercial sources.
- Preference was given to businesses that provide training and employment opportunities for the unemployed or under-employed residents of economically depressed areas,
- The organization is subject to Small Business Administration regulations which impose various considerations that will restrict the degree of financial support that may be offered to a prospective recipient.

Continued on next page
Economic Development, Continued

Other Precedent

- See also Examples 1-6 of Reg. 53.4944-3(b), which describe program-related investments promoting economic development that may lessen neighborhood tensions.

- Compare Rev. Rul. 77-111, which held organizations engaged in economic development not exempt under section 501(c)(3) where the activity was not appropriately targeted to furthering charitable purposes.
Lessening Prejudice and Discrimination

Overview
Many organizations attempt to lessen neighborhood tensions by conducting activities designed to reduce prejudice and various types of discrimination.

Revenue Rulings
Revenue Rulings 68-15, 68-438, and 68-655 describe charitable organizations under section 501(c)(3) of the Code which lessen neighborhood tensions by lessening prejudice and discrimination.

Revenue Ruling 68-15
Revenue Ruling 68-15 held exempt under section 501(c)(3) an organization that formed committees to engage in the following activities for the benefit of the community:

- A Zoning Committee investigated complaints in cases in which possible violations of building codes and zoning ordinances might result in community tensions and deterioration.

- A Streets Committee instructed the people of the community as to proper conduct on the streets in order to reduce tensions that might otherwise result from reckless and negligent acts.

- An Empty Lots Committee counseled residents of the community and city officials in the best use of vacant lots in order to eliminate potential gathering places for unruly elements and to eliminate potential areas of deterioration within the community.

- A School Committee worked with parents, teachers, and school officials to give them a better understanding of any racial and religious tensions that may be present in the community and to insure equal treatment of all pupils.

- A Recreation Committee sponsored meetings and other activities to bring together persons of various races and religions.

Continued on next page
Lessening Prejudice and Discrimination, Continued

Revenue Ruling 68-438
Revenue Ruling 68-438, 1968-2 CB 209 provides that an organization formed for the purpose of lessening racial and religious prejudice in the fields of housing and public accommodations may qualify for exemption under section 501(c)(3) of the Code.

- By investigating the existence of discrimination and seeking compliance with applicable laws, the organization directly contributed to the elimination of prejudice and discrimination, the defense of human and civil rights secured by law, and the lessening of neighborhood tensions.

- The information disseminated to individuals and groups within the community through the organization's publication program and speakers' bureau instructed the public on subjects useful to the individual and beneficial to the community.

Revenue Ruling 68-655
Revenue Ruling 68-655, 1968-2 CB 213 provides that a nonprofit organization formed to promote racial integration in housing, to lessen neighborhood tensions, and to prevent deterioration of neighborhoods may qualify for exemption under section 501(c)(3) of the Code.

- By educating the public about integrated housing and conducting intensive neighborhood educational programs to prevent panic selling because of the introduction of a non-white resident into a formerly all-white neighborhood, the organization strived to eliminate prejudice and discrimination and to lessen neighborhood tensions.

- By making mortgage loans to families that could obtain such loans commercially but that otherwise are considered desirable residents, the organization attempted to break down the barriers of prejudice and gain acceptance of integrated housing within the community.

- By stabilizing the neighborhood, the organization combated potential community deterioration.
Case Development

Important Items to Consider

When developing requests for exemption under section 501(c)(3) of the Code as an organization formed for the charitable purpose of lessening neighborhood tensions, the following items are considered especially important:

- Whether the organization’s activities serve a charitable class.
- Whether the organization’s activities provide a community-wide benefit, rather than serving personal, or limited, interests.
- A description of the type(s) of low-income assistance programs are conducted by the organization.
  - Documentation of the eligibility requirements for the program
  - Documentation of the selection criteria used to determine the recipients of assistance from the organization
  - Documentation of the qualifications of the selection committee
  - Documentation detailing the safeguards implemented to ensure proper usage of funds distributed by the organization
- A description of the type(s) of economic development assistance programs are conducted by the organization.
  - Documentation verifying that the area is economically depressed
  - How the organization will specifically target the benefits towards a disadvantaged group
  - Steps the organization will take to combat community deterioration
  - A detailed description of the organization’s loan program(s)
  - Documentation of the selection criteria used to determine the recipients of assistance from the organization
  - Procedures designed to prevent private benefit among board members or other interested parties

Continued on next page
Case Development, Continued

Important Items to Consider (continued)

- A description of the type(s) of programs designed to lessen prejudice and combat discrimination
  - Documentation of the current problem in the area and the how the organization’s activities will ameliorate the situation
  - Steps the organization will take to combat community deterioration
  - Documentation of the selection criteria used to determine the recipients of assistance from the organization
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Lesson 5

For-Profit Successors
Lesson 5

For-Profit Successors

Overview

Introduction
Applications from organizations that are successors to for-profit organizations are now Grade 12 per the CAG. They were previously Grade 13. Successors to for-profit organizations are required to complete Schedule G to Form 1023.

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

• Identify an exemption application from a successor to a for-profit
• Develop an exemption application for a successor to a for-profit
• Analyze financial transactions between a for-profit and the nonprofit organization taking over its operations
• Apply the appropriate case law to the exemption application

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Preliminary Considerations

**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 then two distinct entities.

When dealing with a conversion from a for-profit to a nonprofit, the applicant may continue to use the same EIN as the for-profit. However, if state law requires the formation of a new corporation, the applicant must secure a new EIN.

When dealing with a simple conversion, it may be necessary in some cases to find out what happened to the common stock of the for-profit upon conversion. If state law requires the formation of a new corporation, it is necessary to determine the status of the related for-profit – was it dissolved, or is it still active? Do they have plans to dissolve the entity? If there are no current plans to dissolve the for-profit, the specialist must find out whether the two organizations will have a continuing relationship.

**Effective Date of Exemption**

The effective date of exemption cannot be earlier than the date the for-profit corporation was converted to a nonprofit. Organizational test issues involving proper section 501(c)(3) language are treated differently, as we routinely grant retroactive exemption to dates preceding amendments to include proper purpose and dissolution clauses. However, exemption cannot be extended during periods when applicants operated under for-profit statutes.

In these situations, the Bylaws should also be reviewed to find out if they contain references to stock or shareholders. Generally, the Bylaws should be amended to remove such references. Take note that some states actually have provisions to allow a nonprofit corporation to have stockholders or shareholders. Amendments are not always necessary in these situations, but we should determine the identity of the stockholders to find out if they are entitled to any benefits. But typically, state law prohibits nonprofit stockholders from receiving dividends or other financial benefits.

Continued on next page
Preliminary Considerations, Continued

Schedule G

Schedule G to Form 1023 should be completed if any of the following are true:

- Applicant has taken or will take over the activities that were previously conducted by another.
- Applicant has taken or will take over 25 percent or more of the fair market value of the net assets of another organization.
- Applicant was established upon the conversion of an organization from for-profit to nonprofit status.

Schedule G is also used to report details on successors to other types of organizations, such as those exempt under section 501(c)(3). Specialists should take care to obtain the necessary research to confirm the exempt status of such predecessor organizations. Nonprofit predecessors with no record of exemption should be treated as though they were for-profit.
Case Development

**Basic Considerations**

The first step in analyzing the application of a for-profit successor is to determine if the activities themselves qualify for exemption. Typically, the organization is conducting an activity that is prevalent in the business sector, but can also qualify as an exempt activity. For example, a school, daycare, or hospital.

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.

*Continued on next page*
Exercise 1

Super Great Cuts was established as a for-profit with their state. They were in the business of providing pet grooming services for dogs and cats. They converted the for-profit corporation to a nonprofit corporation on April 15, 2012. The prior business generated profits of $40,000 for 2011, $30,000 for 2010, and $35,000 for 2009. The nonprofit organization will be engaged in the same activities as the for-profit. The officers of the nonprofit are not related to the previous owners of the for-profit. There were no liabilities transferred to the nonprofit, and all assets were sold to the nonprofit at fair market value. There are no lease agreements for any real or personal property still owned by the previous owners of the for-profit.

The nonprofit is submitting an application for exemption under section 501(c)(3). Explain whether or not they could qualify (or if more information is needed), and explain any potential barriers to exemption. Describe any corrective actions that may be required if exemption could be extended based on certain conditions.

Answer:

Continued on next page
Exercise 2

Little Squirts was established as a for-profit with their state. They operated a preschool for children since their date of formation in 2001. On December 31, 2011, they terminated the for-profit corporation and formed a nonprofit corporation with their state. The prior business generated profits of $65,000 for 2011, $60,000 for 2010, and $75,000 for 2009. The nonprofit organization will continue the operation of the preschool, as well as begin teaching Kindergarten. All three of the shareholders in the for-profit company will become board members with the nonprofit, but they have expanded the Board to include four additional unrelated members. All three previous shareholders will also be compensated employees with the nonprofit school. There were no liabilities transferred to the nonprofit, and all assets were sold to the nonprofit at fair market value. One of the previous shareholders owns the property where the school conducts its activities. They state that the nonprofit school will lease the premises at fair market rental value.

The nonprofit is submitting an application for exemption under section 501(c)(3). Explain whether or not they would qualify (or if more information is needed), and explain any potential barriers to exemption. Describe all recommended case development questions. Describe any corrective actions that may be required if exemption could be extended based on certain conditions.

Answer:
Case Development, Continued

Additional Risk  The specialist may choose to take additional risk in situations where it is apparent that the applicant simply incorporated under for-profit statutes by accident, never operated as a for-profit, and immediately reformed as a nonprofit. Such cases should not be unnecessarily overdeveloped when the incorrect filing status was just an oversight on their part.

Continued on next page
Case Development, Continued

Exercise 3

Bayside High Basketball Boosters was established as a for-profit with their state. They have conducted no activities since they were incorporated on February 1, 2012. In the activity narrative for Form 1023, they indicate that their planned activity is to support the basketball program of a public high school. They filed Articles of Restatement to convert their for-profit corporation to a nonprofit corporation on March 15, 2012. They partially completed Schedule G to Form 1023, stating that many of the items were inapplicable because they incorporated as a for-profit by mistake. Once they became educated on the requirements under section 501(c)(3), they converted to a nonprofit.

Given the information provided, explain whether or not they would qualify under section 501(c)(3), or if more information is needed, and explain any potential barriers to exemption. Describe all recommended case development questions. Describe any corrective actions that may be required if exemption could be extended based on certain conditions.

Answer:
Case Development, Continued

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. We must watch out for situations in which the for-profit is starting a nonprofit simply because they were not profitable as a for-profit. They may hope to get “out of the red” by becoming tax-exempt and avoiding their liability for income taxes. The organization may be trying to transfer liabilities to the nonprofit. They may reveal this fact up front, or we may uncover the fact after requesting their historical financial data.

It is not uncommon for debts to have already been transferred to the nonprofit at the time of application for exempt status. If the previous owners of the for-profit are the creditors, we would look favorably upon a situation in which they decide to forgive the liability. If the creditors are other unrelated third parties, we would also look favorably upon a situation in which the previous owners pay off the amounts themselves, or else agree to reassume the debts transferred to the nonprofit. Take note that prospective exemption would be appropriate as of the date such issues are satisfactorily resolved.

If there is a transfer of assets, the nonprofit should generally pay at or below fair market value for all assets. Again, financial data relating to the for-profit predecessor is not always provided up front. It is not uncommon to request the historical financial data (the “books and records”) of the predecessor. The data from the for-profit can be compared to any available data for the nonprofit to uncover any potential inconsistencies between the two.

If real property is being transferred from the for-profit predecessor to the nonprofit, specialists have less latitude to simply document the risk and grant exemption without further development. Certified third-party appraisals are recommended since there is a greater potential for abuse when dealing with for-profit successors. Similarly, if the previous owners are retaining ownership of property being leased by the nonprofit, certified third-party appraisals of the fair market rental value of the facilities are encouraged.

Continued on next page
A review of the financial transactions involved in a for-profit conversion may reveal payments to the for-profit for goodwill. Goodwill, by definition, is a measure of the profit advantage in an established business. Nonprofit organizations do not have profit motives. Where the provision for goodwill is routine among private organizations, the concept invites a certain amount of scrutiny when a nonprofit organization is involved. In cases where the for-profit company was unprofitable, payments for goodwill are even more questionable.

Hancock Academy Case

*Hancock Academy of Savannah, Inc. v. Commissioner*, 69 T.C. 488 (1977), describes adverse situation under section 501(c)(3). The stockholders in a for-profit private school formed a non-profit corporation to facilitate expansion of the school.

*Continued on next page*
The nonprofit corporation leased facilities from the for-profit corporation and purchased the operations of the school for grades 4 and up for $50,000. The $50,000 was alleged to be a payment for goodwill. The nonprofit corporation continued a policy of the for-profit school whereby parents in addition to paying tuition were required to make interest free loans to the school of $500 for the first child and $100 for each additional child. The loans were repayable in one year. Held, the payment for goodwill was excessive in view of the fact that the operations of the nonprofit organization were expected to produce not profits but losses. The interest free loans benefited the for-profit corporation because the lease required the nonprofit corporation to use its funds to improve the facilities leased from the for-profit corporation, relieving the for-profit corporation of the need to finance the building’s improvements at market rates of interest.

Continued on next page

IRS 00821

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Case Development, Continued

Exercise 4

Pay-To-Learn was established as a for-profit with their state. They operated a commercial tutoring service for students since their date of formation in 1995. On January 1, 2012, they converted their for-profit corporation to a nonprofit corporation. The prior business generated losses of $15,000 for 2011, losses of $5,000 for 2010, and profits of $10,000 for 2009. The nonprofit organization will still be involved in tutoring services, but they plan to carry out their activities in a charitable instead of a commercial manner. Both of the owners of the for-profit company will become board members with the nonprofit, but they have expanded the Board to include three additional unrelated members. Both of the previous owners will also be compensated employees with the nonprofit tutoring service. On Schedule G to Form 1023, they indicated there were no liabilities transferred to the nonprofit, and all tangible assets were sold to the nonprofit at fair market value. In addition to the tangible assets, they revealed a $30,000 payment to the former owners for goodwill. They stated that their commercial business was well-respected in the community and the $30,000 payment served as compensation for being able to attract their former customers. There are no lease agreements for any real or personal property still owned by the previous owners of the for-profit.

The nonprofit is submitting an application for exemption under section 501(c)(3). Explain whether or not they would qualify (or if more information is needed), and explain any potential barriers to exemption. Describe all recommended case development questions. Describe any corrective actions that may be required if exemption could be extended based on certain conditions.

Answer:
**Case Development, Continued**

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<td>We should carefully consider our plan of action before recommending corrective actions to for-profit successors. For example, advising them on dissolving the for-profit predecessor, instructing the previous owners to forgive debts, etc. If additional factors reveal that a proposed denial is probable, then we should not offer such advice. Corrective actions should only be recommended when all other factors indicate that a favorable ruling is likely.</td>
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Corrective Actions (continued)

Exam referrals may be wise in situations requiring corrective actions. An individual exam referral is prudent when the previous owners of the for-profit were creditors and agreed to forgive debts, rather than transferring the debts to the nonprofit. The referral should ensure they do not consider it a “donation” and take a charitable deduction for the amount. We may also consider an exam referral on the for-profit business itself to ensure any forgiven loans from related parties were not written off as bad debts, or if there is evidence that any required taxes were not paid.

Development Questions

Development questions vary depending on the case in question, but may include the following:

• Has the for-profit predecessor been dissolved? If so, provide evidence. If not, describe your ongoing relationship with this entity.

• Describe the history behind the creation of your organization. Provide a detailed explanation why you are taking over the operations of the for-profit entity.

• Is there any relationship between the owners, partners, principal stockholders, officers, and governing board members of the for-profit predecessor and the officers, directors, and board members of your organization? Do or did the two organizations share any common members? Provide copies of any written contracts or agreements between each individual associated with the for-profit who will maintain a working relationship with you.

• Describe all asset transfers from the for-profit predecessor, whether from gift or sale. Indicate the value of each asset and describe how the value was determined. Submit appraisals where necessary. Provide copies of any written asset purchase agreements.

Continued on next page
Case Development, Continued

**Development Questions (continued)**

- The purchase agreement you provided includes the transfer of goodwill. Goodwill is a measure of the profit advantage in an established business. By definition, a nonprofit organization was not formed to make a profit. Where the provision for goodwill is routine among private organizations, the concept invites a certain amount of scrutiny when a nonprofit organization is involved. Please explain how your payment for goodwill does not result in prohibited private benefit for related parties. Describe how profit motive is factored into your financial plan.

- Describe all transfers of debts or liabilities from the for-profit predecessor to your organization. Provide an itemized list of each debt, include any relevant transfer agreements, and describe how each amount was determined.

- Based on your financial data, it appears that the amount of liabilities exceed the amount of assets transferred upon your conversion from the for-profit entity to the nonprofit entity. Please explain how the transfer of liabilities from the prior for-profit entity to your organization is consistent with exempt status under IRC 501(c)(3).

- Describe any lease/rentals of property or equipment previously owned or used by the for-profit predecessor. Submit copies of any associated lease/rental agreements.

- Since your conversion from for-profit to nonprofit entity, has your organization made capital improvements to the facility owned by the stockholders of the for-profit? Please explain how your payment of capital improvements on private property owned by the stockholders of the for-profit entity is consistent with exempt status under IRC 501(c)(3).
**Case Law**

**Rev. Rul. 76-441**

Revenue Ruling 76-441 describes one organization that qualifies for exemption under section 501(c)(3), which purchases or leases at fair market value the assets of a former for-profit school. It employs the former owners, who are not related to the current directors, at salaries commensurate with their responsibilities. The ruling describes another organization which does not qualify for exemption under section 501(c)(3) because it serves the private interests of the former owners. It takes over the school’s assets and liabilities, which exceed the assets, and include notes owed to the former owners and current directors of the school.

**Rev. Rul. 76-91**

Revenue Ruling 76-91 describes a nonprofit hospital seeking exemption under section 501(c)(3), acquiring the assets of a proprietary hospital. Over one-half of the board of directors of the nonprofit consists of stockholders in the for-profit. In order to establish the selling price of the hospital, the owners obtained an independent appraisal of the tangible assets, and then computed the value of the intangible assets by the capitalization of excess earnings formula. The nonprofit purchased the hospital for the price arrived at by this method. Generally, where an organization purchases assets from an independent third party, a presumption exists that the purchase price represents fair market value. However, where the purchaser is controlled by the seller at the time of sale, this presumption cannot be made. Instead, the value must be established by methods such as an independent appraisal. Since the nonprofit hospital in this case utilized such methods, it established that it qualified for exemption under section 501(c)(3).
Summary

When attempting to identify a for-profit successor, it is helpful to understand the nature of the transition, which depends on the state law in effect. In some states, the for-profit corporation may be simply converted to a nonprofit. The effective date of exemption cannot be earlier than the date the for-profit corporation was converted to a nonprofit. In other states, it may be required to start a new corporation. Successors to for-profit organizations are also required to complete Schedule G to Form 1023.

As the specialist develops an application from a for-profit successor, the first step in analyzing the case is to determine if the activities themselves qualify for exemption. Next, the specialist should analyze the motives for converting to a nonprofit. The specialist may choose to take additional risk in situations where it is apparent that the applicant simply incorporated under for-profit statutes by accident, never operated as a for-profit, and immediately reformed as a nonprofit.

