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CPA's guide to getting started with nonprofit organization tax issues

Robert R. Lyons

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A CPA's Guide to Getting Started With Nonprofit Organization Tax Issues



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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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FOREWORD

CPAs today see more and more clients who have nonprofit organization tax questions. It is a rapidly growing area that has captured intense IRS scrutiny for years.

The author, Robert R. Lyons, CPA, Member of Watkins, Meegan, Drury & Company, LLC, Bethesda, Maryland, is an acknowledged nonprofit expert. Mr. Lyons offers a practical, insightful approach to getting started. He covers topics you must know, while venturing beyond merely how to qualify for and maintain exempt status. Technical assistance was provided by R. Bruce Hall, CPA, a Senior Manager in the Washington, D.C., office. Rob has extensive experience as a practitioner, author, and lecturer. Also, we wish to thank Linda Jones for her administrative assistance, and Karen Dingfelder, CPA, Director, Washington National Tax Services of PricewaterhouseCoopers, LLC, Washington, D.C., for her excellent technical review.

Linda Prentice Cohen, Publisher
Professional Publications & Technology Products

TABLE OF CONTENTS

CHAPTER		PAGE
CHAPTER 1	THE CONCEPT AND DESIGN OF NONPROFIT ORGANIZATIONS	1
CHAPTER 2	OBTAINING AND MAINTAINING TAX-EXEMPT STATUS	19
CHAPTER 3	CHARITABLE ORGANIZATIONS—CONCEPTS AND DESIGNS	65
CHAPTER 4	UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES	99
CHAPTER 5	OTHER TYPES OF EXEMPT ORGANIZATIONS	133
CHAPTER 6	THE USE OF JOINT VENTURES AND ALTERNATIVE STRUCTURES	151
CHAPTER 7	THE APPLICATION AND PRINCIPLES OF PRIVATE FOUNDATIONS	165
APPENDIX		195

**THE CONCEPT AND DESIGN OF
NONPROFIT ORGANIZATIONS**

TABLE OF CONTENTS

INTRODUCTION	3
THREE MAJOR SECTORS OF SOCIETY	3
DISTINGUISHING CHARACTERISTICS	4
SANCTIONS	5
MULTI-TIER STRUCTURE	5
Excess Benefit Transaction	6
Disqualified Person/Organization Manager.....	6
IRS REGULATIONS	7
ADVANTAGES AND DISADVANTAGES OF EXEMPTION	7
ADVANTAGES	7
Exemption From Federal Income Taxes	7
Ability to Receive Tax-Deductible Contributions—Charities	8
Technical Aspects	8
Practical Aspects	9
Charitable Subsidiaries	10
Exemption From State and Local Taxes	10
The District of Columbia and Tax Exemption	11
Other State Tax Considerations	11
Other Miscellaneous Advantages	14
DISADVANTAGES	14
Restriction on Activities	14
Increased IRS Scrutiny	15
Increased Public Scrutiny	15

PENALTIES 16
 Failure to File Complete and Timely Annual Information Returns 16
 Failure to Allow Inspection of Annual Returns and Exemption Application 16
 Willful Failure to Allow Inspection 16
 Special Penalty for Large Tax-Exempt Organizations..... 17

THE CONCEPT AND DESIGN OF NONPROFIT ORGANIZATIONS

INTRODUCTION

This book addresses issues concerning tax-exempt organizations. We will consider not only the nature of tax exemption but also the practical application of what has become a very complicated set of rules. Although we will focus primarily on federal taxation of exempt organizations under the IRC of 1986, as amended, we will also review the tax treatment of these organizations based on other federal and state laws.

THREE MAJOR SECTORS OF SOCIETY

In general, exempt organizations represent one of the three major “sectors” of society, the governmental and for-profit sectors being the other two. For purposes of discussion, the sectors comprise the following:

- *For-Profit Sector*—Most of the business and commercial activity of society;
- *Governmental Sector*—Majority of the agencies and bureaus of the federal and state governments; and
- *Nonprofit Sector*—Remaining entities including churches, universities, hospitals, associations, and other organizations normally considered “charitable” or at least tax-exempt.

The distinction between sectors often blurs when entities are classified by their activities. Governmental and nonprofit entities often engage in activities that appear to be commercial in nature, e.g., publication of a magazine with advertising, sales of articles available on the market, such as T-shirts, books, videotapes, etc., rental of property, and myriad other activities that are also conducted by for-profit entities. For-profit entities frequently engage in activities that appear to be charitable in nature, e.g., provision of health care or the conduct of educational activities, to name just two. Entities cannot be classified solely by the results of their operations either. Nonprofit organizations are not prohibited from generating revenues in excess of expenditures.

Rather than classify organizations by their activities or the results of their operations, practitioners must look, instead, to the ownership structure of an entity to ascertain the “sector” in which the entity operates. Nonprofit entities do not have private shareholders. Most are organized under the non-stock statutes in the states in which they are incorporated. In the case of organizations that are allowed to issue “stock” under state statute, shareholders or members are not private individuals. In no case may a nonprofit organization distribute net income to private individuals, i.e., there are no dividend distributions to private parties.

Section 501(a) provides for exemptions from federal income tax for organizations listed in §501 (and also for pensions and qualified trusts). There are 25 different types of exempt organizations listed under §501(c) alone. Charities [§501(c)(3)] are by far the most prevalent type of exempt organization. This book will focus on the special rules governing charities because of their prominence in the nonprofit sector. However, practitioners should be aware of the various noncharitable types of organizations to better assist their clients who plan to enter the nonprofit arena.

Each exemption defines a specific set of organizational and operational requirements, each with a different set of restrictions on activities. For example, charities are prohibited from participating in any way in political campaigns and must limit the amount of lobbying in which they engage. Social welfare organizations [§501(c)(4)] are not limited in the amount of lobbying they are permitted as long as lobbying is not their sole purpose. Social welfare organizations are also allowed to participate in political campaigns without loss of exemption, but they may be required to pay tax on amounts spent on political campaign activities.

DISTINGUISHING CHARACTERISTICS

According to §170(c)(2),¹ a corporation, trust or community chest, fund or foundation is defined as having the following distinguishing characteristics:

- It was created or organized in the U.S. or in any possession thereof, or under the laws of the U.S., any state, the District of Columbia, or any possession of the U.S.
- It was organized and is operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition or for the prevention of cruelty to children or animals.
- No part of the net earnings of the organization inures to benefit any private shareholder or individual.
- It is not disqualified for tax exemption under §501(c)(3) by reason of attempting to influence legislation.

¹ Hereafter, all references to the “Code” and the “Regulations” refer to the IRC of 1986, as amended, and the related regulations.

For the most part, nonprofit organizations have no shareholders beyond the “public trust.” If profits are unjustly (or excessively) distributed to the organization’s controlling entity or person(s), the organization potentially could lose its exemption. This potential has recently been compounded with new rules on sanctions.

Until recently, an exempt organization faced the loss of exemption as a result of improper actions on the part of controlling persons, but this provision was difficult, time-consuming, and costly for the IRS to enforce, and, in some cases, loss of exemption was too severe a punishment and did not fit the nature of the “crime.” As a result, frequently nothing was done. The recent institution of sanctions for some tax-exempt organizations has changed this enforcement problem, however. These sanctions apply to §501(c)(3) charitable organizations (other than foundations) and §501(c)(4) social welfare organizations and are very similar in scope to the self-dealing penalty rules of §4941 applicable to private foundations.

SANCTIONS

The following is a brief overview of the intermediate sanctions provisions. (See also Chapter 3.)

MULTI-TIER STRUCTURE

Intermediate sanctions consist of a two-tier tax on “excess benefit transactions” that involve a “disqualified person” and are to be imposed under new §4958. These transactions involve all organizations exempt under §§501(c)(3) and 501(c)(4) other than private foundations. The following are the key provisions to determine the level of tax.

- *On the Disqualified Person*—An initial tax of 25% of the excess benefit transaction is imposed on each disqualified person. Once assessed, the tax is payable by the disqualified person.
- *On the Management*—An initial tax of 10% of the excess benefit (not to exceed a maximum amount of tax of \$10,000) due to the participation of any organization manager associated with the transaction is imposed. Participating management is fined unless participation is not willful and is due to reasonable cause. The tax is paid by the manager participating in the excess benefit transaction.
- *Second-Level Tax*—Whenever the disqualified person is subject to the tax due to an excess benefit transaction and that excess benefit transaction is not corrected within the current taxable year, a second level of tax is imposed equal to 200% of the excess benefit. As in the previous cases, the tax is payable by the person creating the infraction.

Excess Benefit Transaction

Because of the severity of penalties and the IRS's obvious intention to enforce §4958, having a concise understanding of what constitutes an "excess benefit transaction" and an "excess benefit" is essential.

Section 4958(c)(1)(A) defines an "excess benefit transaction" as any transaction in which an exempt organization provides, directly or indirectly, an economic benefit to or for the use of a disqualified person. To be considered excessive, the economic value of the transaction provided has to exceed what is received in return (this can also include personal services). It is important to note that, in this case, an economic benefit is not treated as consideration for personal services unless the exempt organization clearly states its intentions to treat the benefit as compensation. "Excess benefit" has a far simpler explanation: it is always the object of the excess benefit transaction.

In due course, regulations will expand the definition of excess benefit transactions. Most likely, the definition will be expanded to include any transaction in which the amount of any economic benefit, provided to or for the use of the "disqualified person," is determined in whole or in part by revenues of the exempt organization's activities—but only if the excess benefit transaction would result in inurement under presently existing prohibitions.

Keep in mind that the tax establishes joint and several liability: if more than one person is liable for the tax, then all persons subject to the tax are jointly and severally liable.

Disqualified Person/Organization Manager

Tax is imposed on the disqualified person or the organization manager, and both terms have rather broad meanings. A disqualified person is any person who, at any time during the five years before the transaction, was in a position to exercise *substantial* influence over the affairs of the exempt organization. In the same context, a disqualified person also includes family members and 35% controlled entities. An organization manager is any officer, director, or trustee who exercises authority within the exempt organization. This definition encompasses other individuals performing similar functions though not specifically addressed by those titles.

Even though these rules are explicit regarding the imposition of primary and secondary tax, the rebuttable presumption concerning reasonableness is narrowly defined, but only if the board follows various procedural steps to approve compensation arrangements. The existing standards can continue to apply, will be considered to have been determined on a fair-market basis, and will be assumed reasonable so long as the compensation arrangement was approved by the board that met the following criteria.

- The board comprised individuals who had no direct or indirect connection to the disqualified person or persons involved in the transaction.

- The board made a diligent study into the level of reasonable compensation to the disqualified person. It must have relied on detailed objective criteria including, but not limited to, salary surveys and information about compensation paid by similar organizations for comparable positions in similar geographic areas.
- The board has documented the criteria used as a basis for determination.

Even if these criteria are fully satisfied, the organization may not be out of trouble. The IRS retains the right to assess the tax if it finds sufficient evidence to support improper determination or criteria on the part of the exempt organization.

