Exempt Organizations Determinations
Unit 1b

Student Guide

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IRS
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Catalog Number
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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
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ERRATA SHEET

Instructions:

• Duplicate this form locally as needed to report any errors or problems with course materials.

• E-mail completed forms to: lois.j.watson@irs.gov

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Course #27058-002: Exempt Organizations Determinations Unit 1b (Rev 9-2009)

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Type of Error or problem:

_____ technical
_____ typographical
_____ content clarity
_____ other

Describe error or problem with the material:

Suggested solution:
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Lesson 1
Introduction to Form 1024

Overview

Introduction
As discussed in Unit 1a, Lesson 3, organizations seeking recognition of exemption from Federal income tax under IRC section 501(c)(3) submit Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.

Organizations seeking exemption under IRC sections 501(c)(2), (4), (5), (6), (7), (8), (9), (10), (12), (13), (15), (17), (19), and (25) submit Form 1024, Application for Recognition of Exemption under Section 501(a). Unit 1b includes lessons on all of these subsections excluding IRC sections 501(c)(9), (15) and (17).

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

- Describe the purposes for requesting exemption on Form 1024 as well as the types of organizations that submit Form 1024
- List the requirements for a complete 1024 application
- Name the parts of Form 1024 and the information contained in each part
- Describe the subsections under which an organizations may apply for exemption on Form 1024 as well as required Form 1024 schedules

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Overview, Continued

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Introduction to Form 1024
1-2
Form 1024 Basics

Purpose of the Form

Form 1024 is used by organizations to apply for recognition of exemption under IRC sections 501(c)(2), (4), (5), (6), (7), (8), (9), (10), (12), (13), (15), (17), (19), or (25).

Although some of these organizations are not required to file Form 1024 to be tax exempt, they may choose to file Form 1024 to receive a determination letter of IRS recognition of their IRC section 501(c) status in order to obtain certain incidental benefits such as:

- Public recognition of tax-exempt status
- Exemption from certain state taxes
- Advance assurance to donors of deductibility of contributions (in certain cases)
- Nonprofit mailing privileges, etc.

Continued on next page
The requirements for a "substantially complete" application are set forth in Rev. Proc. 2009-9, which is updated annually. Section 3.08 of the Rev. Proc. states that a substantially complete application:

1. Is signed by an authorized individual.

2. Includes an Employer Identification Number (EIN).

3. Includes a statement of receipts and expenditures and a balance sheet for the current year and the three preceding years (or the years the organization was in existence, if less than four years). If the organization has not yet commenced operations, or has not completed one accounting period, a substantially completed application generally includes a proposed budget for two full accounting periods and a current statement of assets and liabilities.

4. Includes a detailed narrative statement of proposed activities, including each of the fundraising activities of a § 501(c)(3) organization, and a narrative description of anticipated receipts and contemplated expenditures.

5. Includes a copy of the organizing or enabling document that is signed by a principal officer or is accompanied by a written declaration signed by an authorized individual certifying that the document is a complete and accurate copy of the original or otherwise meets the requirements of a "conformed copy" as outlined in Rev. Proc. 68-14, 1968-1 C.B. 768.

6. If the organizing or enabling document is in the form of articles of incorporation, includes evidence that it was filed with and approved by an appropriate state official (e.g., stamped "Filed" and dated by the Secretary of State). Alternatively, a copy of the articles of incorporation may be submitted if accompanied by a written declaration signed by an authorized individual certifying that the copy is a complete and accurate copy of the original copy that was filed with and approved by the state. If a copy is submitted, the written declaration must include the date the articles were filed with the state.

7. If the organization has adopted by-laws, includes a current copy. The by-laws need not be signed if submitted as an attachment to the application for recognition of exemption. Otherwise, the by-laws must be verified as current by an authorized individual.

8. Is accompanied by the correct user fee.
Part I. Identification of Applicant

Part I, Identification of Applicant, requests the following information:

- The IRC section under which the organization is applying for exemption
- The organization's full name and address (The name should match that shown on the applicant's organizing document (Articles of Incorporation, Articles of Association, Constitution, trust document)
- Employer Identification Number (EIN)
- Contact Person (The contact person should be an officer, director, trustee or authorized representative)
- Website address
- Month the annual accounting period ends (The month provided here should be consistent with the fiscal month provided in the organization's bylaws as well as the fiscal month used in financial data submitted)
- Date of incorporation or formation (If incorporated, the effective date of exemption will be the actual date the Articles of Incorporation were filed and approved by the State in which the organization is incorporated or if not incorporated, the effective date of exemption will be the actual date the organization's organizing document was adopted)
- Information regarding a prior submission of Form 1023 or 1024
- Information regarding the organization's history of filing Federal income tax returns
- The entity type (corporation, association or trust)
- The organization must indicate whether or not it has adopted bylaws
### Part II: Activities and Operational Information

Part II of Form 1024, *Activities and Operational Information*, requests the following information:

- A detailed narrative description of past, present, and future activities. *(The specialist must have a full understanding of the organization's activities in order to determine if the organization qualifies for exemption under the requested Code section)*

- A list of the organization's present and future sources of financial support

- Names, addresses and titles of officers, directors, and trustees, as well as the amounts of annual compensation (if any)

- Whether the applicant is an outgrowth of another organization

- Information regarding relationships with other organizations

- Information about issued or plans to issue capital stock

- Information regarding membership requirements, individual member benefits, membership classes, and any rights and privileges of membership

- Information regarding distribution of the organization's assets upon dissolution including any plans to distribute its assets to shareholders or members.

- Information on whether the organization will make payments to others for services, including payments to members

- Information regarding legislative or political activities

- Information regarding contracts or leases the applicant may be liable to fulfill

- Information on pamphlets, newsletters, journals or other printed material published by the applicant
Part III: Financial Data and Part IV. Notice Requirements

Part III: Statement of Revenues and Expenses
The Statement of Revenue and Expenses must be completed for the current year and each of the three years immediately before it (or the years the organization has existed, if less than four).

An applicant that has existed for less than one year must submit financial data for the current year and proposed budgets for the following two years.

Note that some revenue and expense line items require supporting schedules.

Part III: Balance Sheet
The organization must list its assets and liabilities and submit supporting schedules where indicated.

Part IV: Notice Requirements
Part IV only applies to IRC sections 501(c)(9) and (17) organizations. Organizations applying for tax-exempt status under others sections of the Code should not complete Part IV.

Introduction to Form 1024
1-7
Overview of Form 1024 Applicant Subsections

IRC 501(c)(4): Social Welfare Organizations

Organizations that qualify for exemption under IRC section 501(c)(4) are organized and operated for charitable, educational, and recreational purposes. These organizations generally promote social welfare and further the common good and general welfare of the people of the community by bringing about civic betterment and social improvements.

Examples of social welfare organizations are:

- Community associations and civic clubs
- Volunteer fire companies (volunteer fire companies may also qualify for exemption under IRC section 501(c)(3))
- Homeowners' Associations
- Some Veterans' Organizations
- Organizations that hold annual festivals to highlight regional customs and traditions
- Local associations of employees

Organizations applying for exemption under IRC section 501(c)(4) must complete Form 1024, Schedule B.

IRC section 501(c)(4) organizations are discussed in detail in Lesson 2.

Additional Resources

IRM 7.25.4, Civic Leagues, Social Welfare Organizations and Local Associations of Employees

Continued on next page
Overview of Form 1024 Applicant Subsections, Continued

IRC 501(c)(5): Labor, Agricultural, or Horticultural Organizations

Organizations that qualify for exemption under IRC section 501(c)(5) are organizations that conduct labor, agricultural, or horticultural activities.

A labor organization is an association of workers who have combined to protect and promote the interests of its members by bargaining collectively to secure better working conditions, improve the quality of their products, and develop a higher grade of efficiency in their respective occupations.

Agricultural and horticultural organizations are involved with the raising of livestock, forestry, cultivating land, raising and harvesting crops or aquatic resources, cultivating useful or ornamental plants, and similar pursuits.

Examples of activities that further an agricultural or horticultural purpose:

- Operating a state or county farm bureau to promote various cooperative agricultural, horticultural and civic activities among rural residents
- Exhibiting livestock or farm products
- Testing soil for members and non-members on a cost basis, the results of the tests and other recommendations being furnished to the community members to educate them in soil treatment
- Guarding the purity of a specific breed of livestock
- Encouraging improvements in the production of fish on privately owned fish farms
- Negotiating with processors for crop prices to be paid to members

Organizations requesting exemption under IRC section 501(c)(5) must complete Form 1024, Schedule C.

IRC section 501(c)(5) organizations are discussed in detail in Lesson 3.

Additional Resources

IRM 7.25.5, Labor, Agricultural and Horticultural Organizations

Continued on next page
Overview of Form 1024 Applicant Subsections, Continued

IRC 501(c)(6): Business Leagues

The following are examples of IRC section 501(c)(6) organizations:

- Non-profit business league
  
  A business league, in general, is an association of persons having some common business interest, the purpose of which is to promote the common business interest and not to engage in a regular business of a kind carried on for profit.

- Chamber of commerce
  
  A chamber of commerce is usually composed of the merchants and traders of a particular city.

- Board of trade
  
  A board of trade often consists of persons engaged in similar lines of business. For example, a non-profit organization formed to regulate the sale of a specified agricultural commodity to assure equal treatment of producers, warehouse workers, and buyers is a board of trade.

- Real estate board
  
  A real estate board consists of members interested in improving the business conditions in the real estate field.

- Professional football league

Organizations requesting exemption under IRC section 501(c)(6) must complete Form 1024, Schedule C.

IRC section 501(c)(6) organizations are discussed in detail in Lesson 4.

Additional Resources

IRM 7.25.6, Business Leagues

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<table>
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<th>IRC 501(c)(7): Social Clubs</th>
<th>Organizations that qualify for exemption under IRC section 501(c)(7) are social clubs that are organized for the pleasure and recreation of their members.</th>
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<td>Typical social clubs are:</td>
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<td>• College fraternities or sororities</td>
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<td>• Country clubs</td>
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<td>• Amateur hunting, fishing, tennis, swimming and other sport clubs</td>
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<td>• Hobby and garden clubs</td>
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<td>Some of these types of organizations may also qualify for exemption under IRC section 501(c)(3) or (4) based on the extent of their charitable and/or educational activities.</td>
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<td>Organizations applying for exemption under IRC section 501(c)(7) must complete Form 1024, Schedule D.</td>
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<td>IRC section 501(c)(7) organizations are discussed in detail in Lesson 5.</td>
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**Additional Resources**

IRM 7.25.7, *Social and Recreational Clubs*

*Continued on next page*
Overview of Form 1024 Applicant Subsections, Continued

IRC 501(c)(8) and 501(c)(10): Fraternal Societies

IRC sections 501(c)(8) and (10) provide for the tax exemption of fraternal organizations operating under a lodge system.

An IRC section 501(c)(8) Fraternal Beneficiary Society has the following characteristics:

- Is a fraternal organization
- Operates under the lodge system or for the exclusive benefit of the members of a fraternal organization itself operating under the lodge system, and
- Provides for the payment of life, sick, accident or other benefits to the members of the society, order or association or their dependents

An IRC section 501(c)(10) Domestic Fraternal Society has the following characteristics:

- Is a domestic fraternal organization
- Operates under the lodge system
- Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational and fraternal purposes and
- Does not provide for the payment of life, sick, accident or other benefits to the members of the society, order or association or their dependents

Organizations requesting exemption under IRC section 501(c)(8) or (10) must complete Form 1024, Schedule E.

IRC sections 501(c)(8) and (10) are discussed in detail in Lesson 6.

Additional Resources

IRM 7.25.8, Fraternal Beneficiary Societies

Continued on next page
Overview of Form 1024 Applicant Subsections, Continued

IRC 501(c)(12): IRC section 501(c)(12) organizations are membership organizations that join together to cover their expenses to accomplish a mutual goal or objective. The following are examples of organizations that may qualify for exemption under IRC section 501(c)(12):

- Benevolent Life Insurance Associations
- Mutual Ditch or Irrigation Companies
- Mutual or Cooperative Telephone Companies

Organizations applying for exemption under IRC section 501(c)(12) must complete Form 1024, Schedule G.

IRC section 501(c)(12) organizations are discussed in detail in Lesson 7.

Additional Resources

IRM 7.25.12

Introduction to Form 1024

I-13
Overview of Form 1024 Applicant Subsections, Continued

**IRC 501(c)(13): Cemetery Companies**

IRC section 501(c)(13) nonprofit mutual cemetery companies are organized and operated exclusively for the purpose of the disposal of human bodies by burial or cremation.

IRC section 501(c)(13) income can only be used for the following purposes:

- To pay the ordinary and necessary expenses of operating, maintaining and improving the cemetery or crematorium
- To buy cemetery property
- To create a fund that will provide a source of income for the perpetual care of the cemetery or a reasonable reserve for an ordinary and necessary purpose

Organizations applying for exemption under IRC section 501(c)(13) must complete Form 1024, Schedule H.

IRC section 501(c)(13) organizations are discussed in detail in Lesson 8.

**Additional Resources**

IRM 7.25.13, *Cemetery Companies*

*Continued on next page*
Overview of Form 1024 Applicant Subsections, Continued

IRC 501(c)(19): Veterans' Organizations

IRC section 501(c)(19) exempts from Federal income tax a post or organization of past or present members of the Armed Forces of the United States or an auxiliary unit or society thereof, or a trust or foundation for any such post organization. Veterans' organizations must meet membership and purpose requirements in order to qualify for exemption under this subsection.

Organizations applying for exemption under IRC section 501(c)(19) must complete Form 1024, Schedule K.

IRC section 501(c)(19) organizations are discussed in detail in Lesson 9.

Additional Resources

IRM 7.25.19, Veterans Organizations
Overview of Form 1024 Applicant Subsections, Continued

IRC 501(c)(2) and 501(c)(25): Title Holding Companies

IRC sections 501(c)(2) and (25) provide exemption for organizations whose sole purpose is to hold title to property, collect income from the property and turn the income over to an exempt organization. A title holding company must show effective ownership and control over it by the distributee exempt organization. Title holding companies with a single parent are exempt under IRC section 501(c)(2); title holding companies with multiple parents are exempt under IRC section 501(c)(25).

Organizations applying for exemption under IRC section 501(c)(2) or (25) must complete Form 1024, Schedule A.

IRC sections 501(c)(2) and (25) organizations are discussed in detail in Lesson 10.

Applications for exemption under IRC 501(c)(25) are reserved for EO Technical per IRM 7.20.1.3.4(7) but are not subject to QA Mandatory Review per IRM 7.20.5.4(3)(r).

Additional Resources

IRM 7.25.13, IRM 7.25.2, Single Parent Title Holding Corporations
IRM 7.25.21, Multiple Parent Title Holding Companies

Continued on next page
Overview of Form 1024 Applicant Subsections, Continued

Other Subsections Requiring Form 1024

Other organizations which apply for exemption on Form 1024 are:

- IRC section 501(c)(9): Voluntary employees' beneficiary associations (VEBA)
- IRC section 501(c)(15): Mutual insurance companies
- IRC section 501(c)(17): Supplemental unemployment compensation trusts

These subsections are higher graded issues and/or reserved topics for EO Technical and will be discussed in more advanced training.

Additional Resources

IRM 7.25.2, Single Parent Title Holding Corporations
IRM 7.25.21, Multiple Parent Title Holding Companies
Form 1024, Application for Recognition of Exemption under Section 501(a), is used by organizations to apply for recognition of exemption under IRC sections 501(c)(2), (4), (5), (6), (7), (8), (9), (10), (12), (13), (15), (17), (19), or (25).

The requirements for a “substantially complete” application are set forth in Rev. Proc. 2009-9, which is updated annually.

Form 1024 has four parts: Part I. Identification of Applicant; Part II. Activities and Operational Information; Part III. Financial Data; and Part IV. Notice Requirements.
Lesson 2

Civic Leagues, Social Welfare Organizations, and Local Associations of Employees

IRC Section 501(c)(4)

Overview

Lesson 2 addresses Civic Leagues, Social Welfare Organizations, and Local Associations of Employees exempt under IRC section 501(c)(4). The lesson is divided into sections in this discussion of IRC section 501(c)(4). They are:

- Section A - Civic Leagues and Social Welfare Organizations
- Section B - Local Associations of Employees
- Section C - Homeowners’ Associations
- Section D - Activities Not Related to Exempt Purpose

Objectives

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

- Identify the general types of IRC section 501(c)(4) organizations
- Apply the various requirements which an IRC section 501(c)(4) organization must meet to qualify for tax exempt status

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Civic Leagues, Social Welfare Organizations and Local Associations of Employees
2-1
Introduction to IRC 501(c)(4)

This section of the Code provides for the exemption of various types of organizations:

- Civic Leagues
- Social Welfare Organizations
- Local Associations of Employees

An IRC section 501(c)(4) organization does not need to meet an "organizational test," i.e. it does not have to include a purpose clause or dissolution clause in its organizing document. In addition, IRC section 501(c)(4) organizations do not have to meet the foundation status test required for an IRC section 501(c)(3) exemption.

Contributions to an IRC section 501(c)(4) organization are generally not deductible.

An IRC section 501(c)(4) organization must show the primary activity is to promote social welfare for the good of the community in general. The one exception to this rule is a local association of employees whose benefits are limited to providing recreational activities for the employees of a single employer or making contributions to other charitable organizations.

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Introduction to IRC 501(c)(4), Continued

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<td>• Local Association of Employees</td>
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<td>• Homeowners’ Association</td>
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<tr>
<td></td>
<td>• Veterans’ Organization (discussed in Lesson 12, Veterans’ Organizations, IRC Section 501(c)(19))</td>
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</table>

| Must Meet Operational Test | An organization seeking exemption under IRC section 501(c)(4) must be able to show that its proposed activities will promote the common good and the social welfare of the community in general. |

*Civic Leagues, Social Welfare Organizations and Local Associations of Employees*  
2-3
Summary

IRC section 501(c)(4) provides for the exemption of:

- Civic Leagues
- Social Welfare Organizations
- Local Associations of Employees

An IRC section 501(c)(4) organization does not need to meet an "organizational test," or meet the foundation status test required for an IRC section 501(c)(3) exemption.

Contributions to an IRC section 501(c)(4) organization are generally not deductible.

An IRC section 501(c)(4) organization must show the primary activity is to promote social welfare for the good of the community in general.
Lesson 2
Section A

Civic Leagues and Social Welfare Organizations

Overview

Introduction
This lesson addresses the requirement that, with certain exceptions, all applicants for exemption under IRC section 501(c)(4) for civic leagues and social welfare organizations must show that their primary activity promotes the social welfare of the community in general and not the interests of private individuals or groups.

If the primary activity benefits private individuals or groups of individuals, the request for exemption will be denied. If benefits are provided to individuals and shareholders, this is inurement and exemption would be denied even if this were not the primary activity.

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

- Identify the two key elements that organizations seeking exemption under IRC section 501(c)(4) must demonstrate

- Define "social welfare"

- Define "community benefit"

- Determine whether a civic league or social welfare organization qualifies for exemption

- Explain how organizations applying for exemption under IRC section 501(c)(4) may qualify for exemption under other Code sections

- Identify circumstances which make contributions to 501(c)(4) organizations are deductible

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Overview, Continued

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Civic Leagues and Social Welfare Organizations

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### Key Element 1: Promote Social Welfare

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<th>“Social Welfare”</th>
<th>The first key element for receiving exemption under IRC section 501(c)(4) is the ability of the organization to show how their proposed activities will promote the “social welfare” of the community in general.</th>
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</thead>
<tbody>
<tr>
<td>Per Webster’s Dictionary</td>
<td>Social welfare is defined as: any service or activity designed to promote the welfare of the community and the individual, as through counseling services, health clinics, recreation halls and playgrounds ...</td>
</tr>
</tbody>
</table>
| Per the Courts | *Erie Endowment v. United States*, 316 F. 2d 151 (1963) in defining a civic organization stated: “the organization must be a community movement designed to accomplish community ends.”  
*Commissioner of Internal Revenue v. Lake Forest, Inc.*, 305 F 2d 814 (1962) held that “In short, ‘social welfare’ is the well-being of persons as a community.” |
| Social Welfare vs. Charity | The Regulations show how the terms “social welfare” and “charity” may overlap:  
- Treas. Reg. 1.501(c)(4)-1(a)(2) states that an organization that meets the definition of “charitable” under Treas. Reg. 1.501(c)(3)-1(a)(2) and is not an “action” organization may be tax exempt under IRC section 501(c)(3)  
- Treas. Reg. 1.501(c)(3)-1(c)(3)(v) states an “action” organization may qualify for exemption under IRC section 501(c)(4) where it otherwise does not qualify under IRC section 501(c)(3). |

*Continued on next page*
Key Element 1: Promote Social Welfare, Continued

Social Welfare
vs. Charity,
(continued)

Certain organizations whose activities do not benefit a traditional charitable class may not qualify for exemption under IRC section 501(c)(3), but depending on the nature of their activities, they may qualify for exemption under IRC section 501(c)(4). Those organizations qualifying under IRC section 501(c)(3) must benefit the public at large, as well as further a charitable purpose. If benefits are conferred on residents of a limited community the organization may not qualify under IRC section 501(c)(3), but IRC section 501(c)(4) may be an option.

Rev. Rul. 75-286, 1975-2 C.B. 210, holds that a nonprofit 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). To qualify for exemption under IRC section 501(c)(3), the organization should focus on the public at large, not merely residents within the confines of the community in question.

Continued on next page
Key Element 1: Promote Social Welfare, Continued

```
<table>
<thead>
<tr>
<th>“Action” Organization - Illustration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rev. Rul. 67-6, 1967-1 C.B. 135, illustrates an IRC section 501(c)(4) “action” organization as:</td>
</tr>
<tr>
<td>• The voting members of the organization were limited to owners of real estate in a community.</td>
</tr>
<tr>
<td>• The purpose of the organization was to preserve the traditions, architectural style and scenic appearance of a historic community.</td>
</tr>
<tr>
<td>• It opposed any zoning or other changes by appearing before the local council, administrative boards, and commissions.</td>
</tr>
<tr>
<td>• It sponsored enactment of traffic and parking regulations, sought better lighting and sanitation facilities and assisted in crime prevention and anti-litter campaigns.</td>
</tr>
<tr>
<td>• The organization encouraged its members to contact local legislative representatives to encourage enacting or defeating proposed laws.</td>
</tr>
</tbody>
</table>

Combating community deterioration and preserving the traditions, architecture, and appearance of the community for the benefit of the general public would be acceptable activities for exemption under IRC section 501(c)(3), however in this situation the activities were for the sole benefit of residents of the community. Accordingly, the organization would not qualify under IRC section 501(c)(3), but rather 501(c)(4).

<table>
<thead>
<tr>
<th>Prohibited Activities – IRC 501(c)(4) &amp; 501(c)(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 501(c)(4) organizations are prohibited from serving the private interests of members and/or primarily engaging in legislative activities not germane to its exempt purpose.</td>
</tr>
<tr>
<td>In contrast, IRC section 501(c)(3) organizations are prohibited from engaging in substantial legislative activities regardless of whether the activities are germane to the exempt purpose of the organization.</td>
</tr>
</tbody>
</table>
```
Key Element 2: Benefit the Community in General

Introduction

In many ways the definition of “social welfare” and “community in general” are similar in nature.

To qualify for exemption under IRC section 501(c)(4), the applicant must have proposed activities that will be of benefit to the “community in general.”

The proposed activities must be broad enough in scope that the benefits provided do not go to a select group of individuals.

Per Webster’s Dictionary

Webster’s dictionary defines “community” as:

- a group of people who reside in a specific locality, share government and often have a common cultural and historical heritage.

Per the IRS

One definition and example of “community” benefit can be found in Rev. Rul. 74-99, 1974-1 C.B. 131. The Service provides guidance on community in this ruling. Rev. Rul. 74-99 held that in order for a homeowners association to qualify for tax exemption under IRC section 501(c)(4):

1. It must serve a "community" that bears a reasonably recognizable relationship to an area ordinarily identified as governmental
2. It must not conduct activities directed to the exterior maintenance of private residences, and
3. The common areas or facilities it owns and maintains must be for the use and enjoyment of the general public

Providing benefits to a narrow group of recipients, in most instances, is not considered as promoting social welfare under IRC section 501(c)(4). Therefore, while a neighborhood, precinct, or subdivision may constitute a community, a housing development specifically does not constitute a community.

Rev. Rul. 74-99 clarified and modified Rev. Rul. 72-102, 1972-1 C.B. 149, to stress that not just any housing development may qualify as a community for exemption purposes.

Civic Leagues and Social Welfare Organizations

2A-6
Revenue Rulings: “Social Welfare” and “Community”

Remember!

There cannot be “social welfare” unless there are benefits to the “community.”

Benefits limited to members or a select group of individuals is not “social welfare” conducted for the benefit of the “community.”

Favorable Rev. Ruls.

A nonprofit organization formed to establish and maintain a system for the storage and distribution of water to its members only was granted exempt status even though the benefits of receiving the water was restricted to the membership. This ruling holds that the community in general benefited by an increase in the level of underground water. (Rev. Rul. 66-148, 1966-1 C.B. 143)

Note: This Rev. Rul. is a good example to show that some benefits restricted to members only which generally results in a denial can also benefit the community in general which permits granting tax exempt status.

A nonprofit organization formed to protect the legal rights of all tenants in a particular community qualifies as a social welfare organization since the activities benefit the community in general. (Rev. Rul. 80-206, 1980-2 C.B. 185)

A nonprofit organization formed to send TV signals to all area residents qualifies under IRC section 501(c)(4) since their activities benefit the community in general. (Rev. Rul. 62-167, 1962-2 C.B. 142)

Adverse Rev. Ruls.

A nonprofit organization formed to protect the rights of tenants in one particular rental complex was denied exemption because the benefits were for a select group of individuals and not a benefit to the community in general. (Rev. Rul. 73-306, 1973-2 C.B. 179)

A nonprofit community television antenna organization whose only activity was to provide television reception for its members was held not to be exempt as a social welfare organization since the benefits were only available to their members who were not the community in general. (Rev. Rul. 54-394, 1954-2 C.B. 131)

Continued on next page
Revenue Rulings: “Social Welfare” and “Community”  
Continued

Adverse Ruling: Homeowners

Rev. Rul. 69-280, 1969-1 C.B. 152, concerns a membership organization for homeowners with the following considerations:

- An organization that was incorporated for the purpose of providing specified services for the homeowners in a housing development.

- The services provided were the maintenance of the exterior walls and roofs of the individual home units, including painting of exterior walls and repair of roofs.

- If a person purchased a housing unit in the development, he/she was required to become a member of the organization.

- Support of the organization came solely from membership dues based upon estimated expenses plus building a reserve to cover major expenses such as replacing roofs.

- All members have equal voting rights and elect a board of directors who choose the officers of the organization.

- The officers have the authority to contract for maintenance and repair services.

- The developer is not involved in the operation or management of the organization.

Continued on next page

Civic Leagues and Social Welfare Organizations

2A-8
Revenue Rulings: “Social Welfare” and “Community”
Continued

Rev. Rul. 69-280
Conclusion

This Rev. Rul. concluded:

- This organization was proposing to perform services that its members would otherwise have to provide themselves.

- It was a private cooperative enterprise for the economic benefit or convenience of the members.

- The organization was to be operated primarily for the private benefit of the members and their proposed activities were not sufficient in scope to show they would operate for the common good and general welfare of the people of the community.

It ruled that this organization was not exempt from Federal income tax under IRC section 501(c)(4)

Note: IRC section 528 was added to the Code to give an organization denied exemption under this section an option to file a Form 1120-H, which limits the types of income subject to tax. (IRC section 528 is explained later in this lesson in Section C, Homeowners’ Associations.)
"Exclusively" Means Primary

The specialist will apply the facts and circumstances to the receipts and time devoted to the conduct of exempt activities of an IRC section 501(c)(4) organization in the same way it was learned to apply them to an IRC section 501(c)(3) organization.

The specialist will need to know:

- The organization must be operated "exclusively" for social welfare purposes
- "Exclusively" means the proposed activities must promote the social welfare of the community in general
- "Exclusively" means primary

- An organization formed to operate a roller skating rink as a recreational facility for the benefit and use of all the residents of a particular county in a county-owned building that it operates rent-free in cooperation with the county government may qualify for exemption under IRC section 501(c)(4) where the rink is open to the general public upon payment of such nominal dues and admission charges as are needed to defray operating expenses. (Rev. Rul. 67-109, 1967-1 C.B. 136)

- An organization that conducts an annual festival centered around regional customs and traditions may qualify for exemption under IRC section 501(c)(4). The organization provides the community with recreation and provides a means for citizens to express their interest in the community’s history, customs, and traditions. (Rev. Rul. 68-224, 1968-1 C.B. 262)

- An organization that operates an airport in a rural area that has no other airport, and which is essential to the economy of the area, is exempt under IRC section 501(c)(4). The use of volunteer services and the receipt of government grants, as well as overall supervision and control of a municipality, support the conclusion that the organization is not carrying on a business with the general public in a manner similar to organizations operated for profit. (Rev. Rul. 78-429, 1978-2 C.B. 178)

Civic Leagues and Social Welfare Organizations
2A-10
To determine if the primary activity is social welfare, you will not consider the following activities as "social welfare" activities:

- Participation in a political campaign on behalf of or in opposition to a candidate for public office
- Lobbying activities that are not germane to the purpose of the organization
- The conduct of social activities for the benefit of members
- The conduct of business activities not related to an exempt purpose
- The conduct of commercial insurance programs or promoting insurance programs on behalf of commercial insurance companies

*Note:* What effect these activities might have on an organization's exempt status or tax liability will be discussed in detail later in this lesson.

Refer to IRM 7.25.4.2.1 for an extensive digest of published precedent both supporting and disallowing exemption under IRC section 501(c)(4) for other types of organizations attempting to promote social welfare and benefit the community in general.
Contributions Deductible?

Only if Used For a Public Purpose

IRC section 170(c)(1) and Rev. Rul. 71-47, 1971-1 C.B. 92, allow a charitable deduction for contributions given to an IRC section 501(c)(4) organization if the contributions are deemed to be for the use of a political subdivision for exclusively public purposes.

Example 1: When Deductible

Rev. Rul. 74-361, 1974-2 C.B. 159, holds:

- An organization providing fire, ambulance, and rescue services qualifies for exemption as a charitable organization under IRC section 501(c)(3)

- These same services also promote the social welfare of the community in general under IRC section 501(c)(4)

- Therefore, even though they choose to be exempt under IRC section 501(c)(4), contributions to provide these services would be tax deductible by the donor

Example 2: When Deductible

Rev. Rul. 57-493, 1957-2 C.B. 314 holds:

- Contributions to an IRC section 501(c)(4) corporation formed to build and lease a stadium to a school district are tax deductible by the donor

Notifying the Organization

When contributions are deductible, the standard Letter 948 will be modified to clarify deductibility of contributions.

Civic Leagues and Social Welfare Organizations

2A-12
An organization applying for exemption under IRC section 501(c)(4) may have certain activities that might also qualify for exemption under another section of the Code as well as under this section.

The specialist may determine the activities of an organization do not meet the requirements for exemption under IRC section 501(c)(4). Before a proposed adverse determination letter denying exemption under this section is issued, the specialist should determine if those activities would permit exemption under another section of the Code. If those same activities would permit granting exemption under another section of the Code, the organization should be given the opportunity to receive exemption under that section.

The following tables compare the operational requirements and/or benefits and differences between IRC section 501(c)(4) and four other IRC sections: 501(c)(3), (5), (6), and (7).

Civic Leagues and Social Welfare Organizations

2A-13
### Table 1 – Comparing (c)(4) and (c)(3)

<table>
<thead>
<tr>
<th>Item Comparison</th>
<th>501(c)(4)</th>
<th>501(c)(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions to</td>
<td>Deductible only in limited circumstances</td>
<td>Deductible</td>
</tr>
<tr>
<td>Organizational Test</td>
<td>Not required</td>
<td>Required</td>
</tr>
<tr>
<td>Operational Test</td>
<td>Primarily to promote social welfare</td>
<td>Exclusively for charitable purpose</td>
</tr>
<tr>
<td>Foundation status</td>
<td>Not required</td>
<td>Required to meet</td>
</tr>
<tr>
<td>FUTA</td>
<td>Liable</td>
<td>Exempt</td>
</tr>
<tr>
<td>Unrelated Trade or Business Income</td>
<td>Taxable unless excluded by IRC 513. Activity may not be primary activity.</td>
<td>Taxable. Activity must be insubstantial.</td>
</tr>
<tr>
<td>Postal Rates</td>
<td>Postal Regs. control</td>
<td>Preferred rates</td>
</tr>
<tr>
<td>Political Activities</td>
<td>Permitted. May not be primary activity and may be taxable to (c)(4)</td>
<td>Prohibited. Exemption denied if activity is present</td>
</tr>
<tr>
<td>Legislative Activities</td>
<td>Unlimited if germane.</td>
<td>Restricted. May not be substantial. Election under IRC 501(h) may be made.</td>
</tr>
</tbody>
</table>

*Continued on next page*
IRC 501(c)(4) Organizations May Qualify Under Other Code Sections, Continued

### Table 2 – Comparing (c)(4) and (c)(5)

<table>
<thead>
<tr>
<th>Item Comparison</th>
<th>501(c)(4)</th>
<th>501(c)(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational</td>
<td>Promote social welfare</td>
<td>Better conditions of persons engaged in labor, agriculture and horticulture</td>
</tr>
<tr>
<td>Funding</td>
<td>Usually public sources and/or dues</td>
<td>Generally dues</td>
</tr>
<tr>
<td>Purpose</td>
<td>Benefit to community</td>
<td>Improve grade of products and higher degree of efficiency in labor, agriculture, and horticulture</td>
</tr>
</tbody>
</table>

### Table 3 – Comparing (c)(4) and (c)(6)

<table>
<thead>
<tr>
<th>Item Comparison</th>
<th>501(c)(4)</th>
<th>501(c)(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational</td>
<td>Promote social welfare</td>
<td>Promote business interest</td>
</tr>
<tr>
<td>Funding</td>
<td>Usually public sources and/or dues</td>
<td>Primarily membership dues</td>
</tr>
<tr>
<td>Purpose</td>
<td>Benefit to community</td>
<td>Improve business conditions</td>
</tr>
</tbody>
</table>

Continued on next page
Table 4 - Comparing (c)(4) and (c)(7)

<table>
<thead>
<tr>
<th>Item Comparison</th>
<th>501(c)(4)</th>
<th>501(c)(7)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operational</strong></td>
<td>Promote social welfare</td>
<td>Exclusively for members pleasure, recreation, and other non-profitable purposes</td>
</tr>
<tr>
<td><strong>Benefits Provided</strong></td>
<td>Community interests</td>
<td>Private interest of members</td>
</tr>
<tr>
<td><strong>Social Activities</strong></td>
<td>Permitted but may not be primary activity</td>
<td>Must be primary activity</td>
</tr>
<tr>
<td><strong>Unrelated Trade or Business Income</strong></td>
<td>Income not related to exempt purposes income is taxable unless excluded by IRC 513.</td>
<td>Income not related to exempt purposes and all nonmember income is taxable. Exclusions under IRC 513 do not apply.</td>
</tr>
<tr>
<td><strong>Denials</strong></td>
<td>Exemption denied if social activities are primary purpose</td>
<td>Exemption may be denied if 15% or more of gross receipts are from nonmembers. Rev. Proc. 71-17.</td>
</tr>
</tbody>
</table>

Continued on next page
IRC 501(c)(4) Organizations May Qualify Under Other Code Sections, Continued

Table 5 - Garden Clubs
There are multiple sections for exemption of garden clubs. The following table illustrates:

<table>
<thead>
<tr>
<th>If The Activity Is</th>
<th>Then Could Be Exempt Under</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusively educational</td>
<td>IRC 501(c)(3)</td>
</tr>
<tr>
<td>Promoting social welfare</td>
<td>IRC 501(c)(4)</td>
</tr>
<tr>
<td>Promoting horticulture</td>
<td>IRC 501(c)(5)</td>
</tr>
<tr>
<td>Social</td>
<td>IRC 501(c)(7)</td>
</tr>
</tbody>
</table>

Rev Rul. 66-179
For illustrations under which garden clubs may establish exemption as charitable or educational organizations, civic organizations, horticultural organizations, or as social clubs, see Rev. Rul. 66-179, 1966-1 C.B. 139.

General Rules on Qualifying for Exemption
Many organizations that qualify for exemption under IRC section 501(c)(3) would also qualify for exemption under IRC section 501(c)(4). However, not all organizations qualifying for exemption under IRC section 501(c)(4) would also qualify for exemption under IRC section 501(c)(3).

Continued on next page
IRC 501(c)(4) Organizations May Qualify Under Other Code Sections, Continued

Qualified Under 501(c)(3) and 501(c)(4)

Examples of activities designated as acceptable within the meaning of IRC section 501(c)(4) are described in the following rulings:

- Rev. Rul. 55-439, 1955-2 C.B. 257: furnish housing for low-income groups where there is a need for housing


- Rev. Rul. 67-294, 1967-2 C.B. 193: loans to businesses to locate in an economically depressed area to alleviate unemployment

Rev. Ruls. Clarification

The Revenue Rulings cited above provide for granting exemption under IRC section 501(c)(4). In most cases, these types of organizations will initially seek and most likely receive a more favorable ruling under IRC section 501(c)(3).

These types of activities were described in the lesson covering charitable organizations and for that reason will not be further defined in this section.

Keep in mind that if for some reason organizations of this type fail to meet the requirements for exemption under IRC section 501(c)(3), you will need to consider if they would qualify under IRC section 501(c)(4).
When To Suggest Modification from IRC 501(c)(3) to 501(c)(4)

Many organizations are granted exemption under IRC section 501(c)(4) rather than IRC section 501(c)(3) because their activities include legislative or political activities. If you review an application for exemption under IRC section 501(c)(3) which has proposed activities that would not permit exemption under that section, you will need to determine if those same proposed activities would qualify them for exemption under IRC section 501(c)(4).

- If they would qualify under this section, advise the applicant of your recommendation and ask them to modify their request for exemption under IRC section 501(c)(3) to IRC section 501(c)(4).

- If the applicant refuses your request, you will need to issue a proposed adverse determination letter denying exemption under IRC section 501(c)(3).

- If the applicant agrees with your findings, a favorable determination letter granting exemption under IRC section 501(c)(4) may be issued.

Remember that applicants who would not be exempt under IRC section 501(c)(3) for a period of time because they failed to meet the timing requirements under IRC section 508(a) may qualify for exemption under IRC section 501(c)(4) for that period. (Rev. Rul. 80-108, 1980-1 C.B. 119 and Rev. Rul. 81-177, 1981-2 C.B. 132)
### Not Qualified for 501(c)(3) or 501(c)(4)

<table>
<thead>
<tr>
<th><strong>Not Qualified for 501(c)(3) or 501(c)(4)</strong></th>
<th>In certain circumstances, organizations may not qualify under either IRC section 501(c)(3) or 501(c)(4).</th>
</tr>
</thead>
</table>
| **Revoked 501(c)(3) Action Organization Cannot Reapply** | Any organization whose exemption under IRC section 501(c)(3) is revoked as an action organization during an examination for engaging in substantial legislative activity or intervention in political campaigns cannot reapply and receive exemption under IRC section 501(c)(4).  
Refer to IRC section 504. |
| **Denial of Action Organization Exemption Request for (c)(3) Cannot Reapply for (c)(4)** | On a similar note, an organization denied exemption as an action organization under IRC section 501(c)(3) cannot receive exemption under IRC section 501(c)(4) even if their proposed legislative and political activities would be permissible under that section.  
Note that this situation involves an organization that was previously denied exemption under IRC section 501(c)(3), not just a situation wherein they apply under IRC section 501(c)(3) and during the application process we suggest that they switch to IRC section 501(c)(4). |
| **Failure to Meet Public Support Test (Private Foundation) Cannot Request (c)(4)** | An organization seeking exemption under IRC section 501(c)(3) which fails the support test for a public charity but would qualify for exemption as a private foundation cannot request exemption under IRC section 501(c)(4) instead of being classified a private foundation.  
Refer to IRM 7.26.7.1.3(4) |

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*Civic Leagues and Social Welfare Organizations*  
2A-20
## Prohibition on Inurement

### Background:
**Taxpayer Bill of Rights 2**
**Effect on IRC 501(c)(4)**

Prior to July 30, 1996, there was no penalty on an IRC section 501(c)(4) organization when net earnings inured to the benefit of private individuals or shareholders. There was no penalty on an organization exempt under this section when excess benefits were provided to corporate officials.