Investigative techniques must 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.

If there is a transfer of liabilities to the nonprofit, the owners of the for-profit may be attempting to avoid their own responsibility for payment. If the previous owners of the for-profit are the creditors, we would look favorably upon a situation in which they decide to forgive the liability. If the creditors are other unrelated third parties, we would also look favorably upon a situation in which the previous owners pay off the amounts themselves.

If there is a transfer of assets, the nonprofit should generally pay at or below fair market value for all assets. Payments to the for-profit for goodwill invites scrutiny because goodwill, by definition, is a measure of the profit advantage in an established business, and nonprofit organizations do not have profit motives.
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Lesson 6

Convention or Association of Churches
Lesson 6
Convention or Association of Churches

Overview

Introduction

This lesson details the requirements for classification as a convention or association of churches.

An organization that is organized and operated exclusively for a religious purpose may qualify for exemption under section 501(c)(3) of the Code.

There are no legal documents, either statutory or regulatory, that define “religious.” Additionally, the Code and regulations do not define “convention or association” nor do they define “church.”

By law, an organization claiming to be a convention or association of churches is not required to file Form 1023, as they are statutorily exempt. A convention or association of churches automatically qualifies as a public charity under sections 509(a)(1) and 170(b)(1)(A)(i). However, in order to receive a letter stating that it is exempt, the organization must file a Form 1023 application. The burden of proving that an organization is not a convention or association of churches rests on the Service.

If the organization is already exempt under section 501(c)(3) of the Code with a different foundation classification, it can request reclassification as a convention or association of churches through Form 8940.

All organizations exempt under section 501(c)(3) of the Code, including conventions or associations of churches, are subject to the prohibition on inurement and private benefit as well as the prohibition on political activity.

Continued on next page
Overview, Continued

Objectives
After completing this lesson you will be able to:

• Identify the requirements for classification as a convention or association of churches

• Determine whether an organization qualifies for classification as a convention or association of churches

• Identify IRC section 7611 limitations on the scope of examinations

Reference Materials
Exhibit 6-1, Revenue Ruling 74-22.

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Convention or Association of Churches Defined

**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.

The term "convention or association of churches" generally refers to the central association or convention of a group of churches or to an organization of churches of the same, or differing denominations.

**Public Charity Status**
Like churches, conventions or associations of churches are classified as public charities under IRC Sections 509(a)(1) and 170(b)(1)(A)(i).

**Filing Requirements**
Section 1.6033-2(g)(1) of the Treasury Regulations provides, in part, that, conventions or associations of churches are not required to file annual information returns.
Revenue Ruling 77-224

Revenue Ruling 74-224, 1974-1 C.B. 61, provides that an exempt organization whose membership is comprised of churches of different denominations qualifies as an association of churches within the meaning of sections 509(a)(1) and 170(b)(1)(A)(i) of the Code.

The organization 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.

Membership was comprised of Catholic and Protestant Churches of various denominations and the Governing Board of the organization consisted of two (2) voting members from each Church.

The organization engaged in a number of activities such as provision of clergymen at hospitals and college campuses, pastoral counseling, coordinated religious educational programs and facilities, and coordinated efforts to aid the poor.

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 section 501(c)(3).
Other Judicial/Legislative Sources

Lutheran Social Service of Minnesota v. US - 758 F.2d 1283

The court in Lutheran Social Service of Minnesota, after considering the legislative history, stated that an organization whose board was appointed by three major Lutheran church bodies and whose primary activities consisted of providing social services (similar to services performed by secular organizations) to the public, regardless of the clients’ religious beliefs, was not a convention or association of churches.

Revenue Act of 1950

The Revenue Act of 1950 imposed a tax on unrelated business income of all 501(c)(3) organizations except churches and conventions or associations of churches.

The term "convention or association of churches" was added to the statute at the urging of Baptist leaders. This addition relieved concerns that the term "church" included hierarchical churches (such as the Catholic Church), but not congregational churches in which each local congregation is autonomous (such as with the Baptists).

Therefore, churches and conventions or associations of churches were exempted to give equal federal tax treatment to both hierarchical and congregational churches. The Tax Reform Act of 1969, however, applied UBIT more comprehensively, including to churches and conventions or associations of churches.

Section 7701(n)

Section 7701(n) of the Code states that, for purposes of this title, 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 organization.
Case Development

When developing requests for classification as a convention or association of churches, the following information is often requested from the organization.

- Names and employer identification numbers for the member churches.
- Copies of the organization’s Bylaws, Articles of Incorporation, or other document that details its board member appointment procedures.
- Additional information detailing the organization’s efforts to establish and lead the churches which it states comprises its association, such as, but not limited to, whether:
  - The member churches are required to submit financial records to the organization on an annual basis.
  - The organization has established speaking arrangements with its member churches.
  - Publications are distributed from the organization to its member churches.
Other Religious Organizations

Common Religious Organizations

Not all organizations requesting classification as a convention or association of churches meet the requirements for public charity status under sections 509(a)(1) and 170(b)(1)(A)(i) of the Code. However, these organizations may still qualify for exemption under section 501(c)(3) with another foundation classification.

The following organizations would be considered religious organizations and not meet the definition of a convention or association of churches if they are separately organized and operated:

- Evangelistic associations
- Religious schools (such as seminaries)
- Youth groups
- Men’s and women’s associations
- Mission societies
- Religious publishing houses

Filing Requirements

Section 1.6033-2(g)(1) of the Treasury Regulations provides, in part, that, conventions or associations of churches are not required to file annual information returns.

Religious organizations that do not meet the requirements for classification as a convention or association of churches under sections 509(a)(1) and 170(b)(1)(A)(i) of the Code are required to file annual information returns unless they meet the exceptions listed below.

Revenue Procedure 96-10, 1996-1 C.B. 577 and Treasury Regulations 1-6033-2 describe a class of religious organizations, affiliated with a church or convention or association of churches, which are not required to file Form 990.
IRC Section 7611

Introduction  IRC 7611 describes a set of procedures by which the Service will conduct an investigation of a church regarding its tax matters. Congress, when it enacted IRC 7611, tried to minimize the potential for church-state confrontations in Service examinations of churches by adopting detailed procedures to be followed whenever the Service was involved in what the statute characterized as a "church tax inquiry." These procedures emphasized the need for a speedy determination of a church's tax liabilities without unnecessary examination of church records.

For purposes of IRC 7611, a "church" includes any organization claiming to be a church or convention or association of churches.

Limited Audit Scope  Due to the sensitivity of separation of church and state, safeguards have been put in place to prevent potential interference by the government in church affairs. IRC section 7611 limits the scope of the examination of a church or a religious organization claiming to be a church to determining:

- If there is any liability for income tax
- If the claimed church status can be supported by facts

Examinations vs. Determinations and 7611  Although IRC section 7611 applies to examinations only, determination specialists should exhibit caution before granting exemption to a convention or association of churches to ensure that the organization meets all of the legal requirements. The correct determination is critical due to of the restrictions on examinations by field agents with respect to conventions or associations of churches.

- While there are special circumstances in which the restrictions imposed by IRC section 7611 do not apply and an audit examination is allowed, it is important to remember that examinations of conventions or associations of churches are tightly controlled.
Section 170.--Charitable, etc., Contributions and Gifts

26 CFR 1.170A-9: Definition of section 170(b)(1)(A) organization. (Also Section 509; 1.509(a)-3.)

[IRS Headnote] Private foundation status; association of churches of different denominations.--

An exempt organization whose membership is comprised of churches of different denominations qualifies as an association of churches within the meaning of section 170(b)(1)(A)(i) of the Code for purposes of classification as an organization that is not a "private foundation" within the meaning of section 509(a)(1).

[Text]

Advise has been requested whether an organization which has a membership comprised of churches of various denominations qualifies as an "association of churches" within the meaning of section 170(b)(1)(A)(i) of the Internal Revenue Code of 1954 for purposes of classification as an organization described in section 509(a)(1).

The organization is recognized as exempt under section 501(c)(3) of the Code 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. Membership is comprised of Catholic and Protestant Churches of various denominations. The Governing Board of the organization consists of two voting members from each Church.

The organization engages in a number of activities such as provision of clergymen at hospitals and college campuses, pastoral counseling, coordinated religious educational programs and facilities, and coordinated efforts to aid the poor. Support for the organization is primarily derived from its members and public contributions.

Section 509(a)(1) of the Code provides that the term "private foundation" does not include an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)). An organization is described in section 170(b)(1)(A)(i) if it is a church or a convention or association of churches. Neither the Code nor the regulations thereunder define what constitutes a convention or association of churches.

Continued on next page
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 section 501(c)(3). The term is not limited in its application to a group of churches of the same denomination. Accordingly, the organization described herein is an association of churches within the meaning of section 170(b)(1)(A)(i) of the Code for purposes of classification as an organization described in section 509(a)(1).
Lesson 7

Political, Legislative (Lobbying), & Prohibited Activities
Lesson 7

Political, Legislative (Lobbying), and Prohibited Activities

Overview

Introduction

IRC section 501(c)(3) organizations are expressly prohibited from engaging in political activities. This lesson discusses and defines political and legislative (lobbying) activities, differentiates between the two, and explains the extent to which IRC section 501(c)(3) and other exempt organizations may engage in them.

This lesson also discusses “action organizations” and explains why they do not qualify for exemption under IRC section 501(c)(3) but may qualify for exemption under IRC section 501(c)(4).

One of the basic charitable principles for exemption is that charitable organizations may not engage in behavior that is illegal or which violates public policy. This lesson identifies and discusses prohibited activities.

Continued on next page
Overview, Continued

Objectives

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

- Identify “political activities” and “legislative (lobbying) activities” and differentiate between the two
- Determine when an activity is educational rather than political
- Explain how much political and legislative activity is permissible for IRC section 501(c)(3) organizations and other exempt organizations
- Determine whether an organization is substantially engaged in legislative activities
- Identify the consequences of excessive legislative activities
- Define an “action organization” and explain why an action organization does not qualify for exemption under IRC section 501(c)(3)
- Explain the provisions of IRC sections 4911 and 501(h) including the excise taxes that may be imposed on an IRC section 501(c)(3) organization
- Describe the effect of activities that are illegal or contrary to public policy on tax exempt status

Continued on next page
Overview, Continued

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</table>
Under the Internal Revenue Code, all section 501(c)(3) organizations are **absolutely prohibited** from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office.

Contributions to political campaigns or public statements of position (verbal or written) made on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate the prohibition against political campaign activity under section 501(c)(3). Violating this prohibition will result in denial of exemption or revocation of tax-exempt status and the imposition of certain excise taxes.

What Activities constitute participation or intervention in a political campaign?

Treas. Reg. 1.501(c)(3)-1(c)(3)(iii) provides that activities that constitute participation or intervention in a political campaign include, but are not limited to:

- The publication or distribution of written or printed statements or
- The making of oral statements on behalf of or in opposition to a candidate for public office.

The following are examples of activities that constitute participation or intervention in a political campaign:

- Publishing or distributing written or printed statements or making oral statements on behalf of or in opposition to such a candidate
- Paying salaries or expenses of campaign workers
- Conducting or paying the expenses of conducting a voter-registration drive limited to the geographic area covered by the campaign.
  (Treas. Reg. 53.4945-3(a)(2))
Political Activity – Prohibited Under IRC Section 501(c)(3), Continued

What Activities Constitute Participation or Intervention in a Political Campaign? (continued)

IRC section 4955(d)(2) provides the following examples of "political expenditures":

- Amounts paid to a candidate for public office for speeches or other services
- Travel expenses of candidates for public office
- Expenses of conducting polls, surveys, or other studies, or preparing papers or other materials, for use by candidates for public office
- Expenses of advertising, publicity, and fundraising for candidates for public office
- Any other expense which has the primary effect of promoting public recognition, or otherwise primarily accruing to the benefit, of candidates for public office
- A determination as to whether an organization has participated or intervened in a political campaign is based upon all of the relevant facts and circumstances

Who is a Candidate for Public Office?

A candidate for public office means an individual who offers himself or herself, or is proposed by others, as a contestant for an elective public office, whether such office is national, state or local. (Treas. Reg. 1.501(c)(3)-1(c)(3)(iii))

It does not matter if the candidate is not endorsed by a political party or if the office is not contested by a political party. (Rev. Rul. 67-71, 1967-1 CB 125)

Continued on next page
## Political Activity – Prohibited Under IRC Section 501(c)(3), Continued

### Who is a Candidate for Appointive Office?

Notice 88-76, 1988-27 IRB 34, states that attempting to influence the Senate confirmation of a nominee for a federal judgeship does not constitute political activity, because the federal judgeship is an appointive office, not an elective office.

However, these expenditures would be subject to the tax imposed by IRC section 527(b) on political expenditures.

### Indicators of Political Activities

A determination specialist must be alert for evidence of political activity during the determination process. Some sources for revealing political activity are shown in the table below:

*Continued on next page*
Political Activity – Prohibited Under IRC Section 501(c)(3), Continued

<table>
<thead>
<tr>
<th>Source</th>
<th>Reveals...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minutes, newsletters</td>
<td>Discussion of a political figures or political event</td>
</tr>
<tr>
<td>Financial statements</td>
<td>Payments to:</td>
</tr>
<tr>
<td></td>
<td>• politicians</td>
</tr>
<tr>
<td></td>
<td>• political parties</td>
</tr>
<tr>
<td></td>
<td>• political action committees (PACs)</td>
</tr>
<tr>
<td></td>
<td>• trade associations that might support a candidate</td>
</tr>
<tr>
<td></td>
<td>• legal firms diverting funds to political trustee accounts</td>
</tr>
<tr>
<td></td>
<td>• other organizations</td>
</tr>
<tr>
<td>Agreements</td>
<td>Lending/sharing of equipment, facilities, or employees</td>
</tr>
<tr>
<td>Local newspapers</td>
<td>Announcements regarding political events sponsored by the organization</td>
</tr>
<tr>
<td>Application form and activity description</td>
<td>Evidence of political activities</td>
</tr>
</tbody>
</table>

Additional Guidance

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.
Political vs. Educational

**Introduction**

While some activities and disbursements are obviously political in nature, others may seem to be political but actually are educational. For example, certain voter education activities (including presenting public forums and publishing voter education guides) conducted in a non-partisan manner do not constitute prohibited political activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not be prohibited political campaign activity if conducted in a non-partisan manner.

Although discussed here, voter education and registration activities are higher graded issues and will be reviewed more in depth in advanced training. If assigned such a case, see the manager for possible case upgrade and/or reassignment. These types of cases are also subject to mandatory review.

**Voter Education**

Rev. Rul. 78-248, 1978-1 CB 154, gives four situations to illustrate that certain “voter education” activities may or may not constitute prohibited political activity. The chart below summarizes these situations. (All activities were conducted by section 501(c)(3) organizations.)

*Continued on next page*
### Description of Activity

<table>
<thead>
<tr>
<th>Description of Activity</th>
<th>Type of Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepared/distributed a compilation of voting records of Members of Congress on major legislative issues.</td>
<td>Educational</td>
</tr>
<tr>
<td>Solicited the opinions of a state’s gubernatorial candidates on a wide variety of issues. These were assembled into a voter’s guide and distributed.</td>
<td>Educational</td>
</tr>
<tr>
<td>Solicited the opinions of candidates regarding only certain issues. Assembled into voter’s guide and distributed.</td>
<td>Political</td>
</tr>
<tr>
<td>Published/distributed a guide containing voting records of Members of Congress regarding only one issue.</td>
<td>Political</td>
</tr>
</tbody>
</table>

---

**Rev. Rul. 80-282**

Rev. Rul. 80-282, 1980-2 CB 178, held that an organization was not participating or intervening in a political campaign and qualified for exemption under IRC section 501(c)(3) as an educational organization because it:

- Monitored and reported on legislative, judicial administrative, and other governmental activities it considered to be socially important
- Published in its newsletter a summary of voting records of Members of Congress on only those issues important to the organization
- Included in the same publication a comparison of these voting records with the organization’s position

*Continued on next page*
Rev. Rul. 80-282 (continued)

The activities were determined to be educational because:

- All incumbents’ records were included
- Candidates for re-election were not identified
- No comment was made on an individual’s overall qualifications for public office
- No statements were made to endorse or reject any incumbent as a candidate for public office
- The organization cautioned against judging an incumbent’s qualifications based on only certain selected votes
- The publication would be distributed only to the organization’s members
- No attempt was made to target the publication toward specific areas where elections were being held or to time the publication date to coincide with an election campaign
**Legislative (Lobbying) Activities**

**Introduction**

In general, an organization will not qualify for exemption under IRC section 501(c)(3) if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). An IRC section 501(c)(3) organization may engage in some lobbying, but too much of this activity will result in a denial of exemption or revocation of tax exempt status.

An organization will be regarded as attempting to influence legislation if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting or opposing legislation or if the organization advocates the adoption or rejection of legislation.

Organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, organizations may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

Cases involving many public policy issues are higher graded cases. If assigned a case involving public policy, discuss the case with the manager for possible case upgrade and/or reassignment.

*Continued on next page*
### Legislative (Lobbying) Activities, Continued

#### What is Legislation?

Legislation includes action by:

- Congress
- Any state legislature
- Any local council or similar governing body
- The public in a referendum, initiative, or similar procedure
- Indian tribal governments

Legislation does NOT include action by executive, judicial, or administrative entities unless they are developing legislation. (Treas. Reg. 1.501(c)(3)-1(c)(3)(ii))

#### Definition of Direct Lobbying

Direct lobbying is any attempt to influence any legislation through communication with:

- Any member or employee of a legislative body, or
- Any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation, but only if the principal purpose of the communication is to influence legislation. (Treas. Reg. 56.4911-2(b)(1))

- The communication must:
  - Refer to specific legislation, AND
  - Reflect a view on such legislation

*Continued on next page*
Legislative (Lobbying) Activities, Continued

**Definition of Grass Roots Lobbying**

According to Treas. Reg. 56.4911-2(b) (2), grass roots lobbying is any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof. The communication must:

- Refer to specific legislation,
- Reflect a view on such legislation, **AND**
- Encourage the reader to take action with respect to such legislation

**Activities Which Are NOT Considered To Be “Influencing Legislation”**

IRC section 4911(d)(2) specifies that these activities are not lobbying, and are therefore allowable:

- Making available the results of nonpartisan analysis, study, or research
- Providing technical advice or assistance to a governmental body or to a committee or other subdivision thereof in response to a written request by such body or subdivision
- Appearances before, or communications to, any legislative body with respect to a possible decision of such body which might affect the existence of the organization, its powers and duties, tax exempt status, or the deduction of contributions to the organization
- Communications between the organization and its bona fide members about legislation or proposed legislation of direct interest to the organization and such members, as long as the organization does not encourage the members to individually take action
- Certain communications with members or employees of legislative bodies

*Continued on next page*
Legislative (Lobbying) Activities, Continued

**Action Organizations**

Action organizations are organizations whose lobbying (or political) activities are so extensive that they prevent them from being exempt under IRC section 501(c)(3). (Treas. Reg. 1.501(c)(3)-1(c)(3)(ii) and (iii)) Although an action organization cannot be exempt under IRC section 501(c)(3), it may qualify for exemption under IRC section 501(c)(4).