Intermediate sanctions, for the most part, are effective for transactions entered into after Sept. 13, 1995. Transactions are excepted, however, if they are pursuant to a written contract that was binding as of Sept. 13, 1995, and that has not been materially changed since its inception. Legislative history indicates that agreements entered into after Sept. 13, 1995, but before 1997, can rely on the “rebuttable presumption if within a 90-day period after entering into the compensation package the parties satisfy the criteria referred to above in regards to the three presumptions.” After 1996, the rebuttable presumption applies only if the three criteria are met prior to payment of the compensation.

IRS REGULATIONS

On December 31, 1996, the IRS issued proposed, temporary, and final regulations stating that disqualified persons or organizational managers who are liable for paying excise taxes on excess benefit transactions under §4958 are required to file Form 4720.

The final regulations state that disqualified persons and organization managers who are liable for the excise tax are required to file a return on Form 4720 by the 15th day of the 5th month following the close of the disqualified person’s or organization manager’s taxable year.

In addition, returns were due on or before December 15, 1996, for taxable years ending after September 13, 1995, and on or before July 30, 1996.

ADVANTAGES AND DISADVANTAGES OF EXEMPTION

ADVANTAGES

Exemption From Federal Income Taxes

The most obvious advantage is exemption from federal income taxes. Tax exemption is not to be confused with nonprofit status. Nonprofit status is received by the granting of a charter by the state under applicable nonprofit statutes. Exemption is obtained by meeting requirements under the many types of exemptions available and, in a few cases, applying for recognition of exempt

status from the IRS. This exemption extends to the organization's exempt function income and not to unrelated business income. As we shall see later, exempt function income relates to the source of the income and not to its use. In virtually every discussion in the area of unrelated business income, the conversation starts off with a statement regarding the use of the funds earned in unrelated business activities for an exempt purpose. Even though the use of the funds is obviously important, classification of exempt function income is based on the source—not the use—of the funds.

Ability to Receive Tax-Deductible Contributions—Charities

Two aspects of exemption need to be considered when discussing the deductibility of contributions: technical and practical. The technical aspects are quite narrow and are somewhat “cookbook” in nature because specific criteria are laid out. The practical aspect involves how to make the system work for you.

Technical Aspects

Individuals and corporations may deduct charitable contributions under Sec. 170. The term “charitable contribution” refers to a contribution or gift to or for the use of any of the following five types of entities.

- A state, possession of the U.S., or any political subdivision of any of these categories, the U.S. or the District of Columbia. To qualify, the gift or contribution must be made strictly for public purposes without anticipation of economic gain in return.
- A corporation, trust or community chest, fund or foundation that is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, and of which no part of the earnings inures to benefit any private shareholder or individual.
- A post or organization of war veterans or an auxiliary unit or society of or trust or foundation for any such post or organization organized in the U.S. or any of its possessions. No part of the earnings of the post or organization may inure to benefit a shareholder or private individual.
- A contribution or gift by an individual, a domestic fraternal society, order or association, operating under the lodge system, but only if the contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.
- A cemetery company owned and operated exclusively for the benefit of its members or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted

by its charter to engage in any business that is not necessarily incident to that purpose, if such company or corporation is not operated for profit and if no part of the net earnings of such company or corporation inures to benefit any private shareholder or individual.

Practical Aspects

From a purely practical point of view, the obvious advantage to a charitable organization is its ability to receive tax-deductible contributions. From a business point of view, the same can be achieved for other noncharitable exempt organizations, such as trade associations, by virtue of §162(a) [Reg. §1.162-15(c)]. This provision, in effect, provides that any ordinary and necessary expenses incurred in a business—including, for example, dues and assessments paid to a tax-exempt noncharitable organization—are deductible. This provision is not dependent upon the exemption of the recipient organization, but is frequently an important factor in a non-charity's ability to attract funding.

In many metropolitan areas, charitable organizations are being formed to receive grants. In many cases, the terms of grant provisions require that grants can be made only to charitable organizations. This restriction is often the case where pass-through funds are being received to satisfy mandatory payout provisions. In another case, and one that is becoming more common, federal and state agencies are allowed to make grants or enter into agreements only with charitable organizations. In this case, §501(c)(3) provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes. In addition, Reg. §1.501(c)(3)-1(d)(2) states that:

The term charitable is used in §501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in §501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of “charity” as developed by judicial decisions. Such terms include: ...advancement of education... *lessening of the burdens of Government* [emphasis added]; promotion of social welfare by organizations designed to accomplish any of the above purposes, or...lessen neighborhood tensions....

It is necessary to be able to determine whether the organization can, in fact, lessen the burden of government. In this regard, according to Reg. §1.501(c)(3)-1(d)(2), lessening of the burdens of government is a charitable purpose. According to the regulations, determining whether an organization lessens the burden of government involves a two-part inquiry to determine whether:

- Governmental unit considers the activities to be its burden and recognizes that the organization is acting on its behalf, and
- Organization's performance of the activities actually lessens the burden of government.

In many cases, activities conducted through the charitable organization are not significantly different from those of a regular for-profit activity except that a charitable organization must receive the grant.

Charitable Subsidiaries

Because of the importance of being able to deduct charitable contributions, many exempt organizations other than those formed under §501(c)(3) are setting up charitable subsidiaries organized and operated under §501(c)(3). These related charitable organizations are operating in tandem with the noncharitable organization to achieve a common goal. Although these organizations are often called “foundations,” they are generally set up as public rather than private foundations. Public support tests are generally met through the participation of the organization’s members making contributions directly to the charitable organization or indirectly through the noncharitable organization.

Despite the fact that the nexus between the organization and its charitable subsidiary is close, the foundation must stand alone and be organized and operated for charitable purposes. This separation allows it to be eligible to receive charitable donations from members or grants from other organizations. As long as the charitable subsidiary is furthering its exempt purpose, its separate structure will be respected. When it fails to function as a separate foundation, however, it can face the potential loss of its exemption.

Examples

An example of this can be found in PLR 9017003, where the IRS revoked an historical preservation society’s exemption because it furthered a private interest (that of the related trade association) over the public good. By contrast, in Rev. Rul. 75-470, 1975-2 CB 207, the IRS published the position that an organization formed to promote an appreciation of history through the acquisition, restoration, and preservation of homes, churches, and public buildings that have special historical or architectural significance qualifies for exemption under §501(c)(3). In this case, the restored properties were open to the general public, and its operations were financed from admission fees and contributions from the general public. In the first case, the general public had access only, to the outside of the building; limited access to the inside was granted by appointment only because the building served as the association’s headquarters.

Note that it is not totally inconceivable that the exempt charitable organization may make a grant back to the parent organization—for example, where the charitable organization contracts with the noncharitable exempt organization to put on educational seminars or perform research—providing that the exempt organization has taken care to assure itself of the organization’s ability to perform the research.

Exemption From State and Local Taxes

As a rule, organizations that are exempt from federal income taxes are also exempt for state tax purposes, the exception being unrelated business income. Many states have more restrictive

requirements, however, and CPAs must research each state in which a client may operate. To the extent that an organization reports unrelated business income for federal purposes it will normally file in the applicable state as a taxable corporation for that portion of the income.

The District of Columbia and Tax Exemption

One exception that serves as a good example involves the District of Columbia (District). In the District, to become exempt an organization must fit the following definition:

[A] nonprofit corporation, community chest, fund or foundation organized and operated to a substantial extent within the District, exclusively for religious, etc.....of which no substantial part of the activities is carrying on propaganda or otherwise attempting to influence legislation.

Regulations provide that “operations within the District” do not include activities confined solely to solicitation of funds, or the sites of organizational adjuncts, but do include the actual dispensing of benefits to a “substantial extent within the District.”

The District has set a very narrow scope of allowability for determining which activities constitute a substantial benefit to District residences. The Regulations list, among others, direct benefits such as grants, scholarships, and other forms of direct assistance (expenditures are also included) in connection with scientific and research studies and conferences.

If District residents do not directly benefit, then the organization is not exempt for District purposes—even though it is exempt for federal as well as other state purposes.

State laws should be reviewed to determine the most appropriate state or jurisdiction in which to incorporate or to locate the organization’s headquarters. Note that other states may be just as restrictive as the District; it was chosen merely as an example. Although you may not be doing business in the District, before commencing activities anywhere, you must familiarize yourself thoroughly with the applicable state requirements.

Other State Tax Considerations

The states’ authority expands beyond the issue of granting exemption for income tax purposes alone. Exemption can expand to other areas ranging from real property tax exemption to the application of sales and use taxes. Because treatment varies from state to state, advisors should thoroughly familiarize themselves with the specific jurisdiction.

Although it would be impossible to cover all types of taxes assessed by all states, some uniformity exists, at least in the types of taxes if not their treatment, and is worth reviewing.

Sales and Use Taxes

Sales/use tax legislation can be complicated and vary among states if for no other reason than the need for revenue. Just because an organization is exempt in one state may not necessarily mean that it is exempt in another state. For example, many associations hold conventions in Arizona. Unless you are exempt in Arizona, you cannot apply for sales tax exemption. With proper planning and enough time, however, it is possible to apply for exemption in Arizona and then to apply for exemption from sales tax prior to holding a convention there.

Some of the factors that states consider when determining sales and use tax exemption are:

- What is the organization's main purpose or activity?
- Under what section of the Code was exemption granted?
 - In some cases, exemption is granted only to §501(c)(3) organizations and only if all of the activity is dedicated to strictly charitable purposes.
- What are the primary goods or services being offered?

Real Property Taxes

Although real property tax exemption has been a decisive advantage granted to many nonprofit organizations, lately the trend has reversed, and exemptions have been taken away or at least been temporarily set aside, in whole or in part. Many jurisdictions are asking exempt organizations to make payments in lieu of real property tax payments. Negotiating voluntary payments is time-consuming and unpredictable at best and most likely will produce inconsistent results. It is more common for states to take steps to limit the number of real property exemptions granted to exempt organizations.

In many jurisdictions that continue to provide for exemption from real property taxes, the exemption is granted only where the building is a single-purpose facility and used only in the organization's exempt purpose. For the most part, organizations exempt under §501(c)(3) are granted exemption. Non-§501(c)(3) exempt organizations, such as trade associations and social clubs, however, would not be eligible for real property tax exemptions, except by specific exclusion normally granted by state legislation.

Personal Property Taxes

Treatment of personal property taxes is similar to treatment of real property taxes. Exemption depends on the "exclusive" use of most property employed in the exempt function. Some states grant exemption to §501(c)(3) organizations only, whereas others grant exemption depending on the specific purpose of the organization. Often, exemption requires specific legislative action. In

Maryland, for example, once a “letter of exemption” is obtained, the organization must continue to file an annual personal property tax return with a copy of the letter.

Payroll Taxes

Generally, an exempt organization that pays its employees is subject to the same payroll tax filing requirements as any other business entity. Because nonprofit organizations are covered under the Federal Insurance Contributions Act (FICA), they are liable for the employer’s matching share of FICA taxes withheld. The exempt organization is also responsible for withholding and remitting any other payroll taxes relating to its employees.