The Taxpayer Bill of Rights 2 (enacted July 30, 1996), prohibits inurement and permitted an intermediate sanctions tax to be assessed against an organization exempt under IRC section 501(c)(4) when there were excess benefits transactions with corporate officials.

### Exemption Denied when Inurement Occurs

Prior to this law, exemption could not be denied to an IRC section 501(c)(4) organization if there was inurement. An IRC section 501(c)(4) organization can now be denied exemption when inurement occurs.

The law applied to inurement is the same as you learned in the lessons concerning IRC section 501(c)(3) and will not be further detailed in this lesson.

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*Civic Leagues and Social Welfare Organizations*  
2A-21
Summary

Except for a local association of employees, all applications for exemption under IRC section 501(c)(4) must show that their primary activity promotes the social welfare of the community in general and not the interests of private individuals or groups.

If the primary activity is for the benefit of private individuals or groups of individuals, the request for exemption will be denied.

If benefits are provided to individuals and shareholders, this would be inurement and exemption would be denied even if this was not the primary activity.

Contributions to an organization described in IRC section 501(c)(4) are generally not deductible by the donors. If the applicant is found to be operated exclusively for public purposes, contributions may be deductible such as to a volunteer fire department or a school building corporation.
Lesson 2
Section B
Local Associations of Employees

Overview

Introduction
This lesson explains exemption requirements for local associations of employees.

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

List the requirements for an organization to qualify for exemption as a local association of employees under IRC 501(c)(4)

Define “local” as used in IRC 501(c)(4)

Determine whether a local association of employees qualifies for exemption

In This Lesson
This lesson contains the following topics:

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<thead>
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<th>Topic</th>
<th>See Page</th>
</tr>
</thead>
<tbody>
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<td>Overview</td>
<td>2B-1</td>
</tr>
<tr>
<td>Exemption Requirements</td>
<td>2B-2</td>
</tr>
<tr>
<td>Unrelated Activities</td>
<td>2B-4</td>
</tr>
<tr>
<td>Summary</td>
<td>2B-5</td>
</tr>
</tbody>
</table>

Local Associations of Employees
2B-1

IRSTR-B-00679
Exemption Requirements

Purpose:
The requirements for exemption of a local association of employees do not include that social welfare of the community in general be present, but an association:

Must be made up of employees of one person or persons in a given municipality, and

Is required to devote all of its net earnings to a charitable, educational, or recreational purpose

Continued on next page
Exemption Requirements, Continued

For a definition of “local” as used in IRC section 501(c)(4) you will need to refer to Treas. Reg. 1.501(c)(12)-1(b) regarding a local benevolent life insurance association which is tax exempt under IRC section 501(c)(12) of the Code.

As used here, the term “local” means:

The association’s activities are confined to a particular community, place, or district, disregarding political subdivisions.

If an organization’s activities are limited only by the borders of a state it cannot be considered to be purely local in character. (Treas. Reg. 1.501(c)(12)-1(b))

An employees’ association, which operates in several widely separated communities, is not a local association of employees within the meaning of IRC section 501(c)(4).

Example
The employees of Employer X create an association that provides and maintains vending machines for the employee’s use.

The net income from the vending machines is used to hold an annual company picnic, sponsor an employee bowling league, and to make contributions to various charitable causes in the community.

This association qualifies for exemption under IRC section 501(c)(4) because:

They are employees of a single employer
They are local in character
The net income is used to provide recreational activities for members
The association makes charitable contributions to organizations within the community

Local Associations of Employees
2B-3
Unrelated Activities

All activities may not be related to an exempt purpose. Activities not related may be the conduct of a trade or business.

Example
An association proposes as one of its activities to sell coveralls, safety toed shoes, and protective goggles to members for use in the workplace. In this situation, the sales to members is the conduct of a trade or business not related to their exempt purpose for these reasons:

The sale of these items to be used by the workers in their jobs is a commercial activity.

Except for the funds these items may provide to carry out recreational activities for members and make contributions to the community, this commercial activity is not related to their exempt purpose.

Because the activity is not related, the gross income to be derived from the sales may be taxable to the association.
Summary

Applications for tax exempt status as a local association of employees are not as common as other applications for IRC section 501(c)(4). Keep in mind that:

The employees must be those of a single employer

The association must be local in character

The net income they receive must provide for charitable, educational or recreational activities for its members

Any receipts from activities not related to their exempt purpose may be taxable
Lesson 2
Section C
Homeowners’ Associations

Overview

Introduction
In the mid 1970s and early 1980s it was common to find this type of organization tax exempt under IRC section 501(c)(4). The primary purpose of most homeowners’ associations is to enforce covenants and maintain a common area for the use of all residents.

This lesson explains exemption requirements for homeowners associations.

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

• Describe the three criteria of Rev. Rul. 74-99 an organization seeking exemption as a homeowners’ association under IRC section 501(c)(4) must meet

• Explain the three requirements homeowners’ associations must satisfy to qualify for tax relief under IRC section 528
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Reviewing the Application

Rev. Rul. 74-99  
Rev. Rul. 74-99, 1974-1 C.B. 131, established three criteria an association must satisfy to qualify for tax exempt status. The association must:

- meet the community standard, which demonstrates a relationship to a governmental area
- not include exterior maintenance of the private residences of members
- make any common areas maintained by the association available to the general public

Steps to Take  
If you are assigned a Form 1024 seeking exemption as a homeowners' association under this section, you should:

- Document whether or not the association meets the three requirements of Rev. Rul. 74-99 supra
- Prepare a favorable determination letter if the three requirements are met
- Advise the association of the election provisions of IRC section 528 if it fails any one of the requirements

Continued on next page
Reviewing the Application, Continued

Rev. Rul. 80-63: Q & A

Rev. Rul. 80-63, 1980-1 C.B. 116, was issued to discuss, in question and answer format, certain issues raised by Rev. Rul. 74-99.

Rev. Rul. 80-63: Question 1

Does Rev. Rul. 74-99 contemplate that the term “community” for purposes of IRC section 501(c)(4) embraces a minimum area or a certain number of homeowners?

No. Rev. Rul. 74-99 states that it was not possible to formulate a precise definition of the term “community.” The ruling merely indicates what the term is generally understood to mean.

Whether a particular homeowners’ association meets the requirements of conferring benefit on a community must be determined according to the facts and circumstances of the individual case. Thus, although the area represented by an association may not be a community within the meaning of that term as contemplated by Rev. Rul. 74-99, if the association’s activities benefit a community, it may still qualify for exemption.

For instance, if the association owns and maintains common areas and facilities for the use and enjoyment of the general public as distinguished from areas and facilities whose use and enjoyment is controlled and restricted to members of the association, then it may satisfy the requirement of serving a community.

Continued on next page
Reviewing the Application, Continued

Rev. Rul. 80-63: Question 2
May a homeowners' association, which represents an area that is not a community, qualify for exemption under IRC section 501(c)(4) if it restricts the use of its recreational facilities, such as swimming pools, tennis courts, and picnic areas, to members of the association?

No. Rev. Rul. 74-99 points out that the use and enjoyment of the common areas owned and maintained by a homeowners' association must be extended to members of the general public, as distinguished from controlled use or access restricted to the members of the association.

For purposes of Rev. Rul. 74-99, recreational facilities are included in the definition of "common areas."

Rev. Rul. 80-63: Question 3
Can a homeowners' association establish a separate organization to own and maintain recreational facilities and restrict their use to members of the association?

Yes. An affiliated recreational organization that is operated totally separate from the homeowners' association may be exempt. See Rev. Rul. 69-281, 1969-1 C.B. 155, which holds that a social club providing exclusive and automatic membership to homeowners in a housing development, with no part of its earnings inuring to the benefit of any member, may qualify for exemption under IRC section 501(c)(7).

Rev. Rul. 80-63: Question 4
Can an exempt homeowners' association own and maintain parking facilities only for its members if it represents an area that is not a community?

No. By providing the facilities only for the use of its members the association is operating for the private benefit of its members, and not for the promotion of social welfare within the meaning of IRC section 501(c)(4).
IRC Section 528

What is Section 528?
IRC section 528 gives special tax relief to qualified homeowners associations by excluding certain portions of their income from taxation. So, this provision limits the tax liability of the association even if it is not otherwise exempt.

Why Was It Enacted?
IRC section 528 was enacted to protect homeowners associations from being fully taxable as for-profit corporations since:

- The very nature of most homeowners associations is to provide benefits to members
- Providing benefits to members is not an activity promoting social welfare to the community in general
- Failure to qualify for tax exempt status would make them a taxable corporation causing all of their income to be taxed

Sets Conditions for Relief
A homeowners association must meet the following requirements to qualify for IRC section 528 tax relief:

- Ninety percent (90%) of expenditures must be for the purpose of acquisition, construction, management, maintenance and care of association property
- There can be no inurement to the members
- The association must make a valid election under this section

Sets Election Method
If qualified, a homeowners association makes the election by timely filing a Form 1120-H, U.S. Income Tax Return for Homeowners Associations, according to the instructions for that return.
Summary

Homeowners' associations seeking tax-exempt status must meet the three criteria of Rev. Rul. 74-99:

- meet a community standard, which demonstrates a relationship to a governmental area
- not provide exterior maintenance of the private residences of members
- permit the general public access to any common areas it maintains

Homeowners' associations may have difficulty meeting the requirements for exemption under IRC section 501(c)(4) since most provide benefits to members. Associations failing to qualify as for exemption may seek tax relief under IRC section 528.

A homeowners' association must meet three requirements to be qualified for IRC section 528 tax relief. The association must also timely file Form 1120-H to elect the tax relief provisions of IRC section 528.
Lesson 2
Section D

Activities Not Related to Exempt Purpose

Overview

Introduction
You know the primary activity of an IRC section 501(c)(4) organization must be the promotion of social welfare to the community in general. If the conduct of activities not related to an exempt purpose is the primary purpose of an IRC section 501(c)(4) organization, exemption will be denied. Income from all other activities not related to the promotion of social welfare is taxable to the organization unless the income is specifically excluded from taxation by the Code.

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

• Determine whether activities are related to an exempt purpose and the effect on a request for exemption

• Identify activities conducted by an organization that may cause tax to be imposed on the income from that activity

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Political and Legislative Activities

**Political Activity - Different Effect on 501(c)(4) and 501(c)(3)**

An IRC section 501(c)(4) organization may intervene in a political campaign on behalf of or in opposition to a candidate for public office. However, intervention in political campaigns is not an exempt purpose.

An IRC section 501(c)(3) organization that intervenes in the political campaign of a candidate for public office will have its tax exempt status revoked or application for exempt status denied.

How political activities affect organizations was discussed in greater detail in Unit 1a, Lesson 14.

**Legislative Activity - General Rule for Exemption**

An IRC section 501(c)(4) organization may engage in legislative activities. However, engaging in legislative activities is not an exempt purpose.

The attempt to influence legislation must be *germane* to the social welfare purpose of the organization. If engaging in legislative activities that are not *germane* to the social welfare purpose of the organization, exemption will be denied if such legislative activities are the primary activity.

Information given to the general public to educate and promote social welfare to the community is acceptable even if there is controversy about proposed legislation.

Legislative activities of organizations were discussed in greater detail in Unit 1a, Lesson 14.
Social Activities

General Rule for Exemption
An IRC section 501(c)(4) organization may conduct social activities for the benefit of members. However, the conduct of social activities for members is not an exempt purpose to promote social welfare.

If the conduct of social activities for members is the primary activity of the organization, exemption under IRC section 501(c)(4) will not be granted but the organization may qualify for exemption under IRC section 501(c)(7). (See Table 4 in Lesson 2-A under the title: IRC 501(c)(4) Organizations May Qualify Under Other Code Sections)

Effect in Rev. Ruls.
The effect social activities may have on an IRC section 501(c)(4) organization can be found in

- Rev. Rul. 66-179, 1966-1 C.B. 139
- Rev. Rul. 74-361, 1974-2 C.B. 159

The effects of social activities will be discussed through examples.

Example 1: Social Activities May Be Substantial But Not Primary
Rev. Rul. 66-179 holds that:

- The extent to which social activities are conducted for the benefit of members is a factor you will need to consider in your determination that the organization is primarily engaged in social welfare activities.
- Even if a substantial part of the activities of the organization consists of social functions for the benefit, pleasure, and recreation of its members, they might still qualify as tax exempt under IRC section 501(c)(4) of the Code.

The corresponding Treas. Reg. 1.501(c)(4)-1(a)(2)(ii) explains that as long as the conduct of social activities for the benefit of members is not the primary activity conducted by the organization they can be granted exemption under this section.

Continued on next page

Activities Not Related to Exempt Purpose
2D-3
Social Activities, Continued

Example 2: If Social Activities Are Primary They May Qualify for IRC 501(c)(7)

The same Rev. Rul. 66-179 illustrates the effect of social activities conducted by a garden club as follows:

- The garden club instructs the public on horticulture subjects.
- The club holds public flower shows and gives awards for horticulture achievement.
- It also conducts substantial social activities for its members.

The conclusion needs to be reached that the conduct of the social activities for members is not the primary purpose of the organization. If it is determined the social activities are not their primary purpose, exemption under this section will be granted.

If the social activities for members are the primary activity, the organization should be given the opportunity to modify their request from IRC section 501(c)(4) to IRC section 501(c)(7). Before offering exemption under IRC section 501(c)(7), you will need to be assured that no more than 15% of gross receipts will be from nonmembers.

Note: Based on what the primary activity is determined to be, a garden club might qualify for exemption under IRC sections 501(c)(3), (4), (5) or (7). (See Table 5 in Lesson 2-A under the title: IRC 501(c)(4) Organizations May Qualify Under Other Code Sections)

Continued on next page
Social Activities, Continued

Example 3: Social Activities of a Fire Department Promote Social Welfare

Rev. Rul. 74-361 illustrates social activities conducted by a volunteer fire department in this way:

- The fire department charges admission to public dances it conducts each week.

If this is not its primary activity, tax exempt status will be granted because the fire department is promoting the common good and general welfare of the community by providing fire and ambulance service to the community.

Recap Social Activities

In reviewing a Form 1024 you need to:

- Identify any proposed social activities to be provided for members.
- Determine if the conduct of the social activities will be substantial and become the primary purpose of the organization.
- Provide sufficient documentation in cases where the conduct of social activities are substantial but not the primary purpose to support your conclusion for granting exemption under this section.
- In any cases where the social activities are the primary activity, you should give the organization a chance to change their request for exemption to IRC section 501(c)(7) before preparing a proposed adverse determination letter.
Business Activities

General Rule for Exemption

An IRC section 501(c)(4) organization may engage in a business with the general public to finance their social welfare programs. However, the conduct of business with the general public is not an exempt purpose.

If the conduct of such business activities is determined to be the primary activity, exemption under IRC section 501(c)(4) will be denied.

Examples of Denied Exemption for Business Activities

The conduct of the following business activities caused denial of exemption under IRC section 501(c)(4):

- A semiprofessional baseball club, which distributed 95% of its income to players, was a commercial activity. (Rev. Rul. 55-516, 1955-2 C.B. 260)

- A national sorority created by a business enterprise to sell services and supplies to member chapters was denied tax exempt status because the sorority served the financial interests of the business corporation. (Rev. Rul. 66-360, 1966-2 C.B. 228)

- An IRC section 501(c)(4) organization whose only activity was the promotion of a professional golf tournament was operated in a manner similar to a business for profit and exemption was denied. (Rev. Rul. 74-298, 1974-1 C.B. 133)

- An organization providing security services for residents and property owners in a given community was denied exemption since this activity was similar in manner to organizations operated for profit. (Rev. Rul. 77-273, 1977-2 C.B. 195)

Review Form 1024 for Business Activities - Facts and Circumstances

As you review any business activities on a Form 1024, you will need to consider the facts and circumstances of the activity and ask yourself:

- Is this activity commercial or does it promote social welfare?

- Is the activity conducted in a similar manner to a business conducted by a for-profit entity?

Continued on next page
The case of *People’s Educational Camp Society, Inc. v Commissioner*, 331 F. 2d 923 (1964), describes a New York based exempt organization that secured funds to carry out its social welfare programs by operating a commercial resort area in the Pocono Mountains.

The following conclusion was reached regarding business activities:

- The court rejected the claim by the organization that this activity was a social welfare activity.
- The court determined this was a business activity because a substantial amount of the funds from this activity were reinvested in the commercial operation.
- Because the scope of this activity was so substantial, the court found the organization could not be said to be exclusively (meaning "primarily") engaged in the promotion of social welfare.

Based on this conclusion, the court said the organization was not exempt under IRC section 501(c)(4).

The following Revenue Rulings cite examples where the conduct of a trade or business was sufficient to cause denial of exemption:


*Continued on next page*
Business Activities, Continued

Rev. Rul. 70-535: Denial for Management of Exempt Housing Projects for a Fee

Rev. Rul. 70-535 denied exemption based on the following facts and circumstances:

- The organization managed low and moderate income housing projects for a number of other exempt organizations.
- They received all of their income from management fees and these funds were used for management service expenses.
- This was their primary activity and was no different from the same type of services provided by for-profit corporations.
- The fact this service was provided for other nonprofit organizations did not change the business nature of the activities.

Therefore, exemption for the organization was denied because the conduct of a business was the organization’s primary purpose.

Rev. Rul. 68-46: Rental of Building

Rev. Rul. 68-46 concluded that a war veterans’ association did not qualify for exemption under IRC section 501(c)(4) because it was primarily engaged in renting a commercial building and operating a public banquet and meeting hall.

Rev. Rul. 61-158: Weekly Drawings

Rev. Rul. 61-158 denied exemption to a nonprofit organization supposedly created for the promotion of social welfare, conducting weekly drawings among members of the general public as its principal activity, and using the profits therefrom primarily for the payment of its general expenses.

Favorable Rev. Ruls. for Business Activities

The following are Revenue Rulings where the conduct of business activities did not cause a denial of exemption:

- Rev. Rul. 68-45, 1968-1 C.B. 259

Continued on next page

Activities Not Related to Exempt Purpose

2D-8
Business Activities, Continued

Rev. Rul. 68-45: Conduct of Bingo Games

An IRC section 501(c)(4) organization in Rev. Rul. 68-45 conducted the following business activity:

- It held weekly bingo games open to the general public and used volunteer members to conduct the games.
- The net proceeds derived from the general public were its principal source of income used to carry out its exempt purpose.
- The fact that this activity was its primary means of financial support does not mean this was their primary activity.
- Its primary activity remained the promotion of social welfare.

Its exemption as a social welfare organization remained in effect.

Note: Always remember that if the business activity is the primary activity then tax exempt status would be denied.

Rev. Rul. 68-455: Resort Concession

Rev. Rul. 68-455 concluded that a war veterans' association qualified for exemption under IRC section 501(c)(4) even though it operated a resort concession because it was primarily engaged in the promotion of social welfare.

Determine the Use of Business Income

Determine how the income from business activities is used.

If the primary activity of the applicant is conducting a business that generates unrelated business income (primary activity distinguished from primary means of financial support), the organization will not qualify for exemption under IRC section 501(c)(4).

The use of business income to provide benefits to private individuals and shareholders, even if it is not the primary activity, will also cause exemption to be denied.

Providing general benefits to all members is acceptable, but providing special benefits to private individuals or shareholders is not acceptable.

Continued on next page
Rationale and Acceptable Benefits for Members

The conduct of social welfare includes the acquisition, maintenance, and cost of operation of buildings, services, and equipment used in the conduct of an exempt activity.

Example

The following is an example of how this rationale applies to a volunteer fire department:

- A volunteer fire company may qualify for exemption under either IRC sections 501(c)(4) or 501(c)(3) even if the income from the conduct of business activities is used for maintenance and improvement of its buildings and facilities, including social facilities. (Rev. Rul. 74-361, supra)

- The providing of recreational facilities for members of a volunteer fire department is acceptable and not considered a personal benefit for members.

- Any personal benefit assumed to be derived from this activity is acceptable because the activity helps to ease the stress and tension that could cause volunteers to quit the fire fighting service and make it more difficult to recruit new members.

- The providing of recreational activities for all members, both on duty and off duty members, fosters a closeness of the members and spirit of cooperation, which is important to the operation of an effective fire-fighting unit.

Continued on next page
### Business Activities, Continued

#### Example of When Special Benefits to Members Are Not Allowable

An example of an activity which was determined to provide special benefits to members is found in Rev. Rul. 69-385, 1969-2 C.B. 123, which held:

- A community welfare corporation that purchased and sold unimproved land and distributed the profits to its members was not tax exempt under IRC section 501(c)(4).

- The Service concluded that distribution of dividends based on equity ownership was a profit to the members.

#### Business Activity Recap

When reviewing a Form 1024 for an IRC section 501(c)(4) organization, be aware that:

- The conduct of business activities for the purpose of securing needed funds to promote social welfare purposes is not prohibited.

- The conduct of business activities is not an exempt purpose.

- Whenever an organization uses business activities to raise the needed funds to promote social welfare, the conduct of the business activities may not be their primary activity.

- If the conduct of business activities is determined to be their primary purpose, exemption will be denied.

- Whether the conduct of business activities is their primary activity must be based on the facts and circumstances.

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*Activities Not Related to Exempt Purpose*

2D-11
Insurance Activities

General Rule for Exemption
The general rule when members are given a benefit to secure various insurance coverage offered by the organization is:

- Providing insurance coverage as a benefit for members is not an activity that promotes social welfare and, if it is the primary activity of the organization, exemption will be denied.

Different Ways Insurance May Be Offered
An organization may provide member insurance in the following ways:

1. They may offer and administer various insurance programs for members in the same manner as a taxable insurance company.

2. They may promote various types of insurance programs for members on behalf of commercial insurance companies and receive a fee for promoting the insurance and for providing services to the company.

Applicable Code Section is 501(m) When Insurance Is Provided
IRC section 501(m) sets the law which controls how an organization must treat income from providing insurance benefits to members as follows:

- Exemption will not be denied if the commercial insurance activity is not the primary activity.

- The income from a commercial type insurance activity is an unrelated trade or business under IRC section 513.

- In lieu of the tax imposed by IRC section 511 on an unrelated trade or business, the organization will be treated as an insurance company and be subject to the provisions of subchapter L of the Code.

- The taxable income from commercial life insurance activities would be reported on Form 1120-L, U.S. Life Insurance Company Income Tax Return.

- All other commercial insurance activities would be reported on Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return.

Note: Refer to IRC section 501(m) for certain types of income excluded from tax for an insurance company.

Continued on next page
Insurance Activities, Continued

When reviewing a Form 1024 that provides insurance benefits for members, remember:

- Providing insurance benefits for members is not a prohibited activity.
- Providing insurance benefits for members is not an exempt purpose.
- If providing insurance benefits for members is the primary activity, exemption will be denied.
- Any income received from this activity will make the organization liable for income tax because the income from this activity is not related to their exempt purpose.
Overview

The conduct of certain activities not related to an exempt purpose may cause a denial of exemption under IRC section 501(c)(4) if the conduct of the nonexempt activities is their primary purpose.

IRC section 501(m) specifically holds that the income from the conduct of insurance activities for members is taxable because it is not related to an exempt purpose.

Other Code sections provide for a tax on income received from the conduct of other activities not related to an exempt purpose. The law, terminology, and tax implications from the conduct of unrelated business activities were discussed in greater detail in Unit 1a, Lesson 16.

Separating Related & Unrelated Activities and the Primary Activity

The need to know if an activity is related or unrelated to the promotion of social welfare is necessary to assure yourself before granting exemption that the primary activity is the promotion of social welfare and not the conduct of nonexempt activities.

It is the applicant’s ultimate responsibility to report and pay tax on any taxable income unrelated to an exempt purpose.

Additional Information May Be Required

Information submitted in support of a request for exemption under IRC section 501(c)(4) is often not sufficient for you to make a sound conclusion whether that activity is related or not related to the exempt purpose. This may require you to prepare a written request for additional information about an activity and how that activity will be conducted before you reach a final conclusion regarding an application.

A favorable ruling letter you issue to the organization will indicate that certain activities they conduct may make them subject to the provisions of IRC section 511 without identifying which activities may be taxable.

Again, reporting a liability for any tax due on income from an unrelated trade or business is the responsibility of the organization.

Continued on next page
Recap of Unrelated Activities

- The primary activity of an IRC section 501(c)(4) organization must be the promotion of social welfare to the community in general.

- If the conduct of activities not related to an exempt purpose is the primary purpose of an IRC section 501(c)(4) organization, exemption will be denied.

- If the primary activity is an activity that would permit exemption under another section of the Code but not IRC section 501(c)(4), the organization should be given an opportunity to receive exemption under that section.

- Income from all other activities not related to the promotion of social welfare is taxable to the organization unless the income is specifically excluded from taxation by the Code.
Summary

An IRC section 501(c)(4) organization may engage in legislative activities, but it is not an exempt purpose. If an organization’s primary purpose is engaging in legislative activities that are not germane to its social welfare purpose, exemption will be denied.

An organization may conduct social activities for members, but it is not an exempt purpose. If social activities for members is an organization’s primary purpose, exemption will not be granted under section 501(c)(4), but the organization may qualify for exemption under section 501(c)(7).

An IRC section 501(c)(4) organization may engage in a business with the general public to finance its social welfare programs, but it is not an exempt purpose. If the conduct of such business activities is the organization’s primary activity, exemption under IRC section 501(c)(4) will be denied.

Providing insurance benefits for members is not a prohibited activity, but neither is it an exempt purpose. If providing members insurance coverage is an organization’s primary purpose, exemption will be denied.
Lesson 3

Labor, Agricultural, and Horticultural Organizations
IRC Section 501(c)(5)

Overview

Introduction
IRC section 501(c)(5) exempts labor, agricultural, and horticultural organizations from Federal income tax. Treas. Reg. 1.501(c)(5)-1(a) states that the organizations contemplated by this code section are those which have no net earnings inuring to the benefit of any member and have as their objects:

- The betterment of the conditions of persons engaged in the pursuits of labor, agriculture, or horticulture
- The improvement of the grade of their products and
- The development of a higher degree of efficiency in their respective occupations

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

- Identify the qualifications for exemption for labor organizations
- Evaluate activities of an agricultural or horticultural organization to determine if they are exempt
- List allowed lobbying and political activities and their potential tax consequences
- Recognize typical sources of unrelated business income

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Overview, Continued

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Labor Organizations

Definition

A labor organization is an association of workers who have combined to protect and promote the interests of the members by bargaining collectively with their employers.

It includes labor councils and committees as well as labor unions.

Membership

- Generally composed of employees or representatives of the employees (such as collective bargaining agents) and similar groups
- Generally funded by membership dues from members of the labor organization
- May include employer-members whose principal purpose is to benefit employees (Rev. Rul. 59-6, 1959-1 C.B. 121, and Rev. Rul. 77-5, 1977-1 C.B. 146)
- May include limited number of independent contractors as well as employees (Rev. Rul. 74-167, 1974-1 C.B. 134)
- Generally not exempt if most of the members are not employees (Rev. Rul. 78-288, 1978-2 C.B. 179)

Purpose

The Regulations require that the principal purpose be:

- Betterment of conditions of workers
- Improvement of their products, or
- To develop a higher degree of efficiency

Continued on next page
Labor Organizations, Continued

Qualifying Activities:
Death, Sick, Accident, etc.
Benefits, and Dispatch Hall

Treas. Reg. 1.501(c)(5)-1(a)(1) prohibits inurement of earnings to the benefit of any individual member. However, where the plan has as its objective the betterment of conditions of the employee members, and members contributed the funds to the exempt labor organizations, the following furthers the labor union’s exempt 501(c)(5) purposes in betterment of union conditions and is not deemed to be inurement for labor organizations:

- Rev. Rul. 62-17, 1962-1 C.B. 87, held that a labor organization may provide employee-funded sick, death, accident or other benefits to members, since historically labor organizations were exempted from income taxation in part as mutual benefit organizations that had provided these similar benefits.

- Rev. Rul. 75-473, 1975-2 C.B. 213, and Rev. Rul. 77-5, 1977-1 C.B. 148, state that operating a dispatch hall to match union members with work assignments and provide industry stewards who represent employees in grievances against employers does not preclude exemption under IRC 501(c)(5).

Continued on next page
Labor Organizations, Continued

Non-Qualifying Activities

The following are examples of activities that didn’t qualify for exemption under IRC section 501(c)(5):

- Rev. Rul. 77-46, 1977-1 C.B. 147, held that an organization established pursuant to a collective bargaining agreement between a union and an employers’ association to enable members of the union to save money by having a fixed amount withheld from the members’ pay, deposited in a bank account, and paid annually to the members, along with any interest remaining after payment of administrative expenses was not exempt because its activities were not commonly nor historically recognized as characteristic of labor organizations and did not accomplish an exempt purpose.

- Rev. Rul 69-386, 1969-2 C.B. 123 held aiding employment to members thru a business activity was not found to be a 501(c)(5) activity. A business was that was formed to employ its union members was not a labor organization in the commonly accepted senses and not held exempt under IRC 501(c)(5).

- Rev. Rul 66-354, 1966-2 C.B. 207, states a labor union formed to receive employment taxes where the manufacturers were required to deduct these taxes from their union employees and pay them over to the federal and state, and a committee consisting of representatives from the labor union administered the organization was not exempt under IRC 501(c)(5).

Continued on next page
Labor Organizations, Continued

| Financial Aid to Members | The Service has determined that strike benefits are directed to furthering a labor union’s primary purpose of representing its members in union matters for example as wages, hours of labor, economic benefits. Payments to members in the event of strike, lockout, death, sickness, injury, etc. are permitted if the payments:
|                            | • Are made under a plan which has as its object the betterment of conditions of the members
|                            | • Do not constitute inurement, and
|                            | • Are not incompatible with exemption under this section
| Fund Management            | Strike funds that provide income to union members but are not controlled by unions are not exempt under this Code section. (Rev. Rul. 76-420, 1976-1 C.B. 153)
| Commonly Under a Group Exemption | Final Regulations issued in Treasury Decision 8726, effective December 21, 1995, provide that an organization will not be exempt under IRC section 501(c)(5) if its principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs.
| Commonly Under a Group Exemption | Labor unions may be exempt under a group ruling. Therefore, the determinations specialist should determine if the organization is included under a group ruling before granting individual tax exemption.

*Labor, Agricultural, and Horticultural Organizations*  
IRC Section 501(c)(5)  
3-6
Agricultural and Horticultural Organizations

Definitions
Agriculture is defined as pertaining to or engaged in agriculture. Horticulture is the growing of fruits, vegetables, and flowers or ornamental plants. (Horticulture is by definition agricultural therefore agricultural encompasses horticulture.)

Harvesting aquatic resources (animal or vegetable) was added to the agricultural definition by the Tax Reform Act of 1976 for years ending after December 31, 1975. (IRC section 501(g))

Purpose
As with labor organizations, the exempt purposes for an agricultural or horticultural IRC section 501(c)(5) organization may be:

- Betterment of conditions of those engaged in agricultural pursuits
- Improvement of the grade of products of those engaged in agriculture, or
- Development of a higher degree of efficiency in the members’ occupations

Betterment of Conditions Examples
For agricultural organizations, the following activities have been held as betterment of conditions:

- State and county farm bureaus organized to promote cooperative agricultural activities (Rev. Rul. 54-282, 1954-2 C.B. 126)
- Conduct of livestock exhibitions (Rev. Rul. 54-282, supra)
- Soil testing (Rev. Rul. 54-282, supra)
- Guarding the “purity” of a breed of livestock through keeping of records and sponsoring activities to inform and educate (Rev. Rul. 55-230, 1955-1 C.B. 71)
Agricultural and Horticultural Organizations, Continued

<table>
<thead>
<tr>
<th>Direct Services to Members that are Exempt</th>
<th>The following primary activities were held to be <strong>exempt</strong>:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Supplying milk production statistics to USDA (Rev. Rul. 74-518, 1974-2 C.B. 166)</td>
</tr>
<tr>
<td></td>
<td>• Promoting pest control through inspection of fields, compiling data on infestation and sharing such data with members, government agencies and universities (Rev. Rul. 81-59, 1981-1 C.B. 334)</td>
</tr>
<tr>
<td></td>
<td>• Negotiating a satisfactory price for members’ commodities (Rev. Rul. 76-399, 1976-2 C.B. 152)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Services to Members that are Nonexempt</th>
<th>The following activities were held to be <strong>nonexempt</strong>:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Processing data for dairy producers to improve their milk production as it simply relieved producers of work they would otherwise do (Rev. Rul. 70-372, 1970-2 C.B. 118)</td>
</tr>
<tr>
<td></td>
<td>• Owning and operating a livestock facility for weighing, sorting, grading and shipping livestock provided a particular service to members (Rev. Rul. 77-153, 1977-1 C.B. 147)</td>
</tr>
<tr>
<td></td>
<td>• Sponsoring and promoting sale of livestock for members (Rev. Rul. 66-105, 1966-1 C.B. 145)</td>
</tr>
</tbody>
</table>

*Labor, Agricultural, and Horticultural Organizations  
IRC Section 501(c)(5)*
Political and Lobbying Activities

Lobbying
IRC section 501(c)(5) organizations may engage in direct lobbying that is germane to the accomplishment of its exempt purposes.

Political Expenditures
There is no prohibition per se of political activity by an IRC section 501(c)(5) organization that is germane to its exempt purposes. An organization will not be disqualified merely because it engages in some political activity if it otherwise qualifies for 501(c)(5). GCM 34233 (December 3, 1969) reaches the conclusion regarding labor unions described in IRC section 501(e)(5). It 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 under IRC 501(c)(5). The major issues relative to political expenditures is whether dues were used for the expenditures and the deductibility of such dues and whether the expenditures are taxable.

Tax on Political Expenditures
IRC section 527(f) imposes a tax on any direct political expenditures of any IRC section 501(c) organization. To avoid possible tax liability under IRC section 527(f), organizations might spin off political funds into a separate segregated fund, which would be subject to IRC 527.

Application and disbursement information should be carefully reviewed to determine whether separate, segregated funds or trusts exist. If so, then you should discuss this with your manager regarding further action.

Dues Disallowance
IRC section 162(e) prohibits deduction of dues as a business expense to an organization if the funds are used for:

- Participation or intervention in a political campaign
- For direct lobbying expenses at the federal and state (but not local) level
- For grassroots lobbying

Labor, Agricultural, and Horticultural Organizations
IRC Section 501(c)(5)
3-9
**Subsection Distinctions**

**IRC 501(c)(5) vs. 501(c)(3)**

If an organization is organized and operated **exclusively** for IRC 501(c)(3) purposes, it will qualify for IRC 501(c)(3) classification even if the organization’s activities result in the improvement of agricultural pursuits. The determination should always be to the organization’s advantage.

**IRC 501(c)(5) vs. 501(c)(6)**

Many associations related to agriculture may be more properly classified as business leagues. In general, business leagues are covered under IRC section 501(c)(6) exemption. The **principal purpose** of the organization will be determinative.

Decisive factor: Is the purpose to promote the common business interests and better the conditions of persons directly engaged in agricultural pursuits or to promote the common business interests of some other business groups closely related to agriculture (for example, suppliers of goods or services to the agricultural community or packers or processors of raw agricultural commodities, See for example Rev. Rul 67-252 1967-2, CB 195).

**IRC 501(c)(5) vs. 501(c)(9)**

As discussed previously, labor unions may provide certain benefits to their members. Labor unions may administer these benefits or establish an IRC section 501(c)(9) Voluntary Employees’ Beneficiary Association (VEBA) to administer the benefits. (VEBAs are membership organizations that provide their members with health, welfare and other benefits.) Generally a labor union may provide any of the benefits that a Veba may provide. (Prepaid legal services, restricted for a Veba exempt under IRC section 501(c)(9), are permitted for a labor organization. (Rev. Rul. 62-17, 1962-1 C.B. 87))

IRC section 501(c)(9) VEBAs are a higher graded issue. Organizations which appear to be better classified under this subsection should be discussed with the manager for possible case upgrade or reassignment.
Subsection Distinctions, Continued

IRC 501(c)(5) vs. IRC 521

IRC section 521 defines “exempt” farmers’ cooperatives which market the products of members or other producers or purchase supplies and equipment for the use of members or other persons. These organizations must be organized on a cooperative basis. These activities would constitute particular services for members under IRC section 501(c)(5). The result would be either UBI or denial of exemption.

IRC section 521 farmers’ coops are a higher graded issue. Organizations which appear to be better classified under this subsection should be discussed with the manager for possible case upgrade or reassignment.

Garden Clubs

These organizations present a difficult classification issue. Depending on how they are organized and operated, garden or other similar clubs might qualify for exemption under IRC section 501(c)(3), (4), (5), or (7). If the primary purpose of the club is to better the conditions of those engaged in horticulture, or improve the quality of the horticultural products, the club would likely be described in IRC section 501(c)(5). (Rev. Rul. 66-179, 1966-1 C.B. 139)
Unrelated Business Activities

**General**

The following activities have been held to be an unrelated business for an IRC section 501(c)(5) organization:

- Sales of supplies and equipment to members (Rev. Rul. 57-466, 1957-2 C.B. 311)
- Sale of cattle for members (Rev. Rul. 69-51, 1969-1 C.B. 159)
- Operation of a club for members and guests (Rev. Rul. 60-86, 1960-1 C.B. 198)
- Providing accounting and tax services to members (Rev. Rul. 62-191, 1962-2 C.B. 146)

When the unrelated business activity becomes the primary activity for the organization, denial of tax exemption is in order. Otherwise, the organization should be advised of their unrelated business activity obligations and coded for a Form 990-T filing requirement.

**Qualified Convention or Trade Show Activities**

IRC section 513(d) excludes qualified convention and trade show activities from unrelated business income (UBI). This provision is applicable to tax years beginning after October 4, 1976.

Trade show activities will be exempt if conducted by a qualifying organization and the activity is designed to display industry products for the purpose of:

- Stimulating interest in and demand for industry products or services, or
- Educating persons in the industry about new products or services or matters affecting the industry

*Continued on next page*
Unrelated Business Activities, Continued

Group Insurance Activities

Generally insurance programs that provide coverage to members are considered as improving the general welfare of members and are exempt. Many organizations offer limited membership to outsiders who then may participate in group insurance plans. Generally, such associate members or "members at large" cannot vote, hold office or participate in the collective bargaining process.

Payments from Associate Members

Payments from associate members may be classified as unrelated business income. Dues from associate members will be considered exempt income if the associate member category:

- Was not formed or availed for the production of unrelated income, and
- Has been formed principally to further exempt purposes

In applying these principles, the Service will look to the purposes and activities of the organization and not to the membership classification.

See IRC section 512(d) and Rev. Proc. 97-12, 1997-1 C.B. 631, for other circumstances where dues are or are not considered UBI.

Labor, Agricultural, and Horticultural Organizations

IRC Section 501(c)(5)

3-13
Summary

IRC section 501(c)(5) exempts labor, agricultural, and horticultural organizations from Federal income tax.

A labor organization is an association of workers who have combined to protect and promote the interests of the members by bargaining collectively with their employers. Labor organizations' principal purpose must be betterment of workers' conditions, improvement of their products, or development of a higher degree of efficiency.