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**Characteristics of Action Organizations**

An action organization has two characteristics:

- Its main or primary objective is gained only by legislation or a defeat of proposed legislation, **AND**
- It advocates or campaigns for attainment of its primary objective instead of engaging in nonpartisan analysis, study or research and making those results available to the public.

All facts and circumstances should be considered when making this determination. (Treas. Reg. 1.501(c)(3)-1(c)(3)(iv))

Continued on next page
Legislative (Lobbying) Activities, Continued

Substantial Part Test

As previously discussed, an organization will generally not qualify for exemption under IRC section 501(c)(3) if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). The meaning of “substantial” has always been based on facts and circumstances, with no percentage guidelines:

- *Seasongood v. Commissioner*, 227 F.2d 907, (6th Cir, 1955), held that 5% of expenditures was not substantial.
- *Haswell v. United States*, 500 F.2d 1133, (Ct Cl 1974), cert denied, 419 US 1107 (1975), held that 16.6% to 20.5% was substantial.
- *Christian Echoes National Ministry, Inc v. United States*, 470 F.2d 849 (10th Cir 1972), rejected the use of a percentage test to determine whether activities were substantial.
- GCM 36148 (January 28, 1975) stated that the use of a percentage test was not conclusive and, if one were used, then 10% would be too high.

Other factors to be considered in conjunction with the amount of expenditures are:

- Amount of volunteer time devoted to the activity,
- Amount of publicity assigned to the activity, and
- Continuous or intermittent nature of the activity

The vagueness of the substantial part test led to the enactment of IRC sections 501(h) and 4911 in 1976, which together introduced the expenditure test. However, it is generally held that legislative (lobbying) expenditures that are 5% or less of an organization’s total expenditures are not substantial.
IRC Section 501(h) Election

IRC section 501(h) permits certain eligible IRC section 501(c)(3) organizations to elect to make limited expenditures to influence legislation. An organization making the election will, however, be subject to an excise tax under IRC section 4911 if it spends more than the amounts permitted by that section. Also, the organization may lose its exempt status if its lobbying expenditures exceed the permitted amounts by more than 50% over a 4-year period.

For any tax year in which an election under section 501(h) is in effect, an electing organization must report the actual and permitted amounts of its lobbying expenditures and grass roots expenditures on its annual return.

IRC section 501(h):

- Defines the types of organizations which are eligible for the election
- Provides the rules for proper election using Form 5768, Election/Revocation of Election by an Eligible Sec. 501(c)(3) Organization to Make Expenditures to Influence Legislation
- Provides for revocation of exempt status if the “ceiling amount” for either type of lobbying expenditure is exceeded in each year over the four-year period
- Does not provide an escape for action organizations
- Refers directly to the definitions set forth in IRC section 4911

Continued on next page
Expenditure Test

The expenditure test under IRC section 501(h) allows electing organizations to make lobbying expenditures within specified dollar limits.

As long as the limits are not exceeded, the organization will not:

- Be considered to be engaged substantially in legislative activities
- Owe tax under IRC section 4911
- Lose its exempt status due to legislative activity

Eligible Organizations

The provisions of these sections are:

- Elective
- NOT mandatory
- Available only to the following organizations described in IRC section 501(c)(3):
  - Section 170(b)(1)(A)(ii) organizations
  - Section 170(b)(1)(A)(iii) organizations
  - Section 170(b)(1)(A)(iv) organizations
  - Section 170(b)(1)(A)(vi) organizations
  - Section 509(a)(2) organizations AND
  - Section 509(a)(3) organizations, other than those that support organizations described in sections 501(c)(4), (5), & (6)

If elected, the organization’s lobbying activity is then subject to the expenditure test, instead of the substantial part test.

Continued on next page
**IRC Section 501(h) Election, Continued**

### Making the Election
Filing Form 5768 makes the election. The election is effective on the first day of the taxable year in which the form is filed. This election can be made at the time an application is submitted to the Service.

### Revoking the Election
Filing Form 5768 revokes the election. The revocation is effective on the first day of the first taxable year after the year in which the notice is filed.

**Example**
An organization files Form 5768 on May 31, 2008, requesting a revocation of its election. If the organization’s fiscal year ends on December 31, the revocation is effective on January 1, 2009.

### Substantial Part Test
Organizations that do NOT elect the provisions of IRC section 501(h) remain subject to the substantial part test. A determination as to whether or not an organization is substantially engaged in legislative activity is a facts and circumstances test.

### Reporting Excise Taxes Paid By 501(c)(3) Organizations
The Taxpayer Bill of Rights 2 (PL No. 104-168, 110 Stat. 1452, enacted on July 30, 1996 (Act Section 1312(a)), amends IRC section 6033(b) to require all organizations described in IRC section 501(c)(3) to report all excise taxes paid during the year under the specific Code sections, on Form 990 as shown in the table below.

Information must be reported on returns for taxable years beginning after July 30, 1996.

<table>
<thead>
<tr>
<th>IRC Code Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>4911</td>
<td>Excess expenditures to influence legislation</td>
</tr>
<tr>
<td>4912</td>
<td>Disqualifying lobbying expenditures</td>
</tr>
<tr>
<td>4955</td>
<td>Political expenditures</td>
</tr>
<tr>
<td>4958</td>
<td>Excess benefit transactions</td>
</tr>
</tbody>
</table>
Legislative (Lobbying) and Political Activities of IRC 501(c)(4), (c)(5), and (c)(6) Organizations

May IRC 501(c)(4), (c)(5), or (c)(6) Organizations Engage in Legislative (Lobbying) Activities?

Organizations described in IRC sections 501(c)(4), (c)(5), and (c)(6) may engage in an unlimited amount of legislative activities (lobbying), provided that the lobbying is related to the organization’s exempt purpose.

This principle is set forth in Rev. Rul. 61-177, 1961-1 C.B. 117, which holds that a corporation organized and operated primarily for the purpose of promoting a common business interest is exempt under IRC section 501(c)(6) even though its sole activity is introducing legislation germane to such common business interest.

Rev. Rul. 61-177 notes that there is no requirement, by statute or regulations, that a business league or chamber of commerce must refrain from lobbying activities to qualify for exemption.

Rev. Rul. 61-177 applies to organizations described in IRC sections 501(c)(4) and 501(c)(5) as well. (See also Rev. Rul. 67-293, 1967-1 C.B. 185, and Rev. Rul. 71-530, 1971-2C.B. 237)

May IRC 501(c)(4), (c)(5), or (c)(6) Organizations Engage in Political Campaign Activities?

IRC sections 501(c)(4), (c)(5) and (c)(6) organizations may engage in political campaign activities on behalf of, or in opposition to, candidates for public office provided that such intervention does not constitute the organization’s primary activity.

The regulations under IRC section 501(c)(4) provide that promotion of social welfare does not include participation or intervention in political campaigns.

(Treas. Reg. 1.501(c)(4)-1(a)(2)(ii))

Continued on next page
Legislative (Lobbying) and Political Activities of IRC 501(c)(4), (c)(5), and (c)(6) Organizations, Continued

May IRC 501(c)(4), (c)(5), or (c)(6) Organizations Engage in Political Campaign Activities? (continued)

IRC sections 501(c)(4), (c)(5) and (c)(6) organizations may engage in political campaign activities on behalf of, or in opposition to, candidates for public office provided that such intervention does not constitute the organization’s primary activity.

The regulations under IRC section 501(c)(4) provide that promotion of social welfare does not include participation or intervention in political campaigns.
(Treas. Reg. 1.501(c)(4)-1(a)(2)(ii))

GCM 34233 (December 3, 1969) reaches the same conclusion with respect to labor unions described in IRC section 501(c)(5) and business leagues described in IRC section 501(c)(6). The GCM contrasts support of a candidate for office with lobbying activities.

The GCM concludes that political campaign activities cannot be the primary activity of an organization described in either IRC section 501(c)(5) or (c)(6).

Additional information on rules relating to political and legislative activities of IRC section 501(c)(4), (c)(5) or (c)(6) organizations can be found in the EO 2003 CPE, Political Campaign and Lobbying Activities of IRC 501(c)(4), (c)(5), and (c)(6) Organizations.
Prohibited Activities

Introduction


One of the basic charitable principles is that charitable organizations may not engage in behavior that is illegal or violates public policy.

Continued on next page
Prohibited Activities, Continued

Trust Law

The illegality doctrine derives from English charitable trust law, the legal foundation on which IRC section 501(c)(3) was built. Under charitable trust law, trusts violating law or public policy cannot qualify for charitable status. (Restatement Trusts (Second) section 377, Comment c (1959); IVA A. Scott, The Law of Trusts, section 377 (4th Ed. 1989)) Thus, the “illegality doctrine” encompasses illegal activity as well as activity in violation of public policy.

IRS Viewpoint

Rev. Rul. 80-278, 1980-2 CB 175, established a three-part test to determine whether an organization’s activities will be considered permissible under IRC section 501(c)(3):

- Purpose of the organization is charitable

- Activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions, and

- Activities are in furtherance of the organization’s exempt purpose and are reasonably related to the accomplishment of the purpose

Continued on next page
Prohibited Activities, Continued

Relationship with Other Issues
If an organization engages in substantial illegal activity, it usually has also run afoul of other basic principles of tax exemption, and exempt status may be denied on those grounds, independent of the illegality issues. For example, where a hospital violates the Medicare and Medicaid Anti-Fraud and Abuse statutes by giving kickbacks to staff doctors who refer patients to the hospital, it may have also violated the proscription against inurement. In other situations, issues of substantial amounts of private benefit or insufficient community benefit may preclude exemption.

Where the activity does not create inurement and the private benefit is not substantial enough to cause denial when the benefit is weighed against the community benefit, illegality may be the only remaining issue to deny exemption.

Because illegality questions often raise difficult issues of proof, administrative jurisdiction, and substantiality, any other issues present in the case should be thoroughly developed.

Importance of Substantiality
An organization with an illegal purpose will not qualify for exemption. If the organization’s purposes are legal, the substantiality of the illegal activities will determine whether the exempt status is jeopardized.

An organization will not qualify for exempt status if it engages in substantial illegal activity. Substantiality is measured both quantitatively and qualitatively.

Quantitative Test
The quantitative test focuses on the time and attention the organization gives to the illegal activity. No exempt organization may engage in a substantial amount of activity that does not further exempt purposes. (Treas. Reg. 1.501(c)(3)-1(c)) Substantial activity that does not further exempt purposes is inconsistent with exempt status, regardless of illegality.

Continued on next page
Prohibited Activities, Continued

Qualitative Test
The qualitative test focuses on the:

- Seriousness of the illegality involved and
- Extent to which the activity can be attributed to the organization by virtue of:
  - The involvement of directors or officers, or
  - Through clear ratification of the organization governing body.

The illegal activity may be so serious that even an isolated incident would outweigh the organization’s other activities and be a basis for denial or revocation, regardless of the nature and extent of its exempt activities.

Measuring Substantiality
The question of substantiality of illegal activity was considered in GCM 34631 (October 4, 1971). That memorandum concerned an association alleged to be involved with organized crime, which was said to have used force and violence to silence a newspaper opposed to the organization. The GCM states that it is insufficient to consider only the quantitative basis for determining substantiality. For example, although many violations of local pollution regulations would be necessary to disqualify an organization from exemption, only .01% of activities directed toward robbing banks would quickly disqualify an organization. This is an example of an act having a substantial non-exempt quality, while lacking substantiality of amount.

Racial Discrimination
Until 1970, the Service granted tax exempt status to private schools regardless of the schools’ racial policies. In 1970, a District Court issued a preliminary injunction prohibiting the Service from recognizing tax exempt status of private schools in Mississippi that discriminated on the basis of race. (Green v. Kennedy, 309 F Supp. 1127, appeal dism’d sub nom. Cannon v. Green, 398 US 956 (1970)) This new position was set out in Rev. Rul. 71-447, 1971-2 CB 230.

Continued on next page
Prohibited Activities, Continued

**Anti-War Protests and Confrontational Activity**

An organization whose primary activity is sponsoring protest demonstrations at which participants are urged to deliberately block vehicles and pedestrians, disrupt the work of government, and prevent the movement of supplies is not exempt under IRC section 501(c)(3). (Rev. Rul. 75-384, 1975-2 CB 204)

The organization’s activities violated local ordinances and constituted “breaches of public order.” Contrast this with Rev. Rul. 80-278, 1980-2 CB 175, in which the confrontations were accomplished through the courts and were clearly not illegal.

**Determining When Activity Is Illegal**

It is not always easy to determine whether the activity in question is actually illegal. This is especially true when the statute in question is outside of the Service’s jurisdiction. Where the activity does not violate tax laws, the Service must either rely on another governmental body’s determination of illegality or make its own determination.

**Additional Resources**

*Illegality and Public Policy Considerations*, 1994 CPE Text, Topic L
Summary

The Internal Revenue Code prohibits all section 501(c)(3) organizations from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office.

Activities that constitute participation or intervention in a political campaign include the publication or distribution of written or printed statements and the making of oral statements on behalf of or in opposition to a candidate for public office.

A candidate for public office is any contestant for an elective public office, whether such office is national, state or local.

Rev. Rul. 78-248 describes four situations where “voter education” activities may or may not constitute prohibited political activity.

An organization will generally not qualify for exemption under IRC section 501(c)(3) if a substantial part of its activities is attempting to influence legislation (lobbying). Organizations may, however, involve themselves in issues of public policy without the activity being considered lobbying.

The meaning of “substantial” is based on all the facts and circumstances. Generally, however, legislative (lobbying) expenditures that are 5% or less of an organization’s total expenditures are not substantial.

The expenditure test under IRC section 501(h) allows electing organizations to make lobbying expenditures within specified dollar limits. Organizations that do NOT elect the provisions of IRC section 501(h) remain subject to the substantial part test.

IRC section 4911(d)(2) describes specific activities that are not lobbying, and are therefore allowable.

An organization exempt under IRC sections 501(c)(4), (c)(5), or (c)(6) can engage in an unlimited amount of legislative activities (lobbying), provided that the lobbying is related to the organization’s exempt purpose.

All section 501(c)(3) organization are prohibited from engaging in behavior that is illegal or violates public policy.
Class Exercise -1

L - Political, Legislative (Lobbying), and Prohibited Activities

1. Which of the following would not be considered a political activity:
   
   (a) Payments to a political candidate for speeches or other services
   (b) Preparing papers or other material for us by the candidate
   (c) Preparation and distribution of voting records of members of Congress on major legislative issues
   (d) Expenses of advertising, publicity, and fundraising for the candidate

   Answer:

2. Involvement in political activity will deny exemption for which of the following organization:

   (a) 501(c)(6)
   (b) 501(c)(3)
   (c) 501(c)(7)
   (d) 501(c)(4)

   Answer:

3. ________________ lobbying is any attempt to influence legislation through communication with any member or employee of a legislative body, or any government official or employee who may participate in the formation of the legislation.

   Answer:

Continued on next page
Class Exercise -1, Continued

4. ________________ lobbying is any attempt to influence legislation through an attempt to affect the opinions of the general public or any segment thereof.

Answer:

5. ________________ organizations have lobbying and political activities so extensive that exemption is denied under 501(c)(3) but could qualify under 501(c)(4).

Answer:

6. Section ____________ permits certain eligible 501(c)(3) organizations to elect to make limited expenditures to influence legislation.

Answer:

7. Section 501(c)(3) organizations that elect to make limited expenditures to influence legislation under section 501(h) complete Form ________.

Answer:
Lesson 8
Hot Topics
Lesson 8 - Hot Topics

Slide 1

Hot Topics

CPE 2012

Slide 2

Topics

- Fiscal Sponsorship
- Advocacy
- Media

Slide 3

Fiscal Sponsorship

What is it?
Lesson 8 - Hot Topics

Slide 4

**Fiscal Sponsorship**
- Practice of a nonprofit organization offering its legal and tax-exempt status to groups engaged in activities related to the organization’s mission
- Occurs when one or more charities choose to support another charity or nonexempt project

Slide 5

**Fiscal Sponsorship**
- Typically involves a fee-based contractual agreement between a project and an established nonprofit

Slide 6

**Benefits**
- Increased efficiency - Can enable projects to share a common administrative platform with a larger organization
- Sponsors can provide resources such as payroll, employee benefits, office space, etc.
Legitimate Fiscal Sponsorship Arrangements

Examples

Issues
- Sponsor should make sure that activity of sponsoring a project is done in furtherance of its own tax exempt purpose
- Can be conduits for the transmission of deductible contributions to organizations that are not qualified to receive them
- Rev. Rul. 68-489

Improper Fiscal Sponsorship Arrangements

Examples
Lesson 8 - Hot Topics

Slide 10
Improper Use of Fiscal Sponsors - Common Situations

- Individuals
- Fledgling charities that do not have an IRS determination letter
- Non-charities
- Foreign charities

Slide 11
Improper Use of Fiscal Sponsors - Common Situations, cont.

- Private foundations and the contributions are from private foundations
- Charities struggling to meet the public support test under IRC 170(b)(1)(A)(vi)

Slide 12
Questions?
Lesson 8 - Hot Topics

Slide 13
Advocacy Activities

Slide 14
General Advocacy
- Influence public opinion on issues
- Influence non-legislative governing bodies (executive branch, regulators)
- Encourage voter participation
  - Voter registration
  - Get Out the Vote Drives
  - Voter Guides
  - Candidate Debates/Forums

Slide 15
Is Advocacy Permitted under 501
- 501(c)(4), 501(c)(5), 501(c)(6) – Unlimited amount in further of its exempt purpose
- 501(c)(3) – Permitted as an educational activity
Lesson 8 - Hot Topics

Slide 16

Cases with Advocacy Issues

- Wording
- Ask direct questions based upon the information provided in the application and/or website
- Be careful of fishing

Slide 17

Keep in Mind

- Political/Advocacy cases tend to get media attention, particularly during an election year
- When reviewing an application, check narrative, organizing document, meeting minutes, newsletters, financial statements and websites for evidence of these activities
Lesson 8 - Hot Topics

Slide 18

Media

Slide 19

Calls From the Media

- If you receive a message from a member of the media - forward the call to EO Determinations Media Relations Coordinator - 202-622-4000

- If you receive a call from a member of the media and you pick up the phone - refer the individual to the media relations line - 202-622-4000

Slide 20

Questions?
Lesson 8 - Hot Topics

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Lesson 9

Taxpayer Advocate Service
Lesson 9 - Taxpayer Advocate Service

Slide 1

Taxpayer Advocate Service

Slide 2

Topics

- Taxpayer Advocate Service (TAS)
- TE/GE Taxpayer Advocate Service Liaison
- OARs on Assigned Cases
- Closing a Case with an OAR
- Tips to Work an OAR
- Monthly OARs Report

Slide 3

Taxpayer Advocate Service

Helps Taxpayers who:
- are experiencing economic harm
- are seeking help in resolving problems with the IRS
- believe an IRS system or procedure is not working as it should
Lesson 9 - Taxpayer Advocate Service

We work with the Taxpayer Advocate Service to help alleviate taxpayer concerns with regard to the processing of their cases.