Nonprofit organizations are exempt from Federal Unemployment Taxes (FUTA) and, as such, are not required to file Form 940, but many states hold nonprofit organizations liable for state unemployment taxes on wages paid to employees.

Income Taxes

Many states automatically exempt an organization from state income tax if it has been exempted from federal income tax. Delaware, for example, extends this to both domestic and foreign nonprofit organizations that have met the requirements of doing business in Delaware. In many cases, corporations exempt from federal income tax under §501(a) and described in §501(c) are not required to make a formal filing to the state before the state exemption is granted. In many jurisdictions, such as D.C., exemption is denied unless a separate state exemption is granted.

Florida and California impose additional restrictions on organizations applying for exemption from state income taxes. California will not grant an exemption if more than 49% of the organization’s board is “interested persons” or close relatives thereof. An “interested person” is defined as one who has, within the previous year, received compensation for performing services besides those of a director.

Florida law specifies that exempt organizations must justify the rates they charge for services rendered. Exempt organizations must prove that any fee moneys received in excess of costs incurred were either:

- Used for the organization’s maintenance and operational expenses, or
- Used to provide services for individuals unable to pay.

Generally, organizations that have otherwise received exemption for state income tax purposes will be taxed on their unrelated business income (see Chapter 4) as if they were a commercial enterprise in the state. Income and expenses are normally reported using the same forms and in the same manner as any other commercial activity. State definitions for unrelated business income normally follow or make reference to those used in the Code.

Other Miscellaneous Advantages

Retirement Plans

Organizations exempt under §501(c)(3) and public educational institutions can take advantage of tax-deferred annuities for employees under the provisions of §403(b). In addition, certain employees of exempt organizations and state and local governments can avail themselves of the deferred compensation provisions of §457. This provision does not preclude the adoption of a profit-sharing plan even though exempt organizations traditionally do not show a “profit.”

Nonprofit organizations may again take advantage of the provisions of §401(k). Effective for plan years beginning after December 31, 1996, nonprofit organizations may maintain qualified cash or deferred arrangements referred to as “401(k) plans.” The prior law prohibition against the maintenance of cash or deferred arrangements by state and local governments still applies, however, except for Indian tribes.

Surplus Property

Many nonprofit organizations are eligible to receive surplus government property through various federal and state agencies, including the Department of Health and Human Services, in addition to being eligible to receive various grants, loans, and guarantees.

Postal Preference

It is possible for an exempt organization to receive preferential postal rates. The organization needs to establish eligibility with the Postal Service by filing Form 3624. The Postal Service is monitoring these applications much closer than it has in prior years and is matching exact names of the organization with those on the application. Additionally, the Postal Service is not allowing the nonprofit bulk third-class rate to be used when a publication contains anything more than minimal advertising.

DISADVANTAGES

Restriction on Activities

Although the list of advantages is long and detailed, the list of disadvantages is short and basic. The primary disadvantage is that if you do not meet the organization and operational requirements, you will face either substantial sanctions or loss of exemption. The whole concept of private inurement is receiving a great deal of attention by the IRS. This attention can be expected to continue as long as organizations such as United Way continue to make the news because of their real or perceived abuses.

Increased IRS Scrutiny

In its “Coordinated Examination Program,” the IRS is expected to continue to focus primarily on hospitals and healthcare organizations and secondarily on colleges and universities. Key District Offices have been asked to allocate about 30% of their examination resources to this program.

For the period 1991 through September 30, 1996, the following is a statistical summary of the Coordinated Examination Program:

	Open Cases	Closed Cases
Healthcare	38	34
College/University	23	11
Farmers Co-ops	9	15
Media Evangelist	3	4
Churches	1	1
Electric Utility	2	0
Credit Unions	0	1
§501(c) Other	<u>13</u>	<u>7</u>
	89	73

The activities of exempt organizations are generally open to public scrutiny. Unlike for-profit entities, nonprofit organizations face substantial penalties for not making their information returns available for inspection.

Increased Public Scrutiny

The IRS issued Notice 96-48, which summarizes various aspects of the Taxpayer Bill of Rights 2 as it relates to the inspection requirements for exempt organizations and the increase in penalties on exempt organizations. *Taxpayer Bill of Rights 2*, Pub.L. No. 104-168, 110 Stat. 1452 (TBOR2), was enacted July 30, 1996. This notice also discusses a provision of the Small Business Job Protection Act of 1996, Pub.L. No. 104-188, 110 Stat. 1755, which was enacted August 20, 1996, and which increases various penalties on exempt organizations for failing to meet the inspection requirements.

Section 1313(a) of TBOR2 amends §6104(e) regarding the manner in which a nonprofit (other than a private foundation) must allow inspection by the public of its annual information returns and the organization’s application for exemption. The Code has been amended to provide that if a request is made, in person or in writing, for a copy of the documents, an organization must provide the copies to requesters without charge, other than a reasonable fee for any reproduction and mailing costs. The documents that may be requested are:

- One or more of an exempt organization’s three most recent information returns, and

- Organization's application for recognition of exemption under §501(a) (together with a copy of any supporting papers and any document issued by the IRS).
 - If the request is made in person, the copies must be provided immediately. If the request is made in writing, the copies must be provided within 30 days.

Note: The requirement to provide copies without charge (other than a reasonable fee for any reproduction and mailing costs) does not take effect until 60 days after the Treasury first issues regulations under new §6104(e)(3). Until that time, the prior law governs the manner in which an exempt organization, other than a private foundation, must allow inspection of its annual information returns by the public.

PENALTIES

Failure to File Complete and Timely Annual Information Returns

Section 1314(a) of TBOR2 amends §6652(c)(1)(A) to increase the penalties on exempt organizations for failure to file complete and timely annual information returns. Section 6652(c)(1)(A) provides that a failure to file a timely annual information return, failure to include any of the information required to be shown on the return, or failure to show the correct information results in a penalty to be paid by the organization of \$20 per day (up from \$10 per day) for each day during which the failure occurs. The maximum penalty with respect to any one return shall not exceed the lesser of \$10,000 (up from \$5,000) or 5% of the gross receipts of the organization for the year.

Failure to Allow Inspection of Annual Returns and Exemption Application

Section 1704(s) of the Small Business Job Protection Act, Pub.L. No. 104-188, 110 Stat. 1755 (SBJPA), enacted August 20, 1996, amends §6652(c)(1)(C) and (D) to increase the penalties for failure to allow inspection of any return or application under §6104(d) or §6104(e). Under the amended §6652(c)(1)(C), any person failing to allow inspection of annual returns must pay \$20 per day (up from \$10 per day) for each day during which such failure continues, not to exceed \$10,000 (up from \$5,000). Under the amended §6652(c)(1)(D), any person failing to allow inspection of an organization's application for exemption must pay \$20 per day (up from \$10 per day) for each day such failure continues.

Willful Failure to Allow Inspection

Section 1313(b) of TBOR2 amends §6685 to increase the penalty for a willful failure to allow inspection of any return or application for exemption from \$1,000 to \$5,000. As noted above, this amendment does not take effect until 60 days after the Treasury first issues regulations under new §6104(e)(3).

Special Penalty for Large Tax-Exempt Organizations

Section 1314(b) of TBOR2 creates a new special penalty for large organizations under §6652(c)(1)(A). Under this section, a failure to file a timely annual information return, failure to include any of the information required to be shown on the return, or failure to show the correct information by an exempt organization with gross receipts exceeding \$1,000,000 for any year results in a penalty to be paid by the organization of \$100 per day for each day during which the failure occurs. The maximum penalty under §6652(c)(1) for an organization shall not exceed \$50,000.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

TABLE OF CONTENTS

OBTAINING EXEMPT STATUS	23
INTRODUCTION	23
Application	23
Exempt From Filing	23
FORM 1023—APPLICATION FOR RECOGNITION OF EXEMPTION	
UNDER §501(c)(3)	24
APPLICATION FOR EXEMPTION	24
INSTRUCTIONS FOR COMPLETING FORM 1023	26
Form 1023—Part I	26
Form 1023—Part II	27
Form 1023—Part III	30
Form 1023—Schedule A: Churches	31
Form 1023—Schedule B: Schools	31
Form 1023—Schedule C: Hospitals and Medical Research Organizations	32
Form 1023—Schedule D: Supporting Organizations	32
Form 1023—Schedule E: Private Operating Foundations	33
Form 1023—Schedule F: Homes for the Aged or Handicapped	33
Form 1023—Schedule G: Child Care Organizations	33
Form 1023—Schedule H: Student Aid Organizations	33
Form 1023—Schedule I: Successor to For-Profit Institutions	33
Form 1023—Part IV	34

FORM 1024—APPLICATION FOR RECOGNITION OF EXEMPTION	
UNDER §501(a)	34
ORGANIZATIONS REQUIRED TO APPLY	34
GENERAL INSTRUCTIONS FOR COMPLETING FORM 1024	35
INSTRUCTIONS FOR COMPLETING FORM 1024 BY CODE SECTION	37
Title-Holding Companies or Trusts—§501(c)(2) or §501(c)(25).....	37
Civic Leagues and Social Welfare Organizations—§501(c)(4)	37
Labor, Agricultural, and Horticultural Organizations—§501(c)(5)	37
Social Clubs—§501(c)(7)	38
Fraternal Societies, Orders, or Associations—§501(c)(8) or §501(c)(10).....	38
Voluntary Employees’ Benefit Associations (VEBAs)—§501(c)(9)	38
Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies or Like Organizations— §501(c)(12)	39
Cemeteries, Crematoria, and Like Corporations—§501(c)(13)	39
Small Insurance Companies or Associations—§501(c)(15)	39
Supplemental Unemployment Compensation Benefits Trusts—§501(c)(17)	39
Posts or Organizations of Past or Present Members of the Armed Forces, Auxiliary Units or Societies for Such a Post or Organization, and Trusts or Foundations Formed for the Benefit of Such Posts or Organizations— §501(c)(19)	40
 GROUP EXEMPTION	 40
APPLICATION LETTER	40
APPLICATION PROCESS	43
ADVERSE DETERMINATION LETTERS	44
MAINTAINING EXEMPTION	45
ANNUAL REPORTING REQUIREMENTS	45
 FORM 990—RETURN OF ORGANIZATIONS EXEMPT FROM INCOME TAX	 46
COMPLETING FORM 990	46
Form 990—Part I: Revenue, Expenses, and Changes in Net Assets or Fund Balance	47
Form 990—Part II: Statement of Functional Expenses	50
Form 990—Part III: Statement of Program Service Accomplishments	53
Form 990—Part IV: Balance Sheets	54
Form 990—Part IV-A and IV-B: Reconciliation of Revenue and Expenses per Audited Financial Statements With Revenue per Return	56
Form 990—Part V—List of Officers, Directors, Trustees, and Key Employees	57
Form 990—Part VI: Other Information	57
Form 990—Part VII: Analysis of Income-Producing Activities	60

Form 990—Part VIII: Relationship of Activities to the Accomplishment of Exempt Purpose	61
Form 990—Part IX: Information Regarding Taxable Subsidiaries	61
FILING FORM 990—EZ SHORT FORM RETURN OF ORGANIZATION EXEMPT	
FROM INCOME TAX	61
REVOCAION OF EXEMPTION	62
PUBLIC DISCLOSURE AND ACCESS TO INFORMATION	62
Annual Information Return	63

CHAPTER 2

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

OBTAINING EXEMPT STATUS

INTRODUCTION

The IRS does not itself grant exemption to organizations. The authority for exemption is within the IRC, generally within §501. Any organization meeting the exemption requirements of a particular section will qualify as a tax-exempt organization. The IRS is charged with providing recognition of this exemption. The process for recognizing exemption is administered by the IRS through the use of two application forms.