Inurement of net earnings to any individual member is prohibited, but a labor organization may provide employee-funded sick, death, accident or other benefits to members. Payments to members in the event of strike, lockout, death, sickness, injury, etc. are permitted provided the payments:

- Are made under a plan which has as its object the betterment of conditions of the members
- Do not constitute inurement, and
- Are not incompatible with exemption under IRC 501(c)(5)

The primary purpose of an agricultural or horticultural IRC section 501(c)(5) organization must be betterment of conditions of those engaged in agricultural pursuits, improvement of the grade of products of those engaged in agriculture, or development of a higher degree of efficiency.

Many associations related to agriculture may be more properly classified as business leagues under IRC section 501(c)(6). The organization's principal purpose is determinative.

An IRC section 501(c)(5) organization may engage in direct lobbying that is germane to accomplishment of its exempt purposes.
Lesson 4

Business Leagues, Chambers of Commerce, Trade Associations, Real Estate Boards, and Professional Football Leagues
IRC Section 501(c)(6)

Overview

Introduction

IRC section 501(c)(6) provides for the exemption of business leagues, chambers of commerce, trade associations, real estate boards, boards of trade, and professional football leagues, which are not organized for profit and no part of their net earnings inures to the benefit of any private shareholder or individual.

A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not engage in a regular business of a kind ordinarily carried on for profit.

Chambers of commerce and trade associations are organizations of the same general type as business leagues. They direct their efforts at promoting the common economic interests of all commercial enterprises in a particular community or trade.

Likewise, a real estate board consists of professionals in the real estate field who are interested in improving the real estate industry in a particular area.

Continued on next page
Overview, Continued

Objectives

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

- Identify and apply the various requirements which an organization must meet to qualify for exempt status under IRC section 501(c)(6)

- Name the types of organizations that are exempt under IRC section 501(c)(6)

- Define “a common business interest”

- Recognize “improvement of business conditions”

- Recognize a “line of business”

- Describe a “membership organization” and “meaningful level of membership support”

- Distinguish between promoting one or more lines of business and performing particular services for members

- Recognize business activities

- Define permissible political and legislative activities of IRC section 501(c)(6) organizations

Continued on next page
Overview, Continued

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Business Leagues, Chambers of Commerce, Trade Associations, Real Estate Boards, and Professional Football Teams
IRC Section 501(c)(6)
IRC Section 501(c)(6) Organizations Defined

Types
IRC section 501(c)(6) provides for exemption of the following types of organizations:

- Business Leagues
- Chambers of Commerce
- Trade Associations
- Real Estate Boards
- Professional Football Leagues

Inurement
A request for exemption will be denied if an organization seeking exemption is organized for profit or the net earnings of the organization inure to the benefit of private individuals or shareholders.

Treas. Reg. Definition
The Treas. Regs. define a business league as:

- An association of persons (including legal entities) having a common business interest
- An organization which promotes a common business interest but is not engaged in a regular business of a kind ordinarily carried on for profit
- An organization whose activities are directed to the improvement of business conditions of one or more lines of business and does not perform particular services for individual persons

Modifications to General Rule
Chambers of commerce and boards of trade have a broader range since they usually direct their efforts at promoting the common economic interests of all the commercial enterprises in a given trade community (Rev. Rul. 73-411, 1973-2 C.B. 180).

Continued on next page
IRC Section 501(c)(6) Organizations Defined, Continued

Required Characteristics Defined — Tests Must Be Met

An organization seeking exempt status under IRC section 501(c)(6) must meet the following tests:

- It must be an association of persons having some common business interest and it must promote this common business interest.

- It must not be organized for profit.

- It must be a membership organization and have a meaningful level of membership support.

- No part of its net earnings may inure to the benefit of any private shareholder or individual.

- Its activities must be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

- It may not engage in a regular business of a kind ordinarily carried on for profit, even if the business is operated on a cooperative basis or produces only sufficient income to be self-sustaining.

- It must be primarily engaged in activities or functions constituting the basis for its exemption.

- The primary activity may not be performing particular services for members.

Each of these “tests” will be discussed in the lesson.

Key to Exemption

If the primary activity of an organization is the promotion of a common business interest, a favorable determination letter will be issued.

If the primary activity of an organization is providing particular services or benefits to its members or others, it will not qualify for exemption under IRC section 501(c)(6).
Must Share and Promote Common Business Interest

<table>
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<tr>
<th>Examples of Qualifying “Common Business Interests”</th>
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The following are examples of organizations which have common business interests to qualify for exemption under IRC section 501(c)(6):

- An organization formed by members of the medical profession to improve the quality of medical care given to the general public and to establish and maintain high standards of excellence in a particular medical specialty was held to promote the common business interest of the physicians (Rev. Rul. 73-567, 1973-2 C.B. 178)

- An organization formed by members of a state medical association to operate peer review boards to establish and maintain standards for quality, quantity, and reasonableness of medical services was held to promote the common business interests of the profession (Rev. Rul. 74-553, 1974-2 C.B. 168)

- An organization formed to stimulate the development and free interchange of information pertinent to systems and programming of electronic data processing equipment was held to promote the common business interests of the members (Rev. Rul. 74-147, 1974-1 C.B. 136)

- An organization of business and professional women formed to promote the acceptance of women in business and the professions promotes the common business interests of the members (Rev. Rul. 76-400, 1976-2 C.B. 153)

Continued on next page
The following are examples of activities which did not promote a common business interest and exemption was denied under IRC section 501(c)(6):

- An organization made up of individuals, firms, associations, and corporations engaged in different lines of business and seeking to exchange information on business prospects had no common business interest other than to increase individual sales. (Rev. Rul. 59-391, 1959-2 C.B. 151)

- The American Automobile Association, composed of individual automobile owners and affiliated auto clubs, had a primary purpose of securing benefits and promoting particular services to members. (American Automobile Association v. Commissioner, 19 T.C. 1146 (1953))

- An association of dog owners, most of whom were not in the business of raising and selling dogs, did not further a common business interest. (American Kennel Club v. Hoey, 148 F.2d 920 (1945))
Hobby Clubs Not Promoting Common Business Interests

Hobby clubs cannot promote a common business interest required of an IRC section 501(c)(6) organization because a hobby is not considered a business. Hobby clubs may be exempt under other provisions of the Code such as IRC section 501(c)(4) or (7).

Note: It was for this reason that the American Kennel Club, cited earlier, was denied exemption under this section.

“Business” Defined Per Rev. Ruls

The term “business” is broadly interpreted and the following Rev. Ruls. are applicable:

- Rev. Rul. 70-641, 1970-2 C.B. 119, holds that a business is almost any enterprise or activity conducted for remuneration including professions, mercantile enterprises and trading businesses.

- Rev. Rul. 67-264, 1967-2 C.B. 196, expands the definition of business to include the conduct of businesses on a cooperative basis such as consumer cooperatives.

Agriculture Interests: (c)(5) vs. (c)(6)

Organizations whose primary purpose is to better the conditions of persons engaged in agriculture, improve their products, and develop efficiency would be qualified under IRC section 501(c)(5).

Organizations promoting the common business interest of persons in an industry related to agricultural pursuits would qualify for exemption under IRC section 501(c)(6) even if the members were engaged in agriculture.
May Not Be Organized for Profit

Examples of Profit Motive

An organization would be denied exemption under IRC section 501(c)(6) if they:

- Issue stock to members with a right to dividends (Northwestern Jobbers Credit Bureau v. Commissioner, 37 F.2d 880 (1930))
- Provide for the distribution of accumulated income to members, which would be inurement

Assets Distributed Are Not Distribution of Profits

A provision in the organizing document which permits the distribution of assets to members at dissolution is not a distribution of earnings and will not preclude exemption. (Crooks v. Kansas City Hay Dealers Association, 37 F.2d 83 (1929))
Must be a Membership Organization with Meaningful Membership Support

In General

An IRC 501(c)(6) organization is a membership organization characteristically supported by dues.

While such an organization may receive a substantial portion or even the primary part of its income from non-member sources, membership support, both in the form of dues and involvement in the organization's activities, must be at a meaningful level.

Application of Rules

G.C.M. 39723 (Apr. 8, 1988) concluded that a local association of insurance agents, exempt under IRC 501(c)(6), would lose its exempt status because its only significant source of income was commissions earned by providing insurance services to local governmental units in the city in which it is organized.

G.C.M.39723 contrasted the association with the insurance agents' association described in Rev. Rul 71-155, 1971-1 C.B. 152. While the association described in Rev. Rul 71-155 was funded by assessments against members, which G.C.M. 39723 characterized as "an indication that [its activity] was not 'a regular business ordinarily carried on for profit,'" the organization described in the G.C.M. had a revenue source that was typical of a profit-oriented business.

Therefore, for purposes of determining membership support:

- Any income derived from the performance of the organization's exempt functions or from substantially related activities should be treated as membership support
- Contributions or gifts from the general public should be treated as membership support
- Updated income should be included in measuring the extent of membership support

Continued on next page

Business Leagues, Chambers of Commerce, Trade Associations, Real Estate Boards, and Professional Football Teams
IRC Section 501(c)(6)
4-10

IRSTR-B-00732
Must be a Membership Organization with Meaningful Membership Support, Continued

A principal purpose test is used to determine whether a particular class of dues income will be subject to the unrelated business income tax provisions (see Rev. Proc. 97-12, 1997-1 C.B. 631)

Following the provisions of Rev. Proc. 95-21, 1995-1 C.B. 686, if a category of members has been formed or availed of for the purpose of producing unrelated business income, then dues from that category of members will be taxed as unrelated business income. For purposes of IRC 501(c)(6), such income would not be considered as membership support.

In the following cases, the organizations are receiving income from nonmember sources, but the activity producing the income is related to the organization's exempt purpose, and the income from the activity is considered to be membership support:

- An association of insurance agents that receives commissions from handling insurance programs, where the commissions are impressed with a trust and deposited in a special fund to be administered for public purposes (Rev. Rul. 56-152, 1956-1 C.B. 56)

- An organization formed to promote a professional sport that receives income from the operation of championship tournaments open to the public, the sale of broadcasting rights, and the sale of publications (Rev. Rul. 58-502, 1958-2 C.B. 271)

- A veterinarians' association that collects fees from operating a rabies clinic open to the general public (Rev. Rul. 66-222, 1966-2 C.B. 223)

- A professional association that receives fees from nonmembers for a training program (Rev. Rul. 67-296, 1967-2 C.B. 212)

Note: See 2003 EO CPE Text, IRC 501(c)(6) Organizations for more information on membership requirements.
Net Earnings May Not Inure to Shareholders or Individuals

<table>
<thead>
<tr>
<th>Permissible Benefits to Members</th>
</tr>
</thead>
<tbody>
<tr>
<td>An IRC section 501(c)(6) organization may provide certain benefits to members that are not considered inurement. These are:</td>
</tr>
<tr>
<td>• Newsletters and other informative materials</td>
</tr>
<tr>
<td>• Increased profitability of a business by successful promotion of common business interests</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Certain Transactions Not Considered Inurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>For certain transactions not to be considered inurement, the benefits to members must be equal for all.</td>
</tr>
<tr>
<td>Members getting benefits at a special rate at the expense of other members is not acceptable and would be inurement.</td>
</tr>
<tr>
<td>Distributions to members in the form of a reduction in dues or contributions previously paid to support the organization’s activities are not inurement.</td>
</tr>
<tr>
<td>Any return of dues or contributions must be in proportion to dues paid or contributions made. (Rev. Rul. 81-60, 1981-1 C.B. 335)</td>
</tr>
</tbody>
</table>

Continued on next page
Net Earnings May Not Inure to Shareholders or Individuals, Continued

<table>
<thead>
<tr>
<th>Acts of Inurement to Members</th>
<th>The following transactions represent inurement which would cause a denial of exemption:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Payment of dividends on stock</td>
</tr>
<tr>
<td></td>
<td>• Distribution of accumulated earnings</td>
</tr>
<tr>
<td></td>
<td>• Providing financial assistance and welfare benefits for members (Rev. Rul. 67-251, 1967-2 C.B. 196)</td>
</tr>
<tr>
<td></td>
<td>• Payment of expenses of litigation to members for defense of malpractice suits (National Association of Chiropractors v. Birmingham, 96 F. Supp. 824 (1951))</td>
</tr>
<tr>
<td></td>
<td>• An association of wholesale grocers who distributed royalties to members from a copyright on certain grocery labels distributed net earnings to members (Wholesale Grocers Exchange v. Commissioner, Tax Court Memorandum Opinion, entered July 18, 1944)</td>
</tr>
</tbody>
</table>

| Non-member Income | When an organization seeking exemption under IRC section 501(c)(6) has income from sources other than member dues, you must determine whether the income-producing activity is an unrelated trade or business. |

Business Leagues, Chambers of Commerce, Trade Associations, Real Estate Boards, and Professional Football Teams
IRC Section 501(c)(6)
4-13
Activity Must Be for Improvement of Business Conditions

General Rules

- The activities must be directed toward improving business conditions of one or more lines of business.

- The activities may promote the general commercial welfare but this is not required (Rev. Rul. 59-391, 1959-2 C.B. 151).

- The activities cannot be the performance of particular services for individuals and qualify for exemption.

Examples of Improvement of Business Conditions

Examples of improvement of business conditions are:

- The presentation of information, trade statistics and group opinions to government agencies and bureaus (Atlanta Masters Printers Club v. Commissioner, Tax Court Memorandum Opinion entered November 25, 1942).

- Attempting to influence legislation germane to the common business interests of an organization's members (Rev. Rul. 61-177, 1961-2 C.B. 117).


Continued on next page
Activity Must Be for Improvement of Business Conditions,
Continued

Facts and Circumstances
Test Applies

Whether the activities of an organization lead to real and permanent improvement of business conditions is immaterial as long as prudent businessmen believe they will improve business conditions. *(Associated Industries of Cleveland v. Commissioner, 7 T.C. 1449 at 1466 (1946))*

An organization of businessmen whose activities were limited to luncheon meetings to discuss various problems of a particular industry directed to improvement of business conditions as a whole was held to be exempt under IRC section 501(c)(6). *(Rev. Rul. 67-295, 1967-2 C.B. 197)*

However, an organization of business and professional persons of a community which provided luncheon and bar facilities for members, but had no specific program directed to the improvement of business conditions was held not to be exempt under this section. *(Rev. Rul. 70-244, 1970-1 C.B. 132)*

*Business Leagues, Chambers of Commerce, Trade Associations, Real Estate Boards, and Professional Football Teams*
*IRC Section 501(c)(6)*
4-15
Must Promote a Line of Business

General Rule

For exemption purposes, a “line of business” is a trade or occupation not restricted by a patent, trademark, or similar device that would allow private parties to restrict the right to engage in the business.

Examples of Promoting a Single Product

The line of business requirement is generally not met when an organization promotes a single brand name or product instead of the industry as a whole. For example:

- An organization of diversified businesses and dealers that rent, sell, or lease computers of a single manufacturer was not exempt since the activity did not benefit the computer industry as a whole. (Rev. Rul. 83-164, 1983-2 C.B. 95)

- The same conclusion was reached in the case of National Muffler Dealers Association v. U.S., 440 U.S. 472 (1979), which held the promoting of a single brand name within the industry was not the promotion of a business in general.

Note: You need to determine whether the proposed activities promote a line of business in general or just one product within a line of business.
Must Not Provide Particular Services to Members

Examples of Providing particular services to members or individuals is not an exempt purpose and may cause denial of a request for exemption.

Examples of providing personal services to members include:

- Promoting the publication of the writings of members (Rev. Rul. 57-453, 1957-2 C.B. 310)
- A real estate board whose primary purpose was the operation of a multiple listing service of its members (Evanston-North Shore Board of Realtors v. United States, 320 F. 2d 375 (1963))
- An organization that operated a telephone answering service for member doctors (Rev. Rul. 71-475, 1971-1 C.B. 153)
- A nurses' registry controlled and financed by participating nurses where its activities consisted of assigning nurses to jobs (Rev. Rul. 61-170, 1961-2 C.B. 112)

Note: There are a significant number of Revenue Rulings and court case decisions in this area. Remember that if the activity is to provide services to members, exemption should be denied. (refer to IRM 7.25.6.7.2 for additional examples)

Continued on next page
Must Not Provide Particular Services to Members, Continued

Whether the conduct of certain activities is the providing of services to members is not always an easy decision.

Some examples of activities held not to be the performance of services are:

- An association of insurance companies formed to investigate criminal aspects of claims against its members (Rev. Rul. 66-260, 1966-2 C.B. 225)
- An organization of financial institutions which offers rewards for information leading to the arrest and conviction of individuals committing crimes against its members (Rev. Rul. 69-634, 1969-2 C.B. 124)
- An organization formed by manufacturers of a particular product to conduct a program of testing and certifying the product to establish acceptable standards within the industry as a whole (Rev. Rul. 70-187, 1970-1 C.B. 131)

Note: The rationale in these situations is that the benefit to members is incidental and the business in general is the primary beneficiary of these activities, which makes them permissible activities for exemption.
Business Activities: Effect on Exemption

General

An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit does not qualify for exemption under IRC section 501(c)(6).

Business Activity Denials

The following are examples of business activities that caused denial of exempt status:

- An organization selling credit information and collection services *(Credit Bureau of Greater New York v. Commissioner, 162 F.2d 7 (1947))*

- An employment agency *(American Association of Engineers Employment, Inc. v. Commissioner, Tax Court Memorandum Opinion, entered March 7, 1952)*

- An organization testing the safety of electrical products for commercial enterprises *(Underwriter’s Laboratories, Inc. v. Commissioner, 135 F. 2d 371 (1943))*

An automobile association providing commercial towing for its members *(American Automobile Association v. Commissioner, 19 T.C. 1146 (1953))*

Exemption Denied if Business Activity Is Primary

A business league must have a primary purpose of promoting common business interests.

If conducting business activities in the same manner as a commercial enterprise is their primary activity, exemption will be denied.

Continued on next page
Business Activities: Effect on Exemption, Continued

<table>
<thead>
<tr>
<th>Business Activity Subject to UBIT</th>
<th>If the conduct of business activities in the same manner as a commercial enterprise is not the primary activity, the income from the business activity would be subject to tax and a Form 990-T would be required.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special Considerations</td>
<td>There are certain activities that a business league will conduct that will not generally be found in other sections of the Code. They are:</td>
</tr>
<tr>
<td></td>
<td>- Trade publications</td>
</tr>
<tr>
<td></td>
<td>- Trade shows</td>
</tr>
<tr>
<td></td>
<td>- Selling marts</td>
</tr>
<tr>
<td>Trade Publications</td>
<td>A business league which publishes a trade journal that catalogues the products of members is performing a particular service for members.</td>
</tr>
<tr>
<td>Trade Shows</td>
<td>IRC section 513(d), added to the Code by the Tax Reform Act of 1976, provides that trade shows conducted by a qualifying organization are a related activity not subject to UBIT if:</td>
</tr>
<tr>
<td></td>
<td>- The purpose is to attract persons to an industry show for the purpose of displaying industry products</td>
</tr>
<tr>
<td></td>
<td>- The purpose is to stimulate interest in and demand for industry products or services</td>
</tr>
<tr>
<td></td>
<td>- The purpose is to educate persons engaged in the industry in the development of new products and services or new matters affecting the industry</td>
</tr>
<tr>
<td></td>
<td>- A qualifying IRC section 501(c)(5) or (6) organization regularly conducts as one of its substantial exempt purposes a show that stimulates interest in, or demand for, the products and services of the particular industry</td>
</tr>
</tbody>
</table>

Continued on next page

Business Leagues, Chambers of Commerce, Trade Associations, Real Estate Boards, and Professional Football Teams
IRC Section 501(c)(6)
4-20
Selling Marts

An organization whose sole activity is to conduct a trade show for the purpose of bringing buyers and sellers together, and the show was not held in conjunction with a convention or annual meeting of the business league, will be denied exemption. (Rev. Rul. 58-2234, 1958-1 C.B. 242)

IRC section 513(d) did not change this ruling and an organization of this type would not be entitled to exemption.
Professional Societies

501(c)(6) or 501(c)(3)?

A professional society could qualify for exemption under IRC section 501(c)(3) if its purpose is to advance the profession by engaging in exclusively educational or scientific activities.


Note: If a professional society also has substantial non-charitable or non-educational activities, exemption under IRC section 501(c)(3) would be denied regardless of the number or importance of truly charitable or educational purposes it may have. (Rev. Ruls. 71-504 and 505, 1971-2 C.B. 231 and 232)
Political and Legislative (Lobbying) Activities of IRC Section 501(c)(6) Organizations

**Political Activities**

IRC section 501(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.

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 501(c)(6).

**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.


Continued on next page
Dues or contributions to IRC section 501(c)(6) organizations are generally deductible as business expenses under IRC section 162. However, dues and contributions to IRC section 501(c)(6) organizations that are used for political and/or legislative activities may not be deductible.

- Amounts paid for intervention or participation in any political campaign are not deductible as business expenses under IRC section 162(3)(2)(A).

- Amounts paid for direct lobbying expenses at the federal and state (but not local) level are not deductible as business expenses under IRC section 162(3)(2)(A).

- Amounts paid for grass roots lobbying expenditures also are not deductible as business expenses under IRC section 162(3)(2)(A).
IRC section 501(c)(6) provides for exemption of business leagues, chambers of commerce, trade associations, real estate boards, and professional football leagues.

An organization organized for profit or whose net earnings inure to the benefit of private individuals or shareholders does not qualify for exemption.

An organization seeking exempt status under IRC section 501(c)(6) must have certain characteristics.

The primary activity of an IRC section 501(c)(6) organization must be the sharing and promotion of a common business interest of its members. If the primary activity is providing particular services or benefits to its members, the organization does not qualify for exemption.

An organization seeking exempt status under IRC section 501(c)(6) may not be organized for profit.

An IRC section 501(c)(6) organization must be a membership organization with meaningful membership support. Income from performance of an organization’s exempt purpose or substantially-related activities is treated as being membership support. Contributions or gifts from the general public are also treated as being membership support.

Net earnings of IRC section 501(c)(6) organizations may not inure to shareholders or individual members.

Activities of IRC section 501(c)(6) organizations must be for improving business conditions of one or more lines of business. The activities cannot be providing particular services to members.

An IRC section 501(c)(6) organization may engage in an unlimited amount of legislative activities (lobbying), provided that the lobbying is related to the organization’s exempt purpose.
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Lesson 5
Social and Recreational Clubs
IRC Section 501(c)(7)

Overview

Introduction
IRC section 501(c)(7) exempts from tax:

- "Clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes, and no part of the net earnings of which inures to the benefit of any private shareholder"

- Social and recreational clubs which are supported solely by membership fees, dues, and assessments (Treas. Reg. 1.501(c)(7)-1(a))

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

- Process an application from a social club

- Determine whether an organization qualifies for exemption under IRC section 501(c)(7)

Continued on next page
### In This Lesson

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<td>5-14</td>
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<td>Inurement</td>
<td>5-16</td>
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<td>Summary</td>
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Typical Social Clubs

Basis for Exempt Status

Social and recreational clubs under IRC section 501(c)(7) were originally granted exemption in the Revenue Act of 1916. Congress stated that the reason for their exemption was because the Treasury Department considered the securing of returns from clubs a source of expense and annoyance, with little or no tax.

This contrasts with the usual justification of Congress for other exempt classifications, which is that they provide some sort of community service or public benefit.

Membership Organizations

Social clubs are membership organizations primarily supported by funds paid by their members. The tax exemption of social clubs allows individuals to join together to provide themselves with recreational or social facilities on a mutual basis, without further tax consequences. This is based on the premise that the income sources of the organization are limited to receipts from the membership. Individual members are in substantially the same position as if they had spent their own income on pleasure or recreation without the intervening organization.

Examples of Typical Social Clubs

Typical organizations which may qualify for exemption under IRC section 501(c)(7) are:

- College fraternities or sororities operating chapter houses for students
- Country clubs
- Amateur hunting, fishing, tennis, swimming, and other sport clubs
- Dinner clubs which provide a meeting place, library, and dining room for members
- Ethnic clubs
- Yacht clubs
- Hobby clubs
Organizational Test

| Organizational Requirements | Organizations described in IRC section 501(c)(7) must satisfy various special organizational and operational requirements to maintain their exemption. Currently, social clubs are required to meet two organizational tests:
|                           |   
|                           | • Written discrimination test, and
|                           | • Proper purposes test
|                           | Social clubs are also required to meet an operational test, which will be discussed later in this lesson.

| Written Discrimination Test | Public Law 94-568 (1976-2 C.B. 596) passed on October 20, 1976, added IRC section 501(i), and provides that social clubs are to lose their tax exempt status if their charter, bylaws, or other governing instrument, or any written policy statement, contains a provision which provides for discrimination on the basis of race, color, or religion.

*Continued on next page*
Organizational Test, Continued

Public Law 96-601, enacted December 24, 1980, allows social clubs to retain their exemption even though their membership is limited (in writing) to members of a particular religion if:

- The social club is an auxiliary of a fraternal beneficiary society which is exempt under IRC section 501(c)(8), or
- The social club’s membership limitation is a good faith attempt to further the teachings or principles of that religion, and is not intended to exclude individuals of a particular race or color

A written membership limitation with respect to individuals of a particular national origin or gender will not disqualify the club for exemption.

An affirmative statement of nondiscrimination is not required.

Clubs are not required to have a certain percentage, or even any, of their members from different racial or religious groups.

As long as there are no written restrictions, a club does not violate the discrimination provision.

Clubs can limit their membership by the use of criteria that are not directly related to social or recreational purposes or activities. For example:

- Membership can be restricted to a particular political party, or
- Homeowners in a specific housing development

Continued on next page
Social clubs must be organized for the following purposes:

- Pleasure
- Recreation, and
- Other nonprofitable purposes, similar to pleasure and recreation

In order to be exempt, the club must prove that:

- Its members are bound together by a common objective, and
- The common objective is directed towards pleasure, recreation, and other nonprofitable purposes

Members must be joined by a mutuality of active interests or share goals justifying the existence of the organization. Facts to consider are the conditions for or restrictions upon membership. If there are no prerequisite conditions or limitations imposed on members, the organization cannot possess an identity of purpose that would characterize it as a club.

Examples of social organizations that share a common goal or mutuality of interests are:

- A mineralogical or lapidary society (Rev. Rul. 67-139, 1967-1 C.B. 129)
- A flying club (Rev. Rul. 74-30, 1974-1 C.B. 137)
- Garden clubs (Rev. Rul. 66-179, 1966-1 C.B. 139)

A social club formed to assist its members in their business endeavors through study and discussion of problems and other activities at weekly luncheon meetings, does not qualify for exemption. Any social activities at the luncheon are merely incidental to the business purposes of the organization. (Rev. Rul. 69-527, 1969-2 C.B. 125)

Continued on next page

Social and Recreational Clubs - IRC Section 501(c)(7)

5-6
Organizational Test, Continued

Fellowship, Mutual Interest, and Goals

Although there is no statutory definition of “club” as used in IRC section 501(c)(7), it implies the existence of:

- personal contact
- Commingling, and
- Fellowship among members

Generally, a lack of commingling of members is an indication that the basic purpose of the organization is only to provide personal services and goods to the membership in a manner similar to commercial counterparts. (Rev. Rul. 69-635, 1969-2 C.B. 126)

Specific Example - Commingling

A flying club providing economical flying facilities for its members, but having no organized social and recreational program, did not qualify for exemption because the sole activity of the club was rendering services to its individual members, and there was no significant commingling of its members. (Rev. Rul. 70-32, 1970-1 C.B. 132)

Cases Reserved for EO Technical

Certain internet-based clubs attempt to claim exemption under IRC section 501(c)(7). Such groups inherently lack the “commingling of members” necessary to meet the basic requirements of a social club.

Exemption applications under IRC section 501(c)(7) from organizations whose activities are conducted wholly over the Internet are reserved for processing by EO Technical.

Refer to IRM 7.20.13.4(13)c.
Operational Test

"Substantially All" Test

Prior to PL 94-568 (October 20, 1976), IRC section 501(c)(7) provided exemption for social clubs organized **exclusively** for pleasure, recreation, and other nonprofitable purposes. PL 94-568 substituted **substantially** for **exclusively**. The "substantially all" test is an income test. The limitations are as follows:

- Clubs may receive up to 35% of their gross receipts, including investment income, from sources outside their membership.
- Within the 35% limitation, no more than 15% of gross receipts may be derived from **nonmember use** of club facilities and/or services.

As long as a club’s income sources are within these limits, the club will be considered to be operated substantially for pleasure, recreation, and other non-profitable purposes.

If an organization’s income exceeds one or both of these limitations, then the club may still be able to show through facts and circumstances that "substantially all" of its activities are for pleasure, recreation, and other non-profitable purposes.

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*Social and Recreational Clubs - IRC Section 501(c)(7)*

5-8
Recordkeeping Requirements

Introduction

Rev. Proc. 71-17, 1971-1 C.B. 683, provides the recordkeeping requirements for social clubs. This Revenue Procedure has not been updated to reflect the changes made by PL 94-568. This law modified the proportion of gross receipts from nonmember use of club facilities that a club can receive. Although the Rev. Proc. still shows that 5% is permissible, the allowable percentages have increased to 15% and 35%.

Rev. Proc. 71-17 describes the records required when nonmembers use a club’s facilities and the circumstances under which a host-guest relationship will be assumed.

Gross Receipts Test

When doing the income tests, you must use “total gross receipts” as defined in Rev. Proc. 71-17, section 3.02, as subsequently modified by Public Law 94-568. For this purpose, total gross receipts:

<table>
<thead>
<tr>
<th>Includes...</th>
<th>Excludes...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receipts from normal and usual activities of the club including:</td>
<td>• initiation fees and capital contributions</td>
</tr>
<tr>
<td>• charges</td>
<td>• unusual amounts of income</td>
</tr>
<tr>
<td>• admissions</td>
<td></td>
</tr>
<tr>
<td>• membership fees</td>
<td></td>
</tr>
<tr>
<td>• dues, and</td>
<td></td>
</tr>
<tr>
<td>• assessments</td>
<td></td>
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</tbody>
</table>

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Recordkeeping Requirements, Continued

Facts and Circumstances Test

If a club exceeds the 15/35% test, then it will maintain its exempt status only if it can show through facts and circumstances that "substantially all" of its activities are for "pleasure, recreation, and other nonprofitable purposes."

The Court of Appeals has indicated some factors to consider ([*Pittsburgh Press Club v. US*, 536 F.2d 572, (1976)):

- The actual percentage of nonmember receipts or investment income (As the percentages increase above the permitted levels, the facts and/or circumstances in the organization's favor must increase proportionately to avoid revocation.)
- Frequency of use of club facilities or services by non-members (An unusual or single event that generates all of the nonmember income should be viewed more favorably than nonmember income arising from frequent use by nonmembers.)
- The record over a period of years
- The purpose for which a club's facilities are made available to nonmembers
- Whether or not the nonmember income generates net profits for the organization

Calculating "Net Profits"

To determine a club's net profits from nonmember use of its facilities and services, the Court of Appeals stated that it is proper to charge costs directly attributable to these activities (i.e., variable costs such as cost of goods sold, salaries of employees while assigned to these activities, etc.) against the income derived.

Fixed costs, those which the club's members would have to bear in the absence of nonmember income, such as rent, depreciation, utilities, maintenance, etc., should not be charged against nonmember income for this purpose.

However, a portion of fixed costs would be allocated in the computation of unrelated business income tax.

*Continued on next page*
Identification of income sources is vital to social clubs for the following reasons:

- Exceeding the limitations can result in revocation of exempt status, and
- Any income earned outside of the club’s membership is considered to be unrelated business taxable income

According to IRC section 512(a)(3)(A), all income of social clubs is unrelated business taxable income unless it is exempt function income. Exempt function income is income from members earned from traditional activities. In order to substantiate that their income is from members, social clubs must keep adequate records.

If a club has no records to prove that its income is from members, then the income will be considered to be from nonmembers, and therefore, unrelated business taxable income. If the amount of nonmember income exceeds the limitations, revocation of exempt status can result.

In 1976, PL 94-568 raised the permissible limits of nonmember income that could be received by exempt social clubs. However, the Senate Report stated that it is not “intended that these organizations should be permitted to receive within the 15 or 35 percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations.” (S. Rep. No. 1318, 94th Cong., 2d Sess. 4 (1976), 1976-2 C.B. 597)

This language means that Congress intended that exempt social clubs should not be permitted to receive income from activities not conducted in furtherance of their exempt purposes. Therefore, a club that engages in nontraditional business activity can jeopardize its exempt status. This is true even if the gross receipts are within the permissible limits set out above.

Continued on next page
The Service has made several conclusions about traditional activities:

- They are those types of activities that, if engaged in with members, further the exempt purposes of the social club.
- They may be conducted with members or nonmembers.
- Any income from traditional activities conducted with nonmembers will be considered unrelated business income and subject to tax.

Examples would be the operation of a golf course, bar, or restaurant that is used by club members, their guests or nonmembers.

Nontraditional activities are those, which if conducted on a membership basis, would not further the club's exempt purposes.

GCM 39115 considered nine different activities which may be classified as nontraditional, including:

1. Rental of hotel type sleeping rooms
2. Rental of mini offices
3. Operation of a full service barber shop
4. Take-out food sales
5. Operation of a service station
6. Operation of a parking garage
7. Ticket sales
8. Operation of a liquor store
9. Operation of a flower and gift shop

Continued on next page
Recordkeeping Requirements, Continued

**How Much Is Too Much?**

Rev. Rul. 58-589, 1958-2 C.B. 266, states that a business activity will defeat exemption, unless it is:

- Incidental
- Trivial, or
- Non-recurrent

The Service has interpreted this to mean “insubstantial” for this purpose.

The initial point of analysis is to determine the percentage of gross receipts from the nontraditional activity and compare that amount with the gross receipts of all of the organization’s activities. *A 1994 CPE text suggested a 5% standard,* previous guidance was as follows:

<table>
<thead>
<tr>
<th>Source</th>
<th>Finding</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Santa Barbara Club v. Commissioner,</em></td>
<td>25% was too much</td>
</tr>
<tr>
<td>68 TC 200 (1977)</td>
<td></td>
</tr>
<tr>
<td>GCM 39115</td>
<td>13.7% was too much</td>
</tr>
<tr>
<td>TAM 9212002 (1992)</td>
<td>4.28-6.07% was too much</td>
</tr>
</tbody>
</table>

*Social and Recreational Clubs - IRC Section 501(c)(7)*

5-13

Preventing Subsidies

The Tax Reform Act of 1969 did not amend IRC section 501(c)(7). However, enactment of IRC section 512(a)(3) made clubs only quasi-exempt, because it made them subject to tax on their passive income. Because one of the central purposes of social clubs is to provide benefits such as access to social facilities for members, when such benefits are funded by members, exemption is justified on the theory that the members will be in the same position as if they had paid for the benefits directly.

However, untaxed income, such as interest on investments, operates to subsidize the recreational facilities or activities for members. Thus, the exemption operates properly only if these passive sources of income are taxed to the organization as unrelated business taxable income.

General Rule of IRC Section 512(a)(3)

Clubs are required to include all gross income as unrelated business taxable income unless it is “exempt function income.” Exempt function income, defined in IRC section 512(a)(3)(B), is income:

- That arises out of the exempt activity of the club, plus
- All income, (except unrelated business income as commonly defined for purposes of other kinds of exempt organizations), that is set aside for IRC section 170(c)(4) charitable purposes

The usual sources of income from exempt activities are amounts paid by members for use of the club’s facilities. They consist of:

- Dues
- Fees
- Charges, or

Similar amounts paid by members for:

- Goods
- Facilities, or

Services furthering the exempt purposes of the club, and
Provided to members, dependents, or guests

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Typical Sources of Unrelated Income

<table>
<thead>
<tr>
<th>Typical Sources of Unrelated Income</th>
<th>Typical sources of unrelated income are:</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Non-member use of facilities, including income from reciprocal use of the club</td>
<td></td>
</tr>
<tr>
<td>- Other business activities with non-members</td>
<td></td>
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<tr>
<td>- Investment income, including royalty income</td>
<td></td>
</tr>
<tr>
<td>- Nontraditional business activities</td>
<td></td>
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<tr>
<td>- Sales of property</td>
<td></td>
</tr>
</tbody>
</table>

Social and Recreational Clubs - IRC Section 501(c)(7)
5-15
### Inurement

**More than One Class of Members**

Inurement problems may arise when different classes of membership with varied dues structures are created.

**Examples**

When nonvoting members pay disproportionately more for services and use of facilities than voting members (Rev. Rul. 70-48, 1970-1 C.B. 133)

A difference in dues or fees does not result in inurement if there is a reasonable basis for the difference, such as where the classes of members have different rights to use of club facilities or club assets. *(Pittsburgh Press v. US, 536 F.2d 572 (1976), 579 F.2d 751 (1978), 615 F.2d 600(1980))*

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*Social and Recreational Clubs - IRC Section 501(c)(7)*

5-16
Summary

IRC section 501(c)(7) organizations are social clubs that are primarily supported by members’ funds to provide members with recreational or social facilities.

Social clubs must meet organizational and operational requirements to maintain exemption.

The organizational test has two parts:

1. Written discrimination test – An affirmative statement of nondiscrimination is not required. But social clubs lose their exempt status if their charter, bylaws, or other governing instrument, or any written policy statement, contains a provision which provides for discrimination on the basis of race, color, or religion.

2. Proper purposes test – Members must have a mutuality of active interests or share goals justifying the social club’s existence. Generally, a lack of commingling of members is an indication that the basic purpose of the organization is only to provide personal services and goods.

To meet the operational test, a social club must be operated substantially for pleasure, recreation, and other non-profitable purposes. The “substantially all” is an income test.

Rev. Proc. 71-17 describes the record-keeping requirements when nonmembers use a social club’s facilities and the circumstances under which a host-guest relationship is assumed.
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Lesson 6

Fraternal Organizations
IRC Sections 501(c)(8) and 501(c)(10)

Overview

Introduction

Prior to the Tax Reform Act of 1969, IRC section 501(c)(8) was the only section of the Code under which fraternal organizations could be recognized as tax-exempt. IRC section 501(c)(8) required fraternal organizations to provide for the payment of life, sick, accident, or other benefits for the members of such society, order, or association or their dependents. Many fraternal organizations had ceased providing benefits and could not qualify under IRC section 501(c)(8). The Reform Act of 1969 added IRC section 501(c)(10) to provide tax-exemption for fraternal organizations that did not provide benefits to members.

Some common organizations exempt under IRC sections 501(c)(8) and 501(c)(10) include:

- Knights of Columbus
- Loyal Order of Moose
- Fraternal Order of Eagles
- Fraternal Order of Elks
- Free and Accepted Masons

Continued on next page
Overview, Continued

Objectives

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

- Compare the basic requirements of IRC sections 501(c)(8) and 501(c)(10) organizations
- Define "fraternal" and "operating under the lodge system"
- List the IRC section 501(c)(8) requirements for providing life, sick, accident or other benefits to members
- Identify the requirement of an IRC section 501(c)(10) organization to devote net earnings exclusively to religious, charitable, scientific, literary, and fraternal purposes
- Distinguish the differences of IRC sections 501(c)(8) and (c)(10) from 501(c)(7) social and recreational clubs
- Identify common issues regarding unrelated business taxable income and social activities for IRC sections 501(c)(8) and 501(c)(10) organizations
- List procedural issues for IRC sections 501(c)(8) and 501(c)(10) organizations
- Identify allowable contribution deductibility for IRC sections 501(c)(8) and 501(c)(10) organizations

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Overview, Continued

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<td>Lodge System</td>
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Fraternal Organizations
IRC Sections 501(c)(8) and 501(c)(10)  
6-3
Fraternal Organizations: History, Definitions, and Concepts

History of Fraternal Societies

Fraternal societies have existed in the U.S. at least since the 19th century. They began providing insurance-type benefits to their members around the mid-19th century. Many State laws exempted fraternal societies from insurance regulations, creating an incentive for mutual insurance companies to masquerade as fraternal beneficiary societies. (See GCM 38192 (Dec. 7, 1979); National Union v. Marlow, 74 F. 775 (8th Cir. 1896))

Fraternal beneficiary societies were first exempted from Federal income taxation under section 38 of the Tariff Act of August 5, 1909, 36 Stat. 113 (1909). The 1909 Act exempted “fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident and other benefit to the members...” The Revenue Act of 1913, Pub. L. No. 63-6, section II (G)(a), 38 Stat. 172, extended the exemption to organizations operating “for the exclusive benefit of the members of a fraternity itself operating under the lodge system.”