It’s an opportunity to show the taxpayer that we are doing everything we can to process their case timely, resolve any problems and educate the taxpayer on our procedures.

When TAS needs assistance resolving a taxpayer issue, they prepare Form 12412, Operations Assistance Request (OAR).

The OAR is used by the Case Advocate to request assistance from the IRS Operating Division that can help resolve the issue.

The EO Taxpayer Advocate Service Liaison receives and acknowledges the OARs from TAS and reviews the OARs to see how the issues can be resolved.
Lesson 9 - Taxpayer Advocate Service

Slide 7

**Taxpayer Advocate Service Liaison, cont.**

- EO TAS Liaison conducts research on each OAR as applicable - TEDS, EDS, IDRS, TRAC, LINUS, DVD.
- EO TAS Liaison confirms the case status with the Case Advocate.

Slide 8

**OARs on Assigned Cases**

- OARs will be assigned to specialists via email.
- Specialists are responsible for communicating the status of the case and follow-up/completion dates with the Case Advocate.
- When establishing a follow-up date with the Case Advocate, set it at three weeks after the response due date.

Slide 9

**OARs on Assigned Cases, cont.**

- Update the EO TAS Liaison on any follow-up date changes.
- Expedited OAR does not necessarily mean an expedited case.
Lesson 9 - Taxpayer Advocate Service

Slide 10

**OARs on Assigned Cases, cont.**

- Email a copy of the additional information letter to the Case Advocate.
- Establish a follow-up date based on the response due date
- If a taxpayer does not respond, determine your next course of action and update the Case Advocate.

Slide 11

**Closing a case with an OAR**

- Complete Sections V and VI of the OAR Form 12412.
- Make a copy of the closing letter and attach it to the OAR.
- Complete Form 3198-A and attach it to the case file.
- Let EO TAS Liaison know if case is transferred to QA or EO Technical

Slide 12

**Tips for OARs**

- Keep a list of your OARs and review it during WebETS
- Consider providing a status report to your manager on WebETS
- **Just the facts:** The TAS Case Advocate represents the taxpayer, what you say to them is communicated to the taxpayer. Stick to the facts.
Lesson 9 - Taxpayer Advocate Service

Slide 13

**Monthly OARs Report**

- Beginning of each month, an open OARs report is sent to each group manager and the area manager.
- The group manager will update the area manager on OARs that are older than 90 days.

Slide 14

**Summary**

In this lesson, we covered the following topics:

- Taxpayer Advocate Service (TAS)
- TE/GE Taxpayer Advocate Service Liaison
- OARs on Assigned Cases
- Closing a Case with an OAR
- Tips to Work an OAR
- Monthly OARs Report

Slide 15

**Questions?**
Lesson 9 - Taxpayer Advocate Service

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Lesson 10

SQMP & DQMP
Lesson 10 - SQMP/DQMP

Slide 1

Screening Quality Measurement Process (SQMP) & Determination Quality Measurement Process (DQMP)

Slide 2

What are SQMP and DQMP cases?

SQMP cases are closed screening cases sent to Quality Assurance (QA) for sample review.

DQMP cases are closed full development cases sent to QA for sample review.

Slide 3

SQMP/DQMP Cases Returned from QA

If QA identifies a material issue with a SQMP or DQMP case, a Reviewer’s Memorandum will be prepared and forwarded with the case to the Training Coordinator (TC).
Lesson 10 - SQMP/DQMP

Slide 4

Why is the TC involved with SQMP/DQMP Cases?

The TC has several responsibilities:
- Determine if he agrees, disagrees or partially agrees/disagrees with the Reviewer’s Memorandum
- Prepares SQMP/DQMP Case Memo
- Tracks cases
- Identifies patterns
- Report material issues to Management

Slide 5

This part of the Lesson will address the actions taken when the TC agrees with the Reviewer’s Memorandum.

Slide 6

TC Agrees with Reviewer’s Memorandum

The following actions will be taken:
- TC will prepare SQMP/DQMP Case Memo
- TC will forward case to Area Manager
- Area Manager will forward case to Group Manager who will forward to Specialist
- Specialist will take the necessary actions
- Manager will forward case to TC after the required actions have been taken.
Lesson 10 - SQMP/DQMP

Slide 7

**SQMP/DQMP Case Memo**

The SQMP/DQMP Case Memo will list the actions that need to be taken in the Comments/Issues section.

In some instances, cases are returned to specialists for educational purposes without any additional action required.

Slide 8

**The case is given to the Area Manager for review**

- Area Manager agrees with SQMP/DQMP Case Memo
- Area Manager disagrees with SQMP/DQMP Case Memo

Slide 9

**Group Manager and Specialist Responsibilities**

- Comply with the SQMP/DQMP Case Memo.
- Charge time to WebETS Code 7420999
- Manager will initial and date the SQMP/DQMP Case Memo.
- Return case, SQMP/DQMP Case Memo and QA Reviewer’s Memo to TC
Lesson 10 - SQMP/DQMP

Slide 10

**IMPORTANT**

Don’t prepare Form 5457, “Response to Reviewer’s Memorandum-EP/EO”

Return cases to TC and not to EODQA

Slide 11

**Case is returned to TC**

The TC will:

- Ensure all the appropriate actions have been taken.
- Update the SQMP/DQMP spreadsheet
- Forward the case to Records Unit

Slide 12

This part of the Lesson will address the actions taken when the TC disagrees with part of the Reviewer’s Memorandum.
Lesson 10 - SQMP/DQMP

Slide 13

TC disagrees with part of Reviewer's Memorandum

The TC will take the following actions:

- Prepare a memo
- Prepare SQMP/DQMP Case Memo
- Forward the case to the Programs and Support Manager for concurrence

Slide 14

Programs & Support Manager Reviews Memo Prepared by TC

Programs & Support Manager concurs with TC's opinion:

- All documents will be forwarded to the EO Determinations Program Manager for concurrence.
- If the EO Determinations Program Manager concurs, the case memo and Reviewer’s Memo are forwarded to QA.

Slide 15

Programs & Support Manager Reviews Memo Prepared by TC (cont’d)

Programs & Support Manager does not concur with TC’s opinion:

- Case follows the "TC Agrees with Reviewer's Memorandum" procedures
Lesson 10 - SQMP/DQMP

Slide 16

This part of the Lesson will address the actions taken when the TC disagrees with the Reviewer's Memorandum.

Slide 17

TC disagrees with Reviewer’s Memorandum

The TC will take the following actions:

- Prepare a memo addressing the reasons why he disagrees.
- Forward the case and the memo to the Programs and Support Manager for concurrence.

Slide 18

In the next part of the lesson, we will look at some of the issues identified in the SQMP/DQMP process
Lesson 11

Business Performance Review
Lesson 11 - Business Performance Review

Slide 1

Business Performance Review

Slide 2

Topics

- What’s the Business Performance Review (BPR)
- Preparing the BPR
- Analyzing the BPR

Slide 3

What’s the BPR?

The BPR is a high level assessment of the business performance of TE/GE.
Lesson 11 - Business Performance Review

Slide 4

What the BPR Covers

- Performance Highlights
- Critical Issues
- Division Budget Status
- Employee Plans
- Exempt Organizations
- Government Entities
- Toll Free Operations

Slide 5

How Plan Data for BPR is Created

- Training Plan
- Form 5440, “Employee Plans/Exempt Organization Work Plans”
- Measures and Assumptions Document
- Business Performance Review

Slide 6

Preparing the Training Plan

Assessing the training needs:
- The Training Coordinator will work with the Program Manager to assess the training needs for the next fiscal year.
Lesson 11 - Business Performance Review

Slide 7

What does the Training Plan have to do with the BPR?

Why is the Training Plan important?

Slide 8

What happens once the Training Plan has been Prepared?

- The next step is to determine the Full Time Employee (FTE) days for Direct Case Time
- One FTE year is equal to 250 work days.

Slide 9

WebETS!!!
Lesson 11 - Business Performance Review

Slide 10

Exercise:

Would each of the following increase or decrease if 20 new hires started in July?

- Ending Inventory
- Cycle Time
- Case Time

Slide 11

Reasons Why Each Would Increase

- Eight instructors would be needed, three for classroom training and five for OJI.
  - Classroom training - four weeks
  - OJT time - ten weeks

- New hires are considered 0.0% effective their first three months.

Slide 12

Calculating the impact on FTE

Classroom instructors and OJI:

- $3 \times 20 = 60$ FTE days off line
- $5 \times 50 = 250$ FTE days off line

New Hires

- $20 \times 0 \times 180 = 0$ FTE days added

Difference of 310 fewer FTE days charged to direct case time.
Lesson 11 - Business Performance Review

Slide 13

Form 5440 - Employee Plans/Exempt Organization Work Plans

This document consolidates the Training Plans for all of the TE/GE business units (not just EO & EP as the name suggests):

- Headquarters
- GE - Tax Exempt Bonds; Federal, State & Local Governments; Indian Tribal Governments

Slide 14

Measures and Assumptions Document

- It’s a working document
- Must be completed by the end of September

Slide 15

Utilizing the BPR to Track Progress

To view previous BPRs, go to the TEGE intranet home page and select the following:

- Headquarters
- Strategic Planning
- Reports
Lesson 11 - Business Performance Review

Slide 16

**Significant Events Noted in Previous BPRs**
- Technical issues with TEDS
- Elimination of F-Cases
- Expansion of Screening Program
- New Hires

Slide 17

**FY2012 First Quarter BPR**
- Go to page 14
  - Direct Determinations Staff Years
  - Determinations Cases Closed
  - Technical Screening Rate
  - Determination Case Receipts

Slide 18

**Summary**
- Reviewed the make-up of the BPR
- Reviewed the process of preparing the BPR
  - Training Plan
  - Form 5440
  - Measures and Assumptions Document
- Explained how the BPR is used to track progress
Lesson 11 Handout
Exempt Organizations FY2012-13
Summary of Measures & Assumptions

International

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Customer Education & Outreach

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- Decrease in CE&O (PAC 1C) FTE reflects loss of two staff members during FY2011 and assumes no attrition hiring during the remainder of FY2011.
- Exam and R & A Staff Days devoted to PAC 1C: FY2012 assumes 358 days from Exam and 225 days from R & A for Activity Codes 121-127. These amounts are for “direct time.” Allow for “indirect time” at historical ratio of 40%. Yields total of 3.81 FTE.
- Assume rate of 35% of all FTE for Outreach and 65% for Education. Yields FY2012 FTE to Outreach of 4.8 and FTE to Education of 9.
- FY2011 projection above does not match current BPR. BPR projection should be adjusted in the next quarter to correct for loss of staff shown in 1 above.
**Rulings & Agreements**

**FTE & Staffing**

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- 7% attrition rate
- 2 PMF hires in EO Technical in FY11 (beginning week of 8/29)
- FY 2012 no hiring per TEGE hiring plan v2.2
- Assume no hiring or attrition replacement hiring in 2013 so 1 8C loss in FY2013.
  Technical BOY on-rolls FY11 consists of current on-rolls.

**Determination Quantity Measures**

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<tr>
<td>EOY Inventory</td>
<td>20,070</td>
<td>28,432</td>
<td>37,761</td>
</tr>
<tr>
<td>Closed Cases</td>
<td>56,700</td>
<td>56,749</td>
<td>53,357</td>
</tr>
<tr>
<td>Merit</td>
<td>33,384</td>
<td>33,206</td>
<td>31,970</td>
</tr>
<tr>
<td>Non-Merit</td>
<td>23,316</td>
<td>23,543</td>
<td>21,387</td>
</tr>
<tr>
<td>Hours Per Case</td>
<td>3.2</td>
<td>3.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Merit</td>
<td>1.3</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Non-Merit</td>
<td>5.9</td>
<td>6.5</td>
<td>6.4</td>
</tr>
</tbody>
</table>

- No new hiring or attrition hiring in FY 2012 per the TEGE Hiring Plan v1.7.
- No new hiring or attrition hiring assumed for FY 2013.
- Receipts projected by way of linear regression analysis statistical model. Does not include adjustment for potential increase in applications as a result of Auto Revocation process or potential additional receipts due to health care legislation.
- Closures forecasts based upon the total available technical FTE (adjusted for attrition and attrition hiring productivity expectations), average hours per case and a 51% merit closure rate of all receipts.
FY 2012 and 2013 hours per case for merit and non-merit closures expected to increase due to roll out of TEDS for all EO Determinations users. Possible slight decrease from 2012 to 2013 for non-merit hours per case as TEDS learning curve decreases.

**Determinations Quality & Service Measures**

<table>
<thead>
<tr>
<th></th>
<th>FY2011</th>
<th>FY2012</th>
<th>FY2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Customer Satisfaction</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% Satisfied</td>
<td>70%</td>
<td>70%</td>
<td>70%</td>
</tr>
<tr>
<td>% Dissatisfied</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td><strong>Determination Timeliness</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merit</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Non-merit</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Quality (Combined Score)</strong></td>
<td>83.0%</td>
<td>81.4%</td>
<td>80.8%</td>
</tr>
<tr>
<td>Determinations (non-merit)</td>
<td>76.5%</td>
<td>73.3%</td>
<td>73.1%</td>
</tr>
<tr>
<td>% of closures</td>
<td>43.0%</td>
<td>44.0%</td>
<td>42.0%</td>
</tr>
<tr>
<td>Technical Screening (merit)</td>
<td>90.6%</td>
<td>87.8%</td>
<td>88.4%</td>
</tr>
<tr>
<td>% of closures</td>
<td>35.0%</td>
<td>34.5%</td>
<td>35.5%</td>
</tr>
<tr>
<td>Technical Screening (merit with contact)</td>
<td>86.8%</td>
<td>88.0%</td>
<td>87.9%</td>
</tr>
<tr>
<td>% of closures</td>
<td>22.0%</td>
<td>21.5%</td>
<td>22.5%</td>
</tr>
</tbody>
</table>

Quality scores were calculated using the Screening Quality Measurement Process (SQMP) scores beginning January 2009 and Determinations Quality Measurement Process (DQMP) estimates beginning May 2011. Prior periods were measured using the Tax Exempt Measurement System (TEQMS) and therefore, comparisons to prior periods can not be made. Further, because of the limited historical data for SQMP and the lack of data for DQMP, projections may need to be adjusted.

**Technical**

<table>
<thead>
<tr>
<th></th>
<th>FY2011 Projection</th>
<th>FY2012</th>
<th>FY2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Direct Staff Years</strong></td>
<td>19</td>
<td>21.2</td>
<td>19.7</td>
</tr>
<tr>
<td>BOY inventory</td>
<td>634</td>
<td>637</td>
<td>515</td>
</tr>
<tr>
<td>plus: Receipts</td>
<td>418</td>
<td>387</td>
<td>403</td>
</tr>
<tr>
<td><strong>Less: Technical Activities Closed</strong></td>
<td>415</td>
<td>509</td>
<td>473</td>
</tr>
<tr>
<td>EOY inventory</td>
<td>637</td>
<td>515</td>
<td>445</td>
</tr>
<tr>
<td>Hours per Case</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

As of July 2011, EO Technical received 354 technical activities and closed 345 technical activities. The FY 2011 technical activities receipts and closures projections are based on these numbers.

Technical activities receipts in FY 2012 are projected as the average in 2010-2011 = (356 + 418) ÷ 2 = 387. Technical activities receipts in FY 2013 are projected as the average in 2011-2012 = (418 + 387) ÷ 2 = 403.

## Correspondence

<table>
<thead>
<tr>
<th></th>
<th>FY2011 Projection</th>
<th>FY2012</th>
<th>FY2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Staff Years</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>BOY inventory</td>
<td>7,361</td>
<td>3,500</td>
<td>3,500</td>
</tr>
<tr>
<td>plus: Receipts</td>
<td>47,214</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Less: Closures</strong></td>
<td><strong>51,075</strong></td>
<td><strong>52,000</strong></td>
<td><strong>52,000</strong></td>
</tr>
<tr>
<td>EOY inventory</td>
<td>3,500</td>
<td>1,500</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Correspondence Timeliness</strong></td>
<td>42</td>
<td>42</td>
<td>42</td>
</tr>
<tr>
<td><strong>Correspondence Quality</strong></td>
<td>90%</td>
<td>90%</td>
<td>90%</td>
</tr>
</tbody>
</table>

- FY 2012 and FY 2013 projections are based on the trend from receipts and closures for FY 2009, FY 2010 and projected for FY 2011.
- FY 2012 and FY 2013 projections for Correspondence Quality are based on the average from FY 2009, FY 2010, and FY 2011 through the second quarter.