Application

Section 501(c)(3) organizations apply for recognition of exempt status by completing Form 1023. Most other organizations applying for recognition of exempt status must complete Form 1024 (see Appendix). Each of these forms requires the payment of a user fee. Currently, the user fee is \$150 for organizations with gross receipts averaging less than \$10,000 during the preceding four years or for new organizations expected to average less than \$10,000 in gross receipts during its first four years. For organizations exceeding this limit, the user fee is \$465. Group exemption letters require a \$500 fee. These fees are transmitted with Form 8718.

Exempt From Filing

Certain organizations are not required to complete a specific application form. These organizations apply for exemption by letter to the district director for the key district in the organization's area. This letter must be signed by an officer of the organization or by a person authorized by a power of attorney and should include a contact name and telephone number.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

The following organizations are not required to complete a specific application:

- Corporations organized under Acts of Congress, §501(c)(1),
- Teachers' retirement fund associations, §501(c)(11),
- Mutual credit unions, §501(c)(14),
- Corporations organized to finance crop operations, §501(c)(16),
- Employee-funded pension trusts (created before June 25, 1959), §501(c)(23),
- Religious and apostolic associations, §501(d),
- Cooperative hospital service organizations, §501(e), and
- Cooperative service organizations of operating educational organizations, §501(f).

FORM 1023—APPLICATION FOR RECOGNITION OF EXEMPTION UNDER §501(c)(3)

Generally, to be recognized as a charitable organization under §501(c)(3), the organization must file Form 1023. Churches, their integrated auxiliaries, and conventions or associations of churches, as well as any organization that is not a private foundation and that has gross receipts in each taxable year of normally not more than \$5,000 will be recognized as exempt without filing Form 1023. These organizations may want to file Form 1023, however, to gain (1) public recognition of their tax-exempt status, (2) exemption from certain state taxes, (3) advance assurance to donors of deductibility of contribution, (4) reduced postal rates, and (5) exemption from certain federal excise taxes.

For purposes of recognition of exemption, cooperative service organizations, described in §§501(e) and 501(f), and child care organizations, described in §501(k), are treated as §501(c)(3) organizations and should complete Form 1023.

APPLICATION FOR EXEMPTION

Generally, an organization is considered taxable until the IRS approves the application for exemption. A §501(c)(3) organization, however, will generally be considered exempt from the date of organization if the application is filed within fifteen months after the end of the month in which it was formed. The fifteen-month period does not apply to organizations not required to file Form 1023 to have their exemption recognized or to subordinate organizations covered by a group exemption letter if the parent or supervisory organization timely submitted a notice covering the organization.

Rev. Proc. 92-85, 1992-42 IRB 32 (10/01/92), provides that the fifteen-month period is automatically extended twelve months for organizations filing for exemption within twenty-seven months of creation. An application filed after the original fifteen-month due date must include the statement “Filed Pursuant to Rev. Proc. 92-85” at the top of each page to qualify, for the automatic extension. An organization that does not meet the twenty-seven month period can obtain recognition of its exemption from the date of creation by filing its application before the IRS discovers the failure to file the application.

Furthermore, the organization’s exemption will be recognized from creation, even if the IRS has contacted the organization regarding its failure to submit its application within twenty-seven months, if it can show that it acted reasonably and in good faith as described in Rev. Proc. 92-85. Failure to meet the filing deadline or any of the exceptions will result in recognition only from the date of application. Charitable contributions to such organizations will be deductible to the contributor only from the date of recognition of tax-exempt status. The organization can apply, with Form 1023, for exemption under §501(c)(4) for the period of inception through the application date for §501(c)(3), by attaching a completed Page 1 of Form 1024 to Form 1023.

An organization need not wait until operations have commenced to apply for recognition of exempt status.

The IRS will grant recognition of exemption in advance of actual operations to organizations that meet the requirements and provide the required information as indicated below. Additionally, an organization can request “expeditious handling” of its application for recognition of exempt status. The request for “expeditious handling” should be submitted with the application and must be in writing. The request must explain a compelling need for special handling [Rev. Proc. 96-1, Sec. 8, 1996-1 IRB 8 (01/02/96)].

Form 1023 is designed to incorporate all of the requirements for obtaining exemption under §501(c)(3). Form 1023 and the accompanying statements must show the following:

- The organization is organized exclusively for, and will be operated exclusively for, one or more of the following purposes:
 - Charitable,
 - Religious,
 - Educational,
 - Scientific,
 - Literary,

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

- Testing for public safety,
 - Fostering national or international sports competition (but only if none of its activities involve providing athletic facilities or equipment), or
 - Prevention of cruelty to animals.
- No part of the net earnings of the organization will inure to the benefit of private shareholders or individuals.
- The organization will not, as a substantial part of its activities, attempt to influence legislation (unless it elects to come under the provisions allowing certain lobbying expenditures) or participate to any extent in a political campaign for or against any candidate for public office.

INSTRUCTIONS FOR COMPLETING FORM 1023

All organizations applying for exemption under §501(c)(3) must provide all information required on Form 1023 as described in the following sections.

Form 1023—Part I

Lines 1 through 6 require basic identification information, such as name, address, Employer Identification Number, date of organization, activity code(s), contact person, and ending date of annual accounting period. Organizations that have not yet obtained an Employer Identification Number must submit a completed Form SS-4, “Application for Employer Identification Number,” whether or not they have employees.

Activity codes should be chosen with care. Organizations may use up to three codes, but only one is required if all of the organization’s activities fall within that code. Activity codes selected should match the activities of the organization and should not contradict the organization’s exempt purpose or subject the application to undue scrutiny. For example, a health clinic should not choose an activity code from the advocacy section if the clinic will not be attempting to influence public opinion, because the organization will then have to demonstrate that it is not an “action” organization.

Line 7 requires that an organization that is not a §501(c)(3) organization identify the Code section—that is, §501(e), (f), or (k)—under which it is applying for exemption.

Question 8 requires disclosure of previous applications for exemption. If the organization has applied for recognition and been denied, the changes that have been made responding to that denial should be explained in an attachment.

Question 9 inquires about Form 990 filing requirements. If the organization is not required to file due to specific exception or because annual receipts are less than the filing requirement, answer “no” and attach an explanation. Private foundations should answer “n/a” since Form 990PF is required to be filed.

Question 10 inquires about previously filed federal income tax or information returns. If such returns have been filed, the form numbers, years filed, and the IRS office where filed should be indicated.

Line 11 requires that the entity type of the organization be identified. Section 501(c)(3) requires that the organization be a corporation, community chest, fund, or foundation. Acceptable entity types are corporations, trusts, and unincorporated associations; a partnership is *not* an acceptable form of organization for a §501(c)(3) organization. A conformed copy of the organization’s Articles of Incorporation, Articles of Association, Trust Indenture, Constitution, or other enabling documents must be submitted with Form 1023. A conformed copy contains all the provisions of and all amendments to the original document (Rev. Proc. 68-14, 1968-1 CB 768).

The documents are not required to be signed but must be accompanied by a declaration that each is a complete and correct copy of the original document, and that declaration must be signed by an authorized officer of the organization. To be recognized for exemption, an organization must have, at a minimum, organizing documents, governing rules, and regularly chosen officers. Organizations that have adopted bylaws should include a conformed copy certified to be current by an authorized officer. These documents must limit the organization’s purposes to those allowed under §501(c)(3) to meet the organizational test. (See Chapter 3 for a more detailed discussion of the organizational test.)

Form 1023—Part II

Line 1 requires a full description of the purposes and activities of the organization, including standards, criteria, procedures, or other means that have been adopted or planned for carrying out those activities. This description should not be a reiteration of the organizing document but should include a delineation, in order of importance, of all past, present, or planned activities of the organization.

For each of these activities, a detailed explanation of the activity (including the date the activity commenced, where and how the activity is conducted, who the participants in the activity are, and what the activity’s role is in accomplishing the organization’s exempt purpose) should be provided. This section should encompass all of the activities the organization anticipates conducting. A significant expansion of the organization’s activities from those described will require notification to the IRS.

This section is probably the most important one in the application. In the space available (and using attachments) the charity must give adequate information about itself and its activities to allow the IRS to make a determination regarding exemption. This section is the one that

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

invariably creates the need for additional correspondence, which delays the application process. On the other hand, it is a good idea to not give any more information than necessary. Extraneous information may lead to inquiries about activities the IRS considers outside the exempt purposes of the section under which the organization is applying.

Line 2 requires that all sources of financial support be listed in order of size. It is important that the sources listed be consistent with the exempt purpose of the organization and match the information provided in Part IV. In fact, using the same format as Part IV will ensure consistency. Unless the organization is applying for private foundation status, this section should clearly indicate that the organization meets the public support requirements for qualification as a public charity. As discussed in detail in Chapter 4, the source of funds must be *from* exempt purposes. The fact that the funds are used *for* exempt purposes is not sufficient to avoid unrelated business income tax problems.

Line 3 requires a description of the organization's fund-raising program. This description should include details regarding actual and planned events, mailings, fund-raising committees, and the use of volunteers and professional fund-raisers. Examples of fund-raising literature should be attached to the application. The explanation should cover activities related to the organization's exempt purpose as well as unrelated business activities. Particular attention should be given to any activities with officers, directors, employees, professional fund-raisers, and substantial contributors. The IRS will pay particular attention to any activity that may give rise to private inurement or unrelated business income.

Lines 4, a through d, requests information regarding officers, directors, trustees, etc. The information provided will be used to determine issues regarding private inurement and prohibited acts with disqualified persons. The organization's address should not be used for the individuals requested; a home or business address should be used instead.

The compensation information provided should include salaries, consulting fees, retirement benefits, and expense reimbursements. The organizers should use this information in the same manner the IRS will, to determine whether the organization has any issues of excess compensation that could subject it to denial of exempt status or excise taxes.

The information requested regarding public officials on the governing board relates to the close scrutiny applied to such officials in dealing with private foundations. Public officials as part of the governing body may, in fact, be a positive factor because that structure represents a form of public oversight.

The information required about disqualified persons relates to the special relationship between such persons and a private foundation. Although not prohibited from the governing body, disqualified persons are restricted in their dealings with private foundations. (See "Excise Taxes on Prohibited Acts" in Chapter 7.)