In its current form, IRC section 501(c)(8) describes fraternal beneficiary societies, orders, or associations operating under the lodge system (or for the exclusive benefit of the members of a fraternity itself operating under the lodge system), and providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association, or their dependents.

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Fraternal Organizations: History, Definitions, and Concepts,
Continued

Fraternal: Definition

The characteristics of a fraternal beneficiary society can be found in *U.S. v. Cambridge Loan and Building Co.*, 278 U.S. 55 (1923), *Commercial Travelers’ Life & Accident Ass’n v. Rodway*, 235 F. 370 (N.D. Ohio 1913), and *National Union v. Marlow*, 74 F. 775 (1896).

The characteristics in *National Union* are:

- The members have adopted the same, or a very similar calling, avocation or profession
- The members are working in union to accomplish some worthy object
- The members have banded together as an association or society to aid and assist one another
- The members promote the common cause, and
- The term “fraternal” combines the pursuit of a common object, calling, or profession which tends to create a brotherly feeling among those who are thus engaged

Common Tie

In *Hip Sing Ass’n, Inc. v. Comm’r*, T.C. Memo. 1982-203, the court found a common tie among members of an association based on their common ethnic background. It also found that members had a common goal to improve their social, moral and intellectual welfare.

Likewise, persons who join together to promote a common interest, such as a particular method of fortune telling, can be said to have a common tie. (See Rev. Rul. 77-258, 1977-2 C.B. 195) However, mere recitation of common ties in the governing instrument is not enough; there must be a common tie in fact among the members.

Continued on next page

Fraternal Organizations
IRC Sections 501(c)(8) and 501(c)(10)
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While social activities often play a significant role in a fraternal society, the requirement of a common “calling, avocation or profession” or “pursuit of a common object” is not satisfied merely by the presence of social activities alone.

The court in *Polish Army Veterans Post 147 v. Comm'r*, 24 T.C. 891, rev'd on other grounds, 236 F.2d 509 (3rd Cir. 1956) concluded that an organization had not established its exemption as a fraternal beneficiary society because members lacked a common tie:

To qualify for the exemption an organization must be fraternal... Here only the active members, comprising less than 10 per cent of the total membership of the Post, had a common tie. They, of course had the bond of having formerly served in the Polish Army. But approximately 90 per cent of the total membership of the Post were social members who were not ex-members of the Polish Armed Forces and who ... had nothing in common with the active members or with each other. An organization cannot be classed as fraternal where the only common bond between the majority of the members is their membership in that organization.

Even if the members of an organization enjoy a common tie or goal, the organization does not serve a fraternal purpose unless its members engage in fraternal activities. The court in *Philadelphia and Reading Relief Ass'n v. Comm'r*, 4 B.T.A. 713 (1926) cited “rituals, ceremonial, and regalia” as evidence of a fraternal purpose. Social activities are another common element of fraternal organizations.

A lodge’s performance of civic, benevolent, or charitable functions may serve to establish a fraternal purpose in lieu of regular meetings and rituals. But an organization whose fraternal features are so insubstantial as to make it indistinguishable from an ordinary insurance company does not qualify under IRC section 501(c)(8). (See GCM 34607 (Sept. 13, 1971))
Fraternal Organizations: History, Definitions, and Concepts,
Continued

Fraternal Activities and Benefits Must Be Primary

A fraternal beneficiary society that is described in IRC section 501(c)(8) by virtue of engaging in fraternal activities and providing for the payment of life, sick, or accident benefits to its members may not then engage in unlimited non-fraternal activities or provide unlimited non-fraternal benefits and still maintain its exempt status.

The non-fraternal activities and non-fraternal benefits of a fraternal beneficiary society will result in the organization’s loss of exempt status unless the organization remains primarily engaged in fraternal activities and its benefits are primarily fraternal benefits. (See GCM 38312 (Mar. 20, 1980); compare Rev. Rul. 73-165, 1973-1 C.B. 224, discussed later under IRC section 501(c)(8) “Fraternal Activities Needn’t Predominate Over Provision of Benefits.”)

Such non-fraternal activities and benefits may be taxable as an unrelated business.

Political Activity is Not Fraternal

Political activity is not considered a fraternal activity. But engaging in political activity does not, in and of itself, give rise to revocation of exemption. Therefore, a fraternal beneficiary society, so long as it is primarily engaged in fraternal activities and the provision of benefits to its members and their dependents within the meaning of IRC section 501(c)(8), may engage in some political activities, including intervention in political campaigns on behalf of, or in opposition to, candidates for public office, without jeopardizing its exempt status. (See GCM 34985 (Aug. 10, 1972)) Nevertheless, the organization would be subject to tax on its political expenditures under IRC section 527(f).

“Union-like” activities that relate to the members’ working conditions are not fraternal activities. (See GCM 38312)

Further Guidance

Refer to IRM 7.25.8, Fraternal Beneficiary Societies, for additional background and history concerning IRC sections 501(c)(8) and 501(c)(10).
Lodge System

"Operating under the lodge system" means carrying on its objectives under a form of organization that comprises local branches chartered by a parent organization and largely self-governing entities such as chapters or lodges.

The term "operating under the lodge system" implies, at a minimum, two active entities:

(1) A parent; and

(2) A subordinate (referred to as a "lodge")

The court in Fraternal Order of Civitans of America v. Comm'r., 19 T.C. 240 (1952), held that an organization, incorporated in 1937, whose members voted in 1946 to separate the "National Lodge" from the parent lodge and elect national officers, was not "operating under the lodge system" prior to 1946 "in that the petitioner was the only organization of its kind in existence and the record does not show that there was any 'parent organization' separate from the petitioner."

Rev. Rul. 55-495, 1955-2 C.B. 259, establishes that an organization separately organized and operated cannot be tax exempt under IRC section 501(c)(8) because it does not operate under the lodge system, but that such an organization can qualify under IRC section 501(c)(4).

Rev. Rul. 75-199, 1975-1 C.B. 160, modified the above revenue ruling stating that an otherwise fraternal organization not operating under the lodge system will not qualify under IRC section 501(c)(4).

Rev. Rul. 63-190, 1963-2 C.B. 212, held that a nonprofit organization (not operated under the lodge system), which maintains a social club for members and also provides sick and death benefits for members and their beneficiaries, does not qualify for exemption from Federal income tax either as a social club under IRC section 501(c)(7), a civic league under IRC section 501(c)(4), or a fraternal beneficiary society under IRC section 501(c)(8).

Continued on next page
Lodge System, Continued

“Lodge System” Defined

Treas. Reg. 1.501(c)(8)-1 provides that a fraternal beneficiary society is exempt from tax only if it is operated under the “lodge system” or for the exclusive benefit of the members so operating. An organization is “operating under the lodge system” if it is carrying out its activities under a form of organization that comprises local branches called lodges, chapters, and the like. The local branches must be chartered by a parent organization and largely self-governing. An exception applies to an organization that provides benefits to the members of a lodge (See Rev. Rul. 73-192, 1973-1 C.B. 224, discussed in further detail in IRC section 501(c)(8) of this lesson).

The court in Western Funeral Benefit Ass’n v. Hellmich, 2 F.2d 367 (E.D. Mo. 1924), stated that “by the ‘lodge system’ is generally understood as an organization which holds regular meetings at a designated place, adopts a representative form of government, and performs its work according to ritual.” Thus, an organization that provides insurance to members of 80 to 100 lodges or organizations is not, for that reason, itself operated under the lodge system, though it may qualify for IRC section 501(c)(8) exemption as operated for the exclusive benefit of members of a lodge system. However, a former regulation defining a fraternal beneficiary society as having “an adopted ritual or ceremonial, holding meetings at stated intervals” is no longer in force. (See also GCM 34607)

A Lodge Can Create Its “Parent” and Form Other Lodges

Each lodge operating under the lodge system must be recognized as a subordinate by a parent. But that does not mean that a new lodge must be created by the parent. It is possible for existing lodges to create additional lodges. In Rev. Rul. 73-370, 1973-2 C.B. 184, an organization was formed by a lodge of a fraternal beneficiary society to carry out the activities of the society within a particular geographic area. The parent authorized the local lodges to create subordinate organizations to carry its fraternal and charitable activities into additional geographical areas. The new organization operates under a charter from the local lodge, and its members must adhere to the rules and regulations of the local lodge and the laws and edicts of the parent. See also Hip Sing Association, Inc. v. Comm’r, T.C. Memo 1982-203, that describes existing autonomous organizations that chose to operate under the lodge system by banding together and creating their own parent.

Fraternal Organizations
IRC Sections 501(c)(8) and 501(c)(10)
IRC Section 501(c)(8)

Specific Requirements

There are two key elements that must be present in an IRC section 501(c)(8) organization:

1. “lodge system” and
2. “benefits”

The organization must meet the following criteria:

- The organization must operate under the lodge system or for the exclusive benefit of members of a fraternity itself operating under the lodge system.
- The organization must provide for the payment of life, sick, accident or other benefits to members and their dependents.
- It is not required that either of these requirements be dominant.
- Both features must be substantially present and neither element can be a sham.

Benefits Are Required

To be described in IRC section 501(c)(8), an organization must have an established system for the payment to its members, or their dependents, of life, sick, accident, or other benefits. Rev. Rul. 76-457, 1976-2 C.B. 155, holds that an arrangement with independent insurers whereby members, on an individual application to the insurers and not automatically by virtue of membership in the organization, may obtain insurance at reduced cost does not qualify as an established system for the payment of benefits to members. However, the organization need not itself provide for insurance benefits if a parent entity or separately organized insurance branch (discussed later) provides the benefits.

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IRC Section 501(c)(8), Continued

Benefits

Keep in mind that one requirement for tax-exempt status under IRC section 501(c)(8) is to provide benefits to members. Some things to remember when reviewing an application for exemption under IRC section 501(c)(8) are:

- There must be an established system for the payment of life, sick, accident, or other benefits to the members or their dependents, but
- There is no requirement that every member receive or be eligible to receive these benefits.

Fraternal Activities

Rev. Rul. 73-165, 1973-1 C.B. 224, holds that, as between fraternal purposes and the provision of benefits, fraternal purposes need not predominate. It is sufficient if both the fraternal and benefit features are present. However, an association whose fraternal features are so insubstantial as to make it indistinguishable from an ordinary life insurance company does not qualify for exemption under IRC section 501(c)(8).

In Philadelphia and Reading Relief Ass'n v. Comm'r, 4 B.T.A. 713 (1926), the court held that an organization of railroad company employees that made payments to members who became disabled because of accident or sickness was not entitled to exemption because it was not "fraternal":

In dealing with cases coming under [the section of the Revenue Act concerning fraternal beneficiary societies] the character of the organization must be judged by its articles of incorporation, constitution, and by-laws, or by what other instrument it is governed.... Search the petitioner's governing regulations as we may ... we are unable to discover ... a single fraternalistic feature in its organization. It is entirely without social features. Its membership is made up of individuals whose vocations are as numerous and diverse as the classifications of employment of a great railway system.... There is no fraternal object which moves them to seek membership in the Association, but rather the motive is mercenary. The petitioner has neither lodges, rituals, ceremonial, or regalia; and it owes no allegiance to any other authority or jurisdiction.

Continued on next page
Most Members Must Be Eligible for Benefits

An organization that provides benefits to some, but not all, of its members may qualify for exemption under IRC section 501(c)(8) so long as most of the members are eligible for benefits.

Dual Memberships

It is not uncommon when reviewing an application for exemption from an IRC section 501(c)(8) fraternal organization to see more than one class of membership. The most common example of this would be “regular” members that have full benefits and pay higher dues and “social” members that have limited benefits and pay lower dues.

Rev. Rul. 64-194, 1964-2 C.B. 149, describes an exemption under IRC section 501(c)(8) that is not precluded where most of the members of the organization are eligible to receive the benefits provided by the organization and the benefits are paid from a separate fund maintained solely by contributions paid by the beneficial members for that purpose. In this case, the organization has two classes of membership: beneficial and social.

Beneficial membership is available only to a member who joins the organization prior to his fiftieth birthday, and entitles the member to sick, accident, and death benefits. Social membership is available to any member, but is the only class of membership available to a member who joins the organization on or after the member’s fiftieth birthday. Social membership carries all club privileges, but does not confer any sick, accident, or death benefits. Substantially all of the members are beneficial members. The fund from which benefits are paid to beneficial members is contributed to solely by beneficial members and is separated from the general funds of the organization. The ruling finds the age restriction on beneficial membership to be a reasonable means to discourage membership by those interested more in obtaining benefits than in furthering the fraternal purposes of the organization.

The Court held in Polish Army Veterans Post 147 v. Comm’r that “an organization does not qualify as a ‘beneficiary’ society where most of its members are not entitled to receive any benefits.” In this case, only ten percent of the membership were “active members” and entitled to benefits.
When encountering a dual membership situation, the aspects of both the *Polish Army Veterans Post* and Revenue Ruling 64-194 may have to be considered.

In any review of an application for exemption submitted by an IRC section 501(c)(8) organization that has dual membership the specialist will want to determine the ratio between members receiving benefits and social members who receive no benefits.

If it appears questionable as to why there are such a large number of social members the specialist will need to determine and document the organization's reasons for the disparity.

As explained in Rev. Rul. 73-192, 1973-1 C.B. 224, an organization can be exempt under IRC section 501(c)(8), even if it does not operate under the lodge system, if it operates exclusively for the benefit of the members of another fraternal beneficiary society that does operate under the lodge system. Such organizations are understood to be separately organized insurance branches of fraternal societies.

The separately organized insurance branch need not benefit all the members of a lodge system. For instance, it may serve the members of a single lodge. The organization in Rev. Rul. 73-192 had as its sole purpose and activity to provide for the payment of life, sick, and accident benefits exclusively for members and dependents of a separately organized lodge. The lodge is a fraternal beneficiary society operating under the lodge system. Although the organization does not operate under the lodge system, it operates exclusively for the benefit of the members of a fraternal beneficiary society itself operating under the lodge system. Accordingly, it was held that the organization is exempt from Federal income tax under IRC section 501(c)(8) of the Code.
"Primary Activities" Test Inapplicable

The requirement that separately-organized insurance branches operate exclusively for the benefit of members of a fraternity operating under the lodge system may be regarded as an exception to the "primary activities" test set forth in GCM 38312. Such insurance branches should not be authorized to provide benefits to persons that are not members of a fraternity operating under the lodge system. (See GCM 35639)

Types of "Life, Sick, Accident, or Other Benefits"

Rev. Rul. 86-75, 1986-1 C.B. 245, holds that whole life insurance constitutes a "life benefit" under IRC section 501(c)(8) even though the member may borrow against the cash surrender value of the contract or withdraw the cash surrender value and terminate the contract.

Is property insurance a permissible benefit under IRC section 501(c)(8)? In Grange Insurance Ass'n of California v. Comm'r, 317 F.2d 222 (9th Cir. 1963), reversing 37 T.C. 582 (1961), the Ninth Circuit disagreed with the Tax Court's position that "accident insurance" refers only to bodily injury. Instead, the Ninth Circuit concluded that "'accident' benefits include payment for damage to property quite as naturally as payment for injury to the person" and, therefore, "the statutory phrase 'accident or other benefits' is sufficiently broad to include payments for injuries to property as well as to the person."

In considering the purpose of the exemption, the Ninth Circuit stated, "the moving consideration was the character and purpose of the organization. Nowhere have we found any indication that Congress intended the exemption to depend upon the type of benefits paid."

The Service indicated an intent not to follow Grange outside of the 9th Circuit in its holding that property insurance benefits are "accident or other benefits."

In order for a benefit to be included within the term "other benefits," it must be similar in nature to protection designed to compensate for expenses resulting from injury or loss of earning power. "Other benefits" may include a legal defense fund for charges of misconduct arising from employment (Rev. Rul. 84-48, 1984-1 C.B. 133), an orphanage for surviving children of deceased members (Rev. Rul. 84-49, 1984-1 C.B. 134), and annuities (GCM 39575 (Nov. 18, 1986)).

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IRC Section 501(c)(8), Continued

The phrase “life, sick, accident or other benefits” also appears in IRC section 501(c)(9) to describe permissible benefits provided by voluntary employees' beneficiary associations. In GCM 35639, the Service decided that IRC section 501(c)(8) interpretations of the phrase “life, sick, accident, or other benefits” need not be construed consistently with IRC section 501(c)(9) interpretations. Not only did the earliest predecessor of IRC section 501(c)(8) antedate the enactment of the predecessor of IRC section 501(c)(9) by some 19 years, the history and development of the organizations covered by the respective sections is sufficiently different to justify different interpretations, particularly of the scope of the phrase “other benefits” under the two sections. (See also GCM 39212 (April 13, 1984))

Details concerning IRC section 501(c)(9) are reserved for more advanced training, as they are currently classified as Grade 12 issues under the most recent revision of the Case Assignment Guide (CAG).

Participation in Reinsurance Pool Not Prohibited

Rev. Rul. 78-87, 1978-1 C.B. 160, holds that an organization does not endanger its exempt status under IRC section 501(c)(8) by participating in a state sponsored reinsurance pool. Where the organization participates in the best interests of its members, any benefit to the other participating insurers is incidental, and the organization does not fail to operate for the “exclusive benefit” of the members.

May Not Serve Non-Fraternity Organizations

In Western Funeral Benefit Ass'n v. Hellmich, the Plaintiff argued that it was carrying on its activities for the exclusive benefit of the members of many fraternities operating under the lodge system. However, the court found that Plaintiff accepted business from organizations “without any particular inquiry into the nature of the organizations or the manner in which they carried out their business.” The court held that the Plaintiff was not operating for the exclusive benefit of the members of a fraternity itself operating under the lodge system.

Fraternal Organizations
IRC Sections 501(c)(8) and 501(c)(10)
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IRC Section 501(c)(10)

**History of the Statute**

IRC section 501(c)(10) was added to the Internal Revenue Code by the Tax Reform Act of 1969, Pub. L. No. 91-172, section 121(b)(5)(A) (1969), 83 Stat. 487, 541. Prior to that, there was no exemption provided for fraternal societies operating under the lodge system that did not, in addition to their fraternal activities, also provide for the payment of life, sick, and accident benefits to their members.

The Senate Committee on Finance explained the purpose of IRC section 501(c)(10) as follows:

>[A] new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system where the fraternal activities are exclusively religious, charitable, or educational in nature and no insurance is provided for the members. The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members. This more properly describes the different types of fraternal associations. S. Rep. No. 552, 91st Cong., 1st Sess. 72 (1969).

**Primary Differences From IRC section 501(c)(8)**

There are two primary distinctions between organizations described under IRC section 501(c)(10) and 501(c)(8):

- An IRC section 501(c)(10) organization does **not** provide benefits to members.

- Exemption under IRC section 501(c)(10) only applies to "domestic" organizations and therefore, only groups that are organized and operated in the United States can qualify under this section.

IRC section 501(c)(10) organizations are prohibited from providing insurance benefits to their members; therefore, it stands to reason that there is no counterpart under IRC section 501(c)(10) for the separately organized insurance branches found under IRC section 501(c)(8). Any organization purporting to operate for the exclusive benefit of the members of an IRC section 501(c)(10) organization and does not itself conduct fraternal activities or operate under the lodge system would not qualify under IRC section 501(c)(10). (Rev. Rul. 81-117, 1981-1 C.B. 346)

Continued on next page
IRC Section 501(c)(10), Continued

Benefits to Other Organizations
IRC section 501(c)(8) explicitly exempts organizations that are operated for the exclusive benefit of members of other IRC section 501(c)(8) organizations. IRC section 501(c)(10) does not refer to organizations operated for the “exclusive benefit” of members of other IRC section 501(c)(10) organizations.

Legislative history indicates that the “exclusive benefit” category was intended to grant exemption only to separate organizations providing payment of life, sick, and accident benefits. The Service position is that “exclusive benefit” organizations should not be exempt under IRC section 501(c)(10) because they are not specifically described in that section, and because insurance benefits are not available under IRC section 501(c)(10).

Written Purposes
Unlike IRC section 501(c)(8), IRC section 501(c)(10) provides in writing a list of purposes for which fraternal organizations or societies must operate.

Those purposes are:

- Religious
- Charitable
- Scientific
- Literary
- Educational, and
- Fraternal

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Fraternal Organizations
IRC Sections 501(c)(8) and 501(c)(10)
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A separately organized organization, created by a lodge exempt under IRC section 501(c)(10) can be exempt under IRC section 501(c)(10), if it is shown that it is itself operated under the lodge system.

Rev. Rul. 73-370, 1973-2 C.B. 184, recognizes a separate organization created by a local lodge of a fraternal society to carry on fraternal and charitable activities on their behalf in a certain geographical area as tax-exempt under IRC section 501(c)(10).
## IRC Sections 501(c)(8) and 501(c)(10) Comparison

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<td>• Must be fraternal</td>
<td>• Must be fraternal</td>
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<td>• Must operate under the lodge system or for the exclusive benefit of members of a fraternity itself operating under the lodge system</td>
<td>• Must operate under the lodge system</td>
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<td>• Must provide for the payment of life, sick, accident or other benefits for the members of such society, order, or association or their dependents</td>
<td>• The net earnings must be devoted exclusively to fraternal purposes or to purposes that would be considered exempt purposes under IRC section 501(c)(3)</td>
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<td>• Must be a domestic organization</td>
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Fraternal Organizations vs. Social and Recreational Clubs

IRC Sections

501(c)(8)/(c)(10)

vs.

501(c)(7)

IRC section 501(c)(7) describes clubs organized for pleasure, recreation, and other non-profitable purposes. Such “social clubs” offer activities that are often similar to the social activities conducted by fraternal beneficiary organizations. Social clubs are distinguishable from IRC sections 501(c)(8) and (c)(10) organizations, however, in that they are generally not operated under the lodge system. Treas. Reg. 1.501(c)(10)-1 specifically excludes social clubs described in IRC section 501(c)(7) from exemption under IRC section 501(c)(10).

Exemption under IRC sections 501(c)(8) and (c)(10) is considered more desirable than exemption under IRC section 501(c)(7). For one thing, an IRC section 501(c)(8) or (c)(10) organization is not subject to the IRC section 501(c)(7) percentage limitations on non-member and investment income. For another, an IRC section 501(c)(8) or (c)(10) organization is not subject to IRC section 512(a)(3) which imposes special rules on unrelated business taxable income for IRC section 501(c)(7) organizations.

College Fraternities

Although college fraternities are often operated under a lodge system, they are specifically excluded by Treas. Reg. 1.501(c)(10)-1 from qualifying under IRC section 501(c)(10).

In Zeta Beta Tau Fraternity, Inc. v. Comm'r, 87 T.C. 421 (1986), an IRC section 501(c)(7) local chapter of a national fraternity sought exemption from tax on its investment income by changing its classification to a fraternal society under IRC section 501(c)(10). The court held that the possibility of using tax-free investment income for recreational purposes would violate Congressional intention in framing IRC section 501(c)(10) and that the regulation is a reasonable interpretation of the statute. (See also GCM 37179 (June 24, 1977) and GCM 39378 (June 26, 1985))
Unrelated Business Taxable Income and Social Activities

Social and Recreational Activities: Member Participation

Organizations described in IRC sections 501(c)(8) and 501(c)(10) are subject to tax on their unrelated business taxable income (UBTI) under IRC section 511. Fraternal organizations have traditionally engaged in social and recreational activities to complement their purely fraternal activities.

The operation of a bar, restaurant, or general meeting hall is an accepted social and recreational activity in which fraternal organizations may engage.

In addition, gambling, to the extent that fraternal members participate, is considered recreational in nature and a suitable activity of fraternal organizations. (Rev. Rul. 69-68, 1969-1 C.B. 153, holds that gambling (even if illegal) is a proper activity for social clubs exempt under IRC section 501(c)(7) because it supplies pleasure and recreation to members and guests, even if it has an additional purpose of raising money.)

Sale of Alcoholic Beverages

The sale of alcoholic beverages to members for consumption on the premises is considered to be related to the purposes of a fraternal organization. On the other hand, the sale of alcoholic beverages to members for consumption off the premises should be considered an unrelated trade or business. (See TAM 8641001 (June 5, 1986))

Use of Facilities by Non-Members

When a fraternal organization allows or solicits non-members to make use of its social and recreational facilities, there is the potential for the fraternal organization to exceed the bounds of its exemption.

This is especially the case where the activity is of a continuous or recurring nature, such as the operation of a bar and restaurant. If the bar or restaurant is opened to the public, and, over time, is generally known to be available to the public, it risks becoming a regular commercial business.

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Fraternal Organizations

IRC Sections 501(c)(8) and 501(c)(10)
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Participation of Non-Members

A fraternal organization may provide social and recreational activities to its members. Guests of members may also participate in the organization's activities or make use of its facilities so long as the guest is being entertained by the member. However, a non-member is not being "entertained" merely because he or she accompanies a member.

When non-member "guests" spend their own funds to participate in gambling activities operated by fraternal organizations, they are not being entertained by the member. If a non-member incurs a charge to participate in a social or recreational event or to make use of a social or recreational facility, the nonmember is considered to be entertained by a member only if the member pays the charge.

Thus, when a guest gambles with his own money, the fraternal organization is providing recreational activities directly to a non-member rather than as a service to members. When a fraternal organization provides recreational activities, such as gambling, to non-members directly, those activities do not have a substantial causal relationship to the organization's exempt purpose of providing social and recreational activities to the member. As a result, the activity may be considered an unrelated trade or business. (See Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Comm'r, T.C. Memo. 1981-546)

Further, under certain circumstances, gambling activity may essentially be a predominantly public activity and only incidentally a member activity, such as when 80 percent of the receipts of gambling come from non-members who are not even participating as guests of members but simply as members of the public. In that case, the entire activity, including participation by members, would be considered unrelated trade or business because the gambling is not being conducted primarily as a recreation for members. (See GCM 39061 (Nov. 21, 1983))
Unrelated Business Taxable Income and Social Activities, Continued

**Hall Rental Income**

Fraternal organizations commonly raise funds through hall rental and catering. The rental of the hall itself, while an unrelated trade or business if regularly carried on, may meet the exception to unrelated business taxable income (UBTI) for rents from real property under IRC section 512(b)(3). (Rev. Rul. 69-178, 1969-1 C.B. 158)

However, payments for the use of rooms or other space are not rents where services are also rendered to the occupant, if the services are primarily for the occupant's convenience and are not usually rendered in connection with the rental of rooms for occupancy only. (See Treas. Reg. 1.512(b)-1(c)(5); Rev. Rul. 69-69, 1969-1 C.B. 159)

**Catering is Unrelated Business Income**

Catering is a service primarily for the occupant's convenience and not usually rendered in connection with the rental of rooms for occupancy only. However, the catering may be analyzed separately from the rental of space if there is a separate charge paid in accordance with a separate agreement between the parties. Income from catering incidental to the hall rental would be taxable as unrelated trade or business income if volunteer labor is not employed in the provision of services and the catering is regularly carried on. (TAM 9605001 (Feb. 2, 1996))
Deductible Contributions

Contributions

IRC section 170(c)(4) permits a deduction for contributions made to a fraternal organization provided that such contributions are used exclusively for religious, charitable, scientific, literary, or educational purposes, or the prevention of cruelty to children or animals.

Note: In order for a contribution to be deductible, the organization must maintain a separate account to show that all solicited contributions were received and disbursed to carry out such purposes.
Procedural Issues

General Issues

IRC sections 501(c)(8) and IRC 501(c)(10) organizations operate under the lodge system, and as a consequence display certain characteristics that are not commonly found in other types of exempt organizations.

The relationship of the parent to its subordinate lodges is responsible for many of the distinctive characteristics, and also raises issues in the following areas:

- Applications for recognition of exemption
- Group exemptions
- Filing requirements

Recognition of Exemption—No Deadline for Application

Organizations that claim exemption under IRC section 501(a) are subject to the general requirement to file a Form 1024 application in order to establish their exemption. Treas. Reg. 1.501(a)-1(a)(2) and (3).

There is no deadline imposed by the Code for a fraternal beneficiary society or a domestic fraternal society to apply for recognition of exemption under IRC sections 501(c)(8) or 501(c)(10).

Change to Another Code Section May Be Appropriate

An organization that is recognized as exempt as an organization described in IRC section 501(c)(8) but that is found to no longer provide life, sick, accident, or other benefits, should be considered for reclassification under IRC section 501(c)(10) so long as it is operating under the lodge system and otherwise meets the requirements of IRC section 501(c)(10). Such reclassification would require submission of Form 1024 and the appropriate user fee.

Continued on next page
Procedural Issues, Continued

Group Exemptions

While an individual lodge may file an application for recognition of exemption on its own behalf, it is common for the fraternal parent organization to apply for a group exemption covering its subordinate lodges.

Requests for group exemptions must follow the specific guidelines contained within Rev. Proc. 80-27, 1980-1 C.B. 677, and are reserved for particular specialists to process. If it appears that the applicant is requesting a group exemption in addition to its individual exemption, the case should be worked in conjunction with the group request. Discuss the case with your manager for case reassignment to the reserved group ruling inventory.

Filing Requirements and Insurance Premiums as Gross Receipts

Generally, exempt organizations are required to file annual information returns (Form 990) based on the level of their annual gross receipts.

In determining whether their gross receipts reach the threshold, a lodge may disregard insurance premiums received from members in certain instances. Rev. Rul. 73-364, 1973-2 C.B. 393, holds that the insurance premiums are not gross receipts where the parent organization operates the insurance program and issues policies to the individual members, and the local lodge merely collects the premiums and forwards the premiums to the parent, without asserting any right to use them or otherwise deriving benefit from their collection.
Summary

IRC section 501(c)(8) describes fraternal beneficiary societies, orders, or associations operating under the lodge system providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association, or their dependents.

“Operating under the lodge system” means carrying on its objectives under a form of organization that comprises local branches chartered by a parent organization and largely self-governing entities such as chapters or lodges.

To be described in IRC section 501(c)(8), an organization must have an established system for the payment to its members, or their dependents, of life, sick, accident, or other benefits.

An organization that provides benefits to some, but not all, of its members may qualify for exemption under IRC section 501(c)(8) so long as most of the members are eligible for benefits.

There are two primary distinctions between organizations described under IRC section 501(c)(10) and 501(c)(8):

1. An IRC section 501(c)(10) does not provide benefits to members.

2. Only groups that are organized and operated in the United States can qualify for exemption under IRC section 501(c)(10).

Organizations described in IRC sections 501(c)(8) and 501(c)(10) are subject to tax on their unrelated business taxable income.

Operating a bar, a restaurant, and gambling facilities for use by members and their guests are exempt activities of fraternal organizations because they further the exempt purpose of providing members with social and recreational activities. However, when such activities are available directly to non-members, the activities do not have a substantial causal relationship to a fraternal organization’s exempt purpose and, therefore, may be unrelated trade or business.
Lesson 7

Cooperative Mutual Companies
IRC Section 501(c)(12)

Overview

Introduction
IRC section 501(c)(12) provides exemption from Federal income tax for:

- Benevolent life insurance associations of a purely local character
- Mutual ditch or irrigation companies
- Mutual or cooperative telephone companies
- Cooperatives that provide electric services

"Like organizations," but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

The purpose of an IRC section 501(c)(12) organization is to provide certain services to its members at the lowest possible cost.

To qualify for and maintain exemption under IRC section 501(c)(12), a cooperative must receive 85 percent or more of its income each year from members. The income must be collected solely to meet the cooperative’s losses and expenses.

The CPE for FY 2002 includes an article that discusses general cooperative principles and rules governing IRC section 501(c)(12) cooperatives, the history and current issues. The requirements for exemption under IRC section 501(c)(12) are also found in IRM 7.25.12.

Continued on next page
Overview

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

- Name the three requirements to qualify for IRC section 501(c)(12)
- Identify benevolent life insurance associations
- Determine if life insurance associations are “purely local in character”
- Identify mutual and cooperative organizations
- Describe the characteristics of mutual and cooperative organizations
- Define "operating on a cooperative basis"
- Compute the "income source" test
- Identify reserves and determine the purpose and necessity of reserves
- Recognize potential sources of unrelated business income (UBI)

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IRC Section 501(c)(12)
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Requirements for Exemption Under IRC Section 501(c)(12)

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| Mutual or Cooperative | To be exempt under IRC section 501(c)(12), an organization must be operated on a mutual or cooperative basis - an association of persons or organizations banded together to provide themselves a mutually desired service approximately at cost and on a mutual basis. This distinction will come into play when applying the activities test and the operational and organizational test. |
Activities Test

IRC section 501(c)(12) describes four specific categories of organizations that can qualify for exemption:

- Benevolent life insurance associations
- Mutual ditch or irrigation companies
- Cooperatives that provide telephone services, and
- Cooperatives that provide electric services

IRC section 501(c)(12) also provides for a fifth category, “like organizations,” that is not defined in the Code or the regulations. So, an organization’s activities are crucial in determining qualification for exemption under IRC section 501(c)(12).

A benevolent life insurance association provides life insurance coverage to members under an assessment plan, but it cannot issue policies for stipulated premiums.

However, it may require advance deposits or assessments to cover future losses and expenses and still be exempt if:

- It meets the 85 percent of income test at all times, and
- It returns to the members any excess of receipts not needed to pay losses and expenses. (Treas. Reg. 1.501(c)(12)-1(a))

Providing life insurance to members is an IRC section 501(c)(12) activity if restricted to a single identifiable locality. That is, the association must be “of a purely local character.”

Treas. Reg. 1.501(c)(12)-(1)(b) provides that the phrase “of a purely local character” applies only to benevolent life insurance associations and any organization seeking exemption on the grounds that it is similar to a benevolent life insurance association.

Continued on next page
Activities Test, Continued

**“Local In Character” Defined**

A mutual life insurance association is local in character if its business activities are confined to a particular community, place, district, or locality irrespective of political subdivisions. (Treas. Reg. 1.501(c)(12)-(1)(b))

Whether a benevolent life insurance organization satisfies this condition is an issue of facts and circumstances. Factors that indicate a life insurance company is not of a purely local character include members are in several localities or soliciting business in several cities or nationwide.

**Factors to Look For**

Consider the following when trying to determine whether a mutual life insurance association is local in character:

- Where do the members reside?
- In what city, county, or state does the cooperative conduct its insurance activities?
- In what area does it solicit its business? Does it include more than one locality or city?
- In which state is it licensed to do business?
- Does the cooperative refuse applications for membership from outside its area of operation?
- Do the Bylaws limit its business activity within a particular locality?
- Is there a state law limiting insurance cooperatives to operate within a certain area?

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Cooperative Mutual Companies

IRC Section 501(c)(12)

7-5
Activities Test, Continued

Examples of "Local in Character" - Favorable and Adverse

An association limited only by the borders of a state cannot be considered local in character. However, a community which covers a portion of more than one state could qualify for exemption. (Rev. Rul. 64-193, 1964-2 C. B. 151, and Treas. Reg. 1.501(c)(12)-1(b))

An association was considered not exempt when it operated in 14 counties. *Hardware Underwriters and National Hardware Services Corp. v. U.S.*, 65 Ct. Cl. 267 (1928).

An association that does not terminate the membership of a member who moves out of the local area in which the association operates is still considered to be of a purely local character and may qualify for exemption. (Rev. Rul. 83-43, 1983-1 C. B. 108)
Activities Test, Continued

Examples of "Local in Character" - Favorable and Adverse (continued)

An association was considered not of a purely local character when it conducted business in a 32-county area that included three separate metropolitan trade centers, even though 99.6 percent of all policies sold were issued to residents of a local rural area in the vicinity of the home office. (Rev. Rul. 64-193, 1964-2 C.B. 151)

Other Considerations

A copy of each type of policy issued by the organization should be included with the application for exemption.

These organizations include those that, in addition to paying death benefits, also provide for the payment of sick, accident, or health benefits. However, an organization that pays only sick, accident, or health benefits (but not life insurance benefits), is not an organization similar to a benevolent life insurance association.

Applications under IRC section 501(c)(15) from small insurance companies or associations, as well as applications involving IRC section 501(m) (provision of commercial-type insurance), are reserved for EO Technical (IRM 7.20.1.3.4).

Additionally, managed care purchasing organizations (i.e. insurance companies and community groups to set health care rates and enroll participating employers), are subject to mandatory review (IRM 7.20.5.4(3)).

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Cooperative Mutual Companies
IRC Section 501(c)(12)
7-7
Activities Test, Continued

**Mutual and Cooperative Organizations Qualifying Activities**

Certain mutual or cooperative companies and "like organizations" may be exempt under IRC section 501(c)(12) regardless of the area they serve. These organizations are not required to be of a "purely local character."

- **Mutual ditch or irrigation companies** – cooperatives that operate a ditch or irrigation water system. The Code and regulations do not define ditch or irrigation, but the common meaning of both is to bring, channel, or control water to or away from land.

- **Telephone service providers** – cooperatives that provide telephone services include both local and long distance service. Telephone companies may be exempt under IRC section 501(c)(12) regardless of the area they serve.

- **Electric service providers** – cooperatives that provide electricity to members.

**"Like Organizations"**

Rev. Rul. 65-201, 1965-2 C.B. 170, holds that a "like organization," as used in the statutes, is limited by the type of organizations specified in the statute.

The term "like organizations" is applicable only to those mutual or cooperative organizations which are engaged in activities similar in nature to the type of service or business customarily conducted by the specified organizations (benevolent life insurance, mutual ditch or irrigation, etc.)

The following are examples of "like organizations."

"Like" benevolent life insurance companies – Providing burial and funeral benefits has been held to be within the definition of "like activities" similar to providing benevolent life insurance. *Thompson v. White River Burial Association*, 178 F.2d 954 (8th Cir. 1950).

"Like" ditch or irrigation services – Exemption has been granted to an association organized for the protection of riverbanks against erosion whose only income consisted of assessments against the property owners concerned. (Rev. Rul. 68-564, 1968-2 C.B. 221)

Continued on next page
Activities Test, Continued

"Like Organizations" (continued)

"Like" electric service providers - Rev. Rul. 67-265, 1967-2 C.B. 170, held that providing light and water services are "like" activities within the meaning of IRC section 501(c)(12), as light and water services are public-utility services similar to services provided by the organizations specified in IRC section 501(c)(12)(A).

Many cooperatives provide natural gas to members in addition to electricity. Natural gas is usually distributed by pipelines. Rev. Rul. 2002-54, 2002-37 I.R.B. 527, states that public utility type service includes providing gas, steam, water, or sewage disposal service on a cooperative basis. The current EO position is that providing natural gas to members (via pipeline) on a cooperative basis is a public utility type service and, therefore, is a "like organization" activity.

However, per Rev. Rul. 2002-54, 2002-37 I.R.B. 527, the distribution and sale of propane in tanks to members is not a "like organization" activity under IRC section 501(c)(12)(A).


A nonprofit organization, which provided and maintained a two-way radio system for its members on a cooperative or mutual basis qualifies for exemption under IRC section 501(c)(12). (Rev. Rul. 57-420, 1957-2 C.B. 308)

New technology has greatly changed the nature of electronic communication and increased the uses that can be made of traditional telephone wires or wireless systems. Many telephone cooperatives offer new telecommunication services including wireless or cellular phone services, internet access, paging services, home security monitoring, medical alert services, and environmental monitoring. By providing communication capability to members on a cooperative basis these services are similar to the two-way radio system held to be exempt in Rev. Rul. 57-420 and telephone cooperatives under IRC section 501(c)(12)(A).

Like telecommunication technology, paid television service has also changed. Many IRC section 501(c)(12) cooperatives are beginning to offer direct satellite television to members and patrons.