## R-Mail

<table>
<thead>
<tr>
<th></th>
<th>FY2011 Projection</th>
<th>FY2012</th>
<th>FY2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Staff Years</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>R-Mail Closures</td>
<td>5350</td>
<td>6000</td>
<td>6000</td>
</tr>
</tbody>
</table>

- FY 2012 and FY 2013 projections are the average closures for FY 2009, FY 2010, and projected for FY 2011, with a reduction because of decreased staffing applied to R-Mail.
Examinations

**FTE & Staffing**

<table>
<thead>
<tr>
<th></th>
<th>FY2011 Projection</th>
<th>FY2012</th>
<th>FY2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>PAC 7G FTE</td>
<td>288.87</td>
<td>285.69</td>
<td>265.69</td>
</tr>
<tr>
<td>Examinations BOY on-rolls (excl EOCA)</td>
<td>453</td>
<td>428</td>
<td>399</td>
</tr>
<tr>
<td>less: Attrition</td>
<td>25</td>
<td>29</td>
<td>28</td>
</tr>
<tr>
<td>plus: Hiring</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Examinations EOY on-rolls</td>
<td>428</td>
<td>399</td>
<td>371</td>
</tr>
<tr>
<td>EOCA BOY on-rolls</td>
<td>92</td>
<td>106</td>
<td>99</td>
</tr>
<tr>
<td>less: Attrition</td>
<td>4</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>plus: Hiring</td>
<td>18</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>EOCA EOY on-rolls</td>
<td>106</td>
<td>99</td>
<td>92</td>
</tr>
</tbody>
</table>

- On-rolls staffing includes all staffing (technical and non-technical).
- The only FY 2011 hiring was for ACA (Affordable Care Act) related activities. A new ROO group is being developed in the EOCA. Per the latest Hiring Plan (version 1.6), no hiring of any kind is planned for FY 2012.
- FY 2011 Hiring for EOCA per the Hiring Plan ver. 1.6:
  - 6 EOCA ACA hires reporting 10/10/10 (which are included in the BOY on-rolls figure),
  - 17 EOCA ACA hires reporting 6/5/11, and
  - 1 EOCA ACA hire reporting 6/19/11.
- EOCA rolls listed for FY 2011 is assuming an additional 18 ACA hires. Confirmation on these hires should be obtained by mid-May 2011.
- For FY 2012, the attrition rate of 7% was assumed and used based on BOY On-Rolls. For FY 2013, the same assumptions were used (7% attrition, zero hiring).
### Examination Quantity Measures

<table>
<thead>
<tr>
<th></th>
<th>FY2011 Projection</th>
<th>FY2012</th>
<th>FY2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Exam Staff Years (excl. EOCA)</td>
<td>243.8</td>
<td>236.9</td>
<td>220.3</td>
</tr>
<tr>
<td>Direct Time Ratio</td>
<td>57.5%</td>
<td>62.5%</td>
<td></td>
</tr>
<tr>
<td>BOY in-process inventory (stat. 12)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>plus: New return starts</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>less: Examinations Closed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EOY in-process inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Status 51/Closing Unit Inventory</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Examination Returns Closed</td>
<td>11,089</td>
<td>10,419</td>
<td>9,690</td>
</tr>
<tr>
<td>Casework</td>
<td>1,680</td>
<td>2,317</td>
<td></td>
</tr>
<tr>
<td>Gaming</td>
<td>378</td>
<td>244</td>
<td></td>
</tr>
<tr>
<td>Market Segment</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Training</td>
<td>806</td>
<td>221</td>
<td></td>
</tr>
<tr>
<td>Compliance Projects</td>
<td>7,930</td>
<td>7,268</td>
<td></td>
</tr>
<tr>
<td>TEP</td>
<td>295</td>
<td>369</td>
<td></td>
</tr>
<tr>
<td>EOCU (also inc in categories above)</td>
<td>2,008</td>
<td>1,916</td>
<td></td>
</tr>
<tr>
<td>Total Employment Tax (also inc. above)</td>
<td>3,124</td>
<td>3,655</td>
<td></td>
</tr>
<tr>
<td>NRP ET (also inc. above)</td>
<td>2,863</td>
<td>3,185</td>
<td></td>
</tr>
<tr>
<td>Hours per Return</td>
<td>37.4</td>
<td>32.3</td>
<td></td>
</tr>
<tr>
<td>Casework</td>
<td>38.4</td>
<td>42.4</td>
<td></td>
</tr>
<tr>
<td>Gaming</td>
<td>27.6</td>
<td>32.5</td>
<td></td>
</tr>
<tr>
<td>Market Segment</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Training</td>
<td>40.1</td>
<td>31.5</td>
<td></td>
</tr>
<tr>
<td>Compliance Projects</td>
<td>32.5</td>
<td>23.8</td>
<td></td>
</tr>
<tr>
<td>TEP</td>
<td>169.5</td>
<td>140.1</td>
<td></td>
</tr>
<tr>
<td>EOCU (also inc in categories above)</td>
<td>4.8</td>
<td>5.5</td>
<td></td>
</tr>
<tr>
<td>Employment Tax (inc. above)</td>
<td>15.7</td>
<td>10.0</td>
<td></td>
</tr>
<tr>
<td>NRP ET (also inc. above)</td>
<td>30.0</td>
<td>20.1</td>
<td></td>
</tr>
<tr>
<td>Direct EOCA Staff Years</td>
<td>45.0</td>
<td>48.8</td>
<td></td>
</tr>
<tr>
<td>EOCU Educational Letters</td>
<td>1,000</td>
<td>1,008</td>
<td></td>
</tr>
<tr>
<td><strong>EOCU Compliance Contacts Closed</strong></td>
<td><strong>2,355</strong></td>
<td><strong>3,166</strong></td>
<td></td>
</tr>
<tr>
<td>Compliance Contacts HPC</td>
<td>3.9</td>
<td>4.3</td>
<td></td>
</tr>
<tr>
<td><strong>ROO Compliance Reviews</strong></td>
<td><strong>3,549</strong></td>
<td><strong>4,145</strong></td>
<td></td>
</tr>
<tr>
<td>ACA Reviews</td>
<td>2,513</td>
<td>2,241</td>
<td></td>
</tr>
<tr>
<td>Compliance Review HPC</td>
<td>1,036</td>
<td>1,904</td>
<td></td>
</tr>
<tr>
<td>ACA Reviews HPC</td>
<td>8.0</td>
<td>9.0</td>
<td></td>
</tr>
</tbody>
</table>

- The National Research Project (NRP) went into full production during FY 2011, with all 2009 returns being assigned. Through April 2011, 3,046 ET returns have closed (our FY 2011 goal is currently 5,987). Of those current closures, 593 (19%) were NRP. A significant number of employees are currently dedicated to the NRP program.
- At a fixed attrition rate and no hiring on the horizon (as noted above), our overall examination closures are deemed to be on a decline for future years.
<table>
<thead>
<tr>
<th>Examination Quality &amp; Service Measures</th>
<th>FY2011 PROJ.</th>
<th>FY2012</th>
<th>FY2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer Satisfaction</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% Satisfied</td>
<td>68%</td>
<td>69%</td>
<td>70%</td>
</tr>
<tr>
<td>% Dissatisfied</td>
<td>12%</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>Exam Timeliness (excluding TEP)</td>
<td>256</td>
<td>240</td>
<td>230</td>
</tr>
<tr>
<td>Quality</td>
<td>70%</td>
<td>74%</td>
<td>75%</td>
</tr>
</tbody>
</table>

- The new TEQMS standards went into effect FY 2011. These new measurements use a customer-focused weighting system to gauge quality. The second quarter FY 2011 was the first period showing substantial results and was based on a review of 103 returns.
- The increase in employment return closures, reliance on pick-ups, and efficiency of current revenue agents had caused our timeliness figure to steadily decline from our 5-year peak of 273 days in March 2009. Through a review of closure trending, it has been noted that the timeliness rate has been steadily decreasing. At midyear FY 2011, Examination Cycle Time (excluding TEP) was 215 days versus our goal of 256 days; however, after reviewing current pipeline inventory, we expect the increased age of in-process returns to result in higher closed case cycle time as the fiscal year progresses.
Lesson 12
Continuous Learning
Oversight Committee
and
Training Advisory Committee
Lesson 12 - CLOC/TAC

Slide 1
Continuous Learning Oversight Council & Training Advisory Committee

Slide 2
Topics
- TE/GE Investment Projects
- Continuous Learning Oversight Council (CLOC)
- Training Advisory Committee (TAC)
- Resource Material

Slide 3
TE/GE Investment Project
- Improving TE/GE internal communications
- TE/GE human capital strategy
- Building a continuous learning environment
- Modernizing our IRM and guidelines.
Lesson 12 - CLOC/TAC

Continuous Learning Environment

Develop a strategic plan for continuous learning that will allow TE/GE employees to access a platform of updated tools and models and will provide alternate ways to deliver training, in addition to traditional classroom instruction.

Continuous Learning Oversight Council (CLOC)

Oversee all learning activities in TE/GE to:
- Achieve a continuous learning environment
- Utilize modern tools and multiple delivery channels
- Facilitate dynamic learning for a diverse workforce

Accomplishments of the CLOC

- Revised TE/GE On-The-Job Training Course Material
- Developed Continuous Learning webpage
- Worked with L&E to conduct Centra sessions for preparing and maintaining CLPs
- Prepared a comprehensive list of EO, EP and GE courses
- Establishment of Training Advisory Committees
The TAC is similar to the CLOC in purpose. However, the TAC focuses on all the learning activities within EO. Team members include the following:

- EO Exam
- EO Determinations
- EO Technical
- Learning and Education
- Centralized Delivery Services

Continuous Learning Webpage

For Instructors

- Find resources to help plan effective training: Cross-functional classes to help employees and managers plan and deliver effective trainings.
- Find e-learning resources: Comprehensive listing of resources to help build effective e-learning workshops and trainings.
- GoLearn
- Schedule an IVT
  - IVT site locations
  - Multi-Contents
- Request event support
  - Request for Centralized Delivery Services (CDS) Support (Form 13197) [PDF]
  - CDS Coordinators
  - Request offsite meeting facilities
      - Approval Request for Use of Offsite Meeting Facilities (Form 10418) [PDF]
Lesson 12 - CLOC/TAC

Slide 10

Learning Systems
- **ROS KIT**
  - An online resources library offering free access to thousands of business and technology texts, as well as expert summaries of popular business titles.
  - **Search**
  - **Free KIT Quick Start** [PDF]
  - **New User Registration Page**
  - **Printable KIT**
- **CD-ROM**
  - Soft bounded uses the internet to deliver educational sessions, allowing employees in multiple locations to communicate.
  - **BTO CD-ROM Contents**
- **Enhanced Learning Management (ELM)**
  - Offers online courses and updates on events that address specific needs and upcoming events.
  - **JUL 2009**
  - **Update New Learning Options Plan [2008]** [PDF]
  - Required to make course credit level minimums, may be given through normal processing.
  - **Web Administration** [PDF]
- **Interactive Video Template**
  - Provides opportunities for employees to view and interact with courses through live broadcasts and pre-recorded events.
  - **Video Archive**

Slide 11

**For Learners**
- **Continuous Learning Portal** [PDF]
- Create an employee Career Learning Plan (CLP)
  - **Printable CLP Form 10660.pdf** [PDF]
  - Create or update a manager Career Learning Plan (CLP) (managers and other redeployed)
  - CLP (Learning Plan) - This recording will show you how to get started with managing your career path and will demonstrate how to begin creating your Career Learning Plan. This will need to include your IRS email address to access.
  - **Printable CLP Form 10660.pdf** [PDF]
  - **Web-Only CLP**
    - **Web-Only CLP Overview** [PDF]
    - **Web-Only CLP** [PDF]
- **Self-development resources**
  - Free online resources for managers and employees to use for personal and professional development.
  - **T/E/GE Courses List**
  - **TE/GE Course List**
  - **T/E/GE Course List**
  - **T/E/GE Course List**
  - **T/E/GE Course List**

Slide 12

**Continuous Learning Webpage by TE/GE Function**

- **IRS Tax Exempt and Government Entities**
  - **Continuous Learning - TE/GE Essential List**
  - **Continuous Learning - TE/GE Essential List**
  - **Continuous Learning - TE/GE Essential List**
  - **Continuous Learning - TE/GE Essential List**
  - **Continuous Learning - TE/GE Essential List**
  - **Continuous Learning - TE/GE Essential List**

12-4  IRS 00918
Lesson 12 - CLOC/TAC

Slide 13

The Continuous Learning Webpage
- From the Intranet, select:
  - Business Units
  - Tax Exempt & Government Entities (TE/GE)
  - Continuous Learning
  - TE/GE Course List
  - Training Courses (under the EO heading)

Slide 14

Exercise 1
Use the Find function and look for the word “Inurement”

Slide 15

Exercise 2
Use the Find function to look for topics of interest to you.
Lesson 12 - CLOC/TAC

Slide 16

**Future of the CLOC and TAC**

- CLOC:
  - Restructured and renamed as the Continuous Learning Council (CLC).
  - Learning and Education now oversees the team.
- TAC:
  - Will continue to operate as before.

Slide 17

**What can you do to help the CLC and TAC?**

- Send feedback to the CLC on subjects for the trainings that you and your co-workers want and/or need.
- Complete evaluations for trainings that you participate in so that training planners can learn which trainings are effective and which ones are not.
- Let your manager know if you are interested in being a training instructor.
- Talk to your Training Coordinator
Lesson 13

UBI/UBIT
Lesson 13 - UBIT

Slide 1

UBI/UBIT

13-1
Historical Background to UBIT

**Trinidad case (U.S. 1924)**
Historical Background to UBIT, cont.

- **Roche’s Beach**
  (2d Cir. 1938)
Historical Background to UBIT, cont.

- C.F. Mueller Co. (TC 1950, 3rd Cir. 1951)

(b) (3) (A)
Lesson 13 - UBIT

1950 Act

- Unrelated business income tax (511-513)
- IRC 502 – no exemption for feeders
- UBIT paid with Form 990-T
- State colleges and 401 plans also taxed
- Corporations and trusts sometimes treated differently
Unrelated Business Income

- Trade or business - 513
- Regularly carried on - 512
- Not substantially related to organization’s exempt purpose - 513
Trade or Business

- Activity carried on for production of income from sale of goods or performance of services – 513(c)

- need a profit motive – 162 standard -- Am. Bar Endowment, Portland Golf Club
Regularly Carried On

- Income from unrelated business is not taxable unless “regularly carried on”

- Annual dinner or banquet?
Lesson 13 - UBIT

Slide 10

Regularly Carried On, cont.

Public parking lot every Saturday?

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________
Regularly Carried On, cont.

Annual fair that runs for two weeks?
Regularly Carried On, cont.

Horse racing track that runs for several weeks a year?
Regularly Carried On, cont.

Advertising in opera program?
Lesson 13 - UBIT

Slide 14

Regularly Carried On, cont.

Advertising in program for March Madness NCAA Tournament?
Lesson 13 - UBIT

Substantially Related

- Must be “substantially related” to organization’s exempt purpose other than by raising funds
- Look to incorporation documents – declared purpose of the particular organization matters
- Regs say “contributes importantly” so this is obviously a facts and circumstances analysis
Substantially Related, cont.

- Facts and circumstances means you have to do your research to look for analogous precedent
- You may be surprised at what has been approved
- You may be more surprised at what people try to claim is related
Substantially Related, cont.

- Some items are obvious – like ticket sales for a performing arts organizations
- Scale has to be related to the needs of the exempt function – often comes up in training programs
- There are lots of exceptions based on the activity, how it is carried out, etc. – we will address some of those later
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Fragmentation Rule

- An activity will still generate UBI even if it is done together with activities that do not generate UBI
- Originated in IRS regulation about advertising in journals
- Often comes up in sales by museums, zoos, libraries
- Harder to do if a single fee includes related and unrelated activities in one charge, but don’t let that stop you.
- Can also fragment based on who purchases the item, especially if something does not generate UBI if a student buys it and does generate UBI if a non-student buys it
You are the Museum
Retailing Schlock Troopers

Or, let's play spot the UBI
Travel Tours

- Travel tours can be an activity of a larger system such as a museum or colleges and universities.

- The question is whether the travel tour activity is substantially related to an exempt purpose or whether the activity is an unrelated trade or business.
A travel tour should be carefully scrutinized to determine
1) whether the primary purpose of the travel tour is charitable or educational, and
2) whether there exists a substantial non-exempt purpose, such as social or recreational purposes.

- Facts and circumstances test. Each travel tour activity must be analyzed on a case-by-case basis.
- Additionally, the *fragmentation rule* (IRC513(c) and Reg. 1.513-1(b)) indicates that each travel tour conducted by an organization should be analyzed separately.
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Factors:

- **Bona Fide Educational Methodology** - Mandatory attendance at the educational programs is a strong positive factor indicating the existence of an exempt educational purpose.

- **Structure and Design of the Tour** - This factor indicates that if a travel tour is structured as a traveling college course, then the tour activity would not result in UBIT. Additionally, the provision of an extensive, structured social and recreational program points to the existence of UBIT.

- **Intensive Study of the Subject of the Tour and Academic Credit** - The amount of class time in a travel tour should be substantial in relation to the other tour activities.

- **Selection of Tour for Educational Value and Qualifications of Tour Leaders** - If certified teachers are used, such as teachers and other personnel certified by a State board of education, then this is good evidence of an exempt educational purpose.
Travel Tours, cont.

*Treas. Reg. 1.513-7* sets forth seven examples of related and unrelated travel tours.

- Example (2) describes a tour where “five or six hours per day are devoted to organized study, preparation of reports, lectures, instruction and recitation by the students.”
- Example (3) describes a tour where “substantially all of [the participants’] time” is spent on activities related to the organization’s exemption, with some time in the evenings to engage in social or recreational activities. Both tours were related to the organizations’ exempt purposes, and did not result in UBIT.
- Some examples, such as Example (1), a university alumni association, and Example (7), an educational performing arts organization, provide no educational curriculum and are considered to be unrelated.
Other Issues Relating to Travel Tours

- **Royalties** - IRC 512(b)(2) excludes from the computation of unrelated business taxable income:
  - all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property and all deductions directly connected with such income.
  - A travel company could pay an exempt organization for the use of its name in connection with a travel tour, and the payments to the organization would generally be characterized as exempt royalties.
Passive Income Exceptions – 512(b)(1)-(5)

- Dividends
- Interest
- Annuities
- Royalties
- Rents from real property
- Capital gains
Exceptions to UBI
Sale of Real Property

- Many tax-exempt organizations own real property
- Section 512(b)(5) excludes “all gains or losses from the sale, exchange, or other disposition of property other than property held primarily for sale to customers in the ordinary course of the trade or business.”
Exceptions to UBI
Sale of Real Property, cont.

- §512(b)(5)(B) and §1221 same language
- §1221 defines capital asset and excludes “property held primarily for sale to customers in the ordinary course of the trade or business.”
- Cases in §1221 area. Used by EO for §512(b)(5)(B)
- Facts and Circumstances Determination
- Utilize the 6 Adam Factors to determine whether degree and extent of land development and sales activities rise to the level of “dealer” status.
- Weight each factor: but each factor is not given equal weight.
Six Factor Adam Test

1. The purpose for which the property was acquired;
2. The frequency, continuity, and size of the sales;
3. The activities of the seller in the improvement and disposition of the property;
4. The extent of improvements made to the property;
5. The proximity of sale to purchase; and
6. The purpose for which the property was held during the taxable year.
1. The purpose for which the property was acquired

- **Good Facts:**
  - Property acquired to further the organization's tax-exempt purpose.
  - Property received as a gift or bequest (no business purposes).

- **Bad Facts:** Property acquired for development and resale.
2. The frequency, continuity, and size of the sales.

- Significant in determining whether the sales constitute a trade or business that is regularly conducted.
- **Good Facts:** Sales isolated or causal transactions. One-time sale vs. numerous sales
- **Consider:** Large parcel of land, high value, no single purchaser, subdivision, 15 sales over 10-15 years. UBIT? PLR 9247038
3. Activities of the Seller in the improvement and disposition of the property

- More minimal the activities of the owner in improving and disposing of property, the more likely the sale will be excluded.
- **Good Facts:** No development, advertising, or marketing by organization.
- **Consider:** local ordinances requires subdivision + construction of streets, curbs, gutters, sidewalks, drainage, and water supply pipes for sale. UBIT? PLR200544021
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4. The extent of improvements made to the property

- The smaller the extent of improvements by the organization to the property, the more likely the sale will be excluded.
- Sold raw land. UBIT? PLR 8043052
- Sold land developed by lessee. UBIT? PLR 8522042.
- Sold land marketed and developed by real estate broker. Agent? Brown v. CIR
5. The proximity of sale to purchase

- Generally the longer the period between purchase and sale, the more likely the sale will be excluded from unrelated business taxable income.
6. The purpose for which the property was held **during** the taxable year.

- Look at the actual use of the property.
- **Good Fact:** Property used in the organization's exempt purposes.
- Org purchased 139 acres to be used for large sanctuary, parking lot, Christian school, missionary housing, conference center. Zoning changes. Value increased. No advertising. Sale of **unused** 45 acres. UBIT? PLR 8822057.
Case Study: Sale of Land

- C is recognized as a church under the IRC.
- C owns 25 acre parcel on which its monastery and school are located.
- 15 of 25 acres not suitable for campus facilities: best use of property is for residential buildings.
- C decides to sell these 15 acres.
- Town ordinances require 3-lot subdivision and improvement prior to sale.
- C and the Town enter into a Subdivision Agreement.
Case Study: Sale of Land, cont.

- The Subdivision Agreement requires the following:
  1. Construction of primarily roadways and utilities;
  2. Installation of drainage and landscaping;
  3. Construction of pedestrian/equestrian trail across the lots;
  4. Grant of open space easement to Town; and,
  5. Posting of bond by C to guarantee completion of improvements.