Line 5 asks two questions. The first question is about control over the organization by another organization. “Control” is not defined for this purpose, but any financial or governing control should be disclosed, giving details regarding the relationship between the organizations and the exempt status of the controlling organization. The second question is whether the organization is an outgrowth of another organization. The question should be answered correctly with an explanation of the details. Of particular concern is the problem of converting a for-profit organization into a nonprofit organization. Specifically, a for-profit entity with liabilities in excess of assets will gain a benefit from the conversion to nonprofit status; thus, private inurement exists and, consequently, the new entity will not qualify for exemption [Rev. Rul. 75-441 (1975-2 CB 426)].

Question 6 inquires about transactions between the applicant organization and political or other exempt organizations with respect to grants; purchases or sales of assets; rental of facilities; loans or loan guarantees; reimbursement arrangements; performance of services; membership or fund-raising solicitations; or sharing of equipment, mailing lists, or other assets or paid employees. Any “yes” answer must also provide a full explanation including the identity of the other organization. The key to this question is to determine that the applicant does not expend something of value without receiving equal or greater value in return, unless the other organization is a §501(c)(3) organization. Any explanation should provide assurance that the applicant is receiving full value or fulfilling its exempt purpose in any such transaction.

Line 7 inquires about financial accountability to other organizations. Accountability is usually brought about when the applicant is funded from another tax-exempt organization or has been formed by another tax-exempt organization. Any such relationship must be disclosed in full, including any reports the applicant must furnish to the other organization.

Line 8 requires a list of assets used in the performance of the applicant’s exempt function. This list should include a description of the assets and how they are used in performing the organization’s exempt function. Investment assets and cash should not be included. If the assets have not yet been acquired, a list of assets expected to be acquired should be provided with the same information.

Line 9 inquires about the organization’s issuance of tax-exempt bonds. An affirmative answer to this question will result in additional inquiries upon review of the application by the IRS. These inquiries are intended to determine the risk of tax-exempt bond financing being used to further private interests rather than the exempt purpose goals of the organization.

Line 10 requires information regarding any management or lease arrangements. If any such arrangements exist, copies of such documents and an explanation of the relationship between the parties and the applicant must be explained. As with much of the information requested, the issue the IRS is interested in is private inurement.

Line 11, a through c, asks whether the organization is a membership organization. A “yes” answer is required if the membership is able to exercise control over the organization. Honorary membership and memberships that provide only special privileges and discounts are not included

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

for this purpose. If the applicant is a membership organization, the membership requirements, fees, dues, promotional material, and benefits of membership must be disclosed. Membership organizations have difficulty satisfying the requirement that the organizational purpose is for the benefit of the public. Any explanation should indicate the ease of obtaining membership, so that the organization's members are essentially the public or that the organization benefits the public as well as its members through its activities.

Line 12 inquires about benefits, services, and products provided; any required payment; and any restrictions by class or to specific individuals of those benefits, services, and products. A "yes" answer requires an explanation. It would be unusual for a charitable organization not to provide some benefit, service, or product and still be able to fulfill its exempt purpose. The purpose of this inquiry is to determine if the organization is participating in any activity that may lead to unrelated business income. The explanation provided should relate directly to the information provided in Part I about the activities of the organization. Restrictions of benefits, services, or products to a particular class may jeopardize the organization's exempt status. Some discrimination is acceptable; for example, for minority scholarships, the explanation should relate any discriminatory policy to the organization's exempt purpose. Such restrictions may also be indicative of private inurement.

Line 13 inquires about any attempts by the organization to influence legislation. Private foundations are prohibited from such activity and will not be recognized for exemption if the answer is "yes." Public charities may devote an insubstantial amount of time to such activities and must provide an explanation supporting this, including an estimate of the time and funds devoted to such activities.

Line 14 also relates to political activity: the involvement in political campaigns. Because all §501(c)(3) organizations are prohibited from such activity, a "yes" answer, even with the required explanation, will result in denial of exemption.

Form 1023—Part III

Lines 1 through 7 relate to the date of application, so the effective date of the organization's tax-exempt status can be determined. This topic is discussed in detail at the beginning of this chapter.

Lines 8 through 11 are used to determine the proper classification of the entity as a private foundation, private operating foundation, or public charity. A charitable organization is presumed to be a private foundation unless it requests otherwise with the filing of Form 1023. These questions provide the organization with the opportunity to request treatment as a public charity. The benefits and requirements of public charity status are discussed in full in Chapter 3. Chapter 7 contains a full discussion on the merits of private foundation status.

Lines 12 through 14 request information from entities requesting recognition as public charities regarding contributions. Any unusual grants received or anticipated should be listed and an explanation provided supporting the contention that such support is unusual. Contributions received in excess of 2% of the organization's total support must be listed, including the name and amount contributed by each person. Any contributions from disqualified persons must be disclosed, including the name and amount for any contribution in excess of \$5,000. The information derived from this section is used to determine if the charitable organization, in fact, meets the criteria to support its exemption as a public charity. Only organizations attempting to qualify as publicly supported organizations are required to complete this section.

The final question in Part III requires the organization to identify itself by type of charitable organization. In addition to the requirements applying to all organizations applying for exemption under §501(3), additional information is required for specific organizations as follows in the appropriate schedule.

Part IV concerns financial data.

Form 1023—Schedule A: Churches

Churches must complete Schedule A of Form 1023.

Churches must meet two basic guidelines to gain recognition of their exempt status:

- Particular religious beliefs of the organization are truly and sincerely held, and
- Practices and rituals associated with the organization's religious beliefs or creed are not illegal or contrary to clearly defined public policy.

The church's activities must be exclusively religious and must not have a substantial nonexempt purpose of serving the interests of the founder or the founder's family.

Form 1023—Schedule B: Schools

Schools must complete Schedule B of Form 1023. A school's primary function is to provide formal instruction, maintain a regular faculty and curriculum, have a regularly enrolled student body, and have a place where its educational activities are regularly carried on. Organizations not meeting these requirements will not be recognized as exempt. If the school is an instrumentality of a state or political subdivision, it is not a private school and is not required to complete the remainder of Schedule B. All other organizations applying for exemption as schools must provide information regarding discrimination, including statistical information; relevant advertising; newspaper articles and brochures; or catalogs dealing with student admissions, programs, and scholarships. To qualify for exemption, a school must have a racially nondiscriminatory policy toward students. Policies favoring racial minorities in admissions, facilities, programs, and

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

financial assistance will not be classified as discrimination on the basis of race. A list of the organization's incorporators, founders, board members, and donors of land or buildings must be attached to Form 1023.

Form 1023—Schedule C: Hospitals and Medical Research Organizations

Hospitals, and medical research organizations operated in conjunction with a hospital, must complete Schedule C of Form 1023.

To qualify as a tax-exempt hospital, an organization must have as its principal purpose the providing of medical or hospital care or medical education or research. Schedule C requires information regarding (1) the number of doctors on the hospital's courtesy staff, (2) access by doctors in the community to the hospital's facilities, (3) emergency room facilities, (4) payment policies in regard to emergency room use by Medicare and Medicaid patients, (5) policies regarding use of facilities by charity patients, (6) program of medical training and research (if any), and (7) use of office space by physicians carrying on a medical practice.

A medical research center's principal function must be the continuous and active conduct of medical research in conjunction with a hospital described in §501(c)(3), a federal hospital, or an instrumentality of a governmental unit to qualify as a tax-exempt organization. Schedule C requires information regarding the center's relationship with hospitals and regarding current and proposed research activities, including the amount of money that has or will be spent in carrying out those activities and a statement of assets indicating fair market value and the portion of assets directly devoted to medical research.

Form 1023—Schedule D: Supporting Organizations

Supporting organizations, as described in §509(a)(3), must complete Schedule D, providing information regarding the organizations that it supports, including whether the supported organization has received a ruling or determination letter that it is not a private foundation, an explanation for any organization that has not received such information, and the Code section of the supported organization. This information must include an analysis of revenue for the current and preceding three years. Information must be provided regarding the supported organization's control over the supporting organization, including control over election and appointment of officers, description of control exercised over investment policies, grants, and so forth.

Financial information regarding the relationship between the applicant and the supported organization(s) is required. A description of activities that are performed by the supporting organization but that would otherwise be carried out by the supported organization must be included with Form 1023. Disclosure regarding control of the supported organization(s) by disqualified persons, other than managers, or organizations not described in §509(a)(1) or (2), must be included with the application for exemption.

Form 1023—Schedule E: Private Operating Foundations

Private foundations complete Schedule E and must provide information that supports their requirement to meet the income test and one of the three alternative tests: the assets test, endowment test, or support test. The requirements for private foundations gaining recognition of exemption are fully discussed in Chapter 7.

Form 1023—Schedule F: Homes for the Aged or Handicapped

Homes for the aged or handicapped must complete Schedule F, providing information regarding admission, including promotional literature, admission forms, contracts with residents, fees (both entrance and continuing), and policies regarding indigent patients, including arrangements with local and federal welfare agencies, sponsoring organizations, and so forth to pay for indigent patients. Additional information is required in regard to the organization's ability to meet the health, physical, emotional, recreational, social, religious, and similar needs of the aged or handicapped.

Form 1023—Schedule G: Child Care Organizations

Child care organizations must complete Schedule G of Form 1023, providing information regarding the number of children authorized to attend and actually attending, the purpose of the care provided (such as enabling parents to be gainfully employed or seek employment), and who is eligible to apply for care for their children (i.e., low-income parents, working parents, etc.).

Form 1023—Schedule H: Student Aid Organizations

Organizations providing or administering scholarship benefits, student aid, etc., must complete Schedule H. These organizations must provide descriptions of the nature, amount, terms, categories, and criteria of scholarship benefit, student aid, etc., including samples of applications required for consideration. The organization must indicate any limitations or restrictions on the class of eligible recipients, particularly in regard to restrictions based on race and employment status. If the organization has any restrictions based on employment status, additional information must be provided regarding the relationships between the selection committee and the employer and whether relatives of the selection committee are eligible recipients. The organization must also provide the procedures for supervising grants and for taking action in regard to grant violations.

Form 1023—Schedule I: Successor to For-Profit Institutions

Organizations that have or will take over the facilities of a for-profit institution must complete Schedule I. Information is required regarding the predecessor organization, its activities, principal

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

stockholders, business and family relationships between predecessor organization and applicant, and leasing arrangements with predecessor organization owners, principal stockholders, or principal employees. Any changes in operating policies as a result of the transfer of assets from the profit-making entity to the nonprofit organization must be described. A copy of the sales agreement or other contract related to the transfer of assets from the for-profit institution and an appraisal by an independent qualified appraiser must be attached to Form 1023.

Form 1023—Part IV

Part IV requires financial statements showing receipts and expenditures for the current and three preceding years (or number of years in existence if less than four). A balance sheet for the most recent period must be included. A description of receipts and disbursements for each accounting period, indicating whether support is public or private and the nature of the support (such as contributions, grants, or program services) is required and should distinguish expenditures for furtherance of exempt purposes from those for general and administrative purposes. Organizations that have not yet begun operations or have operated less than one year should provide a proposed budget for two full accounting periods and a current statement of assets and liabilities.