Continued on next page
Rev. Rul. 83-170, 1983-2 C.B. 97, holds that a cooperative organization furnishing cable television service to its members qualified for exemption under IRC section 501(c)(12) as a “like organization.” It also held that cable television corporations were similar in nature to public utilities.

The current EO position is that this rationale is applicable to direct satellite television service. So, a cooperative that provides direct satellite television may qualify for exemption as a “like organization” under IRC section 501(c)(12).

The following cases are examples of organizations which were held not to be “like organizations” under IRC section 501(c)(12):

- An organization which provided bus service for its members. (Rev. Rul. 55-311, 1955-1 C.B. 72)
- An organization which financed the purchases and installation of electrical equipment by members of its member cooperatives. Consumers Credit Rural Electric Cooperative v. Commissioner, 37 T.C. 136 (1961) aff’d, 319 F.2d 475 (6th Cir. 1963).
- An organization which sold electrical equipment to its members and performed incidental installation and repair services in connection with these sales, and a cooperative housing organization operated for the personal benefit of its tenant-owners. (Rev. Rul. 65-201, 1965-2 C.B. 170)

“Like organizations” not specifically enumerated under IRC section 501(c)(12) are reserved for EO Technical. See IRM 7.20.1.3.4(4).
Organizational and Operational Test

Operating on a Cooperative Basis

The term "cooperative" is not defined in IRC section 501(c)(12). Instead, the definition comes from common law.

The Tax Court, in Puget Sound Plywood v. Commissioner, 44 T.C. 305, 307-308 (1965), Acq. 1966-2 C.B. 3, described a cooperative as comprised of members who sought

(1) for themselves to own and manage the [organization], as distinguished from having it owned and managed by outside equity investors; and then (2) to have their [organization] turn back to the members the excess of the receipts from the store sales over the cost of goods sold and the expenses of operation.

This description identifies three basic principles or requirements that apply to cooperatives described in IRC section 501(c)(12).

These basic requirements also apply to cooperatives described in Subchapter T and farmers' cooperatives described in IRC section 521.

Three Common Law Requirements

Three basic requirements must be satisfied to qualify for and maintain exemption under IRC section 501(c)(12):

1. Democratic Control by the Members – assures that members participating in the cooperative endeavor remain in control of an IRC section 501(c)(12) cooperative

2. Operating at Cost – cooperative must return the excess of net operating revenues over its cost of operations to the member-patrons

3. Subordination of Capital – contributors of capital to the cooperative, in their status as equity owners, neither control the operations nor receive most of the pecuniary benefits of the cooperative's operations

Cooperative Mutual Companies

IRC Section 501(c)(12)

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Continued on next page
Organizational and Operational Test, Continued

Additional Requirements

Rev. Rul. 72-36, 1972-1 C.B. 151, sets out organizational and operational requirements that an IRC section 501(c)(12) cooperative must satisfy to insure democratic control, operation at cost, and subordination of capital. The cooperative must:

- keep adequate records of each member's rights and interest in the assets of the organization
- distribute any savings to members in proportion to the amount of business done with them (based on the operating at cost principle)
- not retain more funds than it needs to meet current losses and expenses (also based on the operating at cost principle)
- not forfeit a member's rights and interest upon withdrawal or termination of membership
- must distribute, upon dissolution, any gains from the sale of appreciated assets to all who were members while the cooperative owned the asset in proportion to the amount of business done with each, so far as practical

Whether a cooperative satisfies the basic cooperative principles or the requirements of Rev. Rul. 72-36 is a question of fact. A specialist must review the documentation (bylaws, articles of organization, etc.) to determine if the cooperative has satisfied these principles and requirements.

If an IRC section 501(c)(12) cooperative violates any cooperative requirement, it loses exemption from Federal income tax because it is no longer a cooperative.
Organizational and Operational Test, Continued

Service Position for Method of Operation - Rev. Rul. 78-238

Rev. Rul. 78-238, 1978-1 C. B. 161, holds that the Service will not follow the Ninth Circuit's decision entered in Peninsula Light Co., Inc. v. U.S., 552 F.2d 878 (9th Cir. 1977), which permitted an organization that never operated on a cooperative basis to qualify for exemption under IRC section 501(c)(12).

Instead, the organization's charter provided that each member had an equal share in the organization's assets, and that its net assets at dissolution would be divided equally among the current members. Former members' rights and interests were forfeited upon termination of membership.

Note: Rev. Rul. 78-238 holds this method of operation was clearly in conflict with the basic principles of mutual or cooperative operation.

Mutual Ditch Exception - Rev. Rul. 81-109

A mutual ditch company may qualify for exemption under IRC section 501(c)(12) even though it does not satisfy all of the requirements of Rev. Rul. 72-36.

Rev. Rul. 72-36 was modified by Rev. Rul. 81-109, 1981-1 C.B. 347. A mutual ditch company operated in a manner that was consistent with the provisions of state law before Congress enacted legislation that provided for exemption from Federal income tax. It qualified for exemption even though former members had no claim to the organization's assets upon dissolution. Since there were no major changes in the applicable federal tax provisions in the intervening years, the Service believed that Congress intended that mutual ditch and irrigation companies that operate in such a manner would qualify for exemption.

Record Requirements

An actual distribution is not required at the end of each year when the excess funds are needed, but the cooperative must keep adequate records to determine at any time each member's rights and interest in the retained funds, including assets acquired with the funds.

It is not essential that the organization issue patronage certificates informing each member of their amount in the retained earnings provided it keeps the records described above.

Continued on next page
Organizational and Operational Test, Continued

Reserves

Funds in excess of those needed to meet current losses and expenses may be retained for certain purposes.

Funds may not be accumulated beyond the reasonable needs of the organization’s operation in furnishing services covered by IRC section 501(c)(12).

There is no clear-cut specified limitation that can be applied to every organization in determining the amount of accumulated reserves that are reasonable. Each situation will be determined based upon the surrounding facts and circumstances.

Who Are Members

IRC section 501(c)(12) cooperatives are essentially member or consumer service organizations that provide members goods or services.

IRC section 501(c)(12) and the regulations do not define “member,” but the definitions for IRC section 521 and Subchapter T apply as they parallel IRC section 501(c)(12).

Treas. Reg. 1.1388-1(c)(3)(i)(c) defines a member as a “person” (an individual, corporation, or cooperative) entitled to participate in the cooperative’s management.

Treas. Reg. 1.1388-1(e) and 1.522-1(b)(2) defines a “patron” as any person (an individual, corporation, etc.), whether member or non-member, with or for whom the cooperative does business on a cooperative basis. As a member usually gets services from the cooperative, he or she is also a patron.

Continued on next page
Member and Operational Test, Continued

Permissible Membership

Membership of mutual and cooperative organizations may include:

- Other cooperatives so long as 85 percent of the income is derived from cooperatives which are members. (Rev. Rul. 65-174, 1965-2 C. B. 169)

- Government agencies who are members of an electric cooperative. (Rev. Rul. 68-75, 1968-1 C. B. 271)

Note: The fact that all members are exempt under IRC section 501(c)(12) will not alone allow an organization to qualify for exemption under this section. *Consumers Credit Rural Electric Cooperative Corp. v. Commissioner*, 37 T. C. 136 (1961), *affirmed on exemption issue*, 319 F.2d 475 (6th Cir. 1963).
Current Issues Concerning Cooperative Principles

Providing Multiple Services within a Cooperative

Historically, most IRC section 501(c)(12) cooperatives engaged in a single activity. Recently, however, IRC section 501(c)(12) cooperatives have followed the trend in the utility industry to expand to other lines. For example, telephone companies now also offer cellular (or wireless) phone and Internet services.

Under the basic cooperative requirement to operate at cost, an IRC section 501(c)(12) cooperative must:

- account to members and patrons for all costs and savings that result from a particular service, and
- equitably allocate costs or savings among members or patrons of each particular service so savings or losses are returned to each member in direct proportion to their patronage.

Many IRC section 501(c)(12) cooperatives have combined two or more services for purposes of allocating savings, costs, and losses. For example, a cooperative may combine local and long distance telephone services with cellular phone service and Internet service.

A cooperative can combine different services without violating the requirement to operate at cost if it meets the following criteria:

- many member-patrons of one service are also patrons of the other services in the allocation unit
- the cooperative's articles of incorporation, bylaws, or written policies specifically detail the composition of all allocation units and how savings or losses are to be allocated in each unit
- it informs members of each allocation unit of the risk-sharing and benefits of combining different services in one allocation unit
- a majority of the cooperative's members agrees to the grouping
- members periodically vote to affirm the agreement

Continued on next page
These criteria are designed to ensure that, in establishing allocation units, a cooperative does not divert a substantial amount of savings or losses from one group of members to another.

Many IRC section 501(c)(12) cooperatives need outside capital to finance their exempt business activities. One way to raise outside capital is issuing stock.

The Service has received requests to approve the issuance of a class of stock that has the following characteristics:

- dividend payment
- dividend rate is fixed at eight percent per year or the legal rate permitted in the state the cooperative was formed
- shareholders cannot directly or indirectly participate in the cooperative’s savings or profits
- shareholders will not have voting rights

Neither IRC section 501(c)(12) nor the regulations prohibit (or authorize) issuing stock with these characteristics.

IRC section 521(b)(2) and Treas. Reg. 1.521-1(a)(2) permit a farmers’ cooperative to issue non-voting stock with a dividend rate fixed at the greater of eight percent per year or the legal rate of interest in the state of incorporation. Also, the shareholders of this stock have no distribution rights other than fixed dividends.

An IRC section 501(c)(12) cooperative cannot issue unlimited or numerous shares of non-voting stock and remain a cooperative without violating the subordination of capital principle.
Income Source Test

Introduction
A cooperative exempt under IRC section 501(c)(12) must receive 85 percent or more of its income from members. Member income is member-sourced and derived from IRC section 501(c)(12) activities.

The 85 percent member income test is computed annually. An IRC section 501(c)(12) cooperative may be exempt in one year but lose exemption in another if it does not derive 85 percent or more of its income from members.

Rev. Rul. 65-99, 1965-1 C.B. 242, provides that if a cooperative continues to meet the other requirements of IRC section 501(c)(12), it need not reapply for recognition of exemption to be exempt in years it meets the member income test.

The 85 percent member income test is applied on the basis of the organization’s annual accounting method (cash or accrual).

Receipt Analysis Required
In applying the member income test, each item of income is classified as member income, nonmember income, or excluded income. Before applying the member income test on an item of receipt, it must first be income.

Gross Receipts and Gross Income

Member Income
In order for an item of income to be classified as member income, it must satisfy two requirements. First, the income must be derived from members. Second, the income must be used to pay for services listed in IRC section 501(c)(12). (Rev. Rul. 2002-54 and Rev. Rul. 2002-55, 2002-37 I.R.B. 527 (Sept. 16, 2002))

This two-pronged analysis comes from IRC section 501(c)(12)(A), which requires that member income be collected to meet losses and expenses from IRC section 501(c)(12) activities.

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Cooperative Mutual Companies
IRC Section 501(c)(12)
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Income Source Test, Continued

**Member Income (continued)**

**Example:** Commercial bank X is a member of telephone cooperative Y. X, like all other members, pays Y for telephone services in an amount proportional to the services it uses. Y also deposits its reserves in interest-bearing accounts at X. Under the two-prong analysis, X's payments for telephone services are member income for the 85 percent member income test but the interest payments are not. Although X is a member of Y, it does not pay the interest for services described in IRC section 501(c)(12).

**Non-member Income**

Non-member income is income from nonmember sources.

Capital gains from the incidental sale of assets upon dissolution are considered to be a non-member source of income for purposes of applying the 85 percent member income test. *The Mountain Water Co. of La Crescentia v. Commissioner* 35 T. C. 418 (1960) and *Cate Ditch Co. v. U. S.*, 194 F. Supp. 688 (S. D. Calif. 1961).

In the case of an installment sale of assets, only that portion of the installment actually received during the accounting period would be considered from sources other than members in computing the 85% member income test. (Rev. Rul. 65-99 supra)

Non-member income also includes income from patrons who are not members of the cooperative. For example, a telephone cooperative may provide telecommunication services to both members and nonmembers. The income from members is member income but the income from non-member patrons is not. If nonmember patronage income exceeds 15 percent in a tax year, the telephone cooperative would lose exemption for that year.

**Lease of Power Facilities**

Rev. Rul. 65-174, 1965-2 C.B. 169, held that the income from leasing power facilities to a non-member power company is treated as non-member income for purposes of the 85% member income test.

**Excluded Income**

An IRC section 501(c)(12) cooperative can exclude certain kinds of income from the member income test computation.

Continued on next page

*Cooperative Mutual Companies*

*IRC Section 501(c)(12)*

7-19
Capital Contributions

Many IRC section 501(c)(12) cooperatives receive grants from state or federal agencies.

A government grant is treated as a contribution to capital, which under IRC 118(a) is not income, if it meets the following conditions from Rev. Rul. 93-16, 1993-1 C.B. 26. The grant must:

• become a permanent part of working capital
• not be compensation for specific quantifiable services
• have its use subject to conditions imposed by the grantee
• benefit the corporation commensurate with its value
• ordinarily be employed to generate additional income

The member income test does not apply if the grant meets these conditions. All facts and circumstances must be examined to determine if a particular grant satisfies these conditions.

Qualified Pole Rentals

“Qualified pole rentals” means any rental income from the right to use any pole (or other structure to support wires) that is used by the cooperative in providing telephone or electric services to its members.

Income from qualified pole rentals is excluded from the 85 percent member income test requirement.

Pole rentals are also excluded from UBI under IRC section 513(g).

Directory Listings

Income from the sale of display listings in a directory furnished to members is not taken into account for purposes of the 85 percent member income test. (See IRC section 501(c)(12)(B)(iii))

Continued on next page
Income Source Test, Continued

Loan Prepayments

Many IRC section 501(c)(12) electric and telephone cooperatives financed their capital improvements or expansion by borrowing funds from the federal Rural Utilities Service (RUS), formerly Rural Electrification Administration. RUS loans could be retired at a discount if they were paid before the end of the loan period.

Under IRC section 61(a)(12), income includes prepayment of indebtedness at less than face value. The difference between the discounted amount and face value of an RUS loan would be nonmember income for purposes of IRC section 501(c)(12)(A).

Note: IRC section 501(c)(12)(B)(iv) and (C)(ii) excluded this income in computing the 85 percent member income test, but only for RUS loans repaid after 1986 but before 1990.

Therefore, IRC section 501(c)(12) cooperatives must treat any discount realized from partial or complete prepayment of RUS loans made after December 31, 1989 as nonmember income in computing the 85 percent member income test.

Communication Services

IRC section 501(c)(12)(B)(i) states that income from “communication services” to members is excluded from the 85 percent member income test. Many IRC section 501(c)(12) telephone cooperatives administer billing and collection of fees for nonmember long distance carriers that provide long distance telephone service to their members.

Third Party Charges

In Notice 92-33, 1992-2 C. B. 363, the Service held that income received by telephone cooperatives from charges to third parties such as interchange carriers, local exchange carriers, or other exchange carriers for billing or collecting intrastate, interstate, or international revenues is income from the provision of a nonmember service. However, this position was modified in the Golden Belt court case.
Income Source Test, Continued

The Court decision in *Golden Belt Telephone Association, Inc. v. Commissioner*, 108 T. C. No. 23 (1997), held that:

Income received by the cooperative telephone company from charges to third parties, such as interexchange carriers, local exchange carriers, or other exchange carriers for billing or collecting intrastate, interstate, or international revenues should be excluded for purposes of determining whether the company meets the 85 percent member income test.

Such income is not to be considered as member or nonmember income for purposes of the 85 percent member income test.

Such income is to be treated as a communication service and should therefore be excluded from the computation of the 85 percent member income test pursuant to IRC section 501(c)(12)(B)(i).

The Service has acquiesced as to the result of the *Golden Belt* case (AOD 1998-18 I.R.B. 4).

Therefore, billing and collection charges will be excluded from the computation of the 85% member income test.
## Applying the 85 Percent Member Income Test

<table>
<thead>
<tr>
<th>85% Income Test Facts</th>
<th>In applying the 85 percent test, a cooperative’s income is divided into:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Member income</td>
</tr>
<tr>
<td></td>
<td>• Non-member income</td>
</tr>
<tr>
<td></td>
<td>• Excluded income</td>
</tr>
<tr>
<td></td>
<td>• Calculation of the 85 percent test is illustrated in Treas. Reg. 1.501(c)(12)-1(c).</td>
</tr>
</tbody>
</table>

The Regulations’ illustration is summarized in the following example:

In one year, a cooperative telephone company received: $85x from its members for telephone calls, $15x dollars as interest income, and $20x as credits under long distance interconnection agreements with other telephone companies. The $20x as credits were for the performance of communications services involving the completion of long distance calls to, from, or between the cooperative’s members.

The member income fraction is calculated without taking into account (in neither the numerator nor the denominator), the $20x credits received from the other telephone companies.

In this example the 85 percent member income test is satisfied because at least 85 percent of the cooperative’s total income is derived from member income.

---

Cooperative Mutual Companies

IRC Section 501(c)(12)

7-23
Applying the 85 Percent Member Income Test, Continued

Sample Equation

The formula for computing the 85 percent membership income test is:

\[
\frac{\text{member income}}{\text{total income}} = \frac{85x}{85x + 15x} = \frac{85}{100} = 85\%
\]

Based upon this equation, the cooperative telephone company met the required 85 percent member income test.

Sample 85 Percent Test Computation

The following is an example of the 85 percent membership income test computation in a table format based upon the formula above:

<table>
<thead>
<tr>
<th>Sources of Income</th>
<th>Total</th>
<th>Numerator</th>
<th>Denominator</th>
<th>% Test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Membership Income</td>
<td>$85,000</td>
<td>$85,000</td>
<td>$85,000</td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td>$15,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credits</td>
<td>$20,000</td>
<td>Excluded</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$120,000</td>
<td>$85,000</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>% Member Income</td>
<td></td>
<td>$85,000</td>
<td>$100,000</td>
<td>85%</td>
</tr>
</tbody>
</table>

Failure to Meet IRC Section 501(c)(12) Requirements

The Service has taken the position that an organization that meets all the requirements for exemption under IRC section 501(c)(12) but fails to meet the 85 percent member income test cannot be exempt under IRC section 501(c)(4).

The Service does not agree with the decision in United States v. Pickwick Electric Membership Corporation, 158 F.2d 272 (6th Cir. 1946), which held that a cooperative that met all of the requirements for exemption but failed to meet the 85 percent member income test could be exempt under IRC section 501(c)(4).
Service Position on Income from Subsidiaries

Combined Gross Income

TAM 1999908038, relying on Rev. Rul 69-575, 1969-2 C.B. 134 (concerning an IRC 521 farmers’ cooperative), concluded that the cooperative and its subsidiary must combine their gross income in calculating the 85 percent member income test. As a result, the parent derived less than 85 percent of its income from members and was not exempt in the year in question.

However, as a result of Rev. Rul. 2002-55, the current service position is that a subsidiary’s gross income is excluded from the parent-cooperative’s income for purposes of the 85 percent member income test.

IRC Section 501(c)(12) Cooperatives and Their Subsidiaries

An IRC section 501(c)(12) cooperative may have subsidiaries to conduct exempt or non-exempt activities. For example, a subsidiary of an IRC section 501(c)(12) telephone cooperative may provide cable television service. A subsidiary may carry on business with nonmembers on a non-cooperative basis. A subsidiary may conduct activities unrelated to the parent cooperative’s exempt purposes.

The parent-subsidiary relationship raises the issue of whether the subsidiary’s gross income should be included with its parent cooperative’s income in determining the parent cooperative’s exempt status under the 85 percent member income test.

Rev. Rul. 2002-55, 2002-37 I.R.B. 529 (Sept. 16, 2002), concludes that a cooperative exempt from Federal income tax under IRC section 501(c)(12) is not required to include income earned by its subsidiary for purposes of calculating the 85 percent member income test, provided the subsidiary is not an agent or instrumentality of the parent cooperative.

Continued on next page
Rev. Rul. 2002-55 follows the principle stated in the Supreme Court case, *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), which provides that a corporation’s income is not attributed to a shareholder for federal income tax purposes unless the corporation is an agent or instrumentality of the shareholder.

Whether the subsidiary is an agent or instrumentality depends on all the facts and circumstances.

Nevertheless, the cooperative is required to include any dividends or any types of payments it received from its subsidiary in a particular tax year for purposes of calculating the 85 percent member income test.

Rev. Rul. 2002-55 is effective for taxable years beginning after December 31, 2002. However, a cooperative exempt under IRC section 501(c)(12) may rely on this revenue ruling for prior periods.
Unrelated Business Activities

Unrelated Business Income Tax (UBIT)

IRC section 511 imposes a tax on unrelated business taxable income on most IRC section 501(c) organizations, including IRC section 501(c)(12) cooperatives.

IRC section 512(a)(1) provides that unrelated business taxable income is the gross income derived by any organization described in IRC section 501(c) from any regularly carried on unrelated trade or business.

Unrelated Business Activities and the Activities Test

Most IRC section 501(c)(12) cooperatives only conduct activities described in IRC section 501(c)(12). For example, a telephone cooperative may only provide telephone or other “like” services, or an IRC section 501(c)(12) electric cooperative may provide only electric service.

However, some IRC section 501(c)(12) cooperatives provide both IRC section 501(c)(12) services and services not described in IRC section 501(c)(12). For example, an IRC section 501(c)(12) electric cooperative may also sell propane (in tanks) to members for their personal or business use. This raises issues of both exemption and unrelated business income tax (UBIT).

The activities test, UBIT test, and the 85 percent member income test must be applied separately to the activities or income of the IRC section 501(c)(12) cooperative. (Rev. Rul. 2002-54, IRB 527 (Sept. 16, 2002))

Unrelated Business Activities and the 85 Percent Member Income Test

An IRC section 501(c)(12) cooperative must receive 85 percent or more of its income from members. Each item of income, whether from an IRC section 501(c)(12) activity or an unrelated activity, must be included in computing the 85 percent member income test.

Unrelated taxable income is usually nonmember income for purposes of the 85 percent member income test. Nonmember income, however, is not necessarily subject to UBIT.
Unrelated Business Activities, Continued

Example:
An IRC section 501(c)(12) electric cooperative provides electricity to members and nonmembers. The income from nonmembers would be nonmember income. However, the income would not be subject to UBIT since it is related to the organization’s exempt purpose.

However, what if the same organization provides electricity to its members, but also operates a bar exclusively for members? If the bar activity (which is obviously unrelated) is not substantial, it will not jeopardize the organization’s exempt status. But the income from the bar is subject to UBIT because it is a regularly carried on business activity that is not substantially related to the cooperative’s exempt purpose. The cooperative must also include the bar income as nonmember in computing the 85 percent member income test, as it was not derived from services described in IRC section 501(c)(12) (remember the two-pronged analysis). If the bar income exceeds 15 percent of gross income in a tax year, the cooperative would lose its IRC section 501(c)(12) exempt status for that tax year.
An organization must satisfy three requirements to qualify under IRC section 501(c)(12): activities test, organizational and operational test, and income source test.

An organization’s activities are crucial in determining qualification for exemption under IRC section 501(c)(12). IRC section 501(c)(12) describes four specific categories of organizations that can qualify for exemption:

- Benevolent life insurance associations
- Mutual ditch or irrigation companies
- Cooperatives that provide telephone services, and
- Cooperatives that provide electric services

IRC section 501(c)(12) also provides for a fifth category, “like organizations,” that is not defined in the Code or the regulations.

The organizational and operational test has three common-law requirements:

1. democratic control by the members
2. operating at cost
3. subordination of capital

To satisfy the income source test, a cooperative must receive 85 percent or more of its income from members. A cooperative is required to include any dividends or payments from subsidiaries for purposes of calculating the 85 percent member income test.

IRC section 501(c)(12) cooperatives are taxed on their unrelated business income. The activities test, UBIT test, and the 85 percent member income test must be applied separately to the activities or income of the IRC section 501(c)(12) cooperative.
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Lesson 8

Cemetery Companies
IRC Section 501(c)(13)

Overview

Introduction
Cemetery companies have been exempt from taxation since the passage of the Revenue Act of 1913 which exempted cemetery companies organized and operated exclusively for the mutual benefit of their members.

Today, IRC section 501(c)(13) grants exemption from Federal income tax to nonprofit cemetery companies and crematoria which are owned and operated exclusively for the benefit of their members, are solely for burial purposes, are not permitted by their charters to engage in any business not necessarily incident to that purpose, and have no part of net earnings which inure to the benefit of any private shareholder or individual.

IRM 7.25.13 provides guidance for cemeteries. Additional information may also be found in IRM 4.76.21 Examination Guidelines.

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

- Identify IRC section 501(c)(13) requirements for a cemetery’s purpose, organization, and operation
- Recognize potential private benefit or inurement
- Describe IRC section 501(c)(13) requirements for a perpetual care fund
- Identify allowable income sources and income requirements
- Describe IRC section 501(c)(13) requirements for deductible contributions
- Address application issues that deal with crematoriums and family and pet cemeteries

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<tr>
<td>Prohibited Private Benefit and Inurement</td>
<td>8-4</td>
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<tr>
<td>Perpetual Care Funds</td>
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<td>Income Sources and Requirements</td>
<td>8-7</td>
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<tr>
<td>Crematorium and Specialized Cemeteries</td>
<td>8-9</td>
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<td>Additional Resources</td>
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<td>Summary</td>
<td>8-11</td>
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</table>
Exempt Purpose

Cemetery Purposes

Exemption under IRC section 501(c)(13) is allowed only for cemetery purposes. These purposes include the:

- Operation, maintenance and improvement of the cemetery
- Acquisition of cemetery property
- Accumulation of surpluses from investments to provide a source of income for the maintenance and care of the cemetery

Cemetery Requirements - Organized and Operated

To qualify for tax exempt status under IRC section 501(c)(13) a cemetery company must:

- Be owned and operated exclusively for the benefit of members
- Not be operated for profit
- Be chartered solely for the purpose of the disposal of bodies by burial or cremation
- Not be permitted by its charter to engage in any business not necessarily incident to burial or cremation
- Have no part of the net earnings of which inures to the benefit of any private shareholder or individual

Mortuary - Not a Cemetery Purpose

A mortuary is not considered necessary to the procuring, sale, holding, and use of land solely as a burial ground. A cemetery can, however, hold stock for investment purposes in a mortuary company, provided that the mortuary is separately incorporated and run as an independent business with no overlap between the cemetery’s and the mortuary’s Board of Directors. A mortuary business cannot be operated directly by a cemetery. (Rev Rul 64-109, 1964-1 C.B. 190.)
Prohibited Private Benefit and Inurement

Ownership

Under the regulations, an exempt cemetery company must be owned and operated exclusively for the benefit of lot owners and no part of the net earnings may inure to the benefit of any private shareholder or individual.

- Inurement to shareholders or individuals, in the form of dividends on common stock, is prohibited.
- Any preferred stock issued after November 28, 1978, precludes determination of exempt status. (Treas. Regs. 1.501(c)(13)-1(c)(2) and (3) provide transitional rule exceptions for preferred stock issued prior to this date.)

Potential Private Benefit Issues

Sales agreements for plots, crypts, or acreage should be reviewed for private benefit issues including:

- Sales with percentage clauses
- Open-ended sales provisions
- Sham sales
- Otherwise hidden or disguised equity interests

Rev. Rul. 77-70, 1977-1 C.B. 150, (Rev. Rul. 61-137 amplified), held that a nonprofit cemetery company that acquires land from a for-profit cemetery company under an agreement providing payment to the former owners on the basis of a percentage of the sales price of each cemetery lot sold is not exempt from tax as a cemetery described in IRC section 501(c)(13).

Additionally, Rose Hills Memorial Park Association v. United States, 463 F.2d 425 (Ct. Cl. 1972), cert. denied, 414 U.S. 822 (1973), held that open-ended land sale agreements that enable the seller to share in the appreciation of the land and to receive in effect an equity interest in the cemetery company result in private benefits and thus are inconsistent with exemption under IRC section 501(c)(13).

Other areas for review include related party transactions or loans, land purchases, non-cemetery activities and held assets that are not consistent with the operation of a cemetery.

Cemetery Companies
IRC Section 501(c)(13)
Perpetual Care Funds

Perpetual Care Fund Defined

A perpetual care fund is a fund that is formed by a cemetery company to receive and hold funds in trust for the perpetual care and maintenance of the cemetery.

Although not specifically described in the law or regulations, a perpetual care fund can apply for and be given tax exempt status under IRC section 501(c)(13). These organizations are usually formed by cemetery companies to receive and hold funds in trust for the perpetual care and maintenance of the cemeteries.

Although these organizations do not own land dedicated to the burial of the dead or perform other services usual to a cemetery company, they provide an essential part of the functions of the cemetery companies. They are so closely connected with the actual cemetery companies that they partake of the character of the companies for purposes of determining whether they are exempt under IRC section 501(c)(13).

Rev. Rul. 58-190, 1958-1 C.B. 15, describes an organization (including a trust) created by formal action, the funds of which are irrevocably dedicated to the perpetual care of a nonprofit cemetery as a whole, none of the earnings of which inures to the benefit of any private shareholder or individual, may qualify for exemption from Federal income tax under IRC section 501(c)(13). However, a perpetual care fund operated in connection with a profit-making cemetery company was held not to be exempt in Rev. Rul. 64-217, 1964-2 C.B. 153.

Perpetual Care Fund Income Sources

There are three primary sources of income for a perpetual care fund:

- Investment Income
- Contributions
- Percentage of lot sales

Most states require that a percentage of the lot sales be set aside for perpetual care.

\[\textit{Cemetery Companies} \]
\[\textit{IRC Section 501(c)(13)} \]
\[8-5\]
Issues to consider when considering a perpetual care fund:

- The perpetual care fund should be an irrevocable trust
- Determine whether the perpetual care fund is part of an exempt cemetery company or is seeking a separate IRC section 501(c)(13) exemption
- The agreement for perpetual care should be between the cemetery company and the lot owners (may be required by state law)
- Verify the amounts collected by the cemetery company for perpetual care are actually being transferred into the fund by the cemetery company
Income Sources and Requirements

**Income Sources and Expenditures**

Typical exempt cemetery company income sources include:

- Lot sales
- Donations
- Investment Income
- Income from related activities

Expenditures should be for operating, maintaining, improving and paying for the cemetery property.

**Investment Income - Surplus Accumulations**

Accumulations and earnings used for the necessary care or maintenance of an IRC section 501(c)(13) organization's property are considered devoted to exempt purposes and consistent with exempt status under IRC section 501(c)(13). However, surpluses cannot benefit private individuals or shareholders.

As the sales of cemetery lots typically contain provisions for permanent upkeep of the lots, the company ordinarily invests a portion of the sales proceeds in assets to produce income that is used to defray the costs of lot upkeep. A tax-exempt cemetery company may accumulate a surplus from investments in income-producing assets only if no possibility exists of inurement of net earnings to the benefit of any private shareholder or individual.

Accumulation would not be permitted if preferred stock was outstanding under the transitional rule of Treas. Reg. 1.501(c)(13)-1(c)(2) or (3). This is discussed in IRM 7.25.13.4.

**Deductible Contributions, Gifts and Bequests**

IRC section 170(c)(5) provides that a contribution to a cemetery or to its perpetual care fund is deductible if it is voluntary and irrevocably dedicated to the care of the cemetery as a whole.

Continued on next page
Income Sources and Requirements, Continued

Designated Plots or Crypts

There is no deduction under IRC section 170(c)(5) for:

- Contributions made for the upkeep of a designated lot, gravesite or crypt
- Payments made to a cemetery company as part of the purchase price of a burial lot or crypt, even though irrevocably dedicated to the perpetual care of the cemetery as a whole, are not deductible

Estate and Gift Tax

IRC sections 2055 and 2522 provide that bequests or gifts to nonprofit cemeteries are not deductible for Federal estate and gift tax purposes.

Trusts

IRC section 642(c) does not allow a deduction on a trust return (Form 1041) for amounts paid or set aside for the care, maintenance or beautification of a particular burial lot or mausoleum crypt.

Other Sources of Income - Sales Related To Cemetery Uses

During the course of your determination, you may encounter a cemetery company which sells:

- Monuments
- Markers
- Vaults
- Flowers

The exempt status of a cemetery company is not adversely affected if it sells monuments, markers, vaults, and flowers solely for use in the cemetery and uses the sales proceeds for maintenance of the cemetery. (Rev. Rul. 72-17, 1972-1 C.B. 151.)
## Crematoria and Specialized Cemeteries

<table>
<thead>
<tr>
<th>Activity</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crematorium - Related Cemetery Activity</td>
<td>P.L. 91-618, 1971-1 C.B. 539, allows for the operation of a crematorium by a cemetery company as a related activity for an IRC section 501(c)(13) cemetery.</td>
</tr>
<tr>
<td></td>
<td>Rev. Rul. 71-300, 1971-2 C.B. 238, which reflects this position, withdraws Rev. Rul. 69-637, 1969-2 C.B. 127, which held, in part, that the exempt status of a cemetery company would be adversely affected if it also operated a crematorium.</td>
</tr>
<tr>
<td>Family Cemetery - Not Impermissible Inurement</td>
<td>A mutual cemetery company that limits its membership to a particular class of individuals, such as members of a family, will not affect its status as “mutual” so long as all the other requirements of IRC section 501(c)(13) are met. (Treas. Reg. 1.501(c)(13)-1(a).)</td>
</tr>
<tr>
<td></td>
<td>Formerly, the Service considered impermissible inurement to be present where a cemetery company owned, operated, or maintained a private cemetery limited to a particular class of individuals, e.g., the lineal descendants of a particular person and those who inter-married with those descendants.</td>
</tr>
<tr>
<td>Pet Cemetery - Exemption Not Allowed</td>
<td>An organization that owns, operates, and maintains a cemetery for pets does not qualify for exemption under IRC section 501(c)(13). (Rev. Rul. 73-454, 1973-2 C.B. 185.)</td>
</tr>
</tbody>
</table>
## Additional Resources

<table>
<thead>
<tr>
<th>Revenue Rulings</th>
<th>The following revenue rulings provide guidance on exemption of cemetery companies:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rev. Rul. 64-109, 1964-1 C.B. 190</td>
<td>Operation of mortuary is not exempt</td>
</tr>
<tr>
<td>Rev. Rul. 58-190, 1958-1 C.B. 15</td>
<td>Perpetual care fund may be exempt</td>
</tr>
<tr>
<td>Rev. Rul. 64-217, 1964-2 C.B. 153</td>
<td>Perpetual care fund of for-profit cemetery is not exempt</td>
</tr>
<tr>
<td>Rev. Rul. 72-17, 1972-1 C.B. 151</td>
<td>Sale of markers, vaults, flowers, etc. may be permissible</td>
</tr>
<tr>
<td>Rev. Rul. 73-454, 1973-2 C.B. 185</td>
<td>Pet cemetery is not exempt</td>
</tr>
<tr>
<td>Rev. Rul. 71-300, 1971-2 C.B. 238</td>
<td>Operation of a crematorium is a related activity</td>
</tr>
<tr>
<td>Rev. Rul. 77-70, 1977-1 C.B. 150</td>
<td>Percentage sales agreements may preclude exemption</td>
</tr>
</tbody>
</table>
Summary

IRC section 501(c)(13) grants exemption from Federal income tax to nonprofit cemetery companies and crematoria only for cemetery purposes. These purposes include the acquisition of cemetery property, operating, maintaining, and improving the cemetery, and accumulation of surpluses from investments as a source of income for maintaining the cemetery.

To qualify for tax exempt status under IRC section 501(c)(13) a cemetery company must:

- Be owned and operated exclusively for the benefit of members
- Not be operated for profit
- Be chartered solely for the purpose of the disposal of bodies by burial or cremation
- Not be permitted by its charter to engage in any business not necessarily incident to burial or cremation
- Have no part of the net earnings of which inures to the benefit of any private shareholder or individual

Cemetery companies must be owned and operated exclusively for the benefit of lot owners and no part of net earnings may inure to the benefit of any private shareholder or individual.

A perpetual care fund is a fund that is formed by a cemetery company to receive and hold funds in trust for maintaining the cemetery. Perpetual care funds have three sources: investment income, contributions, and percentage of lot sales.

An organization that owns, operates, and maintains a cemetery for pets does not qualify for exemption under IRC section 501(c)(13).
Lesson 9

Veterans’ Organizations
IRC Section 501(c)(19)

Overview

Introduction

IRC section 501(c)(19) exempts from federal income tax a post or organization of past or present members of the Armed Forces of the United States. Exemption is also available for an auxiliary unit or society of, or a trust or foundation for any such post or organization.

Veterans’ organizations may be part of a group ruling or request an individual ruling for exempt status.

Veterans’ organizations hold a unique place in the tax exempt sector. A veterans’ organization may have a broad range of activities and benefits including tax-exempt status, deductibility of contributions, ability to pay benefits to members, lobbying and political activities. Therefore, these organizations may qualify for exemption under IRC section 501(c)(3) as a charitable organization, 501(c)(4) as a social welfare organization, 501(c)(7) as a social club, or 501(c)(8) or 501(c)(10) as a fraternal organization, assuming it meets the requirements of the section under which it has applied.

This lesson focuses on organizations requesting exemption under IRC section 501(c)(19).

The Tax Guide for Veterans’ Organization, Publication 3386, is a good subject matter source and includes a wealth of information.

Continued on next page
Overview, Continued

Objectives

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

- Describe the history and evolution of veterans’ organizations
- Identify IRC section 501(c)(19) purposes
- Recognize non-exempt IRC section 501(c)(19) purposes
- Determine if an IRC section 501(c)(19) veterans’ organization meets the required membership test.
- Recognize when an IRC section 501(c)(19) organization is qualified to receive deductible contributions
- List the qualifications for an auxiliary under IRC section 501(c)(19)
- Describe the qualifications for a supporting trust or foundation under IRC section 501(c)(19)
- Recognize charitable gaming issues related to veterans’ organizations
- Describe the qualifications for a veterans’ organization under IRC section 501(c)(4)
- List the qualifications for a related veterans’ auxiliary social club under IRC section 501(c)(7)
- Recognize unrelated business income in veterans’ organizations

Continued on next page
Overview, Continued

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<td>Summary</td>
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</tr>
</tbody>
</table>

Veterans' Organizations
IRC Section 501(c)(19)
9-3
Exempt Status Under IRC Section 501(c)(19)

**History and Evolution of 501(c)(19)**

Prior to 1969, veterans' organizations were recognized as tax exempt under IRC section 501(c)(4). Their subsidiaries, which were formed to maintain and operate their social facilities, were often recognized as exempt social clubs under IRC section 501(c)(7). The Service had long recognized “social welfare” as an exempt purpose of veterans' organizations. See Rev. Rul. 68-45, 1968-1 C.B.

Public Law 92-418 extended IRC section 501(c)(19) tax exempt status to qualifying veterans' organizations beginning after December 31, 1969. The Tax Reform Act of 1969 extended UBIT to all exempt organizations, and in order to prevent taxation of insurance activities, IRC sections 501(c)(19) and 512(a)(4) were enacted.

After that date, a veterans' organization could choose which section they preferred for tax exempt status.

On September 3, 1982, Congress amended IRC section 501(c)(19) by changing the requirement that 75% of members be War Veterans. See Public Law 97-248, 96 Stat. 640. This change was made in order to address the timing issue of the war veterans in existing veterans' organizations that were at risk of losing their exempt status.

---

**Tax Reform Act of 1969 Provisions**

The following are provisions included in the Tax Reform Act of 1969 in regards to veterans' organizations:

- Exempting any income earned by set aside fund used for the sole purpose of providing insurance benefits to members or dependents. See IRC section 512(a)(4).

- Regarding deductible contributions: The extension of the deduction for charitable contributions to a veterans' organization used to carry out a charitable purpose.

- Defining charitable purpose to include programs involving Americanism, youth activities, community activities, and information programs related to national security and foreign affairs.