- Must C report the gain from its land sale as UBIT under IRC 512(b)(5)?
Volunteer Labor Exception

- Income from an otherwise unrelated trade or business is not UBIT if substantially all of the labor in the activity is performed by volunteers. IRC 513(a)(1)
- Example: Sale of produce from a farm, where all work is performed by uncompensated members of religious order. St. Joseph’s Farms v. Commissioner 85 TC 9 (1985)
- Substantially all: IRS rulings position is 85% of hours worked
Convenience Exception

- Excludes trade or business carried on for the convenience of members, students, patients, officers, employees. § 1.513-2(b)
- EO must be § 501(c)(3) or college/Unv.
- Rev. Rul. 58-194, cafeteria & restaurant
- Rev. Rul. 81-19, vending machines and laundry facilities
- College Bookstores: (i) clothes; (ii) snacks; (iii) computers; (iv) DVDs; (v) greeting cards; (vi) gift cards.
Health Clubs

- UBIT Issues regarding health clubs.
- A health club can be a part of a larger system such as a hospital system.
- The question is whether the health club activity is substantially related to an exempt purpose or whether the activity is an unrelated trade or business.
- The landmark case relating to health clubs is *Isabel Peters v. Commissioner*, 21 T.C. 55 (1953), nonacq., 1955-1 C.B. 8, withdrawn and acq. substituted therefor, 1959-2 C.B. 6, incorporated into Rev. Rul. 59-310, 1959-2 C.B. 146. The *Isabel Peters* case stands for the proposition that providing recreational facilities can be a charitable activity, provided the facilities are available to the general community.
Rev. Rul. 79-360, 1979-2 C.B. 236, sets forth the general rule regarding health clubs and unrelated business income: that is, in order to be exempt from unrelated business income tax, a health club must benefit a significant segment of the local population.

In order to be exempt from unrelated business income tax, a health club conducted as an activity of an exempt organization must benefit a significant segment of the local population.
Community benefit: The issue of what constitutes a "significant segment of the local population" remains murky. There is no precedential guidance that addresses this particular issue in detail. Each case is resolved on the basis of facts and circumstances, and on a community by community basis. One PLR and GCM compared:

- occupational data for the community with the occupational data for the members served,
- income data from the U.S. Census Bureau with a survey of incomes for club members, and
- data regarding what the average American family spent on recreational activities in a year with the yearly cost of the club.
The same type of analysis also applies when a health club offers various levels of memberships for different charges. In those cases, the activities of a fitness center may be fragmented under the **fragmentation rule** (IRC 513(c) and Treas. Reg. 1.513-1(d)(3)), so as to subject those activities, which are indistinguishable from their commercial counterparts to unrelated business income tax.

If the health club serves disparate groups such as, for example, 1) patients undergoing rehabilitation, 2) hospital employees, and 3) the general public, the **fragmentation rule** applies to analyze relatedness. Patients should be analyzed under the promotion of health standard, hospital employees under the convenience exception (IRC 513(a)), and the general public under community benefit.
“Thrift Shop” Exception

- **Sale of Gift Items**
  - §513(a)(3); §1.513-2(b)(3).
  - Items must be donated
    - Thrift shops specifically mentioned
      §1.513-2(b)(3)
Trade Shows

- IRC 513(d) – unrelated business does not include
  - qualified convention and trade show activities
  - conducted by an IRC 501(c)(6) (business leagues, etc.) or
  - qualified public entertainment activities
  - in conjunction with state/local fair conducted by and IRC 501(c)(3), (4), or (5)(labor, agricultural, or horticultural organizations).
“Qualified convention and trade show activity”

The organization needs to conduct the trade show or fair
- as a substantial exempt purpose, and
- the activity needs to be of a kind traditionally conducted at the trade show/fair.

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Gaming

- Bingo exception
- General rules apply for other gambling/gaming activity
Mailing Lists

- IRC 513(h)(1)(B) – excepts rentals and exchanges of mailing lists between charities or veterans organizations.

- (b) (3) (A) – affinity credit cards. Main issue was whether the payment to the EO had a provision of services component. If so, the payment would not constitute a “royalty” excepted from UBIT. IRS lost these cases.
Corporate Sponsorship Income

- Bowl game GCM
- Prop regs and 513(i)
- Not “advertising” merely to “acknowledge” donor
- Allocation rule
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Research exceptions

Income from research:
- for fed/state/local govt – 512(b)(7)
- by college, university, hospital – 512(b)(8)
- by org operated primarily to carry on fundamental research and make results freely available to public – 512(b)(9)
**Associate Member Dues**

- Sometimes associate member dues look like UBI
- IRC 512(d) – no UBTI for dues less than $100
- Focus on EO’s purpose rather than member’s reason for joining
UBIT Loss Allocations

- UBIT = unrelated business income less deductions “directly connected” with carrying on trade/business.
- Directly connected expenses: proximate & primary relationship. See also § 162
- Dual Use property: Must allocate expenses between exempt and non-exempt property.
  - Special rules for journal advertising –see regs.
- Renssalaer, 732 F2d 1058 (2nd Cir 1983): Allocated fixed expenses of ice rink against actual time used for exempt and non-exempt purpose (bigger UBIT deduction) vs. actual time rink available for use (IRS position).
  - CT: any reasonable allocation is acceptable. See § 1.512(a)-1(c)
- Portland Golf Club, 497 US 154 (1990). Taxpayer must use same allocation method for profits as that of losses
512(b)(13) Controlled Entities

- Anti-abuse rule
- Interest, annuities, royalties, and rents received from >50% controlled entity are taxable as UBIT if derived from what would be unrelated business if conducted by controlling org
- PPA rule for existing contracts – tax only portion above FMV
Partnerships

○ IRC 512(c) – look-through rule – character of partnership items of income (related or unrelated), gain, loss, or deduction pass through to the partners.

○ (b) (3) (A) - a partnership arrangement could be structured so as to preclude a conflict between an exempt organization's exempt purpose and the fiduciary obligations of a general partner to its limited or co-general partners.
Partnerships, cont.

Two-part analysis to determine whether participation by an exempt organization as a general partner in a partnership with for-profit investors adversely affects exemption.

This analysis is referred to as the “two-prong test” in that it examines the following issues:

(1) Whether the organization's participation in the partnership serves its exempt purposes.

(2) Whether the partnership arrangement permits the organization to act exclusively in furtherance of exempt purposes rather than for the benefit of for-profit partners.
Ancillary Joint Ventures:

- Rev. Rul. 2004-51, 2004-22 IRB 974, sets forth the proposition that an ancillary joint venture will not affect the exempt status of an organization. Rev. Rul. 2004-51 concerns an ancillary joint venture between exempt university and a for-profit entity in which the two form a domestic LLC, which is classified as a partnership for federal tax purposes.
  - This is because the ancillary joint venture, a teacher training seminar through interactive video, is just a small part of an exempt organization’s activities.
  - Even if an ancillary joint venture fails to further an organization’s exempt purposes, the organization will still continue to be operated for exempt purposes.
  - The only question that remains is whether the ancillary joint venture is subject to unrelated business income tax.
  - In the Rev. Rul., the EO was able to control the educational aspects, and the venture was not subject to UBIT.
UBIT of Social Clubs, VEBA’s, and SUB trusts

IRC 512(a)(3)
A Different Scheme

- Under 512(a)(3), all gross income of 501(c)(7)’s, (9)’s, and (17)’s is unrelated, except for exempt function income
Exempt Function Income

- Exempt function income means dues, fees, charges, or similar amounts paid by members as consideration for providing the members (and their dependents and guests) goods, facilities, or services. This will apply mainly to social clubs.
- EFI also includes income (less any income derived from unrelated trade or business regularly carried on) derived from amounts set aside for charitable purposes.
- Gain will not be recognized on the sale of exempt function property if other property is purchased within certain time frame with a cost at least equal to the sales price of the old property.
Exempt Function Income
VEBA’s, SUB Trusts

- EFI also includes income from amounts set aside for life, sick, accident, or other benefits
- But the amount of the set-aside is limited by section 512(a)(3)(E)
  - Any amounts at the end of the taxable year in excess of the account limit of IRC 419A are subject to UBIT
  - Actual amount of UBIT will be the lesser of the organization’s income for the year or the amount the 419A account limit is exceeded at the end of the year
  - Collectively bargained funds generally have no 419A limits, and consequently escape the 512(a)(3)(E) limitation
  - VEBA’s funded by EO’s escape these limits
Debt-Financed Income - 514

- Income that is otherwise exempt from UBIT may be subject to tax if it is derived from “debt-financed” property.
  - 514(b)(4) certain passive income, annuities, rents and Cap Gains = UBTI if debt-financed.

- Income/ Cap Gains taxed in proportion to which property is debt financed. 514(a)(1)
  - E.g., if 80% of invested debt-financed then 80% income (& deductions) are UBTI.

- EO must report UBI on 990T ($1,000 deduction)
Debt-Financed Income – 514, cont.

- Debt-financed property: income producing property to which there is "acquisition indebtedness" w/n taxable year. 514(b)(1)
  - Property acquired subject to mortgage or lien, even if EO didn't assume debt. 514(c)(2)
    - Exception: Bequeathed property -10 year grace period
  - Extension, renewal or refinancing of original debt not treated as new debt. 514(c)(3)
  - Debt on exempt-use property that is converted to non-exempt use, or sold and non-exempt use property acquired, there is acquisition indebtedness. 1.514(c)-1(a)(3), (4).
Debt-Financed Income – 514, cont.

- Debt-financed property does not include
  - Exempt-use property (substantially all (85%+) use is substantially related to exempt purpose)
    514((b)(1)(A), 1.514(b)-1.
  - Exempt use property includes certain UBTI exceptions
    513(a)(1), (2), (3)
  - Exempt use property utilized for research pursuant to
    512(b)(7),(8),(9).
  - Neighborhood land rule: property acquired by EO, in EO’s neighborhood, to be used in exempt activity w/n 10 years.
    514(c)(9)(C).
  - Foreign Blocker Corporations.
Debt-Financed Income – 514, cont.

- Acquisition Indebtedness 514(c)(1):
  - Debt incurred in acquiring or improving property;
  - Debt incurred before acquisition or improvement of property and wouldn’t occur “but for” acquisition or improvement;
  - Debt incurred after acquisition or improvement of property and wouldn’t occur “but for” acquisition or improvement + indebtedness “reasonably foreseeable” at time of acquisition or improvement.
  - Formula 514(a): avg. acquisition indebtedness for tax year / avg. adjusted basis of property during tax year
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Debt-Financed Income – 514, cont.

- Acquisition Indebtedness Case Study 1
Case Study 1: Acquisition Indebtedness

- A is a scientific organization recognized under IRC 501(c)(3).
- $450,000 mortgage on A's laboratory to replace working capital previously expended.
- A conducts exempt function activities at its laboratory.
- Working capital was used to renovate its rental building.
- Rental building: 80% commercial tenants.
- Receives $120,000 annual rent.
- Are the rents includible on A's 990-T?
Debt-Financed Income - 514

- Acquisition Indebtedness Case Study 2
Case Study 2: Acquisition Indebtedness

- B is an educational organization under IRC 501(c)(3) and not a school under 170(b)(1)(A)(ii).
- B owns and operates an old school building for teaching purposes.
- Sells old school building for $10M cash and a purchase money mortgage of $20M @ 10% per annum.
- Constructs new educational facility: $15M down and a mortgage of $25M @ 6% per annum.
- Will B incur UBIT on financing the construction of its new educational building?

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Case Study 3: Colleges and Universities

- State University needs to increase revenues to fund its educational curriculum.
- Are the following activities UBIT?
  1. Operates a parking lot: hourly parking/open to the general public.
  2. Performing Arts Center: available for public rental.
  4. Stadium Leasing: leased to pro-football team with University providing linen services, grounds keeping and security.
State University needs to increase revenues to fund its educational curriculum.

Are the following additional activities UBIT?

5. Vending Machines/Laundromat: State University contracts with "X" to supply and maintain vending machines and laundry facilities on the campus. State University intends to purchase its own machines in the future.

6. Interest on CD investment

7. Rental Property: State University borrowed money to purchase commercial rental property.

8. Affinity Card Program: State University allows Bank to use its name, logo and mailing list.
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Lesson 14

Inurement & Impermissible Private Benefit under IRC 501(c)(3)
Lesson 14
Inurement & Impermissible Private Benefit
under IRC 501(c)(3)

Overview

Introduction

The operational test standard prohibiting a substantial nonexempt purpose encompasses inurement, impermissible private benefit and operations which further goals outside the scope of IRC 501(c)(3). We develop issues of inurement and impermissible private benefit in order to determine whether an organization meets the operational test under section 501(c)(3) of the Code. When developing issues of inurement and private benefit, the key points to be mindful of are:

- An organization is exempt on the basis of its purpose and not its activities. (However, its purpose may be inferred from its activities.)
- A single activity can serve both an exempt and a nonexempt purpose.
- An organization’s purpose is discerned from the totality of the facts (fact pattern) in a particular case.
- It is the organization’s true purpose, not the stated purpose, that must be considered.
- And the burden is generally upon the organization claiming exemption to establish that its operations are exclusively in furtherance of exempt purposes and that it does not operate for the benefit of private interests.

Continued on next page
Overview, Continued

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

• Define inurement
• Identify inurement issues on Form 1023 applications
• Define impermissible private benefit
• Identify impermissible private benefit issues on Form 1023 applications
• Distinguish between inurement and impermissible private benefit

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Inurement

**Why are we Concerned with Inurement?**

Reg. 1.501(c)(3)-1(c)(1) provides that an organization will not meet the “operational test” if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

The operational test standard prohibiting a substantial nonexempt purpose encompasses inurement, impermissible private benefit and operations which further goals outside the scope of IRC 501(c)(3).

Thus, if inurement or impermissible private benefit is present, the organization fails the operational test and does not qualify for exemption under IRC 501(c)(3).

**What is Inurement?**

Inurement is impermissible private benefit to insiders or those in positions of control over the organization’s operations.

IRC 501(c)(3) expressly forbids the inurement of net earnings to the benefit of a private shareholder or individual.

The phrase, “no part of the net earnings of which inures to the benefit of any private shareholder or individual” is the source of the word “inurement.” This phrase is present in IRC 501(c)(3), IRC 501(c)(4), IRC 501(c)(6), IRC 501(c)(7), IRC 501(c)(9), IRC 501(c)(11), IRC 501(c)(13) and IRC 501(c)(19).

Reg. 1.501(c)(3)-1(c)(2) clarifies that an organization is not operated exclusively for exempt purposes if its net earnings inure to the benefit of private individuals.

“Net earnings” may inure to the benefit of an individual in a many ways, not just the distribution of dividends or net profits as shown on the organization’s books.

In fact, inurement refers to any use, other than in an arm’s-length transaction or as reasonable compensation, of an organization’s income or assets for private gain by an insider.

*Continued on next page*
Inurement, Continued

The words “private shareholder or individual” refer to persons having a personal and private interest in the activities of the organization. See Reg. 1.501(c)(3)-1(c). It places the focus of the inurement prohibition on those who, by virtue of a special relationship with the organization in question, are able to influence the expenditure of its funds or the use of its assets, for personal enrichment rather than for the benefit of the general public.

The Service does not limit the class of insiders to persons who are able to exercise legal control over the organization such as officers, directors or trustees. (Although, in most instances insiders do involve officers, directors or trustees, etc.) Instead, an insider is any individual with significant influence over the organization’s operation.

Insiders may include:

- Trustees
- Board members
- Officer
- Founders
- Significant donors
- Individuals with a close professional working relationship

Inurement may exist in many forms including:

- Steering of business to a related for-profit company
- Receipt of less than fair market value on sales or exchanges of goods, services or property
- Promotion of copyrighted materials
- Unsecured or inadequately secured loans
- Unreasonable compensation
- Payment of excessive rents
- Receipt of grants and scholarships on a pre-selected basis

Continued on next page
Inurement, Continued

**How much Inurement can an Organization Have Before Tax Exemption is in Jeopardy?**

Even one dollar of inurement is cause for denial of tax exemption.

In *Spokane Motorcycle Club v. U.S.*, 222 F. Supp. 151 (E.D. Wash. 1963), net profits were found to inure to private individuals where refreshments, goods and services amount to $825 were furnished to members.

Those in control may not, by reason of their position, acquire any of the charitable organization’s funds. If funds are diverted from exempt purposes to private purposes, exemption is in jeopardy.

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**Examples of Inurement: Goodwill**

In *Hancock Academy of Savannah, Inc. v. Commissioner*, 69 T.C. 488 (1979) stockholders in a for-profit private school formed a non-profit corporation to facilitate expansion of the school. The nonprofit corporation leased facilities from the for-profit corporation and purchased the operations of the school for grades 4 and up for $50,000. The $50,000 was alleged to be a payment for goodwill. The nonprofit corporation continued a policy of the for-profit school, whereby parents in addition to paying tuition were required to make interest free loans to the school of $500 for the first child and $100 for each additional child. The funds from the interest-free loans were used to improve the school grounds.

Held, the payment for goodwill was excessive in view of the fact that the operations of the nonprofit organization were expected to produce not profits but losses. The interest free loans benefited the for-profit corporation because the lease required the nonprofit corporation to use its funds to improve the facilities leased from the for-profit corporation, relieving the for-profit corporation of the need to finance the building improvements at market rates of interest. Since most of the officers were the owners of the three for-profit corporations involved in the transactions, they were in a position to personally gain from the transactions. Thus, the net earnings of a day school inured to the benefit of private individuals within the meaning of IRC 501(c)(3).

*Continued on next page*
Inurement, Continued

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<td><em>Birmingham Business College, Inc. v. Commissioner</em>, 276 F.2d 476 (5th Cir. 1960), held that those in control of an organization may not withdraw its earnings under the guise of salary payments.</td>
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<tr>
<td>Compensation arrangements include a variety of benefits in addition to salary, such as welfare benefits, fringe benefits, and deferred compensation. Look to the total compensation to determine if it is reasonable.</td>
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<td>In <em>People of God Community v. Commissioner</em>, 75 T.C. 127 (1980), the Court decided that a percentage compensation arrangement for an organization’s minister resulted in unreasonable compensation. There was no upper limit on the amount of compensation that the minister could receive. Because there was no upper limit, the Court found that a portion of the church’s earning was being passed on to its minister.</td>
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<th>Unreasonable Rental Payments</th>
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<td>In <em>Texas Trade School v. Commissioner</em>, 30 T.C. 642, aff’d, 272 F.2d 168 (5th Cir. 1959), a school operated on property leased from the corporation’s officers and made expensive improvements to property which became a part of the officers’ property. The court ruled that the excessive and unreasonable rent payments and improvements made by the organization resulted in inurement to its officers.</td>
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<td>An employee benefit organization funded and controlled by the employer may be operated to serve a business interest of the employer rather than an exclusively charitable purpose.</td>
</tr>
<tr>
<td><em>Horace Heidt Foundation v. United States</em>, 170 F. Supp. 634 (Ct.Cl. 1959) described a foundation formed to assist young performers with exceptional talent to get started in show business. The performers were employed by the founder under his own private business. The foundation paid the educational and medical expenses of the young performers. These expenditures relieved the founder the burden of paying compensation expenses in his own private business and thus, the organization served the founder’s private interests.</td>
</tr>
</tbody>
</table>

Continued on next page
Inurement, Continued

Benefits to Employers (continued)

Rev. Rul. 56-138 held that a trust created by an employer to pay pensions to retired employees relieved the employer of the burdens of the pension program. Also, payments to retired individuals are not in themselves charitable.