FORM 1024—APPLICATION FOR RECOGNITION OF EXEMPTION UNDER §501(a)

Organizations described in §501(a)—other than §501(c)(3) organizations required to file Form 1023 and organizations not required to file a specific application (listed at the beginning of this chapter)—are required to submit Form 1024 to have their income tax exemption recognized by the IRS. Qualified Group Legal Services Plans under §120 and group legal services trusts under §501(c)(20) were required to file for exemption using Form 1024. The law authorizing these plans expired June 30, 1992; consequently, these plans are not discussed in this chapter.

ORGANIZATIONS REQUIRED TO APPLY

Much like Form 1023, Form 1024 is designed to accumulate all the information required to ascertain whether the organization meets the requirements to be recognized as exempt under the particular Code section for which the organization is attempting to qualify. The following organizations are required to complete Form 1024 to gain exempt status:

- Title holding corporations—§501(c)(2);
- Civic leagues, social welfare organizations, and local association of employees—§501(c)(4);

- Labor, agricultural, or horticultural organizations—§501(c)(5);
- Business leagues, chambers of commerce, and so forth—§501(c)(6);
- Social clubs—§501(c)(7);
- Fraternal beneficiary societies and so forth, providing life, sick, accident, or other benefits to members—§501(c)(8);
- Voluntary employees' beneficiary associations—§501(c)(9);
- Domestic fraternal societies, orders, and so forth not providing life, sick, accident, or other benefits to members—§501(c)(10);
- Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations—§501(c)(12);
- Cemeteries, crematoria, and like corporations—§501(c)(13);
- Mutual insurance companies or associations, other than life or marine—§501(c)(15);
- Trusts providing for the payment of supplemental unemployment compensation benefits—§501(c)(17);
- A post, organization, auxiliary unit, etc., of past or present members of the U.S. Armed Forces—§501(c)(19); and
- Title holding corporations or trusts—§501(c)(25).

GENERAL INSTRUCTIONS FOR COMPLETING FORM 1024

Organizations that have not yet obtained an Employer Identification Number must submit a completed Form SS-4, "Application for Employer Identification Number," whether or not they have employees.

Submit a conformed copy of the organization's Articles of Incorporation, Articles of Association, Trust Indenture, Constitution, or other enabling documents with Form 1024. To be recognized for exemption, an organization must have, at a minimum, organizing documents, governing rules,

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

and regularly chosen officers. Organizations that have adopted bylaws should include a conformed copy certified by an authorized officer as current.

Provide a full description of the purposes and activities of the organization, including standards, criteria, procedures, or other means that have been adopted or planned for carrying out those activities. This description should not be a reiteration of the organizing document.

Supply financial statements showing receipts and expenditures for the current and three preceding years (or number of years in existence if less than four). A balance sheet for the most recent period must be included. A description of receipts and disbursements for each accounting period and gross receipts and disbursements from unrelated business income should be segregated from activity substantially related to the exempt purpose of the organization.

If a substantial change in the financial activities has occurred since the end of the period shown in the financial statements, provide a detailed explanation of the change with Form 1024. For organizations that have not yet begun operations or have operated less than one year, provide a proposed budget for two full accounting periods and a current statement of assets and liabilities.

If previous federal income tax returns have been filed, include the form number, years, and IRS office where filed as part of the organization's application. Provide information regarding present and future sources of financial support.

Describe the organization's relationship with other organizations, including any predecessor organizations. Attach copies of all documents that effected any transfer of assets. Describe equity structure, including classes of stock, number of shares issued, par value, consideration received, and dividend-paying authority.

Provide information regarding membership, including classes of membership, voting rights, and number of members in each class. Attach solicitation materials and membership certificates. Provide details regarding any distributions of property or surplus funds to shareholders or members. Describe services performed for which the organization receives payment. Describe services performed by members or shareholders for which the organization makes payments.

Provide details regarding insurance arrangements for members, their dependents or others, including explanation of eligibility requirements. Sample copies of plan documents and policies must be included.

Provide copies of any lease documents, including a description of the property, amount of rent, and any relationship between the organization and the other party to the lease. Explain any attempts made or planned to influence the selection, nomination, election, or appointment of any person to any federal, state, or local public office or to an office in a political organization. Include amounts spent or to be spent in each case. Attach copies of any pamphlets, brochures, newsletters, journals, or similar printed material to the application.

INSTRUCTIONS FOR COMPLETING FORM 1024 BY CODE SECTION

In addition to the information required of all organizations seeking to be recognized as exempt, an organization must provide information related to the specific exemption for which it is applying. Instructions for meeting the requirements for each Code exemption are provided below.

Title-Holding Companies or Trusts—§501(c)(2) or §501(c)(25)

Supply the complete name, address, and Employer Identification Number of each organization for which title to property is held and the number and type of the applicant's stock held by each organization.

Describe the purpose for which excess of revenue over expenses is held, if such excess exists. Explain the basis of each shareholder's qualification under §501(c)(2) or §501(c)(25). Determination or ruling letters recognizing exemption of shareholders must be attached if such documents have been received.

Describe income received from other than the rental of real property. Specifically, provide the percentage of income derived from the rental of personal property leased with real property and the percentage of incidental income derived from the holding of real property (i.e., income from parking lots, etc.).

Civic Leagues and Social Welfare Organizations—§501(c)(4)

Provide information regarding revocation of recognition of §501(c)(3) status due to participation in political activity or attempting to influence legislation, if such revocation has occurred.

Describe services performed, such as cooperative purchasing, maintenance of common areas, and provision of recreation facilities for members, shareholders, or others. Include an explanation of the nature of benefits to the general public and provide details regarding income realized and expenses incurred.

For organizations applying for exemption as a homeowners' association, explain any restrictions to access of any property or facilities it owns or maintains. For organizations applying for exemption as a local association of employees, provide the name and address of each employer whose employees are eligible for membership. If employers have multiple locations with eligible employees, provide the address of each location.

Labor, Agricultural, and Horticultural Organizations—§501(c)(5)

Describe services rendered by the organization for members or others. For organizations applying for exemption as fishermen's organizations, describe the kinds of aquatic resources cultivated or

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

harvested by those eligible for membership. For labor organizations, attach a copy of the organization's latest collective bargaining agreement, if organized under such an agreement.

Social Clubs—§501(c)(7)

Attach a copy of any contract or agreement entered into for the management or operation of its property and/or activities, such as restaurants, pro shops, etc. For an organization seeking public patronage of its facilities or activities, explain the plans for such patronage and attach copies of advertising or promotional material.

Describe permitted nonmember use of facilities and participation in functions and activities of the club. This description must include the amount of nonmember income and the percentage of nonmember gross receipts to total receipts, as well the percentage of nonmember and investment gross receipts to total receipts. A copy of the house rules should be attached to the application, if such rules exist.

State whether any provision regarding any discrimination, based on race, color, or religion, contained in the organization's charter, bylaws, other governing instrument or any written policy will be kept. The date any such provision will be or has been stricken from such documents must be provided. Restrictions based on religion must be explained.

Fraternal Societies, Orders, or Associations—§501(c)(8) or §501(c)(10)

Provide information regarding operation under the lodge system. Subordinate organizations must provide a certificate signed by the secretary of the parent organization, under the seal of the organization, certifying that the subordinate lodge is a duly-constituted body under the jurisdiction of the parent body. Parent or grand lodge organizations must attach a schedule for each subordinate lodge in active operation showing name and address, number of members, and frequency of periodic meetings.

Voluntary Employees' Benefit Associations (VEBAs)—§501(c)(9)

Provide a description of the benefits available to members. Copies of any plan documents describing benefits, terms, and conditions of eligibility for each benefit should be attached to the application. Explain any differences in benefits available to various employees or classes of employees.

Provide information regarding timely filing of Form 1024. These organizations qualify for the same relief provisions as charitable organizations regarding the timely filing of application for recognition as an exempt organization. (See discussion above under Form 1023.)

Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies or Like Organizations—§501(c)(12)

Provide a columnar schedule for each tax year for which application for exemption is made, indicating total gross income received from members or shareholders and the total amounts of gross income received by other sources. If claiming exemption as a local benevolent association, provide information indicating which counties members are from, or will be accepted from, and whether stipulated premiums are, or will be, charged in advance or whether losses are, or will be, paid solely through assessments.

If claiming exemption as a “like organization, “ provide explanation regarding how the organization is similar to a mutual ditch or irrigation company or a mutual or cooperative telephone company. For a mutual or cooperative telephone company, attach copies of contracts with companies providing long-distance services.

Cemeteries, Crematoria, and Like Corporations—§501(c)(13)

Attach complete copy of sales contracts or other documents, including any “debt” certificates involved in acquiring cemetery or crematorium property, a complete copy of any contract designating an agent to sell cemetery lots, and a copy of the appraisal of the cemetery property as of the date acquired. Attach a copy of the fund agreement and explain the nature of the fund (investments) regarding perpetual care funds, if any. If the organization is claiming exemption as a perpetual care fund for a §501(c)(13) organization that has not established exemption under that section, provide an explanation.

Small Insurance Companies or Associations—§501(c)(15)

Provide information regarding amounts of direct premiums written, reinsurance assumed, and reinsurance ceded to determine that the organization meets the requirements regarding premium limitations. Organizations that are part of a controlled group must complete the information for all members of the controlled group.

Supplemental Unemployment Compensation Benefits Trusts—§501(c)(17)

Explain in detail any plan provisions that are for the benefit of sole proprietors, partners, or self-employed persons. Supply information concerning benefits provided under the plan other than supplemental unemployment compensation benefits. Supply statistical information, including (1) the number of employees covered by the plan, segregated to identify the number of shareholders, officers, self-employed persons, or highly compensated individuals included in this group; (2) the number of employees not covered by the plan; and (3) the total number of employees. Provide an explanation regarding any transaction or planned transaction with a creator or contributor of the

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

trust, including related parties of the creator or contributor. For supplemental unemployment compensation benefits trusts, provide information regarding timely filing of Form 1024 as well. These organizations qualify for the same relief provisions as charitable organizations regarding the timely filing of application for recognition as an exempt organization. (See discussion above under Form 1023.)

Posts or Organizations of Past or Present Members of the Armed Forces, Auxiliary Units or Societies for Such a Post or Organization, and Trusts or Foundations Formed for the Benefit of Such Posts or Organizations— §501(c)(19)

Provide statistical information regarding the members of the organization, including the categories of membership and the numbers of members in each category. Additional information is required to determine if the organization qualifies to receive tax-deductible contributions as a “war veterans organization” described in §170(c)(3). For organizations seeking recognition as auxiliary units or societies affiliated with posts or organizations, present additional information regarding such affiliation, including membership and relationships of members with past or present members of the Armed Forces. Trusts must explain any use of income or corpus not directly used in funding the exempt organization and, if it is a charitable trust, must indicate that its organizing documents contain proper dissolution provisions as described in Reg. §1.501(c)(3)-1(b)(4).