*Continued on next page*
Veterans' organizations must be operated for one or more of the eight purposes listed in Treas. Regs. 1.501(c)(19)-1(c). It is not necessary that the organizations' purposes or activities include all the listed purposes to be exempt, but they cannot have purposes of a substantial nature that are not listed and retain IRC section 501(c)(19) status. The exempt purposes are:

- Must be operated exclusively to benefit the social welfare of the community per Treas. Reg. 1.501(c)(4)-1(a)(2)
- Assist disabled and needy veterans and members of the U.S. Armed Forces and their dependents, widows or widowers and orphans
- Entertain and/or care for hospitalized veterans and members of the U.S. Armed Forces
- Perpetuate the memory of deceased veterans and members of the Armed Forces, and to comfort their survivors
- Conduct religious, charitable, scientific, literary or educational programs as set forth in IRC section 170(c)(4)
- Sponsor or conduct patriotic programs
- Provide insurance benefits to members, dependents or both
- Provide social and recreational activities for their members

Continued on next page
Social Welfare Activities

Social welfare activities cover a wide range of activities. Following are examples of activities that are considered furthering a social welfare purpose:

- Sponsoring youth activities whether or not limited to the member’s children
- Buying equipment and uniforms for a youth athletic team is an appropriate post activity
- Allowing other community organizations such as the Lions Club, a public school organization, or a community group to use the post without charge
- Sponsoring the Boy Scouts, Girl Scouts, or other youth units of the post, and providing scholarships for students
- Making donations to charities described in IRC section 501(c)(3), such as hospitals, the Red Cross, and the Local Community Chest
- Visiting the sick or hospitalized members, veterans and their families

Assistance to Disabled and Needy Veterans

Implicit in this activity to further an exempt IRC section 501(c)(19) purpose is an objective and non-discriminatory basis for making selections and providing assistance.

Entertainment and Care for Hospitalized Veterans

This is an activity you will likely see in a veterans’ organization. A veterans’ organization may be located close to military installations and veterans’ hospitals.

Continued on next page
Memorials

This activity may take the form of public statues, memorials, ceremonies, plaques, parks, grounds, and other centers for remembrances.

Charitable Activities

Programs and activities that exclusively further religious, charitable, scientific, literary, or educational purposes, or are for the prevention of cruelty to children or animals.

Patriotic Programs

This includes programs and activities that promote Americanism, sponsor youth activities, provide color guards, conduct patriotic ceremonies and functions, and conduct community activities.

Insurance Benefits

Congress originally enacted IRC section 501(c)(19) to allow war veterans' organizations to continue providing life, sick, accident, or health insurance benefits for their members and their members' dependents. All IRC section 501(c)(19) organizations are now permitted to provide these benefits. Most veterans' organizations do not provide these benefits directly; they contract out to existing public insurance companies. The administration of the insurance programs is often the responsibility of trusts or foundations created for this specific purpose.

These organizations may also qualify for exemption under IRC section 501(c)(19). Should a veterans' organization wish to provide the insurance benefits directly, it may so through the creation of insurance set-asides.

Continued on next page
### Exempt Status Under IRC Section 501(c)(19), Continued

<table>
<thead>
<tr>
<th>Social and Recreational Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social and recreational activities are exempt activities if conducted among post members. Such activities may include:</td>
</tr>
<tr>
<td>• The operation of a bar and/or restaurant</td>
</tr>
<tr>
<td>• Gambling</td>
</tr>
<tr>
<td>• Dinners and dances</td>
</tr>
</tbody>
</table>

A bar and restaurant is an acceptable social and recreational setting for a veterans organization exempt under IRC section 501(c)(19). The use must be limited to members or their guests. Guests must be invited and all expenses must be paid by the member. If facilities are open to the general public the income may be UBIT and may adversely affect exempt status.

<table>
<thead>
<tr>
<th>Legislative Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legislative activities that are consistent with exemption under IRC section 501(c)(19) include:</td>
</tr>
<tr>
<td>• Reviewing proposed legislation that may affect veterans, at both the federal and state levels</td>
</tr>
<tr>
<td>• Testifying before a governmental body with respect to such legislation</td>
</tr>
<tr>
<td>• Informing members about proposed legislation</td>
</tr>
</tbody>
</table>

Veterans' organizations are in a unique position to provide information regarding proposed legislation to both veterans and the legislature and have historically functioned as representatives before legislative bodies.
## Non-Exempt Activities Under IRC Section 501(c)(19)

<table>
<thead>
<tr>
<th>Substantial Unrelated Activities May Prevent Exemption</th>
<th>Substantial unrelated activities may prohibit exemption under IRC section 501(c)(19). The following are examples of unrelated activities that may affect exemption:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Rents out its facilities to the general public</td>
</tr>
<tr>
<td></td>
<td>- Facilities, such as bar and dining facilities, are open to the general public</td>
</tr>
<tr>
<td></td>
<td>- Sells liquor and/or food to members and/or the public for consumption off the premises</td>
</tr>
<tr>
<td></td>
<td>- Gaming activities with non-members</td>
</tr>
<tr>
<td></td>
<td>If the organization receives a substantial portion of its gross income from the general public, a facts and circumstances test must be used to determine if the organization is organized and operated within the meaning of IRC section 501(c)(19).</td>
</tr>
<tr>
<td>Inurement</td>
<td>Treas. Reg. 1.501(c)(19)-1 (a) prohibits the inurement of net earnings to the benefit of any private shareholder or individual for exempt IRC section 501(c)(19) organizations.</td>
</tr>
<tr>
<td>Failing to Qualify Under 501(c)(19)</td>
<td>A veterans’ organization that seeks exemption under IRC section 501(c)(19) and fails to qualify under that section may request exemption under IRC section 501(c)(4).</td>
</tr>
</tbody>
</table>
Membership Requirement

Present or Former Members of the Armed Forces

At least 75% of the members are present or former members of the Armed Forces of the United States (veterans). Substantially all the other members must be cadets or spouses, widows, widowers of veterans or cadets, or ancestors of lineal descendants of past or present members of the Armed Forces of the United States or of cadets. (Note: Section 105(a) of the Military Tax Relief Act (MFTRA) amended IRC section 501(c)(19)(B) to include ancestors.)

"Substantially all" means 90%. Of the 25% that are non-veterans 90% must be cadets or spouses, etc. Only 2.5% of the organization's total membership may consist of individuals that are not veterans, cadets, spouses, widows, or widowers of these individuals.

Application of 75% Test

When applying the 75% test requirement, keep in mind:

- No more than 25% of total membership may be non-veterans
- Of the 25%, at least 90% of the members must be cadets, spouses, widows, or widowers of veterans

Members of the Armed Forces

Veterans are defined as present or former members of the United States Armed Forces. The term “military or naval forces of the United States” and the term “Armed Forces of the United States” each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force. Each term also includes the Coast Guard.

The National Guard is considered a part of the Armed Forces of the United States for purposes of section 1.61-2 of the regulations. See Rev. Rul. 60-65, 1960-1 C.B. 21.

Continued on next page
Membership Requirement, Continued

### Burden of Proof

The burden of proof that an IRC section 501(c)(19) organization meets the membership requirements under this section is that of the organization.

The burden of proof may be established by providing:

- Copies of DD Forms 214 that were submitted to them that shows the period the veteran served in the Armed Forces
- Any other information presented by a member as evidence of veteran status
- Completed application forms for membership
- Membership cards

### Failure to Substantiate Veteran Status

A failure on the part of the organization to submit sufficient information to show compliance with the membership requirements of IRC section 501(c)(19) will cause denial of their request for exemption under that section.

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*Veterans' Organizations*

*IRC Section 501(c)(19)*

*9-11*
Deductible Contributions

A contribution is deductible under IRC sections 170(c)(3) and 2522(a)(4) only if it meets the membership and purpose requirements. The war veterans organization must be organized in the United States or any of its possessions and no part of the net earnings inures to the benefit of any private shareholder or individual. The deductibility can apply to the war veterans organization or its auxiliary units.

Membership Requirement:

- The veterans’ organization membership consists of 90% war veterans (see definition below)
- The remainder of the members is veterans (but not war veterans) or cadets, spouses, widows, or widowers of war veterans, veterans, or cadets
- A war veteran for the 90% test may include members of expeditionary forces who actually served in combat situations in foreign countries between the periods of war as defined below

Purpose Requirement:

The organization must be organized and operated primarily for purposes that are consistent with its status as a war veterans’ organization. (Rev. Rul. 84-140, 1984-2 C.B. 56)
Deductible Contributions, Continued

War Veteran Defined

A war veteran is an individual who served in the Armed Forces of the United States during a period of war as follows:

- April 21, 1899, through July 4, 1902
- April 6, 1917, through November 11, 1918
- December 7, 1941, through December 31, 1946
- June 27, 1950, through January 31, 1955
- August 5, 1964, through May 7, 1975
- August 2, 1990, and ending on the date prescribed by Presidential Proclamation or by law. (As of the date for drafting these guidelines, the date was open)

Note: Check to see if any subsequent periods are determined by Congress to be periods of war for purposes of this section. These dates are important in determining membership requirements for a “Veterans of Foreign Wars” organization.

Veterans' Organizations
IRC Section 501(c)(19)
9-13
Auxiliary Organizations

Auxiliary Provisions

An auxiliary unit or society of a post or organization of veterans, exempt under IRC section 501(c)(19), may be exempt as an organization described in IRC section 501(c)(19), and may be eligible for tax deductible contributions under IRC section 170(c)(3), if it:

- Meets membership requirements
- Is affiliated with and organized in accordance with an IRC section 501(c)(19) organization
- The auxiliary unit or facility is organized in the United States or any of its possessions
- No part of the net earnings inure to the private benefit of any private shareholder or individual
- The unit is separately organized and has its own EIN

Membership Requirements for an Auxiliary

All of the auxiliary members must be comprised of the following:

- Members of an organization described in IRC section 501(c)(19) or
- Spouses of a member of such an organization or
- Widows or widowers of former members of such organization or of the United States Armed Forces or
- Related to such members or present or former members of the United States Armed Forces by blood within two degrees of consanguinity. (Within two degrees of consanguinity is grandparent, brother, sister, grandchild)

Note: Treas. Reg. 1.501(c)(19)-1(d), does not reflect the 1982 amendment of IRC 501(c)(19) that changed the membership requirement from war veterans to members of the Armed Forces.

Continued on next page
Auxiliary Organizations, Continued

Affiliation Requirements for an Auxiliary

The auxiliary unit or society is affiliated with, and organized in accordance with, the bylaws and regulations formulated by an IRC section 501(c)(19) post or organization of veterans.

Note: "Affiliated with" indicates an act or condition of being affiliated, allied, or associated with an IRC section 501(c)(19) organization.
**Trusts or Foundations**

**Supporting an Exempt Veterans Organization**

The regulations provide that a trust or foundation for a post or organization of veterans described in IRC section 501(c)(19) may be exempt under IRC section 501(c)(19) if it:

- Has a legal existence
- Is organized exclusively for IRC section 501(c)(19) purposes
- Has a dissolution provision as described in Treas. Reg. 1.501(c)(3)-1(b)(4) in its organizing document if it is organized for charitable purposes
- Has no unreasonable accumulation of income and
- Is used only for:
  - The purposes of funding a veterans' organization
  - IRC section 170(c)(4) purposes, or
  - An insurance set-aside

**Note:** Unless the trust or foundation is an insurance set-aside, a substantial portion of the income must actually be distributed for these purposes.
Charitable Gaming

An Allowable Form of Recreation

Many veterans' organizations engage in some sort of charitable gaming as recreation and as a means of raising additional funds. Gaming may be in the form of bingo games, pull-tab sales, and raffles.

Gaming provides recreation for many people. If the gaming is limited to members of the post and their guests (guests must not only be invited by a member but must have all of their expenses paid by a member), it is an acceptable activity for an IRC section 501(c)(19) organization.

Gaming open to the public may jeopardize an organization's exemption and may result in Unrelated Business Income Tax.

In your review of an application from a veterans' organization with gaming you will need to determine if the gaming activity is for members only or also provided to the public.

For further information on UBIT from gaming refer to Publication 3079, Gaming Publication for Tax-Exempt Organizations.
**Veterans’ Organizations and Other Applicable Subsections**

<table>
<thead>
<tr>
<th>501(c)(4) Veterans’ Organizations</th>
<th>IRC section 501(c)(4) exemption is based upon activity, not membership. A veterans’ organization seeking exemption under IRC section 501(c)(4) must be operated to promote social welfare and benefit the community in general, in the same manner as other IRC section 501(c)(4) organizations. You will work an application for exemption of a veterans’ organization seeking exemption under IRC section 501(c)(4) in the same manner as any other request for exemption under that section. Keep in mind a veterans’ organization exempt under IRC section 501(c)(4) whose primary activity is to provide social and recreational activity for members would first be considered for exemption under IRC section 501(c)(19). Providing social and recreation activity for members is an acceptable exempt purpose for an IRC section 501(c)(19) veterans’ organization.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Club Subsidiaries of 501(c)(4) Veterans’ Organizations – IRC 501(c)(7)</td>
<td>Veterans’ organizations exempt under IRC section 501(c)(4) often maintain and operate their social facilities as a wholly owned subsidiary under IRC section 501(c)(7). See Rev. Rul. 66-150, 1966-1 C.B. 147. An IRC section 501(c)(7) club’s members must share common goals and interests that are furthered through its social and recreational activities. The fellowship among members that grows through such participation is considered a key component of a social club. For example, by operating a bar, restaurant, bingo nights and similar recreational facilities and activities for its members and bona fide guests, a veterans’ organization is promoting the fellowship and common interests of its members. Clubs that do not engage in activities where its members meet, such as automobile clubs or discount buying clubs, do not have this essential element and do not qualify for exemption.</td>
</tr>
<tr>
<td>Other Subsections</td>
<td>Veterans’ organization may qualify for exemption under a number of other Code sections. See the specific section for requirements and guidelines for making a determination. Also refer to Publication 3386.</td>
</tr>
</tbody>
</table>

*Veterans’ Organizations*  
*IRC Section 501(c)(19)*  
*9-18*
Unrelated Business Taxable Income (UBTI)

Unrelated Business Income Described

Just like other exempt organizations, veterans’ organizations exempt under IRC section 501(c)(19) are required to pay tax on income earned in an unrelated trade or business. To be considered unrelated, a trade or business must be regularly carried on and not substantially related to the performance of an organization’s exempt purpose other than its need to raise money to carry on its programs.

Unrelated activities may be from the selling of goods or performing services.

“Regularly carried on” means if the activity is conducted frequently or continually, and pursued in a manner similar to a commercial entity.

Exceptions to UBTI

Certain activities when conducted under specific conditions will be excluded from unrelated business income (UBI). These exclusions include:

- Volunteer labor – substantially all the work is performed by volunteers
- Selling donated goods – thrift shop selling donated goods
- Certain bingo games that are legal. They cannot be pull-tabs, instant bingo, or similar type raffles
- Low cost articles - like selling candy or stationery
- Exchange or rental of membership lists - when between posts of war veterans eligible to receive tax deductible contributions

Reciprocal Privileges

Members of an exempt IRC section 501(c)(19) veterans’ organization and its subordinate posts may use the facilities of its related post without generating UBTI. This is also the case for members of auxiliaries related to the exempt post.

Continued on next page
Unrelated Business Taxable Income (UBTI), Continued

Social Functions

Family participation in weekly social functions furthers the IRC section 501(c)(19) purpose of providing social activities for members. Therefore a member that brings his or her family to the post’s weekly social function will not generate UBTI.

Conducting social functions like spaghetti dinners, breakfasts, and dances for members and their guests will not be subject to UBTI.

Rev. Rule 68-46
Effect When UBI Activities Are Primary

Rev. Rul. 68-46, 1968-1 C.B. 260, holds that where the conduct of unrelated business activities is the primary activity of an IRC section 501(c)(4) organization, exemption will be denied.

This Rev. Rul. would also apply to an IRC section 501(c)(19) veterans’ organization whose primary activity is the conduct of unrelated business income activities.

Reporting Requirements

An exempt organization is responsible for reporting unrelated business income (UBI) and paying any tax liabilities. If an organization can be expected to have UBI then their account should reflect a 990-T filing requirement.

Note: When the total amount of UBI is $1,000 or less, the organization is not required to report the UBI on the Form 990-T.

Veterans’ Organizations
IRC Section 501(c)(19)
9-20

IRSTR-B-00856
Veterans' organizations must be operated for one or more of the eight purposes or activities listed in Treas. Regs. 1.501(c)(19)-1(c):

- operated exclusively to benefit social welfare of the community
- assist disabled and needy veterans
- entertain and care for hospitalized veterans
- perpetuate the memory of deceased veterans
- conduct religious, charitable, scientific, literary, or educational programs
- conduct patriotic programs
- provide insurance benefits to members
- provide social and recreational activities for members

Substantial unrelated activities may prohibit exemption under IRC section 501(c)(19).

Net earnings of veterans organizations' may not inure to the benefit of any private shareholder or individual.

At least 75% of the members of a veterans' organization must be present or former members of the Armed Forces of the United States (veterans). Of the 25%, at least 90% must be cadets, spouses, widows, or widowers of veterans.

An auxiliary unit of a veterans' organization may be exempt as an organization described in IRC section 501(c)(19) if it:

- Meets membership requirements
- Is affiliated with an IRC section 501(c)(19) organization
- Is organized in the United States or any of its possessions
- Has no part of the net earnings inure to the benefit of any private shareholder or individual
- Is separately organized and has its own EIN
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Veterans' Organizations
IRC Section 501(c)(19)
9-22
Lesson 10

Title Holding Companies
IRC Sections 501(c)(2) and 501(c)(25)

Overview

Introduction

Exemption for corporations that hold title to property for another exempt organization goes back to 1916 when the statutory predecessor to IRC section 501(c)(2) was enacted.

Title holding companies are recognized as exempt under either IRC section 501(c)(2) or 501(c)(25). IRC section 501(c)(2) provides for recognition of exemption of single-parent title holding companies. IRC section 501(c)(25) describes multiple-parent title holding companies.

Some of the reasons for creating a title holding company include:

- Limiting the owner’s liability from ownership
- Improving the owner’s ability to borrow funds
- Clarifying title
- Simplifying accounting
- Complying with state law requirements

Continued on next page
Overview, Continued

Objectives

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

- Identify the types of organizations that are classified as title holding companies
- Determine when the organizational test is met
- Identify permissible activities of title holding companies
- List permitted sources of income
- Determine what constitutes an excessive accumulation of income
- Identify sources of unrelated business income (UBI) that affect tax exempt status
- Describe the differences between IRC section 501(c)(2) and 501(c)(25) organizations

In This Lesson

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<td>Statute Modifications</td>
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<td>Comparing IRC Sections 501(c)(2) and 501(c)(25)</td>
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<td>Summary</td>
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</tbody>
</table>

Title Holding Companies
IRC Sections 501(c)(2) and 501(c)(25)
10-2
IRC Section 501(c)(2)

Statutory Definition
IRC section 501(c)(2) provides for the tax exemption of:

*Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under section 501(a).*

Treas. Reg. 1.501(c)(2)-1(a) further clarifies that:

***a corporation described in section 501(c)(2) cannot be exempt under section 501(a) if it engages in any business other than that of holding title to property and collecting income therefrom***.

IRC 501(a)
Organizations described in IRC section 501(a) are entities exempt from tax under IRC sections:

- 501(c) - all subsections
- 501(d) - religious and apostolic organizations
- 401(a) - tax exempt pension trusts

Multiple Parents
There is no Treasury regulation or revenue ruling prohibiting multiple parents of a title holding company. However, the Service has taken the position in several GCMs that a multiple-parent title holding company should not be exempt under IRC section 501(c)(2). The emergence of the Service position on multiple parents led to the enactment of IRC section 501(c)(25).

GCM 37351 (dated Dec. 20, 1977) discussed exceptions to the general rule that an IRC section 501(c)(2) organization may have only one parent. Multiple parents may be allowed if related organizations create a title holding company to hold title to a building used at least in part by the organizations themselves. Multiple parents may also be allowed when unrelated organizations that jointly own real property used in part by such organizations transfer their interests in this property to a title holding corporation they create.

Continued on next page
IRC Section 501(c)(2), Continued

Organizational Requirements

A title holding company may be formed as a corporation or an association; it cannot be formed as an ordinary trust.

There is no organizational test in the sense of IRC section 501(c)(3) requirements for purpose and dissolution provisions. However, the organization must not have powers broader than the statutory purposes in IRC section 501(c)(2).

The organizing document should not authorize the organization to engage in business other than that of holding title to property and collecting income there from. Having a purpose clause that includes the broader purposes of the parent organization is acceptable if there is no problem with the actual activities of the organization.

Rev. Rul. 58-566, 1958-2 C.B. 261, held that a corporation will not be considered a holding company within the meaning of IRC section 501(c)(2) where it has broad powers and business purposes far beyond the scope necessary to a holding company. Furthermore, where part of its income is used to reduce indebtedness on property which will ultimately revert to private individuals, it will not be considered as being operated for exempt purposes.

Continued on next page
IRC Section 501(c)(2), Continued

Relationship Requirements
IRC section 501(c)(2) statutes do not specify the relationship required between a title holding company and the exempt organization receiving its income. Traditionally, the relationship is that of a parent and subsidiary.

Examples of this include when the exempt organization:

- Owns the voting stock of the title holding company or
- Possesses the power to select nominees to hold the voting stock

Rev. Rul. 71-544, 1971-2 C.B. 227, held that when a title holding company is independent of the distributee and has complete discretion as to the selection of the distributee, the title holding corporation will not be considered as described in IRC section 501(c)(2).

Disqualifying Activities
A title holding company must limit its activities to those described in IRC section 501(c)(2) in order to qualify for exemption.

An example of a disqualifying activity is the operation of the social facilities (e.g., a bar, restaurant, and game room) in a building to which the organization holds title. Rev. Rul. 66-150, 1966-1 C.B. 147, held that the organization did not qualify for exemption under IRC section 501(c)(2) or (4) but may qualify under IRC section 501(c)(7).
## Permitted Income Sources

### Permissible Income

The following sources of income are permitted for IRC section 501(c)(2) title holding companies:

- Investment income from stocks and bonds
- Rent from real property
- Royalty interests in oil and other similar mineral production

### Permissible Holdings

Whereas IRC section 501(c)(25) specifically requires that held property be real property (i.e., land and buildings), IRC section 501(c)(2) states only "property" without further qualification.

Therefore, an IRC section 501(c)(2) organization can hold title to both real property and investments.

### Investment Income

Although investment in stocks and bonds is not listed in the regulations as a permissible activity, the passive collection of income from such investment is allowed. However, permissible investment activities should be distinguished from the active "business" of securities trading. (Rev. Rul. 69-528, 1969-2 C.B. 127)

### Rent from Real Property

Rent from real property is a traditional source of income for title holding corporations. Rental income has long been held as a permitted income source.

Nothing in IRC section 501(c)(2) prevents an exempt title holding company from renting its real property to the general public.

Continued on next page
Permitted Income Sources, Continued

Rent from Mixed Leases

In general, the definition of rent from real property for purposes of IRC section 501(c)(2) follows IRC section 512(b)(3) in including rent from personal property leased with the real property, provided the portion of the rent attributable to the personal property is 10% or less of the total rent.

Examples of personal property rented with real property in a mixed lease are furniture or other moveable property used on the premises by the tenants. Leasing personal property separately from the real estate is considered the active conduct of a trade or business.

Royalties

Generally, a royalty interest would be a permissible source of income as opposed to a working interest. A royalty interest is a right to receive oil or mineral production payments.
## Prohibited Income Sources

<table>
<thead>
<tr>
<th>Prohibited Income</th>
<th>The following income sources are non-passive and are not permitted for IRC section 501(c)(2) title holding companies:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Trade or business income from active business operations</td>
<td></td>
</tr>
<tr>
<td>• Rental income from personal property that is not leased with real property</td>
<td></td>
</tr>
<tr>
<td>• Income from operating an investment fund (i.e., actively trading securities)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>501(c)(2) or Feeder Organization</th>
<th>IRC section 501(c)(2) organizations may not receive income from the active conduct of trade or business. Like IRC section 502 feeder organizations, title holding companies pay over all of their income to exempt parent organizations. However, feeder organizations differ from title holding companies because they engage in an active trade or business other than the mere passive rental of property or passive collection of royalties or investment income.</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 502(a) states:</td>
<td>(a) An organization operated for the primary purposes of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the grounds that all of its profits are payable to one or more organizations exempt from taxation under section 501.</td>
</tr>
</tbody>
</table>

| Personal Property Rental Income | Renting personal property separate from any real property is a prohibited income source for IRC section 501(c)(2) organizations. Rev. Rul. 69-278, 1969-1 C.B. 148, held that an organization that rented trucks with no direct relationship to any leased building held by the title holding corporation and that also received a substantial amount of its revenues from the personal property leases did not qualify for exemption under IRC section 501(c)(2). |

| Active Investment Income | Operating an investment service, including the active trading of common stocks, is not exempt activity under IRC section 501(c)(2). (Rev. Rul. 69-528, 1969-2 C.B. 127) |

---

*Title Holding Companies*

*IRC Sections 501(c)(2) and 501(c)(25)*

10-8
Unrelated Business Income

Unrelated Business Income

As a general rule, unrelated business income (UBI) is not a permitted income source for IRC section 501(c)(2) title holding companies. However, there are certain exceptions to the prohibition of UBI as an income source. These provisions refer only to the effect on the title holding company’s exemption. They do not affect the taxability of the income in question. These exceptions are found in Treas. Reg. 1.501(c)(2)-1(a).

A title holding corporation will not be barred from exemption if it has unrelated business income solely because:

- The parent organization is exempt under IRC section 501(c)(7), (9), (17), or (20) (IRC section 501(c)(20) is an expired section)
- It receives income from real or personal property that is encumbered by a debt
- Its rental income is determined by the net profits of the renter or lessee
- It receives interest, rents, annuities, or royalties from a controlled corporation
- More than 10% of the rental income is attributable to personal property leased with the real property in a mixed lease, or
- More than 50% of the rental income in a mixed lease is attributable to the personal property (This case is distinguished from the preceding in that all the rental income is now UBI)

Note that all of these types of UBI arise in connection with permitted activities of rental of real property and holding of passive investment property.

An IRC section 501(c)(2) organization with these types of UBI must file Form 990-T and pay any applicable taxes.

Continued on next page
Unrelated Business Income, Continued

Example 1  Corporation T holds title to the real property of an organization exempt under IRC section 501(c)(5). The organization borrowed funds in order to purchase the building from which it derives rental income and is paying off the mortgage.

The title holding corporation is liable for unrelated business income tax on the rental income from debt-financed property (per IRC section 514), but its exemption under IRC section 501(c)(2) is not in jeopardy.

Incidental Income

Originally, tax law denied exemption to a title holding company deriving any amount of income from prohibited sources.

When IRC section 501(c)(25) was enacted in 1986, it contained a provision (subparagraph (G)) which preserved the exemption of a title holding company if it derived a limited amount of income from certain prohibited sources.

Subsequently, the Omnibus Budget Reconciliation Act (OBRA 93) made the provision applicable to IRC section 501(c)(2) corporations also.

IRC section 501(c)(25)(G) permits title holding companies to receive up to 10% of gross income from activities incidental to the rental of real property, such as operating vending machines and parking lots. Not all disqualifying unrelated business income comes under this exception. The business must be incidental to the rental of the real property.

The IRC section 501(c)(25)(G) 10% limit on income from activities incidental to the rental of real property is not to be confused with the 10% test for UBI classification of rental income from a mixed lease (personal property leased with real property).

Continued on next page
Unrelated Business Income, Continued

Example 2

Corporation T holds the real property for Veterans Post V, an organization exempt under IRC section 501(c)(19).

The organization derives 95% of its gross income from the rental of real property. The organization derives 5% of its income from vending machines in the building. The vending machine income is unrelated business income and the vending machine activity is incidental to the rental activity.

The vending machine income would be fatal for the exemption of the title holding company were it not for the rule of IRC section 501(c)(25)(G). Because the vending machine activity is incidental to the rental of real estate and is responsible for less than 10% of the company’s total receipts, the company will qualify for exemption under IRC section 501(c)(2).

It must, however, file Form 990-T and pay any unrelated business income tax due on the vending machine income.

Consolidated Return

Unlike other organizations exempt under IRC section 501(c), an IRC section 501(c)(2) title holding company can file a consolidated return with the parent to which it pays over its income. If a consolidated return is filed, the title holding company, for purposes of the unrelated business income tax, is treated as organized and operated for the same purposes as its parent. (See IRC section 511(c).)

Special Rule

Unrelated business taxable income for title holding companies of organizations exempt under IRC section 501(c)(7), (9), (17) or (20) is computed in the same way as for the parents. (see IRC section 512(a)(3)(C))

Title Holding Companies
IRC Sections 501(c)(2) and 501(c)(25)
10-11
Turning Over Income

When to Turn Over Income

Neither the IRC nor the regulations specify how soon the income of the title holding company must be turned over to the distributee. Treas. Reg. 1.501(c)(2)-1(b) does state:

_A corporation described in section 501(c)(2) cannot accumulate income and retain exemption._

Accumulation beyond sufficient time for normal administrative or accounting action is not permitted.

As a practical matter, it would seem reasonable to allow the title holding company until the end of the succeeding taxable year to make the distribution. Such a rule of thumb would provide ample time for normal accounting and other administrative procedures by the title holding company.

What Is Income?

In determining income to distribute, gross income of the title holding company may be reduced by:

- Operating expenses that would be deductible by a taxable corporation, including depreciation (Rev. Rul. 66-102, 1966-1 C.B. 133)

- Reasonable amounts to retire indebtedness of the property (Rev. Rul. 67-104, 1967-1 C.B. 120)

Income may not be reduced by deductions such as charitable contributions that are not "costs" related to the property.

Continued on next page
Turning Over Income, Continued

Income used for the purpose of retiring indebtedness is not treated as part of the accumulated earnings of a title holding company. If a title holding company was required to remit all its net income to the parent every year, it would have no funds to meet any indebtedness on the property it holds.

The Service has ruled that a title holding company may retain part of its income each year to apply to indebtedness on property it holds. The transaction will be treated as if the income had been turned over to the parent.

The characterization of the required distribution of income is immaterial. It could be termed a dividend on stock or given some other description. The essential factor is that the distribution must actually be paid to the exempt parent organization. A mere obligation to use the income for the parent's benefit or the parental control of the title holding company would not satisfy this requirement.

For example, an exempt parent may occupy realty owned by the holding company and pay no rent. The statutory requirement that income be paid over to the parent is satisfied if the holding company turns over whatever income is available to the parent.

Title Holding Companies
IRC Sections 501(c)(2) and 501(c)(25)
10-13
In enacting IRC section 501(c)(25), Congress allowed certain pension trusts, governmental entities and IRC section 501(c)(3) organizations wider latitude to pool their resources in their real property investments than permitted for IRC section 501(c)(2) title holding companies. Even though the purpose of IRC section 501(c)(25) was to recognize title holding companies with multiple parents as exempt from federal tax, the vast majority of IRC section 501(c)(25) applicants have a single parent.

Although no regulations have been issued under this Code section, the Service has published Notice 87-18, 1987-1 C.B. 455, and Notice 88-121, 1988-2 C.B. 457, to provide guidance in this area. Notice 87-18 essentially requires that most of the statutory requirements be included in the title holding company's organizing document. Notice 88-121 clarified permissible holdings and unrelated business income issues.

Continued on next page
IRC Section 501(c)(25), Continued

Differences from IRC Section 501(c)(2)

IRC section 501(c)(25) differs from IRC section 501(c)(2) in that:

• Income must be derived from rental of real property
• The organization must be a corporation or a trust
• There may be up to 35 tax exempt organizations as shareholders or beneficiaries
• The entire income, after expenses, must be remitted to one or more organizations described in IRC section 501(c)(25)(C) which are shareholders or beneficiaries of title holding companies. Allowable shareholders or beneficiaries are:
  ○ Qualified pension, profit sharing, or stock bonus plans that meet the requirements of IRC section 401(a)
  ○ Governmental plans under IRC section 414(d)
  ○ The United States, a state or political subdivision thereof, or
  ○ An agency or instrumentality of the foregoing
  ○ IRC section 501(c)(3) organizations (Note: Organizations exempt under other subsections of IRC section 501(c) cannot be shareholders)

Reserved For EO Technical

Applications from IRC section 501(c)(25) title holding companies are currently reserved for EO Technical because Treasury regulations have yet to be issued with respect to this Internal Revenue Code section. Refer to IRM 7.20.1.3.4(7).

Applications for exemption under section 501(c)(25) are not subject to Mandatory Review by Quality Assurance.

Title Holding Companies
IRC Sections 501(c)(2) and 501(c)(25)
10-15
## Statute Modifications

<table>
<thead>
<tr>
<th>Member Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>When enacted in 1986, IRC section 501(c)(25) organizations were allowed as shareholders or beneficiaries of other IRC section 501(c)(25) organizations. This circumvented the intention of the statute to limit shareholders to 35 members. The Technical and Miscellaneous Revenue Act (TAMRA 88) repealed this provision.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IRC Section 514(c)(9)(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>This section provides that IRC section 501(c)(25) organizations are among the qualified organizations not subject to taxation of debt-financed income from real property. Before TAMRA 88, all shareholders could benefit from this privilege, but TAMRA 88 restricted the benefit to organizations which were themselves qualified organizations under IRC section 514(c)(9)(c), such as educational institutions and IRC section 401 trusts.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1993 Amendment to IRC Section 501(c)(2)</th>
</tr>
</thead>
</table>
| IRC section 501(c)(25)(G) provides that an organization will continue to be exempt under IRC section 501(c)(25) even if it receives up to 10% of its income from "otherwise disqualifying income which is incidentally derived from the holding of real property."

The same rule was made applicable to IRC section 501(c)(2) organizations in 1993. |
Comparing IRC Sections 501(c)(2) and 501(c)(25)

<table>
<thead>
<tr>
<th>CHARACTERISTIC</th>
<th>501(c)(2)</th>
<th>501(c)(25)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organizational and Operational</td>
<td>• Hold title to property</td>
<td>• Hold title to real property</td>
</tr>
<tr>
<td></td>
<td>• Collect the income from the property held</td>
<td>• Collect the income from the property held</td>
</tr>
<tr>
<td></td>
<td>• Turn entire amount of income over to an organization described in</td>
<td>• Turn entire amount of income over to</td>
</tr>
<tr>
<td></td>
<td>IRC sections 501(c), 501(d), or 401(a).</td>
<td>1-35 organizations listed below:</td>
</tr>
<tr>
<td></td>
<td>• May be a corporation or an unincorporated association treated as a</td>
<td>• IRC 401(a) organization</td>
</tr>
<tr>
<td></td>
<td>corporation, but not a trust</td>
<td>• IRC 414(d) Plan</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• United States government</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Political subdivision</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• IRC section 501(c)(3) organizations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• May be a corporation, or an unincorporated association treated as a</td>
</tr>
<tr>
<td></td>
<td></td>
<td>corporation, or a trust</td>
</tr>
<tr>
<td>Permissible Holdings</td>
<td>• Real property</td>
<td>• Real property</td>
</tr>
<tr>
<td></td>
<td>• Personal property leased with real property</td>
<td>• Personal property leased with real property</td>
</tr>
<tr>
<td></td>
<td>• Investments</td>
<td>• Cash and short term Investments</td>
</tr>
<tr>
<td></td>
<td>• Royalty interests</td>
<td></td>
</tr>
<tr>
<td>Permitted Sources of Income (not subject to UBIT)</td>
<td>• Rent from real property</td>
<td>• Rent from real property (including debt-financed property)</td>
</tr>
<tr>
<td></td>
<td>• Rent from personal property leased with real property (up to 10% of</td>
<td>• Rent from personal property leased with real property (up to 15% of</td>
</tr>
<tr>
<td></td>
<td>total rent from both) (Treas. Reg. 1.512(b)-1(c)(2))</td>
<td>total rent from both (IRC section 501(c)(25)(F))</td>
</tr>
<tr>
<td></td>
<td>• Investment income (interest and dividends)</td>
<td>• Investment income from short term investments (reasonable reserves)</td>
</tr>
<tr>
<td></td>
<td>• Royalties in oil or other mineral production</td>
<td></td>
</tr>
</tbody>
</table>

Title Holding Companies
IRC Sections 501(c)(2) and 501(c)(25)
10-17
## Comparison of IRC sections 501(c)(2) and 501(c)(25)

### Differences Highlighted in Bold Print

<table>
<thead>
<tr>
<th>CHARACTERISTIC</th>
<th>501(c)(2)</th>
<th>501(c)(25)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-disqualifying Unrelated Business Income</td>
<td>• IRC section 514 debt-financed income</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>• Interest, rents, annuities or royalties treated as UBI solely due to IRC section 512(b)(13) (controlled organizations)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Income treated as UBI solely due to IRC section 512(a)(3)(C) (pertains only to title holding companies with IRC 501(c)(7), (9), (17) or (20) parent organizations)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rent from personal property leased with real property (more than 10%)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rent from mixed lease in which more than 50% of rent is attributable to personal property</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rental income based in whole or in part on the income or profits derived by any person from the property (IRC section 512(b)(3)(B)(ii))</td>
<td></td>
</tr>
</tbody>
</table>
Comparing IRC Sections 501(c)(2) and 501(c)(25), Continued

<table>
<thead>
<tr>
<th>CHARACTERISTIC</th>
<th>501(c)(2)</th>
<th>501(c)(25)</th>
</tr>
</thead>
</table>
| Reserves       | Accumulate income sufficient to:  
  • Cover operating expenses including depreciation (usually one year)  
  • Retire indebtedness on the property | Reasonable cash reserves (short term investments up to 91 days) sufficient to:  
  • Cover operating expenses including depreciation (usually one year)  
  • Retire indebtedness on the property |

**Title Holding Companies**

IRC Sections 501(c)(2) and 501(c)(25)

10-19
Summary

IRC section 501(c)(2) provides for recognition of exemption of single-parent title holding companies and IRC section 501(c)(25) describes multiple-parent title holding companies.

There is no organizational test comparable to the IRC section 501(c)(3) requirements for purpose and dissolution provisions, but an organization must not have powers broader than the statutory purposes in IRC section 501(c)(2).

To qualify for exemption, a title holding company must limit its activities to those described in IRC section 501(c)(2): holding title to property and collecting income there from.

Permissible sources of income for IRC section 501(c)(2) organizations are investment income from stocks and bonds, rent from rental property, and royalty interests from oil and similar mineral production.

Prohibited sources of income for IRC section 501(c)(2) organizations include income from active trade or business operations, rental income from personal property, and income from operating an investment fund.

Unrelated business income generally is not a permitted source of income for IRC section 501(c)(2) title holding companies. Treas. Reg. 1.501(c)(2)-1(a) contains exceptions to this general rule. These exceptions do not affect the taxability of unrelated business income.

A title holding company must turn over its accumulated income to the distributee. Accumulation beyond sufficient time for normal administrative or accounting action is not permitted.

IRC section 501(c)(25) differs from IRC section 501(c)(2) in that:

- Income must be derived from rental of real property
- The organization must be a corporation or a trust
- There may be up to 35 tax exempt organizations as shareholders or beneficiaries
- The entire income, after expenses, must be remitted to one or more organizations described in IRC section 501(c)(25)(C)

Title Holding Companies
IRC Sections 501(c)(2) and 501(c)(25)
10-20
Lesson 11
Section A

A/T/P Cases – Amendments

Overview

Introduction

Lesson 11, A/T/P Cases, has been divided into sections (A, B, C and D) to discuss some of the different types of cases: amendments, terminations and mergers, terminations of PF status, and group rulings. These case types were introduced in Unit 1a, Lesson 4, *Types of Cases, Expedites, and User Fees*. Amendment cases will be covered in this first section.

When an organization is recognized as exempt, it is required to inform the Service of any changes in its purposes, character, name, or method of operation. Making these changes is called an amendment.