Inadequately Secured Loans

John Marshall Law School and John Marshall University v. United States, 81-2 USTC 9514 (Ct. Cl. 1981), described a private law school operated by two brothers, Theo and Martin Fenster. The Court found that a series of interest-free, unsecured loans used by the Fensters to purchase a home and furnish it, the scholarships to the Fenster children, and other personal expenses including travel, health spa membership and entertainment resulted in inurement to individuals.

The school has since expanded its board of trustees so that a majority of the trustees are not related. Family member compensation is now controlled by an independent board. Also, the school’s bylaws have been amended to provide that the trustees can no longer vote on their own compensation. Effective January 18, 1993, the school is exempt under IRC 501(c)(3).

In Lowry Hospital Association v. Commissioner, 66 T.C. 850 (1976), an organization made substantial unsecured loans to a nursing home owned by an officer, which resulted in inurement. The loans relieved the officer of the need to obtain loans at fair market rates of interest and reduced the officer’s personal financial risk in the nursing home.

Best Lock Corporation et al., 31 T.C. 1217 (1959), held that the unsecured loans, made to close friends of an organization’s officer who were in financial difficulty, were made with the purpose of benefiting the individuals involved rather than based on sound business judgment.

Continued on next page
Inurement, Continued

Personal Grants

Gifts by a charitable organization to friends and relatives of persons in control of the organization are personal in nature rather than public. The recipients are natural objects of the “donor’s” bounty. Therefore, by aiding them, the organization is serving the insider’s private purposes. This is true even though the recipients may be members of a charitable class, if the organization provides benefits using criteria other than those that define the charitable class.

In Charleston Chair Company v. United States, 203 F. Supp. 126 (E.D S.C. 1962), a large part of a foundation’s funds were used for scholarship grant to the son of a foundation trustee which resulted in inurement of earnings.

A private foundation that makes grants to friends and relatives of insiders may face penalties under Chapter 42 of the Code.

Tax Avoidance Schemes

Sometimes a business or professional person will transfer business and personal assets to a controlled nonprofit organization for the purpose of avoiding taxes.

The individual will continue to carry on the business or profession as an employee of the transferee organization and will continue to enjoy personal assets such as a home and/or automobile. Transactions of this type are lacking in substance.

Since the transferor operates the organization essentially as an attempt to reduce personal federal income tax liability while still enjoying the benefits of earnings, the organization’s primary function is to serve the private interest of its creator rather than a public interest.

Continued on next page
Continued on next page
Inurement, Continued

**Tax Avoidance Schemes, (continued)**  

Rev. Rul. 78-232 described ABC Church, whose membership consisted of the founder, his spouse, his two children and a few family friends. The founder assigned his income from outside employment to the Church. The Church’s account was used to pay for his families lodging, food and other living expenses. The organization served to the benefit of the founder.

In Rev. Rul. 81-94, a professional nurse formed a church. The nurse served as the Church’s minister, director and officer. She “donated” the income earned from her outside employment to the Church. The Church served as vehicle for handling the nurse’s personal finances. Thus, the organization was formed to serve private purposes rather than public purposes.

Rev. Rul. 69-266 described a doctor that transferred assets, including his medical practice, to a nonprofit organization that he formed and controlled. The doctor was then “hired” to conduct “research programs” that consisted of the examination and treatment of patients charged at prevailing rates. In return for his services the doctor received a salary and other benefits.

In effect, the organization was operated by the doctor to reduce his Federal income tax liability. Therefore, it was not operated for charitable purposes.

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*Continued on next page*
Inurement, Continued

Examples of Where Inurement did Not Apply

IRC 501(c)(3) does not prohibit all dealings between a charitable organization and its founder or with those in controlling positions. An organization’s trustees, officers, members, founders, and contributors may, of course, receive reasonable compensation or fair market value for services or goods, or other expenditures in furtherance of exempt purposes.

*Donald G. and Lillian S. Griswold v. Commissioner*, 39 T.C. 620 (1962), acq., 1965-1 C.B. 4, held that numerous loans to insiders at current commercial rates that were secured by adequate collateral did not result in inurement.

*William Waller, et al. v. Commissioner*, 39 T.C. 665 (1963), acq., 1963-2 C.B. 5, described a charity that purchased securities from its creator for less than the fair market value. The creator claimed a charitable contribution equal to the difference between the fair market value of the securities and the price at which they were sold to the charity. Although the transaction might have resulted in an advantage to the creator, the charity profited from the transaction and its exemption was not affected.

*Rev. Rul. 69-383* held that the exempt status of a hospital under IRC 501(c)(3) was not jeopardized where, after arms’ length negotiations, it entered into an agreement with a hospital based specialist for compensation on the basis of a fixed percentage of the departmental income.

The use of a method of compensation based upon a percentage of the income of an exempt organization can constitute inurement of net earnings to private individuals. For example, a percentage compensation agreement will destroy the organization’s exemption under IRC 501(c)(3) if the arrangement is merely a device for distributing profits to persons in control.

Continued on next page
Examples of Where Inurement did Not Apply, (continued)

However, under the circumstance described in Rev. Rul. 69-383, the radiologist did not control the organization and the agreement was negotiated at arm's length. The amount the radiologist received was reasonable in terms of the responsibilities and activities that he assumed under the contract. For these reasons, it was held that the arrangement entered into between the hospital and the radiologist did not constitute inurement of net earnings to a private individual. (Contrast to People of God Community v. Commissioner, 75 T.C. 127 (1980)).

While the lack of arm’s length bargaining is an important factor, it does not always create inurement. A climate created by control or dominance does not alone justify disqualification. Control and dominance become relevant only when it is abused.

In World Family Corporation v. Commissioner, 81 T.C. 958(1983), the court stated that “Although in some circumstances such a finding may be warranted, it is clear that payment to an interested individual does not make a commission unreasonable as a matter of law.”

In The Church of the Visible Intelligence that Governs the Universe v. U.S., 4 Cl.Ct. 55 (CT.Cl. 1983), the Service argued that because the organization’s bylaws allowed its founder to completely dominate the organization, there was an inference that the organization was operated for his benefit. The Claims Court agreed that this structure raised concern about the potential for abuse unless allayed by other information in the record. However, the court found no evidence to support the inference of improper private inurement because the founder had contributed money without receiving any benefit in return. He did not actually exercise his totalitarian powers.

Nevertheless, the presence of control of an organization by a few insiders should lead to close scrutiny for the presence of inurement.
**Impermissible Private Benefit**

**What is Impermissible Private Benefit?**

Impermissible private benefit is non-incidental benefit that is accorded to certain individuals or entities that is not provided to the public as whole.

Reg. 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated exclusively for one or more of the purposes specified under IRC 501(c)(3) unless it serves a public rather than a private interest. To meet the requirement of IRC 501(c)(3), it is necessary for an organization to 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.

*The burden of proof* as stated in Reg. 1.501(c)(3)-1(d)(1)(ii) *is on the organization* to show that it is not organized or operated to serve private interests.

**How Do We Determine When there is Impermissible Private Benefit?**

The private benefit restriction is not just limited to benefits provided to insiders. But instead, the restriction applies to benefits provided to *any individual*, whether or not the individual is in a position to control or influence the organization.

The private benefit restriction operates against *all parties* who receive a benefit not accorded to the public as a whole.

- How much private benefit can be tolerated before exemption is in jeopardy?

Private benefit will not jeopardize tax-exempt status if it is considered *incidental*.

If an organization serves a public interest and also serves a private interest other than incidentally, it is not entitled to exemption under IRC 501(c)(3).

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

#### How Do We Determine When there is Impermisible Private Benefit?

To be incidental:

The private benefit must be a *necessary concomitant* of the activity which benefits the public at large and accomplishes exempt purposes. In other words, *the benefit to the public cannot be achieved without necessarily benefiting certain private individuals.*

Furthermore, private interests must be benefited only to the extent necessary to accomplish exempt purposes.

#### What is Permissible Private Benefit?

Permissible private benefit must be both quantitatively and qualitatively incidental.

- **Qualitatively** incidental means the private benefit is a mere byproduct of the public benefit. *It would be nearly impossible for the organization to accomplish its exempt purposes without benefiting certain private individuals.*

  For private benefit to be **quantitatively** incidental, it must be insubstantial in amount. The private benefit must be compared to the public benefit of the specific activity in question, not the public benefit provided by all the organization’s activities.

  It is a *facts and circumstances test* in that public benefit from the organization’s activities must outweigh any individual benefit.

  The amount of private benefit that will be permitted depends on the magnitude of the private benefit in relation to the public benefit derived from the organization’s activities and whether the private benefit is necessary in order to accomplish the organization’s exempt purpose.

  The determination that the organization is serving private interests is based on a *detailed knowledge of all of the facts* surrounding the organization’s operations. If the facts show a consistent pattern of nonexempt purpose based on activity, then the organization is not exempt.
## Examples of Impermissible Private Benefit

<table>
<thead>
<tr>
<th>General Example</th>
<th>Restrictions on membership, or other demarcations that restrict the class of persons served by an organization can result in the organization primarily serving private interests.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>In <em>Flat Top Lake Association, Inc. v. U.S.</em>, 868 F.2d 108 (4th Cir. 1989), the Association bought 2,200 acres of property and constructed an artificial lake on the site. The Association then sold lake front lots to individuals who became members. The Association built its own private road to serve the development and strictly limited access to the community to its members and their guests. The lake was maintained for the exclusive use of the members. Since the benefits of the Association were restricted to its members, the organization served the private interests of its members more than incidentally.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business Benefits</th>
<th>Private benefit can result from <em>research that creates substantial benefits for particular business interests</em>. Specific situations the Service has considered include:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Rev. Rul. 65-1</strong> held that an organization making research grants on the development of new machinery to be used by a particular commercial operation, retained all the rights to the new development and licensed certain manufacturers to produce the new products, often on an exclusive basis, did not qualify for exemption. The research and development benefitted the particular commercial operation and certain manufacturers more than incidentally.</td>
</tr>
<tr>
<td></td>
<td><strong>Rev. Rul. 68-373</strong> held that an organization engaged in the clinical testing of drugs for commercial pharmaceutical firms benefited such firms since clinical testing was an ordinary part of pharmaceutical firms marketing operations.</td>
</tr>
<tr>
<td></td>
<td>In <strong>Rev. Rul. 78-426</strong>, an organization whose activities included the inspection, testing and safety certification of cargo shipping containers and research, development, and reporting information in the field of containerization was not operated exclusively for exempt purposes as the activities served the private interests of the manufacturers and shippers more than incidentally.</td>
</tr>
</tbody>
</table>

*Continued on next page*
Examples of Impermissible Private Benefit, Continued

**Business Benefits**

In Rev. Rul. 78-86, a group of local merchants formed an organization to construct and operate a public off-street parking facility in the central business district. The organization set up a free parking validation stamp system for the merchants’ customers. The organization served the merchants’ private interests more than incidentally by *encouraging the public to patronize their stores* and did not qualify for exemption.

In *International Postgraduate Medical Foundation v. Commissioner*, TCM 1989-36, the Tax Court concluded that when a for-profit organization benefits substantially from the manner in which the activities of a related nonprofit organization were carried on, the latter organization was not operated exclusively for exempt purposes within the meaning of section 501(c)(3), even if it furthers other exempt purposes.

*Est of Hawaii v. Commissioner*, 71 T.C. 1067 (1979) described an organization engaged in activities relating to “est” programs involving training, seminars, lectures, etc., in areas of intrapersonal awareness and communication which were conducted under licensing arrangements with a for-profit corporation, was held not to be exempt under IRC 501(c)(3). The court held that although the organization was educational in nature, it served the commercial purposes of the for-profit corporation and, therefore, was not operated exclusively for exempt purposes.

**Employee Benefits**

Rev. Rul. 75-199 described an employee benefit fund supported by the employees themselves where benefits were awarded in the event of death, illness, or disability, without regard to financial distress. The organization was a sort of mutual benefit association, not a charity. This form of self-help served the interests of the members, which was not a public purpose.

*Continued on next page*
Examples of Impermissible Private Benefit, Continued

**Member Benefits**

*Rev. Rul. 61-170* provided that maintaining an employment register primarily for the employment of members of a nurses’ association promoted the interests of its individual members.

*Rev. Rul. 67-367* held that an organization whose sole activity was the operation of a scholarship fund plan for making payments to pre-selected, specifically named individuals, did not qualify for exemption under IRC 501(c)(3).

*Rev. Rul. 69-175* provided that bus transportation for members’ children attending a private school served a private rather than a public interest.

*Benedict Ginsberg v. Commissioner*, 46 T.C. 47 (1966) described a nonprofit corporation, formed to dredge a navigable waterway fronting the properties of its members, received contributions solely from its members in proportion to the value of their properties.

Evidence showed that the waterway was little used by the general public but its navigability greatly affected the value of members’ properties. It was formed for private purposes of its members.

*Syrang Aero Club v. Commissioner*, 73 T.C. 717 (1980), described an organization that owned one airplane, which was rented at low cost to its members.

Its membership was restricted to members of the Syracuse Air National Guard and civilian employees, active and retired members of reserve military units, and personnel of the Federal Aviation Agency. Because of its limited facilities, membership was further restricted to thirty individuals.

The organization provided no classes or instructional materials, and employed no faculty. The court held that the private benefit to the members was substantial and not incidental to the public benefit of assisting the Syracuse Air National Guard.

*Continued on next page*
Examples of Impermissible Private Benefit, Continued

Private Benefits to Donors

*Christian Stewardship Assistance, Inc. v. Commissioner*, 70 T.C. 1037 (1978) described an organization formed to provide financial planning services to wealthy individuals who have contributed to various Christian organizations and whose net worth exceeded one-half million dollars.

The stated purpose of the organization was to aid religious and educational organizations to fulfill their mission by assisting these organizations with their relationship with their contributors and in stimulating proper application of Christian stewardship principles among their contributors.

The Court held that the organization’s activities provided a substantial private benefit to wealthy individuals through its advantageous tax planning services. (See also Rev. Rul. 76-442)
Examples of Incidental Private Benefit

In Rev. Rul. 66-358, a business corporation donated lands and money to a foundation to establish a public park. Exemption was not jeopardized by the donor’s retention of the right to use as a brand symbol a scenic view located in the park.

Rev. Rul. 77-367 held that a corporation created an organization to operate a replica of an early 19th Century American village named after the corporation. The corporation donated the land upon which the village was located and provided a substantial amount of financial support. Although the corporation benefited by having its name mentioned in conjunction with the organization’s advertising program, such benefits were merely incidental to benefits flowing to the general public from access to the village and its historic structures.

Rev. Rul. 72-559 described an organization that subsidized recent law graduates who provided free legal services to low income residents of economically depressed communities. This ruling dealt with the difficult issue of balancing the public interest against private benefit and held that the private benefit derived by the legal interns did not override the charitable purpose of providing free legal service for those unable to pay for such services. Any private benefit derived by the legal interns was incidental to the public charitable purpose.

Rev. Rul. 55-656 held that a community nursing bureau, operated as a community project, that maintained a register of all qualified professional and paraprofessional personnel for the benefit of hospitals, health agencies, doctors, and members of the community, was held exempt under IRC 501(c)(3). (Contrast to Rev. Rul. 61-170)

An organization described in Rev. Rul. 70-186, formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake, benefited the community as a whole. It was financed by lake front property owners, by members of the community adjacent to the lake, and by municipalities bordering the lake. (Contrast to Benedict Ginsberg v. Commissioner, 46 T.C. 47 (1966))
Summary

Summary: When developing issues of inurement and private benefit, the key points to be mindful of are:

- An organization is exempt on the basis of its purpose and not its activities. (However, its purpose may be inferred from its activities.)
- A single activity can serve both an exempt and a nonexempt purpose.
- An organization’s purpose is discerned from the totality of the facts in a particular case.
- It is the organization’s true purpose, not the stated purpose, that must be considered.
- And the burden is generally upon the organization claiming exemption to establish that its operations are exclusively in furtherance of exempt purposes and that it does not operate for the benefit of private interests.
Lesson 15

Automatic Revocation
Lesson 15 - Auto Revocation

Automatic Revocation

What you need to know

Agenda

Auto Revocation

2011-43 and 2011-44

Research

Current procedures

Summary

Automatic Revocation Background

Pension Protection Act of 2006

2007 - Small organizations have filing requirements

Form 990-N (E-postcard)

Automatically revoked after three consecutive failures to file.

Revocation effective due date of third return

IRS maintains list – updated monthly
Lesson 15 - Auto Revocation

Slide 4

Auto-Revoked Seeking Exemption

- Must reapply
  - Form 1023 or 1024
  - Application is required even if the organization did not originally have to file
  - Subordinates in revoked group rulings (Group 7829)
  - Specialty cases to specialty groups
  - Notice 2011-43 or 44

Slide 5

Notice 2011-43

- Transitional Relief
  - Small organizations
    - 2007, 2008, 2009 (≤ $25,000)
    - 2010 (≤ $50,000)
    - Reduced user fee ($100)
    - Retroactive reinstatement granted if requested
    - December 31, 2012 postmark deadline

Slide 6

Notice 2011-44

- Gross receipts:
  - ≥ $25,000 for 2007, 2008, 2009
  - ≥ $50,000 for 2010 and later

- Very few organizations qualify for retroactive relief under Notice 2011-44

- If retroactive relief requested, the case must be sent to Group 7822
Lesson 15 - Auto Revocation

Slide 7

Processing New Applications

- Application more than 27 months after formation date
- Research required
- Organization may have to be revoked prior to determination
- Screeners – do not close on merit
- This does not apply to organizations that have already been auto-revoked
- This does not apply to organizations not required to file Form 990

Slide 8

Securing Research

- IDRS research must be secured:
  - AP
  - IP
  - Full development cases
- Email Karen Craig:
  - Subject "DATE OF FORMATION RESEARCH"
  - Organization's name
  - EIN
  - Formation date
  - Indicate if a postmark date request
  - Fiscal Year Month

Slide 9

What are you looking for?