GROUP EXEMPTION

Central organizations that have subordinate organizations under their general supervision or control may apply for a group exemption letter for those subordinates if the central organization has obtained its own exemption. Obtaining a group exemption letter relieves the subordinate organizations from filing applications for exemption.

To obtain a group exemption, the central organization should apply by letter, including its Employer Identification Number, the date of its exemption recognition letter, and the IRS office that issued the recognition letter. No documents previously submitted in obtaining its exemption need to be resubmitted, but any amendments to governing instruments, internal regulations, or changes in the character, purposes, or method of operation of the organization should be included with the group exemption application letter.

APPLICATION LETTER

In addition, the central organization must provide a letter signed by a principal officer of the central organization specifying the following regarding subordinate organizations:

- Provide information verifying that the subordinates are:

- Affiliated with the central organization;
 - Subject to its general supervision and control;
 - All eligible to qualify for exemption under the same paragraph of §501(c);
 - Not private foundations if §501(c)(3) organizations are involved;
 - All on the same accounting period as the central organization if they are to be included in group returns; and
 - Organizations that have been formed within the fifteen-month period preceding the group application if they are claiming §501(c)(3) status and are subject to the requirements of §508(a) (requiring application for exemption to be recognized) and want to be recognized as exempt from their dates of creation.
- Describe in detail the purposes and activities of the subordinates, including sources of receipts and nature of expenditures.
 - Provide a sample copy of a uniform governing instrument.
 - Supply an affirmation to the effect that, to the best of the officer's knowledge, the purposes of the subordinates are as stated in the information provided above. Supply a statement that each subordinate included in the group exemption request has furnished written authorization, signed by a duly authorized officer, to that effect to the central organization.
 - Provide a list of subordinates, included in the group exemption letter, that have received an outstanding ruling or determination letter related to exemption.
 - Supply an affirmation that to the best of the officer's knowledge and belief no subordinate included in the group exemption letter is a private foundation (if applicable).
 - For each subordinate that is a school claiming exemption under §501(c)(3), provide the information required of schools in applying for exemption. (This requirement primarily involves organizational requirements and racial discrimination policies; see requirements for schools under Form 1023 applications above.)
 - For any school affiliated with a church, provide the information required of school in applying for exemption. Church-affiliated schools are subject to the same nondiscrimination policy requirements as non-church-affiliated schools.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

- Provide a list of the names, mailing addresses, actual addresses if different from mailing addresses, and Employer Identification Numbers of subordinates to be included in the exemption letter.

A new §501(c)(3) organization to be included in the group exemption must provide the authorization indicated above before the end of the fifteenth month after it was formed and must be included in the central organization's next annual submission of required information.

To maintain the group exemption letter, the central organization must:

- Continue to exist,
- Continue to qualify for exemption under §501(c),
- Submit required information annually (described below), and
- File Form 990 annually, if required.

The subordinate organizations must continue to qualify for inclusion in the group exemption letter, must not withdraw authorization for inclusion in the group exemption letter, and must fulfill their annual filing requirements, if any.

The central organization must submit the following annually, at least ninety days prior to the close of its annual accounting period, to the IRS center with which it files (or would file) its information returns:

- Provide information regarding all changes in the purposes, character, or method of operation of the subordinates included in the group exemption letter.
- Supply a separate list, including name, mailing address, actual address, and Employer Identification Number for each of the following categories:
 - Subordinates that have changed names or addresses during the year,
 - Subordinates no longer included in the group exemption letter, and
 - Subordinates to be added to the group exemption letter.
- If new subordinates are added during the year, submit the information required for the original group exemption described above for the new subordinates. If the original information is applicable in all material respects, a statement to this effect is acceptable, in regard to the items described above, as part of the original information submission.

APPLICATION PROCESS

Organizations seeking recognition of tax-exempt status must complete the appropriate application Form 1023 or 1024 or apply by letter if so allowed as described above. These applications must be complete, or they will be returned to the organization. All applications must be in writing; oral representations will not be considered in the recognition process. Attachments in the form of tape recordings are acceptable only when a written transcript is also provided. A completed Form 8718 must accompany the recognition application along with the appropriate user fee.

All required information must be included with the organization's application. Every attachment should show the name and address of the organization, the date, identifiable heading, and reference to the application form or letter. All information submitted will become part of the IRS file and will not be returned.

All information submitted is subject to public inspection with two exceptions. Information identifying contributors will not be released nor will information regarding trade secrets, patents, and the like be released if the IRS determines that the disclosure of that proprietary information would adversely affect the organization. A full discussion of public inspection is provided later in this chapter.

An incomplete application will be returned without being considered on its merits. A letter of explanation will be provided indicating the time frame in which the application must be resubmitted to be considered filed as of the original submission date.

If the organization has agreed to be considered for exempt status under a different Code section than the one under which it applied, the organization may be recognized as exempt under any paragraph to which the form submitted applies. If a different application form is required, the organization will be so advised and the appropriate application form will be provided. Any information submitted with the original application is not required to be duplicated upon resubmission. Any required information that was not submitted with the original application must be provided with the new form.

An application may be withdrawn at any time before the issuance of a ruling or determination letter, upon written request of a principal officer or authorized representative of the organization. Neither the information submitted with the application nor the user fee will be returned. The IRS may use any submitted information in examining the organization's returns without regard to the withdrawal of the application.

If the organization is represented by an agent or attorney, a power of attorney must be filed with the application specifically authorizing the agent or attorney to represent the organization. Form 2848 may be used. The application must be filed with the district director for the key district in which the organization's principal office or place of business is located.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

The organization will receive a response from the key district acknowledging receipt of the organization's application, if the information was complete, or a request for additional information. Upon considering a complete application, the key district office will then either issue a favorable letter of determination, issue a proposed adverse determination letter denying exemption, or refer the case to the national office.

If the organization receives a favorable letter of exemption, recognition will be granted from the date of formation of the organization, if the organization's purposes and activities were those required by law during the application period. Section 501(c)(3), (9), and (17) organizations may be exempt only from the application date in certain circumstances (see discussion in section regarding Form 1023 for details). If substantial changes in the organization's activities were required or if the charter has been amended, the determination letter will indicate the effective date of the exemption.

The key district office will refer an organization's application to the national office if an issue arises concerning qualification for exemption or foundation status for which there is no published precedent or for which there is reason to believe that nonuniformity exists. The organization can request that any issue that it considers complex or unusual, or for which it feels that a lack of uniformity exists concerning its disposition, be referred to the national office. If an issue is referred to the national office and a subsequent determination letter is issued, that issue cannot be appealed.

ADVERSE DETERMINATION LETTERS

If the organization's request for recognition of exempt status results in an adverse determination letter, the organization has the right to protest to the appeals office. The protest must be submitted to the key district director within thirty days from the date of the adverse determination letter and must state whether it wants an appeals office conference. The protest must include the following:

- Organization's name, address and Employer Identification Number;
- Statement that the organization wants to protest the determination;
- Date and symbols on the determination letter;
- Statement, signed under penalties of perjury, of facts supporting the organization's position in any contested factual issue;
- Statement outlining the law or other authority the organization is relying on; and
- Statement as to whether a conference at the appeals office is desired.

After consideration of the protest and any information presented in any conference held, the appeals office will notify the organization of its decision and issue an appropriate determination letter. If the determination is adverse, the organization may appeal to the courts.

Prior to appealing an adverse determination to the courts, §501(c)(3) organizations must first exhaust the following administrative remedies:

- Filing a substantially completed application Form 1023 or filing a request for a determination of foundation status;
- Requesting relief under Reg. §301.9100, in the case of a late-filed application, regarding applications for extensions of time for making an election or application for relief from tax;
- Timely submitting all additional information requested to perfect an exemption application or request for determination of private foundation status; and
- Exhausting all administrative appeals available within the IRS, including protest of an adverse ruling in national office original jurisdiction exemption application cases.

The actions just described will not be considered completed until the IRS has had a reasonable time to act upon the appeal or protest.

MAINTAINING EXEMPTION

Once approved, recognition of an organization's exemption will normally continue as long as the organization continues to operate in accordance with the criteria for which it was granted exemption. An exempt organization must comply with a number of requirements to maintain exemption, including filing annual information returns and complying with public disclosure laws. These requirements and the situations that might cause an organization's exemption to be revoked are discussed in more detail below.

ANNUAL REPORTING REQUIREMENTS

Every organization exempt from federal income tax under §501(a) must file an annual information return except:

- Church, an interchurch organization of local units of a church, a convention or association of churches, an integrated auxiliary of a church, or an internally supported church-affiliated organization;
- Exclusively religious activity of an religious order;

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

- Mission society sponsored by or affiliated with one or more churches or church denominations, more than one-half of the activities of which society are conducted in, or directed at persons in, foreign countries;
- School below college level affiliated with a church or operated by a religious order, even though it is not an integrated auxiliary of a church;
- Religious or apostolic organization described in §501(d) (required to file Form 1065);
- State institution, the income of which is excluded from gross income under §115;
- Corporation described in §501(c)(1) that is organized under an Act of Congress and is:
 - An instrumentality of the U.S.; and
 - Exempt from federal income taxes under such Act;
- Stock bonus, pension, or profit-sharing trust which qualifies under §401;
- Black-lung benefit trust described in §501(c)(21) (required to file Form 990-BL, “Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons”);
- Exempt organization (other than a private foundation) having gross receipts in each tax year that normally are not more than \$25,000; and
- Foreign organization described in §501(a) (other than a private foundation) that normally does not have more than \$25,000 in annual gross receipts from sources within the U.S. and has no significant activity in the U.S.

Forms 990, 990-EZ and 990-PF are used to accumulate the information required by §6033, which requires that organizations exempt from taxation under §501(a) file an annual information return specifically setting forth its items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the IRS may prescribe. Section 501(c)(3) organizations are required to furnish the information in Form 990.

FORM 990—RETURN OF ORGANIZATIONS EXEMPT FROM INCOME TAX

COMPLETING FORM 990

Tax-exempt organizations, other than private foundations, must file Form 990 or Form 990-EZ. Private foundations must file Form 990-PF. Forms 990, 990-EZ, or 990-PF must be filed by the

fifteenth day of the fifth month after the end of the accounting period. Extension of the deadline for filing is not automatic but is rarely denied. Requests for extensions should be made by filing Form 2758. Generally, the request will not be approved for more than ninety days unless sufficient need for the extended period is clearly shown. In no event will an extension be granted for more than six months to any domestic organization.

Organizations described in §501(c)(3) (charitable organizations), §501(e) (cooperative hospital service organizations), §501(f) (cooperative service organizations of educational organizations), §501(k) (child care organizations), and §501(n) (charitable risk pools), as well as nonexempt charitable trusts described in §4947(a)(1), must complete Schedule A of Form 990 if otherwise required to file Form 990. Sections A through J require the organization to complete basic identifying information.