In general, a specialist does not receive cases where changes clearly have no effect on the exempt status or foundation status. For example, changes in the name or address, new officers, minor revisions in the bylaws, etc., are handled by the Correspondence Unit.

However, if the change(s) may affect the exempt status, foundation status, filing requirements, etc. of the organization, an “A” (amendment) case is established to be reviewed by a determinations specialist.

“A” cases are currently a reserved inventory category.

Continued on next page

A/T/P Cases - Amendments

11A-1

IRSTR-B-00879
Overview, Continued

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

- List common “A” cases
- Describe general “A” case procedures
- Identify issues for which an “A” case determination letter will not be issued

In This Lesson
This lesson contains the following topics:

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<tr>
<td>General “A” Case Procedures</td>
<td>11A-4</td>
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<td>No “A” Case Determination Letter Issued</td>
<td>11A-7</td>
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<tr>
<td>Summary</td>
<td>11A-8</td>
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<tr>
<td>Exhibit 14A-1, Letter 4174</td>
<td>11A-9</td>
</tr>
</tbody>
</table>

A/T/P Cases - Amendments

11A-2
Common “A” Cases

Rev. Proc. 2008-4, 2008-1 I.R.B. 121, Section 7.04, specifies matters in which EO Determinations will issue a determination letter. Many of these requests (other than initial determinations) are established and worked as “A” cases.

Letter requests that are established as “A” cases include:

- Requests for change in foundation classification (e.g., change to church status, voluntary request for private foundation classification, request for private operating foundation classification, etc.)
- Recognition of unusual grants to certain organizations under IRC section 170(b)(1)(A)(vi) or 509(a)(2)
- Advance approval of certain set-asides described in IRC section 4942(g)(2) (a Grade 13, reserved category issue)
- Exemption from Form 990 filing requirements
- Advance approval of scholarship procedures under IRC section 4945(g) (discussed in Lesson 12)

In addition to the above situations, “A” cases are established to “reinstate” organizations that are in an inactive status (IDRS current status is 20, 21 or 32) with the Service. These “reinstatement” cases are currently a reserved inventory category.

Exempt organizations previously informed the Service of new and discontinued exempt activities by letter. These requests were established as A cases, and the Service responded to these requests by issuing an updated exemption letter on the effect of the change in activities on exempt status.

Under provisions of Revenue Procedure 2008-4, Section 7.04.2, the Service will not issue updated exemption letters on the effect of any changes in activities on exempt status. Organizations now report information on new, ongoing, and discontinued exempt purpose achievements and related revenue and expenses on the redesigned Form 990, Part III, Statement of Program Service Accomplishments.

A/T/P Cases - Amendments

11A-3

IRSTR-B-00881
General "A" Case Procedures

"A" cases in which EO Determinations will issue a determination letter are reviewed and developed to determine whether the organization meets the requirements of the request.

In general, when processing an "A" case:

- Review IDRS information (if current status of organization is 20, 21 or 32, see the manager for possible case reassignment). If IDRS indicates an advance ruling date, discuss the case with your manager.

- Review the case information. If additional information is required to make the determination, prepare and send an additional information request. The organization will be given 21 days to respond.

- If a response is not received by the end of the 21 days, the specialist will call the organization to inquire about the status of the response. If the organization requests additional time to respond, reasonable extensions of up to 14 days should be considered. The specialist should advise the organization that if they do not respond, the case will be closed and no determination will be made. The conversation should be documented fully on the Case Chronology Record.

- If sufficient information is received to make a determination, the appropriate composed letter should be prepared, and the case closed "01" in EDS.

- If the organization does not respond, the appropriate composed letter should be prepared, and the case closed "12" in EDS.

- Current composed letters are posted on Outlook public folders.

- Adverse determinations on "A" cases should be discussed with the manager and are subject to mandatory review.

Continued on next page
Request for Change in Foundation Classification

When reviewing requests for changes in foundation classification, the determinations specialist should obtain sufficient information to ensure that the organization meets the requirements of the requested classification.

For example, if an organization requests reclassification as a school under IRC section 170(b)(1)(A)(ii), the organization must submit information demonstrating compliance with Rev. Proc. 75-50 as well as demonstrating that it meets the operational requirements for classification as a school. The specialist should also ensure that the effective date of the change in foundation classification is correct and be aware that requests for change in foundation status to that of a supporting organization under section 509(a)(3) are reserved inventory cases.

Additional information on reclassification requests can be found in IRM 7.20.3.3.7.

Voluntary PF

Organizations which recognize that they no longer qualify as public charities may voluntarily request reclassification as a private foundation. Detailed procedures for voluntary requests for private foundation status are found in IRM 7.20.3.3.7.1.

In addition, any 4945(g) advanced approval issues should be developed by the assigned determinations specialist.

Voluntary private foundation requests are subject to mandatory review.

Continued on next page
An organization may request a determination on whether it is exempt from filing annual information returns under § 6033 as provided in:


The assigned determinations specialist should obtain sufficient information to ensure that the organization meets the requirements for exemption from the information filing requirement.

Additional information on exemption from 990 filing requirements is found in Lesson 16, Introduction to Returns.
No “A” Case Determination Letter Issued

Change in Activity

Although exempt organizations are required to notify the Service of structural or operational changes, EO Determinations does not issue a determination letter on changes in activities or the effect the changes have on exempt status. Any submitted information is reviewed, and, if appropriate, an EO Classification referral or review of operations follow-up request is completed. This may be completed by the Correspondence Unit or by the assigned specialist.

A composed Letter 4174 is sent to the taxpayer, acknowledging receipt of the information (see Exhibit 14A-1). Case will be closed status 12 in EDS.

Prospective or Proposed Transactions

EO Determinations does not issue determination letters as to the tax consequences of prospective or proposed transactions. (See IRM 7.25.1.2.1)

A proposed transaction described under this section is a new substantial activity that has not yet been engaged in, is not covered by the original exemption letter, and may have an effect on exempt status.

If an “A” case involves a proposed transaction, the organization should be advised that it must get a ruling from EO Technical if it wants reliance that its exemption will continue. In addition, the organization should be advised of the user fee required (currently $8,700) per Rev. Proc. 2008-8 (updated annually) and directed to Rev. Proc. 2008-4 (also updated annually) for guidance in submitting a ruling request.

A composed Letter 976 is sent to the taxpayer. This letter is found in the EO Determinations public folder, Letters & Paragraphs, A Case Letters & Paragraphs. Case will be closed status 12 in EDS.

Change in Subsection or Form

In cases other than Service error, a request to change subsection will require a new application (Form 1023 or Form 1024) and appropriate user fee payment. Also, if an exempt organization changes form (e.g., an exempt unincorporated organization incorporates), a new application and user fee is required.

These applications will be established and processed as if they were initial requests for exemption (“I” cases). “A” case will be closed status 12 in EDS.

A/T/P Cases - Amendments

11A-7
Exempt organizations are required to inform the IRS of any changes in their purposes, character, name, or method of operation.

If these changes may affect the exempt status, foundation status, filing requirements, etc. of the organization, an “A” (amendment) case is established to be reviewed by a determinations specialist.

Letter requests from exempt organizations that are established as “A” cases include requests for:

- Change in foundation status
- Recognition of unusual grants
- Advance approval of certain set-asides
- Exemption from Form 990 filing requirements
- Advance approval of scholarship procedures

“A” cases are also established to “reinstate” organizations that are in an inactive status. These “reinstatement” cases are currently a reserved inventory category.

EO specialists follow established procedures when reviewing and developing an “A” case to determine whether the organization meets the requirements of the request.

EO Determinations does not issue an “A” case determination letter on changes in activities, the effect the changes have on exempt status, or the tax consequences of prospective or proposed transactions. Also, requests to change subsection require the organization file a new application (Form 1023 or Form 1024).
Dear Sir or Madam:

Thank you for the information recently submitted regarding your change in activities.

We will retain the information in our records. Please let us know about any future changes in your purpose, activities, method of operation, name or address. You are required to notify the IRS of such changes in order to maintain your exempt status.

We have sent a copy of this letter to your representative as indicated in your power of attorney.

If you have any questions, please call us at the telephone number shown in the heading of this letter. Thank you for your cooperation.

Sincerely,

Cindy Westcott
Manager, Exempt Organizations
Determinations

Letter 4174 (CG)
Catalog #49589Q

A/T/P Cases - Amendments
11A-9
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A/T/P Cases – Terminations and Mergers

Overview

Introduction
A termination (T) case is established when an exempt organization notifies the Service that it has dissolved or is involved in a merger. In addition, a “T” case may be established when an exempt organization files a return notated as “Final Return” with or without notification of termination or when a specialist is working on an open case and has been notified that the exempt organization is dissolving or has dissolved.

Objectives
At the end of this lesson you will be able to:
- Process a “T” case for termination of an exempt organization
- Process “A” and “T” cases for the surviving and terminating organizations involved in a merger

In This Lesson
This lesson contains the following topics:

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</table>
## Terminations

<table>
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<tr>
<th>Basic Guidelines</th>
<th>Basic guidelines to process a termination case are provided in IRM 7.20.2.4.3. This lesson updates specific procedures that are currently part of the determination process.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notification of Dissolution</td>
<td>If the organization is incorporated, secure a complete copy of the Articles of Dissolution with proof of filing. If the organization is incorporated but has not filed Articles of Dissolution or is an unincorporated association or trust then secure a resolution signed by at least two officers indicating the date of dissolution.</td>
</tr>
<tr>
<td>IRC Section 501(c)(3) Organizations</td>
<td>For IRC section 501(c)(3) organizations, secure a statement signed by an officer of the organization regarding the disposition of assets on hand at the time of dissolution and verify that the recipient organization was exempt under section 501(c)(3). If assets have not been distributed exclusively for IRC section 501(c)(3) purposes, discuss an EO Classification referral with the manager.</td>
</tr>
<tr>
<td>Dissolution with an Open Advance Ruling Period</td>
<td>If IDRS research for a terminating IRC section 501(c)(3) organization indicates an advance ruling period, discuss current processing procedures with the manager.</td>
</tr>
<tr>
<td>Securing Additional Information</td>
<td>If additional information is required, the determination specialist should issue a composed additional-information request using the current letter posted in the EO Determinations public folder, Letters &amp; Paragraphs, T-Case Letters &amp; Paragraphs.</td>
</tr>
</tbody>
</table>

*Continued on next page*
Terminations, Continued

Closing Procedures

When the case is ready to be closed:

- Prepare Letter 2242. For IRC section 501(c)(3) terminations, ensure the appropriate selective paragraphs are entered and prepare an extra copy of the letter to notify state officials.

- Prepare Form 2363-A to reflect status “20” (See Handout xx-B-1)

- Complete 8670 with closing code “01” (there will be no second screen)

- Complete Form 3198-A with the appropriate boxes checked (2363-A; for 501(c)(3) organizations - Termination – Notify State Officials)

- Forward any final returns submitted by the organization to the Ogden Service Center

No Response to Additional Information Request

If no response is received to an additional-information letter, close the case by doing the following:

- Prepare Form 2363-A to reflect status “20”

- Complete Form 8670 with closing code “12” (there will be no second screen)

- Complete 3198-A with a statement “Termination - Do not notify state officials”

No letter will be sent to the organization; include a note in the folder to alert the person who has the responsibility of mailing letters.
Mergers

Introduction

For purposes of this discussion, a merger describes a situation, in which an existing organization combines its assets and operations with those of another existing organization, one predecessor organization survives, and one predecessor organization terminates its existence. When working a case involving a merger, at least two organizations will be involved: the merged organization(s) and the surviving organization.

When working a case involving a merger, a “T” case should be established on EDS for the organization(s) being merged out of existence and an “A” case established for the surviving organization. Current merger procedures are discussed in IRM 7.20.4.1.1 (draft) on the EO Determinations public folder, *Desk Guide* and IRM 7.20.4.4.

Processing the “T” Case

The “T” case should be processed as discussed earlier in this lesson. The organization will submit Articles of Merger instead of Articles of Dissolution. Update the status code of the dissolving organization to “26” at case closing using Form 2363-A. See Handout 11B-1.

Note that in the case where an IRC section 501(c)(3) organization merges into a non-IRC section 501(c)(3) organization or nonexempt organization, the dedication of assets requirement in Treas. Reg. 1.501(c)(3)-1(b)(4) may not be met and should be discussed with the manager for possible EO Classification referral.

Continued on next page
Mergers, Continued

Processing the “A” Case

Review the Articles of Merger for the effective date of merger and any organizational, operational or financial changes that might affect the exemption of the surviving organization. If additional information is needed, use the current composed letter posted in Outlook public folders. Discuss any unresolved issues with the manager.

If no issues exist, issue the composed merger letter found in Outlook public folders and close the “A” case status “01” on EDS.

Merger of Two Private Foundations

The specialist will notify the group manager if they receive a case that indicates that two or more private foundations have merged. Contact with EO Technical is required on these types of mergers.
Summary

A "T" (termination) case is established when an exempt organization notifies the IRS that it has dissolved, is involved in a merger, or files a return notated as "Final Return". In a merger, an existing organization combines its assets and operations with those of another existing organization, one organization survives, the other terminates its existence.

If the organization is incorporated, secure a complete copy of the organization's Articles of Dissolution with proof of filing. If the organization has not filed Articles of Dissolution or is not incorporated, secure a resolution signed by at least two officers indicating the date of dissolution.

For IRC section 501(c)(3) organizations, secure a statement signed by an officer of the organization regarding the disposition of assets on hand at the time of dissolution.

Close a case by:
- Preparing Letter 2242
- Preparing Form 2363-A to reflect status "20"
- Completing 8670 with closing code "01"
- Completing Form 3198-A
- Forwarding any final returns submitted by the organization to the Ogden Service Center

If additional information is required, issue a composed additional-information request. If no response is received to an additional-information letter, close the case by:
- Preparing Form 2363-A to reflect status "20"
- Completing Form 8670 with closing code "12"
- Complete 3198-A with a statement "Termination - Do not notify state officials"
Lesson 11
Section C

Overview

Introduction

IRC section 507 covers three areas in which private foundation status is terminated and one in which private foundation status is not terminated.

One method of terminating private foundation status is by operating as a public charity. Requests to terminate PF status under this method are established and worked as “P” cases. “P” cases are currently a reserved inventory category.

The area in which private foundation status is not terminated concerns transfer of assets from one private foundation to another as described in IRC section 507(b)(2). This type of transaction is not discussed in this lesson. See IRM 7.26.7.6 for additional information.

Objectives

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

- Identify the three methods by which a private foundation can terminate its private foundation status
- Process an initial request for a private foundation to terminate its private foundation status by operating as a public charity (IRC section 507(b)(1)(B) termination) for a 60-month period
- Determine whether the private foundation meets the public charity requirements by the end of the 60-month period

Continued on next page
Overview, Continued

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<td>Termination of PF Status by Operating as a Public Charity, Advance Ruling</td>
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<td>Completion of 60-Month Termination Period</td>
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<td>Failure to Meet Termination Requirements</td>
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</table>

A/T/P Cases - Terminations of PF Status
11C-2
## Methods of Terminating PF Status

<table>
<thead>
<tr>
<th>Termination of Private Foundation Status</th>
<th>An organization which is a private foundation can terminate that status only by one of the following methods:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• IRC section 507(a) Termination</td>
</tr>
<tr>
<td></td>
<td>• IRC section 507(b)(1)(A) Termination</td>
</tr>
<tr>
<td></td>
<td>• IRC section 507(b)(1)(B) Termination</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IRC Section 507(a) Termination</th>
<th>Under this section, a private foundation may voluntarily or involuntarily terminate private foundation status for repeated or flagrant violations of Chapter 42. A tax is imposed under IRC section 507(c).</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>See IRM 7.26.7.2.1 for a more detailed discussion. EO Determinations has no jurisdiction in this area; EO Examinations is responsible for these types of terminations.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IRC Section 507(b)(1)(A) Termination</th>
<th>Under this section, private foundation status may be terminated without incurring the tax imposed by IRC section 507(c) if:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• There have not been willful and flagrant acts giving rise to liability for tax under Chapter 42 and</td>
</tr>
<tr>
<td></td>
<td>• The private foundation distributes all of its net assets to one or more organizations described in IRC section 170(b)(1)(A)(i) through (vi), and recipient organizations have been so described for a continuous period of at least 60 calendar months.</td>
</tr>
<tr>
<td></td>
<td>See IRM 7.26.7.2.2.1 for a more detailed discussion. EO Determinations has no jurisdiction in this area; EO Examinations is responsible for these types of terminations.</td>
</tr>
</tbody>
</table>

### A/T/P Cases - Terminations of PF Status

11C-3

**Continued on next page**
Methods of Terminating PF Status, Continued

Under this section, a private foundation may terminate its private foundation status by operating as a public charity for a continuous 60-month period.

These requests are established as “P” cases (both at the initial request for the termination process and at the end of the 60-month period).

This is the method the specialist will most frequently encounter and is discussed in this lesson (See also IRM 7.20.3.3.8).

A/T/P Cases - Terminations of PF Status

11C-4
Termination of PF Status by Operating as a Public Charity, Advance Ruling

<table>
<thead>
<tr>
<th>IRC 507(b)(1)(B) Basic Requirements</th>
<th>The basic requirements for terminating private foundation status under IRC section 507(b)(1)(B) are:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The private foundation has not been involved in willful repeated or flagrant acts giving rise to liability for tax under Chapter 42</td>
<td></td>
</tr>
<tr>
<td>• The private foundation meets the requirements of IRC section 509(a)(1), (2) or (3) for a continuous period of 60 calendar months</td>
<td></td>
</tr>
<tr>
<td>• The private foundation gives notification of termination to the Service, before the start of the 60-month period, that it is terminating its private foundation status</td>
<td></td>
</tr>
<tr>
<td>• The private foundation, within 90 days of the end of the 60-month period, furnishes the Service sufficient information to allow a determination that the private foundation met the requirements of IRC section 509(a)(1), (2) or (3)</td>
<td></td>
</tr>
</tbody>
</table>

Continued on next page
Termination of PF Status by Operating as a Public Charity, Advance Ruling, Continued

<table>
<thead>
<tr>
<th>Notification of Termination</th>
<th>The notification of termination to the Service must provide the following (no user fee is required):</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Name and address of the private foundation</td>
<td></td>
</tr>
<tr>
<td>• Its intention to terminate its private foundation status and a description of how it intends to become a public charity. (For example, if it intends to become an IRC section 509(a)(1) and 170(b)(1)(A)(vi) or IRC section 509(a)(2) organization, it would describe how it intends to attract the necessary public support, including providing proposed budgets that list anticipated public support)</td>
<td></td>
</tr>
<tr>
<td>• Date its regular tax year begins</td>
<td></td>
</tr>
<tr>
<td>• Date the 60-month period begins</td>
<td></td>
</tr>
<tr>
<td>• Code section under which it seeks classification (IRC section 509(a)(1), (2) or (3)) and clause of IRC section 170(b)(1)(A) if IRC section 509(a)(1) is applicable</td>
<td></td>
</tr>
<tr>
<td>• An executed Form 872-B, Consent to Extend the Time to Assess Miscellaneous Excise Taxes</td>
<td></td>
</tr>
</tbody>
</table>

_A/T/P Cases - Terminations of PF Status_  
_11C-6_
Termination of PF Status by Operating as a Public Charity, Advance Ruling, Continued

Advance Ruling for the 60-Month Termination

A private foundation filing the notification that it is terminating its private foundation status may obtain an advance ruling that it can reasonably be expected to satisfy requirements of IRC section 509(a)(1), (2), or (3) during the 60-month period.

If the private foundation requests and is granted an advance ruling, it will be treated as a public charity by contributors during the 60-month termination. However, it continues to have a Form 990-PF filing requirement. Page 1 of Form 990-PF has a block the private foundation should check to indicate that it is terminating its private foundation status under the 60-month provisions of IRC section 507(b)(1)(B).

If an organization does not file a request to extend the time to assess the tax imposed under IRC section 4940, the private foundation must pay the excise tax imposed during the 60-month period. If it successfully completes the 60-month termination, a claim for return of the tax may be filed.

Advance Ruling Closing Procedures

If the organization requests an advance ruling, signs Form 872-B, and appears likely to satisfy the requirements of IRC section 507 in the 60-month period:

- Issue Letter 2245
- Prepare Form 2363-A to update the Master File to status 25 and to input the advance ruling ending date. The computation of this expiration date is facilitated by the “872 Date Calculator” located in the “Internal Forms” section of the “Checksheets and Worksheets” folder on Outlook Public Folders.
- Close case status 01 in EDS

A/T/P Cases - Terminations of PF Status
11C-7
Completion of 60-Month Termination Period

Establishing that the Organization Meets Requirements

At the end of the 60-month termination period, the organization must establish immediately that it has met the requirements of IRC section 509(a)(1), (2), or (3).

If the organization meets the requirements of IRC section 507(b)(1)(B) during the continuous 60-month period, it will be treated as an IRC section 509(a)(1), (2), or (3) organization for the entire 60-month period.

Successful Completion of 60-Month Termination Period Closing Procedures

If, at the end of the 60-month period, the organization has provided sufficient documentation to show that it has met the requirements of IRC section 507(b)(1)(B):

- Issue Letter 4422 “Final Ruling Letter” for a P case at the end of the 60-month termination
- Prepare Form 2363-A to remove the advance ruling ending date
- Close case status 01 in EDS
Failure to Meet Termination Requirements

Failure to Meet 60-Month Period Requirement

In general, if the private foundation fails to meet the requirements of IRC section 509(a)(1), (2), or (3) during the continuous 60-month period, it will be treated as a private foundation for the entire 60-month period. (Any grants or contributions made to such an organization will be treated as contributions made to a private foundation, assuming the organization was not granted an advance ruling).

In such a case, the “P” case is closed as adverse and is subject to mandatory review.

Certain 60-Month Terminations

If the private foundation fails to meet the requirements during the continuous 60-month period, but satisfies the requirements of IRC section 509(a)(1), (2), or (3) for any taxable year or years during such 60-month period, it will be treated as an IRC section 509(a)(1), (2), or (3) organization for such taxable years.

Accordingly, for any taxable year or years in which the organization meets the requirements of IRC section 509(a)(1), (2), or (3):

- Grants and contributions made to the organization will be treated as having been made to an organization described in IRC section 509(a)(1), (2), or (3), assuming the organization was not granted an advance ruling
- IRC section 507 and Chapter 42 will not apply
Summary

IRC section 507 covers three methods of terminating an organization's private foundation (PF) status:

IRC section 507(a) - Provides for termination of PF status for repeated or flagrant violations of Chapter 42. Tax is imposed under IRC section 507(c).

IRC section 507(b)(1)(A) - Provides for termination without incurring IRC section 507(c) tax if:
- There have been no willful and flagrant acts giving rise to liability for tax under Chapter 42
- PF distributes all of its net assets to one or more organizations described in IRC section 170(b)(1)(A)(i) through (vi)

IRC section 507(b)(1)(B) - Provides for termination when a PF operates as a public charity for a continuous 60-month period.

EO Determinations is not responsible for terminations under IRC sections 507(a) and 507(b)(1)(A).

If terminating under IRC section 507(b)(1)(B), a PF may request an advance ruling that it can reasonably be expected to satisfy requirements of IRC section 509(a)(1), (2), or (3) during the 60-month period. If the advance ruling is granted, the PF will be treated as a public charity by contributors during the 60-month termination.
Lesson 11
Section D

A/T/P Cases – Group Ruling Overview

Overview

Purpose

A central organization, which is exempt under IRC section 501(c), may obtain recognition of exemption, on a group basis, for subordinate organizations. The purpose of a group exemption is to relieve subordinate organizations from filing their own applications for recognition of exemption. It may also allow the central organization to file a group information return on behalf of some or all of its subordinates, which reduces the administrative burden for both the organizations and the Service.

Applications for group exemption are currently a reserved inventory category. Additional training will be provided to individuals designated to work these applications.

This lesson provides an introduction to group exemptions.

Objectives

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

• Describe the purpose and basic form of a group exemption

• Identify organizations in a group exemption

• Describe the process for a subordinate establishing an individual exemption
### Overview, Continued

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<td>Summary</td>
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*A/T/P Cases - Group Ruling Overview*  
11D-2
Group Exemption Overview

Definitions

A group exemption is a ruling or determination letter issued to a central organization recognizing on a group basis the exemption of the central organization's subordinates.

A central organization, also known as a parent organization, is an organization that has one or more subordinates under its general supervision or control.

A subordinate is a local chapter, post, or unit of a central organization, generally with similar purposes and activities of the parent organization.

Parent Must Be Exempt

A parent organization applying for a group exemption letter must either:

- Have previously established its own exemption or
- Establish its own exemption concurrently with the request for group exemption

The parent organization does not have to be exempt under the same subsection of IRC section 501(c) as its subordinates; however, all the subordinates to be included must be described in the same subsection.

Case Establishment and User Fee

Applications for group exemption are established as Form 1026 “A” cases. The user fee for a group ruling request is $900. A separate “I” case and user fee are required for an individual ruling request worked concurrently with a group exemption request.

Continued on next page
Group Exemption Overview, Continued

**Processing Group Exemption Requests**


Group rulings are intended as an administrative convenience to relieve organizations with historically high levels of compliance from the burden of filing an application for each subordinate. They were also intended as an administrative convenience for the Service, as they eliminate the need to rule individually on organizations which are essentially identical to each other in form and function.

**Declining to Rule**

However, the Service may decline to issue a group exemption letter if warranted by the specific facts and circumstances involved.

Group exemptions were intended for the administrative convenience of both the Service and the applicant when appropriate and in the interest of sound tax administration. If the organizations involved have not established a good track record of compliance with the basic requirements of the relevant Code section concerned, the Service may at its discretion decline to issue a group exemption.

This declination does not constitute a denial of tax-exempt status, though, as the subordinates can file individual applications to request individual determinations.

The group exemption user fee is refunded if the Service declines to issue a group exemption letter.

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*A/T/P Cases - Group Ruling Overview*

11D-4

IRSTR-B-00908
Annual Update

Future Changes

Once the Service grants a group exemption, the central organization is responsible for:

- Ensuring that its current subordinates continue to qualify for exemption
- Verifying that any new subordinates are exempt, and
- Updating the Service on an annual basis of new subordinates, subordinates no longer to be included, and subordinates that have changed their names or addresses

Submission

Annual updates are not processed by EO Determinations in Cincinnati, but rather the Ogden Service Center in Utah.

The full mailing address is: Ogden Service Center, Mail Stop 6271, Ogden, UT 84404-4749.

Six months before the update is due, the Service will send a list of current subordinates to the central organization, sometimes called the List of Parent and Subsidiary Accounts. This helps the organization ensure their records correspond with those currently on file with the Service.

In order for the central organization to maintain its group exemption letter, the annual update must be submitted to the Service at least 90 days before the close of its annual accounting period.
Identifying a Group Exemption

How to Identify a Group Exemption Member

Approved group exemptions are issued Letter 2419 which includes a unique four digit Group Exemption Number (GEN). This number is used by both the parent and the subordinates and is indicated in IDRS for both the parent and the subordinates. Parent organizations are indicated by an affiliation code of “6” or “8.” Subordinates are indicated by an affiliation code of “9.”

(BMFOLO research should reflect these items.)

Subordinates in a group exemption are not issued individual letters from the Service and are not listed individually in Publication 78 at this time.

Group Exemption Roster

The Group Exemption Roster, Document 6023, identifies organizations holding group exemptions and serves as a convenient reference of key exemption data. The organizations are listed in alphabetical order, followed by a separate list of the same organizations in numerical order by GEN.

The information for each group includes, in part, the name of the organization, city and state of parent, subsection, date of group exemption letter, group exemption number, and parent’s employer identification number.

The roster can be accessed via the Forms/Pubs/Docs link on the IRS intranet.

Exceptions

Be aware that the BMFOLO master file is not an all-inclusive listing of organizations recognized as subordinates in group exemptions. Due to system constraints, some of the oldest and largest of the groups, such as the Catholic Church (United States Conference of Catholic Bishops), have subordinates which are not individually listed on the master file.

Rather, we may rely on other sources, such as the annually published edition of the Official Catholic Directory, to confirm inclusion in a group exemption. Such practice is limited to extenuating circumstances, but be aware that the master file may not always be a definitive source of information.

A/T/P Cases - Group Ruling Overview

11D-6
Establishing Individual Exemption

When a subordinate wishes to establish its own individual exemption after having been included in a group exemption or has been told by its parent to seek its own exemption, it must file a Form 1023 or Form 1024 and pay the appropriate user fee. These cases are not reserved inventory and can be worked by all specialists using the following procedures:

- Obtain BMFOLO research to verify that the applicant is already covered under a GEN

- Determine the effective date of the individual exemption:
  - If the central organization notified the applicant that they will no longer be covered under the group exemption, the effective date of individual exemption is the date specified in the notification from the central organization.
  - If the central organization does not specify an effective date, the effective date is the date the central organization notified the subordinate.
  - If the applicant chooses to withdraw from coverage under a group exemption, it must notify the central organization in writing and specify the effective date of its withdrawal. This is the effective date of their individual exemption.
  - If an effective date is not specified in the notification, the effective date is the date the subordinate notified the central organization of its intention to withdraw (i.e., the date of the letter).

- Process application following normal case processing procedures

Note: An organization that is described in IRC section 501(c)(3) may be classified as a public charity if its financial history under the group ruling demonstrates public support.

Continued on next page
Establishing Individual Exemption, Continued

Case Closing

Closing procedures for subordinates establishing individual exemption require additional steps to be taken:

- Prepare the appropriate determination letter. The effective date on the determination letter will be the effective date of the applicant's individual exemption.

- An addendum should be added to the determination letter explaining that the organization was previously exempt as a subordinate in a group exemption ruling. Following is an example of an addendum that can be used:

  Your organization was previously exempt as a subordinate of **insert name of central organization** under Group Exemption Number xxxx from **insert date of formation, or date of inclusion in group ruling** to **insert one day prior to effective date**. As of **insert effective date**, your organization is exempt under the individual ruling described in this letter.

- On Form 8670, the effective date of exemption will be the date of formation or the date the organization was included in the group exemption ruling, the ruling date is the ruling date listed on BMFOLO or other IDRS research.

- Prepare Form 2363-A to remove the GEN# from the organization's EO sub-module inputting the old GEN# in the “From GEN” field and “9999” in the “To GEN” field.

Continued on next page
Establishing Individual Exemption, Continued

Example

A subordinate that was recognized as part of a group exemption as of January 5, 1995, informed the parent, on March 3, 2005, that it no longer wanted to be included in the group exemption. It filed Form 1023 on March 25, 2005. The subordinate may be eligible for classification as a public charity during the years it was included in the group exemption.

Letter 947 shows an effective date of March 3, 2005. An addendum in the letter indicates prior exemption under the group exemption and references March 3, 2005, as the individual exemption date. On Form 8670, Screen 2, input an effective date of January 1995 and the original ruling date as indicated on BMFOLO.
A group exemption allows a **central** (or parent) organization, which is exempt under IRC section 501(c), to obtain recognition of exemption for **subordinate** organizations. This relieves subordinate organizations from filing their own applications for recognition of exemption.

A central organization may also file a group information return on behalf of some or all of its subordinates.

The Service may decline to issue a group exemption letter if warranted by the specific facts and circumstances involved. This is not a denial of tax-exempt status; the subordinates can file individual applications to request individual determinations.

After the Service grants a group exemption, the central organization must:

- ensure that its subordinates continue to qualify for exemption
- verify that new subordinates are exempt
- update the IRS, annually, of any new subordinates

When a subordinate wishes to establish its own individual exemption after having been included in a group exemption or has been told by its parent to seek its own exemption, it must file a Form 1023 or Form 1024 and pay the appropriate user fee.
Lesson 12

Advance Approval of Grant-Making Procedures
IRC Section 4945(g)

Overview

Introduction

Prior to the enactment of the Tax Reform Act of 1969, IRC section 504(a)(2) provided, in part, that a private foundation would lose its tax exempt status if its aggregate accumulated income was used to a substantial degree for purposes or functions other than those constituting the basis for its exemption.

Congress deemed this law ineffective and, consequently, IRC section 504(a)(2) was repealed and IRC section 4945 was enacted.

IRC section 4945 imposes an initial excise tax of 10% on a private foundation’s taxable expenditures. Taxable expenditures are defined as any amounts paid or incurred for any of the following:

- Lobbying
- Electioneering
- Grants to individuals
- Grants to other organizations
- Grants for any purpose other than an exempt purpose under IRC section 170(c)(2)(B)

Certain payments are not treated as taxable expenditures provided they are paid under a program that is approved in advance by the Service.

This lesson discusses the advance approval of a private foundation’s grant-making procedures as described under IRC section 4945(g).

Continued on next page
Overview, Continued

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

- Explain the reason advance approval under IRC section 4945(g) is required
- Process a request for advance approval under both IRC sections 6104 and 6110
- Identify an employer-related grant program

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IRC Section 4945(d)(3)

Background: Private Benefit and Inurement With Grants

It's clear from the legislative history that Congress was concerned that prior tax law did not effectively limit the private benefit and inurement risk associated with a foundation using its funds. Congress was concerned that grants made under a broad statement of purpose afforded grant recipients too much freedom in deciding how the funds would be spent.

IRC sections 4945(d)(3) and 4945(g) were enacted to curb abuses while permitting programs that encourage charitable purposes to continue. The term "specific objective" and the other purposes described in IRC section 4945(g)(3) were employed to describe those individual grants that are made for purposes sufficiently narrow and definite to ensure that recipients are authorized to expend the funds only in furtherance of charitable purposes described in IRC section 501(c)(3).

Taxable Expenditure

IRC section 4945(d)(3) provides that the term “taxable expenditure” means any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or similar purposes by such individual, unless the grant satisfies the requirements of IRC section 4945(g).

Accordingly, IRC section 4945(d)(3) is applicable only if the following factors are present:

- The payment in question is a grant
- The grant is to an individual
- The grant is made for travel, study, or other similar purposes by such individual

Continued on next page
"Grants" Defined

Treas. Reg. 53.4945-4(a)(2) provides that the term "grants" includes but is not limited to:

- Scholarships
- Fellowships
- Internships
- Prizes
- Awards

Note: The term "grants" does not ordinarily include salaries or other compensation to employees. Neither does the term ordinarily include payments to persons for personal services such as assisting the foundation manager in planning, evaluating, or developing its projects.
Exception to IRC Section 4945(d)(3)

IRC Section 4945(g) and Rev. Rul. 77-434

IRC section 4945(g) provides that IRC section 4945(d)(3) shall not apply to an individual grant awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary, if it is demonstrated to the satisfaction of the Service that:

- The grant constitutes a scholarship or fellowship grant which would be subject to the provisions of IRC section 117(a) and is to be used for study at an educational organization described in IRC section 170(b)(1)(A)(ii)

- The grant constitutes a prize or award which is subject to the provisions of IRC section 74(b) (without regard to paragraph (3) thereof) if the recipient of such prize or award is selected from the general public, or

- The purpose of the grant is to achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee (Rev. Rul. 77-434, 1977-2 C.B. 420).

Court Case: In John Q. Shunk Association, Inc. v. United States, 626 F. Supp. 564 (S.D. Ohio 1985), the court held that advance approval under IRC section 4945(g) is a mandatory, substantive requirement as opposed to a merely ministerial filing requirement.

Continued on next page

Advance Approval of Grant-making Procedures
IRC Section 4945(g)
12-5
Exception to IRC Section 4945(d)(3), Continued

Proper Procedure for Advance Approval

Treas. Reg. 53.4945-4(c)(1) provides that to secure advance approval, a private foundation must demonstrate that:

- Its grant procedure includes an objective and nondiscriminatory selection process
- Such procedure is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance
- The foundation plans to obtain reports to determine whether the grantees have performed the activities that the grants are intended to finance

Note: No single procedure or set of procedures is required. Procedures may vary depending upon such factors as the size of the foundation, the amount and purpose of the grants, and whether one or more recipients are involved.

Continued on next page
Exception to IRC Section 4945(d)(3), Continued

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<td>Treas. Reg. 53.4945-4(b)(1) provides that for a foundation to establish that its grants to individuals are made on an objective and nondiscriminatory basis, the grants must be awarded in accordance with a program which would be consistent with:</td>
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- The existence with the foundation’s exempt status under IRC section 501(c)(3)
- The allowance of deductions to individuals under IRC section 170 for contributions to the granting foundation
- The candidates for grants should be chosen on the basis of criteria reasonably related to the purposes of the grant to fulfill a purpose described in IRC section 170(c)(2)(B) (e.g., constitute a charitable class)
- The criteria used in the selection from within a group of potential grantees should be related to the purpose of the grant, such as criteria for selecting scholarship recipients (e.g., prior academic performance, financial need, or performance on tests to measure ability and aptitude)
- The persons making the selection of recipients should not be in a position to derive a private benefit directly or indirectly.

Advance Approval of Grant-making Procedures
IRC Section 4945(g)
12-7

IRSTR-B-00921
Request Procedures

Approval Procedure

Treas. Reg. 53.4945-4(d)(1) provides, in part, that the contents of a request for approval of grant-making procedures must fully describe the foundation’s procedures for awarding grants.

- The approval procedure is a one-time approval of a system of standards, procedures, and follow-up actions utilized in awarding grants.

- Such approval shall apply to subsequent grant programs provided the procedures do not materially differ from those described in the original approval request. If there are substantial changes to the original program, it may be appropriate to acknowledge our acceptance in writing in the form of a new approval letter.

Advance Approval Requests

A private foundation may make its request for advance approval of grant-making procedures as an integral part of the initial Form 1023. If a private foundation elects to enact a grant-making program after the application for exemption has been approved, advance approval must be requested prior to awarding grants.

Continued on next page
Request Procedures, Continued

The request for approval must contain the following:

- A statement describing the selection process sufficiently detailed as to demonstrate whether the grants are made on an objective and nondiscriminatory basis.

- A detailed description of the terms and conditions under which the foundation ordinarily makes such grants, which is sufficient to demonstrate such procedures meet the requirements of IRC section 4945(g).

- A detailed description of the foundation's procedures for exercising supervision over the grants.

- A detailed description of the foundation's procedures for review of the grantee reports, for investigation where diversion of grant funds from their proper purposes is indicated, and for recovery of any diverted funds and for withholding further funds during the investigation if a diversion of funds existed.
Action on Request for Approval

45-Day Rule
If a foundation properly submits a request for approval of grant-making procedures, and it is not notified within 45 days that such procedures are not acceptable, then such procedures shall be considered as approved.

This tacit approval is effective from the date of submission until receipt of an actual notice that such procedures are not acceptable.

Specialists must send additional information letters to develop grant-making programs that are vague or do not appear to meet the requirements of IRC section 4945(g). The additional information letter should include the organization's standing with respect to the 45-day rule, informing them that any grants made from that day forward may be taxable expenditures if we determine the grants are not acceptable.

Notification of Unacceptable Procedures
If a grant to an individual for a purpose described in IRC section 4945(d)(3) is made after notification to the foundation that the grant procedures under which the grant was made are not acceptable, such grant is a taxable expenditure.

Examples of this 45-day rule are provided in Rev. Rul. 81-46, 1981-1 C.B. 514.

Equivalent to a Proper Request
If a foundation makes a full and complete disclosure of its grant-making procedures with its initial application, the disclosure should be equivalent to a request for an advance approval. This is true even if the foundation did not specifically request such a determination or check the appropriate block on the application.

Examples of this are contained in Rev. Rul. 86-77, 1986-1 C.B. 334.

Continued on next page
Action on Request for Approval, Continued

Specific Request

Private foundations seeking advance approval of grant-making procedures must specify whether the approval is requested under IRC section 4945(g)(1) or 4945(g)(3).

This is to prevent the foundation from later claiming protection under the 45-day rule where it requested approval under IRC section 4945(g) and the Service assumed the grant program was a scholarship or a specific grant.