INOLES
- EO Submodule
- Current status

BMFOLI
- Form 990 within the past three years
  - MFT Code 67 or 44

BMFOLT
- Transaction code that satisfies the return filing requirement
  - 590, 591, 594, 595, 596 or 599
Lesson 15 - Auto Revocation

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<table>
<thead>
<tr>
<th>Research has been secured</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No returns filed</strong></td>
</tr>
<tr>
<td>- Organization must be automatically revoked before exemption can be granted.</td>
</tr>
<tr>
<td><strong>Returns were filed</strong></td>
</tr>
<tr>
<td>- Postmark - work the case as usual.</td>
</tr>
<tr>
<td>- Retroactive – relief request via EO Technical</td>
</tr>
</tbody>
</table>

### Slide 11

<table>
<thead>
<tr>
<th>Form 990 Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>If a 990 has been filed in the past 3 years:</strong></td>
</tr>
<tr>
<td>- If organization agrees to postmark date, we do not have to put them into Status 97.</td>
</tr>
<tr>
<td>- If organization wants retroactive, coordinate with EO Technical.</td>
</tr>
</tbody>
</table>

### Slide 12

<table>
<thead>
<tr>
<th>Form 1120 Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>If a Form 1120 has been filed in past 3 years:</strong></td>
</tr>
<tr>
<td>- Organization agrees to postmark date:</td>
</tr>
<tr>
<td>- Will not go into Status 97</td>
</tr>
<tr>
<td>- Work the case as usual</td>
</tr>
<tr>
<td>- Organization does not agree to postmark date:</td>
</tr>
<tr>
<td>- Will be placed in Status 97</td>
</tr>
<tr>
<td>- Worked as an auto-revocation reinstatement</td>
</tr>
</tbody>
</table>
Lesson 15 - Auto Revocation

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Nothing filed
- Place in Status 97 before proceeding
  - Allow 2 weeks
- Revocation letter sent
  - Allow 6 weeks
- Placed on auto-revoke list
  - Allow 10 weeks from 97 date
- Work as an auto-revocation case

Slide 14

Processing
- Run the cases through Auto-Revocation number
- Black folder:
  - Full development cases of auto-revoked organizations
  - Suspense cases
- Case file assembly
  - Non-disclosable

Slide 15

Working the case
User fee refund:
- Notice 2011-43
  - 990-N could have been filed

IRS 01021

IRS 01021

Doc 2013-26056 (338 pgs)
Lesson 15 - Auto Revocation

**Slide 16**

**Effective Date**

- Date of revocation
  - Notice 2011-43

- Postmark date
  - Notice 2011-44 and
  - DO NOT qualify for retroactive reinstatement

**Slide 17**

**Effective Date (cont.)**

Notice 2011-44 effective date
- Retroactive relief requests to Group 7822 after you have worked the case to the extent possible

Revocation effective date on list [www.irs.gov](http://www.irs.gov)

**Slide 18**

**Deductibility Year**

Notice 2011-43
- Deductibility year is revocation year

Notice 2011-44(postmark)
- Postmark year
Lesson 15 - Auto Revocation

Slide 19

**Suspending Cases**
- Use normal procedures
- No response to suspense:
  - Status 12 instead of Status 11
  - Note on the closing worksheet

Slide 20

**Issuing Determination Letter**
- No ruling until on the revocation list
- Fully work the case
- Ready to approve, not on list:
  - Case to Group 7822 to be held
  - Prepare closing worksheet
  - Case to Status 74
  - Turn in case to manager

Slide 21

**Addendum**
- All approved revocation cases have an addendum
  - NERD:
    - Closing worksheets for revocation cases
    - Addendums
Lesson 15 - Auto Revocation

Slide 22

Contact the Organization

- Alert them regarding revocation
- Avoid confusion

Slide 23

Summary

- 27 months
- Notice 2011-43
- Notice 2011-44
- Research needed
- Understand procedures

Slide 24

Questions?
Lesson 16

Form 990

Filing Exemption
Lesson 16
Form 990 Filing Exception

Overview

Introduction

This lesson details the types of organizations not required to file Form 990, 990-EZ, or 990-N due to an IRS determination that they are excepted from Form 990 filing requirements.

Section 6033(a)(1) of the Code generally requires the filing of annual information returns by exempt organizations. Most organizations exempt from income tax under section 501(a) must file an annual information return (Form 990 or 990-EZ) or submit an annual electronic notice (Form 990-N), depending upon the organization’s gross receipts and total assets.

Section 6033(a)(3)(A) of the Code provides certain mandatory exceptions to this filing requirement.

Section 6033(a)(3)(B) of the Code provides discretionary exceptions from filing such returns where the Secretary “determines that such filing is not necessary to the efficient administration of the internal revenue laws.”

An organization can request a determination that it is excepted from Form 990 filing requirements through its Form 1023 application or as a miscellaneous determination via Form 8940.

This lesson will detail the requirements that an organization must meet in order to receive exception from Form 990 filing requirements.

Continued on next page
Overview, Continued

Objectives

After completing this lesson, you will be able to:

- Identify the various types of exceptions from Form 990 filing.
- Determine whether an organization meets the requirements for its requested filing exception.

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<tr>
<td>Certain Church-Affiliated Organizations</td>
<td>16-16</td>
</tr>
</tbody>
</table>
## Types of Form 990 Filing Exception

### Overview
There are six (6) types of exceptions from filing Form 990 that will be discussed in this lesson:

- Affiliate of a government unit (Other than a section 509(a)(3) supporting organization)
- Integrated auxiliary of a church (such as a men’s or women’s organization, religious school, mission society, or religious group).
- Mission society (other than a section 509(a)(3) supporting organization) sponsored by, or affiliated with, one or more churches or church denominations
- School below college level affiliated with a church or operated by a religious order
- A church-affiliated organization (other than a section 509(a)(3) supporting organization) that is exclusively engaged in managing funds or maintaining retirement programs.
- A state institution (other than a section 509(a)(3) supporting organization) whose income is excluded from gross income under section 115 of the Code.
**Affiliate of a Government Unit**

**Introduction**

Revenue Procedure 95-48 details the provisions by which organizations are classified as government units and affiliates of government units.

With respect to Revenue Procedure 95-48, this lesson pertains only to organizations requesting classification as an affiliate of a government unit.

An organization that is an affiliate of a governmental unit or an affiliate of another affiliate of a government unit, within the meaning of section 4 of Revenue Procedure 95-48, is not required to file Form 990.

Per the Pension Protection Act of 2006, a supporting organization under section 509(a)(3) is not eligible for classification as an affiliate of a government unit.

As of the issuance of this lesson, these types of requests must first receive additional review by EO Technical before an organization is classified as an affiliate of a government unit.

**Government Units**

Please note that this lesson does not pertain to organizations requesting classification as a government unit.

If an organization requests classification as a government unit, it must obtain a letter ruling by following the procedures specified in Rev. Proc. 2011-1, 2011-1 I.R.B. 1 or its successor.
Section 4.02(a) states that an organization is treated as a “affiliate of a governmental unit” if it is described in section 501(c) of the Code and has a ruling or determination from the Service that meets any of the three (3) provisions listed below:

- Its income, derived from activities constituting the basis for its exemption under section 501(c) of the Code, is excluded from gross income under section 115;
- It is entitled to receive deductible charitable contributions under section 170(c)(1) of the Code, on the basis that contributions to it are “for the use of” governmental units; OR
- It is a wholly owned instrumentality of a state or a political subdivision thereof, for employment tax purposes (see sections 3121(b)(7) and 3306(c)(7) of the Code); or

If an organization submits a previously-issued IRS letter with their request, which details that it has met any of the three (3) provisions detailed above, the organization qualifies for classification as an affiliate of a government unit and is excepted from filing Form 990.

Such an organization, therefore, would not be required to meet any of the other provisions listed in Revenue Procedure 95-48.

Continued on next page
An organization is treated as an “affiliate of a governmental unit” if it is described in section 501(c) of the Code and meets all three (3) of the requirements detailed below:

- It is either “operated, supervised, or controlled by” governmental units, or by organizations that are affiliates of governmental units, within the meaning of section 1.509(a)-4(g)(1)(i) of the regulations, or the members of the organization's governing body are elected by the public at large, pursuant to local statute or ordinance;
- It possesses two (2) or more of the affiliation factors listed in section 4.03 of Revenue Procedure 95-48; AND
- Its filing of Form 990 is not otherwise necessary to the efficient administration of the internal revenue laws.

In order to meet the “operated, supervised, or controlled by” requirement, the organization’s governing body must be either:

- Elected by the public pursuant to local statute or ordinance, or
- A majority of the members of its governing body must be appointed by the affiliated governmental unit, an affiliate of a governmental unit or a public official acting in an official capacity.
Board member appointment and removal procedures must be clearly outlined in the organization’s bylaws or organizational documents. The location of such procedures should be cited on Form 14318, the Revenue Procedure 95-48 Guidesheet. Note: It is not sufficient if the organization merely share the same board with the affiliated government unit. Control of these appointments should not revert back to organization. The organization must possess two (2) of the following affiliation factors as part of the requirements for classification as an affiliate of a government unit, per section 4.02(b)(ii) of Revenue Procedure 95-48.

- The organization was created by one or more governmental units, organizations that are affiliates of governmental units, or public officials acting in their official capacity.

- The organization's support is received principally from taxes, tolls, fines, government appropriations, or fees collected pursuant to statutory authority. Amounts received as government grants or other contract payments are not qualifying support under this paragraph.

- The organization is financially accountable to one or more governmental units. This factor is present if the organization is:
  - Required to report to governmental unit(s), at least annually, information comparable to that required by Form 990; **AND**
  - Is subject to financial audit by the governmental unit(s) to which it reports. A report submitted voluntarily by the organization does not satisfy clause (i). Also, reports and audits pursuant to government grants or other contracts do not alone satisfy this requirement.

- One or more governmental units, or organizations that are affiliates of governmental units, exercise control over, or oversee, some or all of the organization's expenditures (although it is not financially accountable to governmental units as described in paragraph (c) of this section).

- If the organization is dissolved, its assets will (by reason of a provision in its articles of organization or by operation of law) be distributed to one or more governmental units, or organizations that are affiliates of governmental units within the meaning of section 4 of this revenue procedure.

**Note:** The location of such procedures should be cited on Page 2 of Form 14318, the Revenue Procedure 95-48 Guide sheet.
Affiliate of a Government Unit, Continued

**Procedure 95-48**  
**Section 4.02(a)(iii)**

In making a ruling or determination whether the organization's filing of Form 990 is otherwise necessary to the efficient administration of the internal revenue laws, all relevant facts and circumstances shall be considered.

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**Efficient Administration of Internal Revenue Laws**

Relevant facts and circumstances suggesting that filing is necessary for efficient tax administration include the following:

- The extent to which the organization has taxable subsidiaries or participates in joint ventures with non-exempt entities.
- Whether it engages in substantial public fund-raising efforts, **AND**
- Whether its activities provide significant benefits to private interests.

*Continued on next page*
Before the case can be closed, it must first be reviewed by EO Technical.

Case file should include copies of Form 14318 and all cited documentation, which will be forwarded group manager for review.

After manager’s review, the Guidesheet and supporting documentation will be scanned and forwarded to additional levels of review, concluding with EO Technical.

Upon approval of the recommended Form 990 filing exception by EO Technical, the case may be recommended for approval by the specialist.

Letter 4715 should be completed and all other standard closing procedures are to be followed.

Continued on next page
Affiliate of a Government Unit, Continued

Definition

Treasury regulation section 1.6033-2(g)(1)(i) provides that an integrated auxiliary of a church exempt from taxation under section 501(a) of the Internal Revenue Code is not required to file Form 990.

Per section 1.6033-2(h)(1) of the Treasury Regulations, in order to meet the requirements for Form 990 filing exception as an integrated auxiliary of a church, an organization must meet the following three criteria.

- Described both in sections 501(c)(3) and 509(a) (1), (2), or (3);
- Affiliated with a church or a convention or association of churches; **AND**
- Internally supported.

Affiliated with a Church or a Convention or Association of Churches

Per section 1.6033-2(h)(2) of the Treasury Regulations, there are three ways for an organization to demonstrate that it is affiliated with a church or a convention or association of churches.

- It is covered by a group exemption letter issued under applicable administrative procedures, to a church or a convention or association of churches,
- It is operated, supervised, or controlled by or in connection with (as defined in § 1.509(a)-4) a church or a convention or association of churches, **OR**
- Relevant facts and circumstances show that it is so affiliated.

*Continued on next page*
### Affiliate of a Government Unit, Continued

#### Operated, Supervised, or Controlled By

In order to meet the “operated, supervised, or controlled by” requirement, the affiliated church must have the authority to appoint and/or remove the members of the organization’s governing body.

Board member appointment and/or removal procedures must be clearly outlined in the organization’s bylaws or organizational documents and the location of such procedures should be cited on Form 14320, Integrated Auxiliary Guidesheet.

Note: It is not sufficient if the organization merely share the same board with the affiliated church. Control of these appointments should not revert back to organization.

#### Relevant Facts and Circumstances

Per section 1.6033-2(h)(3) of the Treasury Regulations, the following facts and circumstances are used to determine whether an organization is affiliated with a church or a convention or association of churches.

However, the absence of one or more of the following factors does not necessarily preclude classification of an organization as being affiliated with a church or a convention or association of churches

- The organization's organizing document or by-laws affirm that the organization shares common religious doctrines, principles, disciplines, or practices with the church or the convention or association of churches.
- The church or a convention or association of churches has the authority to appoint or remove, or to control the appointment or removal of, at least one (1) of the organization's officers or directors.
- The corporate name of the organization indicates an institutional relationship with the church or the convention or association of churches.
- The organization reports at least annually on its financial and general operations to the church or the convention or association of churches.
- An institutional relationship between the organization and the church or the convention or association of churches is affirmed by the church, or convention or association of churches, or a designee thereof; and

*Continued on next page*
Affiliate of a Government Unit, Continued

Relevant Facts and Circumstances (continued)

- In the event of dissolution, the organization's assets are required to be distributed to the church or the convention or association of churches, or to an affiliate of the church or the convention or association of churches.

Internally Supported

Per section 1.6033-2(h)(4) of the Treasury Regulations, an organization is internally supported unless both of the following items are true.

- It offers admissions, goods, services or facilities for sale, other than on an incidental basis, to the general public (except goods, services, or facilities sold at a nominal charge or for an insubstantial portion of the cost); AND

- It normally receives more than 50 percent of its support from a combination of governmental sources, public solicitation of contributions, and receipts from the sale of admissions, goods, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses.

Case Closure

Upon receipt of all requested information, Form 14320 (Guidesheet for Integrated Auxiliaries and Church-Affiliated Schools) should be completed to provide documentation that the organization has met all requirements for classification as an integrated auxiliary of a church.

Additionally, Form 14320 should include citations detailing the locations within the case file where the various requirements have been met by the organization.

Letter 4715 should be completed and all other standard closing procedures are to be followed.
Certain Mission Societies

Definition

Treasury Regulation section 1.6033-2(g)(1)(iv) provides that certain mission societies are not required to file Form 990.

In order to qualify for Form 990 filing exception, a mission society, exempt from taxation under section 501(a) of the Code, must meet the following criteria.

- Be sponsored by or affiliated with one or more churches or church denominations, **AND**
- Conduct more than one-half of its activities in, and directed at, persons in foreign countries.

Sponsored By or Affiliated With a Church

The term “sponsored by” is not defined in the Code or Treasury Regulations.

Section 1.6033-2(h)(2) of the Treasury Regulations, as detailed above with respect to Integrated Auxiliaries of a Church, details the criteria that a mission society must meet in order to demonstrate that it is affiliated with a church or church denomination.

Continued on next page
### Certain Mission Societies, Continued

<table>
<thead>
<tr>
<th><strong>Internal Support</strong></th>
<th>Per section 1.6033-2(h)(5) of the Treasury Regulations mission societies are not required to meet the internal support requirements described in section 1.6033-2(h)(4) of the Treasury Regulations.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>509(a)(3) Supporting Organizations</strong></td>
<td>Per the Pension Protection Act of 2006, a supporting organization under section 509(a)(3) is not eligible for exception from filing Form 990 as a mission society under section 1.6033-2(g)(1)(iv) of the Treasury Regulations.</td>
</tr>
</tbody>
</table>
| **Case Closure** | Upon receipt of all requested information, Form 14320 (Guidesheet for Integrated Auxiliaries and Church-Affiliated Schools) should be completed to provide documentation that the organization has met all requirements for classification as an integrated auxiliary of a church.

Additionally, Form 14320 should include citations detailing the locations within the case file where the various requirements have been met by the organization.

Letter 4715 should be completed and all other standard closing procedures are to be followed. |
Schools below College Level Affiliated w/a Church

Definition
Treasury regulation section 1.6033-2(g)(1)(vii) provides that certain educational organizations are not required to file Form 990 if organization is:

- Described in section 170(b)(1)(A)(ii) of the Code,
- Below college level and has a program of general academic nature, AND
- Affiliated with a church or operated by a religious order.

Affiliated With a Church
Section 1.6033-2(h)(2) of the Treasury Regulations, as detailed above with respect to Integrated Auxiliaries of a Church, details the criteria that a school below college level must meet in order to demonstrate that it is affiliated with a church or church denomination.

Internal Support
Per section 1.6033-2(h)(5) of the Treasury Regulations schools below college level are not required to meet the internal support requirements described in section 1.6033-2(h)(4) of the Treasury Regulations.

Case Closure
Upon receipt of all requested information, Form 14320 (Guidesheet for Integrated Auxiliaries and Church-Affiliated Schools) should be completed to provide documentation that the organization has met all requirements for classification as an integrated auxiliary of a church.

Additionally, Form 14320 should include citations detailing the locations within the case file where the various requirements have been met by the organization.

Letter 4715 should be completed and all other standard closing procedures are to be followed.
Certain Church-Affiliated Organizations

Definition

Section 6033(a)(3)(B) of the Internal Revenue Code and the accompanying regulations provide the IRS with discretionary authority to specify that certain exempt organizations are not required to file annual information returns on Form 990.

Under this discretionary authority, Revenue Procedure 96-10, 1996-2 I.R.B. 17 (Jan. 8, 1996) lists a class of organizations affiliated with a church or convention or association of churches and exempt from federal income tax under section 501(c)(3) that are not required to file Form 990.

Operated, Supervised, or Controlled By One or More Church-Affiliated Organizations

An organization described in section 501(c)(3) qualifies for exception from Form 990 filing requirements if it is operated, supervised, or controlled by one or more churches, integrated auxiliaries, or conventions or associations of churches, and the following criteria are also met:

- The organization is engaged exclusively in financing, funding the activities of, or managing the funds of the following:
  - A church, integrated auxiliary, or convention or association of churches, OR
  - A group of organizations substantially all of which are described in (1)(a)(i), if substantially all of its assets are provided by, or held for the benefit of, organizations described in (1)(a)(i); OR

- The organization maintains retirement insurance programs primarily for church-affiliated organizations, AND
  - More than 50 percent of the individuals covered by the programs are directly employed by those organizations, OR
  - More than 50 percent of the assets are contributed by, or held for the benefit of, employees of those organizations.

Operated, Supervised, or Controlled By One or More Religious Orders

An organization described in section 501(c)(3) qualifies for exception from Form 990 filing requirements if it is operated, supervised, or controlled by one or more religious orders and is engaged in financing, funding, or managing assets used for exclusively religious activities.

Continued on next page
Certain Church-Affiliated Organizations, Continued

509(a)(3) Supporting Organizations

Per the Pension Protection Act of 2006, a supporting organization under section 509(a)(3) is not eligible for exception from filing Form 990 as a mission society under section 1.6033-2(g)(1)(iv) of the Treasury Regulations.

Case Closure

Upon receipt of all requested information, Form 14319 (Guidesheet for Revenue Procedure 96-10) should be completed to provide documentation that the organization has met all requirements for classification as an integrated auxiliary of a church.

Additionally, Form 14319 should include citations detailing the locations within the case file where the various requirements have been met by the organization.

Letter 4715 should be completed and all other standard closing procedures are to be followed.
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