IRC Section 4945(g)(2)

As discussed in Unit 1a, Lesson 12, EO Determinations does not issue advance approval of grants under IRC section 4945(g)(2). An IRC section 4945(g)(2) grant is a grant that constitutes a prize or award which is subject to the provisions of IRC section 74(b) (without regard to paragraph (3) thereof), if the recipient of such prize or award is selected from the general public.

IRC section 74(b) allows for the exclusion of certain prizes and awards from gross income. It requires that the prize or award was made primarily in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievements and that the recipient was selected without any action on his part to enter the contest or proceeding and is not required to render substantial future services as a condition to receiving the prize or award.

A “prize” or “award” that requires travel or study should be viewed as either a scholarship or fellowship described in IRC section 4945(g)(1), or a grant to achieve a specific objective, produce a report or similar product, or to improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee described in IRC section 4945(g)(3).

If a specialist receives a request for advance approval under IRC section 4945(g)(2) which involves a true IRC section 74(b) prize or award (without regard to paragraph (3) thereof), we should decline to issue advance approval and simply inform the taxpayer that such approval is not necessary. If the IRC section 4945(g)(2) request appears to involve a “prize” or “award” that is not a true IRC section 74(b) prize or award, the specialist should determine whether the grant is better classified under IRC sections 4945(g)(1) or 4945(g)(3). The specialist should then explain our position to the taxpayer and ask them to submit a revised written request under one of the other classifications.

Advance Approval of Grant-making Procedures
IRC Section 4945(g)
12-11
Request Processing

If an organization makes a full and complete disclosure of its grant-making procedures with its Form 1023, then it is considered to have requested approval of its grant-making procedures. The agent will:

- Contact the organization to confirm that the organization is requesting advance approval and whether the request is for approval under IRC sections 4945(g)(1), (2), or (3)

- When preparing Letter 1076, *E&O Favorable Determination to a Non-Operating Private Foundation*, use the appropriate paragraph(s) that applies to the facts and circumstances (paragraph numbers to follow in the lesson)

- If the request for approval of grant-making procedures is received after tax-exempt status has been approved, the case is established and worked as an Amendment (A) case. If the grant-making procedures are approved:
  - Issue a composed letter to the private foundation using legends to recite the pertinent facts regarding the foundation’s grant program (letter templates can be found on the Outlook Public Folders)
  - Prepare a sanitized version of the composed letter

- The request for approval of grant-making procedures is subject to mandatory review (refer to IRM 7.20.5.4)

- Because the request for approval of grant-making procedures is submitted after tax exemption is approved, the letter is treated as a ruling to which the disclosure rules of IRC section 6110 apply

- Notice 437, prepared by Quality Assurance, accompanies the approval letter and the sanitized copy sent to the organization

- Prepare Form 3198-A case with instructions:

  "The Materials in the File Relate to a Ruling Request Under IRC 6110. This Material is Not Available for Public Inspection Under IRC 6104."

Continued on next page
Request Processing, Continued

IRC Section 6104: General Rules

IRC section 6104 states that much exempt organization paperwork is excepted from the general confidentiality provisions of IRC section 6103.

IRC section 6104 governs the information required from exempt organizations for public disclosure which includes the following:

- Exemption application
- Supporting documents
- Returns
- Certain rulings, determinations, and technical advice memorandums issued with respect to an application

IRC Section 6104: Advance Approval

As previously discussed, private foundations filing an application Form 1023 requesting exemption under IRC section 501(c)(3) may also request advance approval of their grant-making procedures simultaneously.

Upon approval of the exempt status, the application and all supporting documents are open for public disclosure as provided by IRC section 6104(a)(1). Accordingly, no special procedures have to be followed to prepare the case for the proper disclosure treatment.

IRC Section 6110 Disclosure Requirements

When a private foundation requests advance approval of its grant-making procedures, but not in conjunction with an exemption application, such request is subject to the public disclosure provisions under IRC section 6110(a).

Continued on next page
Request Processing, Continued

Exemption Letter

Each determination letter subject to the provisions of IRC section 6110 must contain:

- Complete description of all the pertinent facts and circumstances regarding the scholarships
- Applicable principals of law, and
- Rationale for the conclusion reached

Sanitized Letter

IRC section 6110(c) exempts seven categories of information from public disclosure. The categories are:

- The names, address and other identifying details of the person to whom the determination pertains or of any other person identified in the written determination or any background file
- Information classified secret in the interest of national defense or foreign policy by Executive Order
- Information specifically exempted from disclosure by any statute, other than the Code, applicable to the Service
- Privileged or confidential trade secrets and commercial or financial information obtained from a person as defined by Treas. Reg. 310.6110-3(a)(4)
- Information the disclosure of which would constitute a clearly unwarranted invasion of personal privacy as defined by Treas. Reg. 301.6110-3(a)(5)
- Information contained in or related to examination, operation, or condition reports prepared by, or on behalf of, or for use of an agency responsible for the regulation or supervision of financial institutions as provided by Treas. Reg. 301.6110-3(a)(6)
- Geological and geophysical information and data, including maps concerning wells

Continued on next page

Advance Approval of Grant-making Procedures

IRC Section 4945(g)

IRSTR-B-00928
Request Processing, Continued

Approval of Sanitized Letter

The foundation has the right to review the proposed sanitized version of the approval letter and request additional deletions prior to the letter being made open for public inspection.

Penalties for Improper Disclosure

IRC section 6110(i) provides a civil remedy against the government employees who willfully or intentionally fail to make the deletions required by IRC section 6110(c) or to follow IRC section 6110(g) disclosure provisions.

The recipient of the determination or any person identified therein may sue the Service in the United States Court of Claims.

The party may be entitled to collect from the government actual damages or $1,000, whichever is more, plus the cost of litigation.

Payments Included as Taxable Income to the Recipients

Certain scholarships, awards, and other grants are included as taxable income to the individual recipient. Accordingly, care must be taken to ensure the correct paragraphs are included in the exemption letter regarding grants which constitute taxable income to recipients.

The following applies:

- IRC section 4945(g)(1) scholarship payments are NOT taxable as provided by IRC section 117(a).

- IRC section 4945(g)(2) prizes and awards ARE taxable UNLESS the recipient transfers the payment to a charity or governmental entity as provided by IRC section 74(b).

- IRC section 4945(g)(3) payments ARE taxable under the general provisions of IRC section 61(a).
Employer-Related Grant Programs

Many private companies have established private foundations to fund scholarship or loan programs for employees or their children. An employer-related grant program is a program that:

- treats some or all of the employees of a particular employer or their children as a group from which grantees will be selected for educational grants,
- limits the potential grantees for some or all of the educational grants to individuals who are employees or children of employees of a particular employer, or
- otherwise gives such individuals preference or priority over others being selected.

Two relevant revenue procedures describe the requirements for company scholarships and loans:

- Rev. Proc. 76-47, 1976-2 C.B. 670 (clarified by Rev. Proc. 85-51, 1985-2 C.B. 717), deals with criteria that must be met for the scholarship to meet the requirements of IRC section 117 and therefore not be taxable income to the recipient of the grant.

- Rev. Proc. 80-39, 1980-2 C.B. 772, deals with the requirements that must be met for loans to qualify as disbursements that are not taxable expenditures under IRC section 4945(g).

Note: As the requirements for employer-related loans under Rev. Proc. 80-39 (conditions and percentage test) are basically the same as the requirements for scholarships under Rev. Proc. 76-47, only Rev. Proc. 76-47 will be discussed in this lesson.
Employer-Related Scholarship Programs, Continued

Rev. Proc. 76-47 Requirements for Approval Under IRC Section 117

The requirements set forth in the Rev. Proc. 76-47 are based on the assumption that the eligible group of recipients is sufficiently broad to qualify under IRC section 117. However, there is no absolute number to define "sufficiently broad," so if the sponsoring company is very small you should consult your manager.

Section 4 of Rev. Proc. 76-47 sets forth seven conditions which must be met (as well as a percentage test) in order for a ruling to be made that employer grants awarded are scholarships or fellowship grants under IRC section 117.

Seven Conditions

The seven conditions are:

- **Inducement**: the employer-related scholarship program must not be used by the employer and the private foundation as an inducement to recruit or retain employees to continue their employment.

- **Selection Committee**: must be comprised of individuals totally independent and separate from the private foundation and the employer. These individuals may not be employees or former employees and should be knowledgeable in the educational field.

- **Eligibility Requirements**: must be related to the purpose of the grant program. Potential recipients must be able to meet the admission requirements of and attend an educational institution. Eligibility must not be related to any other employment-related factors, such as the employee's position, services, or duties. If a minimum period of employment is required to qualify for such scholarships, this period may not exceed three years.

- **Objective Standard**: selection must be based solely upon objective standards that are unrelated to employment of the recipient (or his/her parents) or to the employer's line of business.

Advance Approval of Grant-making Procedures

IRC Section 4945(g)

12-17
Employer-Related Scholarship Programs, Continued

Seven Conditions (continued)

- Employment: once awarded, a scholarship (and its renewal, if applicable) may not be terminated if the recipients (or their parents) are no longer employed with that employer.

- Course of Study: the courses of study for which the scholarship are available must not be limited to those that would benefit the employer or the private foundation.

- Other Requirements: the employer-related scholarship program must meet all other requirements of IRC section 117 and the regulations.

Percentage Test

In addition to the seven requirements above, Rev. Proc. 76-47 requires that the program meet a percentage test.

- Percentage Test – Employees’ Children: if the employer-related scholarship program provides grants to employees’ children, the scholarships awarded must not exceed: (i) 25% of the number of employees’ children who were eligible, applied for scholarships, and were considered by the selection committee in selecting the recipients; or (ii) 10% of the number of employees’ children who were eligible (whether or not they submitted an application) in that year. See Rev. Proc. 85-51, 1985-2 C.B. 717, for requirements in determining the number of employees’ children who can be eligible recipients for purposes of the 10% test.

- Percentage Test – Employees: If the employer-related scholarship program provides grants to employees, the scholarships awarded must not exceed 10% of the number of employees who were eligible, were applicants for such grants, and were considered by the selection committee in selecting the recipients of grants in that year.

Continued on next page

Advance Approval of Grant-making Procedures

IRC Section 4945(g)

12-18
If the employer-related scholarship program satisfies the seven conditions but not the percentage test, the program may nevertheless qualify if, in view of all the facts and circumstances, its primary purpose is to educate recipients in their individual capacities. Section 4 of the revenue procedure lists facts and circumstances test requirements.

Examples of application of the facts and circumstances test are found in Rev. Rul. 86-90, 1986-2 C.B. 184, which discusses a program involving one scholarship awarded to a child in an employee pool of thousands, and Rev. Rul. 2003-32, 2003-1 C.B. 689, which discusses grants awarded to employees or their children who are victims of a qualified disaster. Applications from private foundations that rely on the facts and circumstances test for qualification should be discussed with your manager.

For specific examples of employer-related scholarships, see the following revenue rulings:

- Rev. Rul. 79-131, 1979-1 C.B. 368, holds that an employer funded scholarship program for all students in a community is not an employer-related grant program as defined in Rev. Proc. 76-47.

- Rev. Rul. 79-365, 1979-2 C.B. 389, holds that a private foundation's scholarship program for children of deceased or retired employees is within the scope of Rev. Proc. 76-47.

- Rev. Proc. 94-78, 1994-2 C.B. 833, permits rounding off of the number of employer-related scholarship or loan grants.

IRC Section 4945(g) requests should be worked as expeditiously as possible:

Treas. Reg. 53.4945-4(d)(3) provides that a private foundation which submits a request for advance approval may consider its request to have been approved (from the date of submission) if we have not stated otherwise within 45 days of submission. This means that the foundation could make improper grants after the date of submission and avoid the normal excise taxes of IRC section 4945 (although there still could be excise taxes under IRC section 4941 if applicable). This "window" would close only when we issue a letter stating that the advance approval rules have not been met.

Developing issues relating to an IRC section 4945(g) request:

Use caution here. Provisions that might be sufficient to establish the absence of inurement or private benefit may not be restrictive enough to permit advance approval or to avoid other Chapter 42 excise taxes. For example, an agreement from an officer not to vote on a proposal to pay a scholarship to a close relative may be an acceptable safeguard against inurement, but if the organization were a private foundation, this would still constitute self-dealing under IRC section 4941 and would probably not be acceptable under IRC section 4945(g), either.

Guidelines on how to make the IRC section 6110 deletions on a sanitized approval letter are outlined in the 1984 CPE IRC section 4945(g) article.

Details to include in the "facts" section of an IRC section 6110/4945(g) approval letter:

The 1984 CPE article provides examples. The amount of detail to put in the facts section of the letter generally depends on such factors as the size and complexity of the grant-making program and whether significant issues were considered in the development of the case.

Continued on next page
The existing composed letter templates to approve IRC section 4945(g) grant programs are available on Outlook Public Folders and include:

- Programs with regular grants
- Programs with regular loans
- Programs with employer-related grants, and
- Programs with employer-related loans

Guidance on how to prepare an EDS letter for an IRC section 6104/4945(g) approval:

See IRM 7.21.5 for various EDS paragraphs to use in situations involving grants, loans, employer-related programs, and various combinations thereof.

Current EDS paragraphs include paragraph 3239 for scholarships, 3243/3244 for employer-related scholarships, 3250 for educational loans, 3254/3255 for employer-related educational loans, 3260 for scholarships and educational loans, and 3265/3266 for employer-related scholarships and educational loans. Other programs not covered in the EDS paragraphs may require a 9001 paragraph.
Tips and Helpful Information Concerning IRC Section 4945(g), (continued)

- Process followed when issuing a proposed adverse ruling under IRC section 4945(g):

- Prior to preparing an adverse letter, the foundation should be given an opportunity to amend the proposed grant program to meet the requirements under IRC section 4945(g). Proposed adverse rulings should not be issued for those cases where we first seek technical advice.

- Special procedures to consider for a case involving an IRC section 6104/4945(g) or 6110/4945(g) request prior to closing case as failure to establish or similar closing:

- If a failure to answer questions relating to the grant program was the cause of the fail to establish or similar closure, we should consider advising the foundation that it can no longer rely on the 45-day rule of Treas. Regs. section 53.4945-4(d)(3). Refer to the IRC section 4945(g) article within the 1984 CPE training material.
• Racially discriminatory advance approval requests - any racially discriminatory program will not qualify under IRC section 4945(g).

• Considerations for processing a program that discriminated on the basis of ethnic or similar criteria - technical advice may be needed in these situations, but we should first consult with an EO Technical expert by phone (after discussing the issue with the group manager).

• Considerations for processing an advance approval case where there is a lack of precedent:

• We may not simply transfer the case to EO Technical, rather we would have to write up a request for technical advice. However, before preparing the technical advice request, we should first consult with one of the designated EO Technical experts by phone (after discussing the issue with the group manager).

• Notice 437 (Notice of Intention to Disclose – Rulings) advises an organization of its rights under the IRC section 6110 disclosure process on requests submitted apart from the Form 1023:

• Notice 437, which accompanies the IRC section 6110/4945(g) approval letter (and the sanitized copy) advises the organization of these rights. Quality Assurance prepares the Notice 437 because a series of dates regarding the proposed disclosure must be entered on the notice. These dates are dependent on the date of the advance approval letter, which will be dated and mailed in Quality Assurance.

• 30-Day hold of the IRC section 6110/4945(g) approval letter:

• Copies of all composed letters are saved to a computer disk and submitted to Quality Assurance with the closed case, so reviewers can easily make updates and minor changes.

• After Quality Assurance mails the approval letter, the foundation has the right to request additional deletions from the letter during the 30-Day hold period.
Tips and Helpful Information Concerning IRC Section 4945(g), (continued)

- If the foundation does not request additional deletions, then Quality Assurance will mail the sanitized letter to the “Public Access Center” for publication.

- If the foundation asks for additional deletions from the advance approval letter while the case is still in review, the case may be returned to the specialist on a “No Error” review memo. If returned, the specialist will grant the additional deletions (if appropriate), and will prepare a new sanitized letter and return the case to Quality Assurance. However, since Quality Assurance closes the case when the IRC section 6110/4945(g) approval letter is first mailed out at the beginning of the 30-Day hold period, they may choose to make the necessary adjustments instead of reopening the case and returning it to the specialist.

- There are no restrictions on the disclosure of an approved IRC section 6104/4945(g) request.

- If the advance approval request is submitted and approved as a part of the Form 1023 application, all of the material relating to it (except for internal workpapers) will remain on the right side of the file and will be open for public inspection like any other materials relating to the Form 1023 application.

Continued on next page
• Approved IRC section 6104/4945(g) cases are not subject to mandatory review.

• IRC section 6104/4945(g) cases are available for merit closure:

• Since many private foundation applications are fairly simple and often prepared by professionals, there is good potential for merit closure even if advance approval is needed. However, technical screeners need to take the time to make sure that all of the necessary EDS paragraphs are added to the determination letter.

• IRC section 6110/4945(g) cases cannot be closed on merit:

• Even if all of the information was submitted with the advance approval request, the need to prepare a composed approval letter (and the sanitized copy) makes the case unsuitable for merit closure.

• Screening process when a Form 1023 reveals the foundation’s intention to operate a grant program but does not specifically request advance approval under IRC section 4945(g):

• The screener should send the case to the group for development of the advance approval request. The specialist should ask the foundation to specifically request advance approval and to submit any additional information required.

• In this case, if the screener or specialist fails to detect or fails to develop the IRC section 4945(g) issue and simply issues a standard determination letter without the advance approval paragraphs, upon audit the foundation may be subject to IRC section 4945 excise tax on taxable expenditures for any grant payments. A complete description of the grant program on the Form 1023 might be sufficient to engage the 45-day automatic approval of Treas. Reg. 53 4945-4(d)(3), but either the examining agent or the foundation would have to be knowledgeable enough to raise this point. Much time and effort would have been saved if the screener or specialist had identified, developed, and resolved the advance approval issue.
Before processing an IRC section 6110/4945(g) case, always obtain the DVD research of the original Form 1023 application and subsequent requests. We must ensure the grant-making program is in fact a new program which has not already received advance approval in the past (as part of the initial application or subsequent requests). A new approval letter is not required if the procedures do not materially differ from those described in the original approval request. Securing the DVD research also helps to ascertain the purpose of the organization to input into the composed approval letter.

Please note that even if the grant-making program is not a new program, but rather a modification of an existing program, a new approval letter may assure the organization that the changes are acceptable if there are substantial changes to the original program.

While processing an IRC section 6110/4945(g) case, the specialist may consider completing a Form 5666 for EO Classification referral if there is evidence that the grant-making program is already underway. It may be worthwhile to investigate the excise tax potential for the period of operation before advance approval was requested.

IRM Exhibit 7.20.4-11 contains an informative Guidesheet which can be used to help process advance approval requests.

IRC section 6110/4945(g) requests (4945(g) “A” cases) are currently reserved for Group 7823 in Cincinnati.
IRC sections 4945(d)(3) and 4945(g) were enacted to curb organizations’ abuses in making grants while permitting programs that encourage charitable purposes to continue.

IRC section 4945(d)(3) is applicable only if the payment is a grant, the grant is to an individual, and the grant is made for travel, study, or other similar purpose. IRC section 4945(g) provides that IRC section 4945(d)(3) shall not apply to an individual grant awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary.

To secure advance approval, a private foundation must demonstrate that:

- Its grant procedure includes an objective and nondiscriminatory selection process
- Such procedure is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance
- The foundation plans to obtain reports to determine whether the grantees have performed the activities that the grants are intended to finance

The contents of a request for approval of grant-making procedures must fully describe the foundation’s procedures for awarding grants.

Private foundations seeking advance approval of grant-making procedures must specify whether the approval is requested under IRC section 4945(g)(1) or 4945(g)(3).

If an organization makes a full and complete disclosure of its grant-making procedures with its Form 1023, then it is considered to have requested approval of its grant-making procedures. If the request for approval of grant-making procedures is received after tax-exempt status has been approved, the case is established and worked as an Amendment (A) case.
Lesson 13

Introduction to Returns

Overview

Introduction

You will be asked many questions about the types of returns exempt organizations are required to file.

- Public charities under IRC section 501(c)(3) and exempt organizations under IRC section 501(a) file an annual information return on Form 990, Form 990-EZ, or Form 990-N.

- Certain exempt organizations are not required to file an annual information return. These exceptions are listed on page 24-6 of this lesson.

- All exempt organizations classified as private foundations or private operating foundations are required to file Form 990-PF.

- Exempt organizations are subject to most of the same filing requirements for employment taxes as taxable organizations.

- An exempt organization that has $1,000 or more gross income from an unrelated trade or business must file Form 990-T.

Form 990 has been redesigned effective for the 2008 tax year. The new form consists of an 11-page core Form and 16 Schedules. The parts of the new Form 990 are described on pages 24-8 through 24-11 of this lesson.

Continued on next page
Overview, Continued

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

- Describe annual filing requirements for IRC section 501(c)(3) public charities and other exempt organizations under IRC section 501(a)
- Identify filing requirements for private foundations and private operating foundations
- Name those exempt organizations that are not required to file an annual information return
- List additional returns that an exempt organization must file including employment returns

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EO Information Returns

EO Returns

The following is a list of the most common returns which an organization exempt from Federal income tax might be required to file:

- **Form 990**, Return of Organization Exempt From Income Tax
- **Form 990-EZ**, Short Form Return of Organization Exempt From Income Tax
- **Form 990-N**, Electronic Notice (e-Postcard) for Tax Exempt Organizations Not Required to File Form 990 or 990-EZ.
- **Form 990-T**, Exempt Organization Business Income Tax Return
- **Form 990-PF**, Return of Private Foundation
- **Form 4720**, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code (Sections 4911, 4912, 4941, 4942, 4943, 4944, 4945, 4955, and 4958)
- **Form 1120-POL**, U. S. Income Tax Return for Certain Political Organizations
- **Form 5227**, Split-Interest Trust Information Return
- **Forms 1041** and **1041-A**, U. S. Income Tax Return for Estates and Trusts
- **Form 941**, Employer's Quarterly Federal Tax Return
- **Form 940**, Employer’s Annual Federal Unemployment (FUTA) Tax Return
Forms 990, 990-EZ, and 990-N

Purpose

Forms 990, 990-EZ, and 990-N are information returns.

Form 990 reports, to the Service and general public, all sources of revenue, expenses, balance sheet and other required information about an organization's activities for the year.

Form 990-EZ reports the same type of information but in less detail.

Form 990-N, also known as the e-Postcard, is electronically filed by small tax-exempt organizations with gross receipts under $25,000. Form 990-N requests the following information only:

- The organization's legal name as well as any name under which it operates and does business
- Its mailing address and internet website address (if any)
- Its taxpayer identification number
- The name and address of a principal officer
- The organization's tax period
- Verification that the organization's annual gross receipts are still normally $25,000 or less
- Notification if the organization has terminated

Continued on next page
Purpose

Prior to enactment of the *Pension Protection Act of 2006* (PPA), exempt organizations with annual gross receipts under $25,000 were not required to file an annual information return. Under provisions of the PPA, exempt organizations with annual gross receipts under $25,000 are required to file Form 990-N, beginning in 2008 for the tax year ending December 31, 2007. The 990-N filing requirement was imposed to ensure that the IRS and the general public (including potential donors) have current information about all exempt organizations. The Form 990-N filing requirement will also assist in keeping the Master File of exempt organizations current because an organization that fails to file Form 990-N for three years will have its exemption revoked.

An organization that has submitted an application for exemption on Form 1023 or Form 1024 but has not yet received a determination letter, is required to submit Form 990. Organizations with pending applications for exemption should check the “application pending” checkbox in the Form 990 header.
An organization whose gross receipts are normally more than $25,000 is required to file a Form 990 or 990-EZ. For this purpose, gross receipts is the organization's total revenue from all sources during its annual accounting period, without subtracting any costs or expenses.

**Form 990-EZ**

Form 990-EZ, *Short Form Return or Organization Exempt From Income Tax*, may be filed by most organizations with gross receipts and total assets below certain amounts.

- For the 2007 tax year, most organizations with gross receipts less than $100,000 and total assets of less than $250,000 may elect to file Form 990 or Form 990-EZ.

- For the 2008 tax year, most organizations whose gross receipts are less than $1,000,000 and total assets are less than $1,250,000 may file either Form 990 or Form 990-EZ.

- For the 2009 tax year, most organizations with gross receipts less than $500,000 and total assets less than $1,250,000 may file either the Form 990 or Form 990-EZ.

- Beginning with the 2010 tax year, most organizations with gross receipts less than $200,000 and total assets of less than $1,250,000 may file either Form 990 or Form 990-EZ.
Forms 990, 990-EZ, and 990-N, Continued

<table>
<thead>
<tr>
<th>Filing Requirements for Forms 990, 990-EZ, and 990-N Based on Gross Receipts and/or Assets (continued)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Form 990-EZ (continued)</td>
</tr>
<tr>
<td>Although Form 990-EZ was not redesigned for 2008, some changes have been made so that certain information previously required to be submitted in attachments will now be reported on Schedules. Organizations that file Form 990-EZ (2008) must review the instructions for Schedules A, B, C, E, G, L, and N to determine whether they must report any of their activities or information on those Schedules. Form 990-EZ filers will not be required to complete any of the other 2008 Form 990 Schedules.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Form 990-N, Electronic Notice (e-Postcard)</th>
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<tbody>
<tr>
<td>Small tax-exempt organizations with gross receipts under $25,000 must now file Form 990-N.</td>
</tr>
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</table>

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<tr>
<th>Due Dates</th>
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<tbody>
<tr>
<td>Forms 990, 990-EZ, or 990-N must be filed by the 15th day of the fifth month after the close of the organization’s tax year. IRS will assess a penalty of at least $20 for each day your Form 990 is late. The maximum late filing penalty is $50,000 or 5% of gross receipts. Penalties will not be assessed, if an extension has been requested and approved.</td>
</tr>
</tbody>
</table>

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<tr>
<th>Penalties</th>
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</thead>
<tbody>
<tr>
<td>Unless an extension is granted (extensions are requested on Form 8868), IRS will assess a penalty of at least $20 for each day Form 990 is late. The maximum late filing penalty is $50,000 or 5% of gross receipts.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Open to Public Inspection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forms 990, 990-EZ, and 990-N are available for public inspection and copying upon request.</td>
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</tbody>
</table>

Excluded from public inspection are any lists of contributors submitted with the returns. 

*Continued on next page*
Forms 990, 990-EZ, and 990-N, Continued

Excluded from Filing Forms 990, 990-EZ, or 990-N

The following types of organizations do not have to file a Form 990, Form 990-EZ or Form 990-N:

- A church, an interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church (such as a men’s or women’s organization, religious school, mission society, or youth group)

- A church-controlled organization described in Rev. Proc. 86-23, 1986-1 C.B. 564

- A school below college level affiliated with a church or operated by a religious order

- A mission society sponsored by, or affiliated with, one or more churches or church denominations, if more than half of the society’s activities are conducted in, or directed at persons in, foreign countries

- An exclusively religious activity of any religious order

- A state institution whose income is excluded from gross income by IRC section 115

- Organizations described in IRC section 501(c)(1) which are exempt by an Act of Congress and include instrumentalities of the United States

- A governmental unit or an affiliate of a government unit that meets the requirements of Revenue Procedure 95-48, 1995-2 C.B. 418

An organization requests exception from Form 990 filing requirements by checking item 10, Part 1, of Form 1023 and submitting a narrative explanation of why they are not required to file an annual information return.
Redesign of Form 990

Core Form

Following is an outline of the redesigned Form 990 including a brief description of each part.

The core form required to be completed by all organizations consists of the following eleven Parts:

Part I, Summary, which provides certain important information regarding the organization’s mission, activities, and current and prior years’ financial results;

Part II, Signature Block, which contains the signature of an organization’s officer, and if applicable, paid preparer;

Part III, Statement of Program Service Accomplishments, which requires reporting of the organization’s new, ongoing and discontinued exempt purpose achievements and related revenue and expenses. Exempt organizations previously informed the Service of new and discontinued exempt activities by letter. These requests were established as A (amendment) cases, and the Service responded to these requests by issuing an updated exemption letter on the effect of the change in activities on exempt status. Under provisions of Revenue Procedure 2008-4, Section 7.04.2, the Service will not issue updated exemption letters on the effect of any changes in activities on exempt status.

Part IV, Checklist of Required Schedules, to be used by the organization to determine which Schedules it must complete and file with the Service as part of the Form 990;

Part V, Statements Regarding Other IRS Filings and Tax Compliance, to be used by the organization to report its compliance with other federal tax reporting and substantiation requirements;

Part VI, Governance, Management, and Disclosure, which requires information regarding the organization’s governing body and management, policies, and disclosure practices.

Continued on next page
Redesign of Form 990, Continued

Core Form (continued) Part VII, Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors, to report compensation paid to such persons by the organization and its related organizations that is reported on Forms W-2 and 1099-MISC, and certain other compensation;

Part VIII, Statement of Revenue;

Part IX, Statement of Functional Expenses;

Part X, Balance Sheet, which comprise the financial statements of the organization for federal tax reporting purposes; and

Part XI, Financial Statements and Reporting, to report information regarding the organization's accounting methods and its compiled, reviewed, or audited financial statements.

Continued on next page
Redesign of Form 990, Continued

**Schedules**

The new Form 990 contains 16 Schedules. Each organization must complete Part IV, *Checklist of Required Schedules*, to determine those Schedules it must complete. These Schedules replace the prior form’s schedules and most required attachments that previously had to be constructed and completed by the filing organization. The following is a list and brief description of the new Schedules.

Schedule A, *Public Charity Status and Public Support*, to be completed by organizations described in IRC sections 501(c)(3) and 4947(a)(1) to provide information relevant to its status as a public charity, including satisfaction of applicable public support tests on an ongoing basis. Schedule A is especially important in view of elimination of the Advance Ruling period;

Schedule B, *Schedule of Contributors*, to be completed by organizations to provide information regarding contributions they report as revenues;

Schedule C, *Political Campaign and Lobbying Activities*, to be completed by organizations that conduct political campaign activities, organizations described in IRC sections 501(c)(3) and 4947(a)(1) that conduct lobbying activities, and organizations subject to IRC section 6033(e) notice and reporting requirements and potential proxy tax on certain membership dues, assessments and similar amounts;

Schedule D, *Supplemental Financial Statements*, to be completed by organizations to supplement certain balance sheet information, as well as conservation organizations, museums and other organizations maintaining collections, credit counseling organizations and others holding funds in escrow or custodial arrangements, and organizations maintaining endowments or donor advised funds and similar funds or accounts;

Schedule E, *Schools*, which is the private school questionnaire previously contained in the former Schedule A;

Schedule F, *Statement of Activities Outside the United States*, to report the organization’s activities conducted outside the United States.

*Continued on next page*
Redesign of Form 990, Continued

Schedules (continued)

Schedule G, Supplemental Information Regarding Fundraising or Gaming Activities, which requires reporting by organizations that reported certain amounts of professional fundraising expenses, revenue from special events, and revenue from gaming activities;

Schedule H, Hospitals, to be completed by organizations that operate one or more facilities licensed or registered as a hospital under state law;

Schedule I, Grants and Other Assistance to Organizations, Governments and Individuals in the U.S., to report grants and other assistance provided by the organization to others within the United States;

Schedule J, Compensation Information, to be completed by organizations to provide detailed compensation information for certain current or former officers, directors, trustees, key employees, and highest compensated employees, and certain information regarding the organization’s compensation practices and arrangements;

Schedule K, Supplemental Information for Tax Exempt Bonds, to be completed by organizations with outstanding tax-exempt bond liabilities;

Schedule L, Transactions with Interested Persons, to be completed by organizations that engage in certain types of relationships or transactions with interested persons, including excess benefit transactions, loans, grants or other financial assistance, and other financial or business transactions or arrangements;

Schedule M, Non-Cash Contributions, to report contributions other than cash received by the organization;

Schedule N, Liquidation, Termination, Dissolution or Significant Disposition of Assets, to report major dispositions of assets by the organization;

Schedule O, Supplemental Information to Form 990, to be used by organizations to provide supplemental information to describe or explain the organization’s responses to questions contained in the core form or Schedules, and

Schedule R, Related Organizations and Unrelated Partnerships, to provide information regarding the organization’s relationships with other exempt and taxable organizations.

Introduction to Returns

13-12
### Form 990-T

**Reports Unrelated Business Income of Exempt Organizations**

Even though an organization is recognized as tax exempt, it still may be liable for tax on its unrelated business income. An exempt organization that has $1,000 or more gross income from an unrelated trade or business must file Form 990-T, *Exempt Organization Business Income Tax Return*. The obligation to file the Form 990-T is in addition to the obligation to file the annual information return. Tax-exempt organizations must make quarterly payments of estimated tax on unrelated business income. An organization must make estimated tax payments if it expects its tax for the year to be $500 or more.

**Public Inspection**

Section 3(g) of the Tax Technical Corrections Act of 2007 amended IRC section 6104(d)(2) to require that Form 990-T, filed by IRC section 501(c)(3) organizations, be made available for public inspection for a period of 3 years from the date Form 990-T is required to be filed. All information included in Form 990-T is to be made available for public inspection unless specifically excluded under IRC section 6104(b).

**Due Date**

Form 990-T for a tax-exempt organization must be filed by the 15th day of the 5th month after the tax year ends.

*Introduction to Returns*  
13-13
Form 990-PF is filed annually by an organization classified as a private foundation or a private operating foundation under IRC section 509(a).

Form 990-PF:

- Is required to be filed by every private foundation regardless of gross receipts or assets
- Reports the income, expenses, and balance sheet for the private foundation
- Requires that additional information be provided to show compliance with the requirements of private foundation status
- Imposes a 2 percent excise tax on the net investment income earned by a private foundation; if certain conditions are met, the excise tax imposed is reduced to 1 percent (Section 4940)

The due date for filing the Form 990-PF is the 15th day of the fifth month after the close of the tax year.

A private foundation with gross receipts from activities unrelated to their exempt purpose is required to file a Form 990-T in addition to the Form 990-PF.

The Form 990-PF is open for public inspection.

The private foundation is required to publish a legal notice in a newspaper to advise the public of the hours and location where the Form 990-PF can be inspected.
Form 4720

<table>
<thead>
<tr>
<th>Required for Violations of Private Foundation Laws</th>
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</thead>
<tbody>
<tr>
<td>The law provides for imposing a penalty tax on a private foundation and/or certain individuals for violations described in following Code sections:</td>
</tr>
<tr>
<td>- Section 4941 Taxes on Self-Dealing</td>
</tr>
<tr>
<td>- Section 4942 Taxes on Foundation Failure to Distribute Income</td>
</tr>
<tr>
<td>- Section 4943 Taxes on Excess Business Holdings</td>
</tr>
<tr>
<td>- Section 4944 Taxes on Investments Which Jeopardize Charitable Purposes</td>
</tr>
<tr>
<td>- Section 4945 Taxable Expenditures</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Most Common Violations</th>
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<tbody>
<tr>
<td>The most common violations occur in the following sections:</td>
</tr>
<tr>
<td>- Section 4941 imposes a tax on the foundation and individuals who receive benefits from transactions with the foundation.</td>
</tr>
<tr>
<td>- Section 4942 imposes a tax on a foundation which fails to distribute the required amount for charitable purposes.</td>
</tr>
<tr>
<td>- Section 4945 imposes a tax on the foundation when they make distributions for non-charitable purposes.</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>Who Must File</th>
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</thead>
<tbody>
<tr>
<td>Individuals who knowingly and willingly engage in a transaction in violation of the law are required to file a Form 4720 and pay the tax due.</td>
</tr>
</tbody>
</table>

Foundations are required to file a Form 4720 for each year they are in violation of any of the above sections.

Continued on next page

Introduction to Returns
13-15
**Form 4720, Continued**

| Correction | These sections have provisions which require the foundation and the individuals to undo the act which caused the violation.  
|            | The purpose is to put the foundation back to the position it was in before the act occurred.  
|            | Failure to make the necessary corrections results in assessing a substantial penalty tax against the individual and/or foundation. |
| Due Dates  | The Form 4720 required to be filed by an individual is due by April 15th of the year following the year the violation occurred.  
|            | The Form 4720 required to be filed by a foundation is due at the same time as the Form 990-PF for those years in which a violation occurred. |
Form 5227

Split-Interest Trust Return

The Form 5227 is the return that would be filed by a nonexempt split-interest trust described in IRC section 4947. Organizations liable for filing this return are:

- A Split-interest Trust described in IRC section 4947(a)(2)
- A Pooled Income Fund
- A Charitable Remainder Trust described in IRC section 664
- A Charitable Lead Trust

Note: These types of trusts are treated as private foundations but are required to file a Form 5227 instead of the Form 990-PF required to be filed by an exempt private foundation.

Due Date

The Form 5227 is required to be filed by a split-interest trust by the 15th day of the 4th month after the close of the trust’s year.

Introduction to Returns

13-17
Forms 1041 or 1041-A

Split Interest Trust Return

A nonexempt split-interest trust may be required to file a Form 1041 or 1041-A in addition to the Form 5227 defined on page 24-9 if:

- A split-interest trust described in IRC section 4947 has gross income of $600 for the year, unless they owe no tax
- Gross income of other split-interest trusts is $600 (a charitable remainder trust described in IRC section 664 is not subject to this filing requirement)
- A charitable remainder trust described in IRC section 664 - Form 1041 is filed as an attachment to Form 5227 if they have unrelated business taxable income
- A split interest trust (including a trust described in IRC section 664) and the governing instruments do not require them to distribute all their income annually, the trust would be required to file the Form 1041-A

Due Date

The due date for filing the Forms 1041 and 1041-A is the 15th day of the 4th month following the close of the trust’s year.
### Form 1120-POL

**Reports Tax on Political Expenditures**
A Form 1120-POL is required to be filed by any tax exempt organization which makes political expenditures of more than $100 on behalf of or in opposition to a candidate seeking public office.

The tax would be imposed on the lesser of the amount spent for that purpose or the amount of investment income earned by the organization.

The tax rate on political expenditures made by an exempt organization is 35 percent.

**Due Date**
The Form 1120-POL is required to be filed by the 15th day of the third month following the close of the organization’s tax year.
Employment Tax Returns

If an exempt organization has employees it may also be required to file Form 940 and Form 941. These forms are as follows:

- **Form 940, Employer’s Annual Federal Unemployment (FUTA) Tax Return**

- **Form 940-EZ, Employer’s Annual Federal Unemployment (FUTA) Tax Return**

- **Form 941, Employer’s Quarterly Federal Tax Return**

Introduction to Returns
13-20
Forms 940 and 940-EZ

Requirements
The Forms 940 and/or 940-EZ are returns filed annually by an exempt organization which is liable for Federal Unemployment Tax.

An organization exempt under IRC section 501(c)(3) is not required to file Forms 940 and/or 940-EZ.

Due Date
The Forms 940 and/or 940-EZ are required to be filed by January 31 of the succeeding year.
Form 941

Purpose
The Form 941 is required to be filed quarterly by an exempt organization which has employees.

This return reports wages paid and the amount due to be deposited and paid over to the Service for employee withholding, FICA, and Medicare.

Due Date
The Form 941 is due by the last day of the month following the end of the quarter.
Public charities under IRC section 501(c)(3) and exempt organizations under IRC section 501(a) file an annual information return on Form 990, Form 990-EZ, or Form 990-N.

Form 990 reports, to the Service and general public, all sources of revenue, expenses, balance sheet and other required information about an organization's activities for the year. Form 990-EZ reports the same type of information but in less detail. Organizations with gross receipts of normally more than $25,000 are required to file a Form 990 or 990-EZ.

Form 990-N (e-Postcard) is electronically filed by small tax-exempt organizations with gross receipts under $25,000.

Even though an organization is recognized as tax exempt, it still may be liable for tax on its unrelated business income. An exempt organization that has $1,000 or more gross income from an unrelated trade or business must file Form 990-T, Exempt Organization Business Income Tax Return.

If an exempt organization has employees it may also be required to file Form 940 and Form 941.

Form 990-PF is filed annually by an organization classified as a private foundation or a private operating foundation under IRC section 509(a).
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