Form 990—Part I: Revenue, Expenses, and Changes in Net Assets or Fund Balance

Line 1 is divided into three parts: direct public support, indirect public support, and government contributions. The source of the contribution determines the appropriate reporting line.

Line 1a (direct public support) includes amounts received directly from individuals, trusts, corporations, estates, foundations, and other exempt organizations to the extent they are not fund-raising or affiliated organizations of the receiving entity. Membership dues and assessments in excess of fair market value of benefits received are considered direct public support as is revenue from fund-raising events at which the donor pays more than the fair market value received. If the goods or services have only nominal value, the entire amount paid is reported as direct public support. Grants from nongovernmental entities that enable the organization to carry on programs or activities that further its exempt purpose are also reported on Line 1a.

Line 1b (indirect public support) includes amounts received from affiliated organizations and from other exempt fund-raising organizations (such as the United Way).

Line 1c (government grants) are reported if the purpose of the grant is to allow the organization to fulfill its exempt purpose by providing a direct service to the public, rather than to accomplish a purpose for the government's benefit.

Line 2 reports the total amount of program service revenue. In general, all revenue associated with fulfilling the organization's exempt purpose should be reported on Line 2 even if it may otherwise qualify for another category. Program service revenue is analyzed in Part VII of Form 990 and is discussed in full in that section of this chapter.

Line 3 is where membership dues and assessments are reported. Many tax-exempt organizations are membership organizations (fraternal organizations, social clubs, business leagues, etc.). The members of these organizations receive benefits from their membership as opposed to having the

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

donative intent of making a charitable contribution. Consequently, the income received from these activities is reported as membership dues on this line.

As mentioned earlier, if membership benefits are of nominal value, membership dues are properly reported as contributions on Line 1a. When membership dues are more than the value of the benefits provided, but the benefits are of more than nominal value, the dues received must be allocated between direct public support and membership dues for reporting purposes. The amounts reported as direct public support should be the total of the amounts disclosed to members as deductible under the quid pro quo rules. In certain circumstances, charitable organizations are required to report the value of the benefits provided in connection with contributions received, when more than a nominal value, if the benefit is provided to the contributor. A full discussion of these rules is outside the scope of this book.

Line 4 is used to report income from savings and temporary cash investments. This amount includes earnings on interest-bearing checking accounts, money market funds, commercial paper (e.g., short-term corporate I.O.U.s), certificates of deposit, and Treasury Bills and other governmental obligations maturing in one year or less. These requirements are the same as for reporting segregation on the balance sheet. Thus, the income from any balance that should be reported on Line 46 of Part IV should be reported on this line.

Line 5 is used to report income from securities, including income earned from publicly traded corporate stocks; publicly traded corporate bonds; other publicly traded securities (e.g., mutual funds); and U.S., state, and municipal government obligations that mature in one year or more. These requirements are the same as for reporting segregation on the balance sheet. Thus, the income from any balance that should be reported on Line 54 of Part IV should be reported on this line. The exception to this is for income earned on investments made in furtherance of the organization's exempt purpose (e.g., interest earned on student loans). Income from these types of investments should be reported as program service revenue on Line 2.

Line 6 generally is used to report the organization's gross rental income (**Line 6a**) less rental expenses (**Line 6b**). Rent collected in connection with the organization's exempt purpose should be reported as program service revenue. Rent collected from renting property to affiliated tax-exempt organizations is also treated as program service revenue and reported on Line 2 of Part I. Rent collected from unaffiliated organizations is reported on Line 6, unless:

- Below-market rent is charged and the purpose of the low rent is to achieve the reporting organization's exempt purpose, or
- Tenant's activities are related to the exempt purpose of the entity collecting the rent.

It is important to reflect properly the nature of the earnings, particularly if an otherwise investment-type activity should be reported as a program service in furtherance of the organization's exempt purpose. As discussed throughout this book, the limitations, prohibitions, and taxes on the performance of activities and the earning of income outside the organization's exempt purpose are many. If the nonexempt-purpose activities are too extensive, loss or denial of

exemption can occur. No such limitations are placed on an organization's activities in carrying out its exempt purpose.

Line 7 should be used to report investment income from sources not reported elsewhere on the return. Like other income, earnings from such an investment should be reported on Line 2 if connected with a program service. The income reported here should be from "other investments" which are reported on Line 56 of Part IV. An example of such an investment is royalty income from mineral interests.

Line 8 is used to report the gain or loss from the sale of noninventory items. The sale of securities should be reported in **Column a**. In determining the basis of such assets for reporting gain or loss, typically the original cost is used; for donated property, the basis is typically the fair market value on the date of the contribution. Some organizations adjust the carrying value of securities to reflect the fair market value of the asset. For purposes of Form 990, unrealized gains and losses should not be reported on Line 8; Line 20 is used to reconcile the book-retained earnings with earnings reported on Form 990. When an organization disposes of less than 100% of a particular security, the basis of securities sold can be determined using the specific identification, first-in/first-out, or average cost method.

Line 8, Column b is used to report the sales of noninventory assets other than securities. Examples are sales of stock in privately held companies, furniture or equipment used by the organization, or program-related investments. The basis of such assets is the cost or other basis less depreciation. A schedule should be attached for Column b indicating (1) date and how acquired; (2) date sold and to whom; (3) gross sales price; (4) cost, other basis, or if donated, value at time acquired; (5) expense of sale and cost of improvements; and (6) accumulated depreciation if applicable.

Line 9 requires the reporting of gross receipts less direct non-fund-raising expenses and has a notation regarding amounts raised from special events reported as direct public support on Line 1a. A "special event" is defined as an activity that is primarily engaged in to raise funds and that is only incidentally related to the organization's exempt purpose. It must involve more than the mere solicitation of funds and include the selling of goods or services for more than the direct cost of the items sold. Examples of special events are raffles, Monte Carlo nights, bingo games, carnivals, concerts (if not an exempt purpose of the organization), etc. Such events can produce direct public support as well as special event income.

Line 10 is normally the correct place to report sales of inventory either purchased or produced by the organization for resale. Sales of inventory at special events is reported on Line 9 as described above. Sales of inventory items that are related to the organization's exempt purpose are reported on Line 2, "Program Service Revenue." Costs of goods are reported in the same section as the associated revenue. A schedule computing the gain on the sale of inventory should be attached to Form 990.

Line 11 must equal the total of Line 103 Part VII. In general, income that cannot be properly reported in another category should be reported here. An example of revenue that should be

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

reported on Line 11 is interest on loans to officers, directors, trustees, and key employees. Revenue should not be indiscriminately reported on Line 11. Generally, Lines 1 through 10 provide the proper categories to report revenue.

Lines 13 through 15 are carryforward lines from Part II. The proper reporting of these expense classifications is discussed below.

Line 16 requires a schedule of required payments to affiliates. For example, dues paid to an organization's parent should be reported on this line. Expenses paid to provide goods or services to an affiliated organization may be reported on Line 16 if such expenses cannot be properly classified as program services, management and general, or fund-raising expenses. For example, the cost of reporting information to a parent organization can be reported here. If expenses are properly classified in accordance with Columns b through d of Part II, such expenses should be reported there and carried forward to Lines 13 through 15, as appropriate. Payments made voluntarily to an affiliated organization should be reported on Line 22 as a grant or award, as are grants and awards to unaffiliated organizations.

Line 20 must contain information regarding changes in net assets or fund balance not properly reported in any other section. The most common information reported on this line is unrealized gains and losses on investments carried at fair market value, the difference between fair market value of a grant or award given and its carrying value, and adjustments for changes in accounting methods [§481(a) adjustments].

Form 990—Part II: Statement of Functional Expenses

Part II requires §§501(c)(3), 501(c)(4), and 4947(a)(1) nonexempt charitable trusts to report expenses by natural classification (salaries, occupancy, etc.) and by functional classification: program services (**Column b**), management and general (**Column c**), and fund-raising (**Column d**). All other organizations must provide the natural classification totals (**Column a**) and may provide the functional allocations. Part II provides useful information to the IRS and the general public in determining the extent to which an organization is carrying out its exempt purpose and how efficient the organization is in using its resources to fulfill such purposes.

Line 22 is used to report grants and allocations to individuals and organizations, including voluntary amounts paid to affiliated organizations, as noted for Line 16. A schedule of grants and allocations must be attached with the following information:

- Each class of activity;
- Donee's name, address, and the amount given;
- Whether a grant to an individual any relationship to any person with an interest in the organization (officer, director, etc.); and

- Specific activity for which the grant or allocation is made.

If property other than cash is given, a schedule providing a description of the property, book value, and fair market value, as well as how each was determined, must be attached. Only the amount of the grant or award should be reported on Line 22. Any expenses related to such payment, such as costs of selecting the recipient or monitoring his or her progress should be reported in Lines 25 through 43.

Line 23 should be used to report payments of specific assistance to individuals, including amounts such as rent payments or medical expenses on behalf of a specific individual whether made to the individual or to the provider of goods or services. Amounts paid to such providers to provide goods or services to the general public, without specifying the individual, should be reported on Line 22.

Line 24 is used to report benefits paid to or for members. As discussed in Chapter 4, certain organizations, such as voluntary employees' benefit associations [§501(c)(9)] and fraternal beneficiary societies [§501(c)(8)], are created, or at least allowed, to provide benefits to their members. Typically, these benefits include death, medical, hospitalization, disability, and unemployment benefits. Only the actual amounts of benefits paid should be included on Line 24. Any expenses in administering the payments of benefits should be reported on Lines 25 through 43, as appropriate.

By definition, the expenditures made for grants and allocations, specific assistance to individuals, and benefits paid to members are made in furtherance of the organization's exempt purpose. Consequently, any amounts reported on Lines 22 through 24 do not require any functional allocation and should be reported only in Column b, "Program Services."

Column b is used to report program service expenses, i.e., the direct and indirect costs associated with fulfilling the organization's exempt purpose. Also reported as program services are the expenses associated with unrelated business income. These amounts are also reported on Form 990-T as discussed in Chapter 4.

Column c is used to report management and general expenses, i.e., expenses that are not associated with program service or fund-raising activities. Typical management and general expenses are those incurred in the overall direction of the organization, board meetings, reception, accounting, auditing, financial reporting, etc. Occasionally, some of these activities may be associated with program service or fund-raising activities and should be allocated accordingly. For example, a special board meeting to direct fund-raising activities should be reported in Column d.

Column d is used to report costs associated with fund-raising activities incurred in soliciting others to contribute money, property, or time to the organization without receiving direct economic benefit. Typically, these costs include personnel, consultants, occupancy, printing, postage, telephone, etc. Costs associated with a special event, as discussed in Part I, Line 9, should be reported on Line 9b even though the purpose of the event is to raise funds.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

As indicated above, certain organizations are required to provide a functional allocation of their expenses. These organizations, as well as others choosing to provide such allocation, should identify expenses directly associated with the appropriate function (“program services,” “management and general,” or “fund-raising”). For example, the cost of printing application forms for a scholarship program is a direct expense of that program service. Many costs are indirect in nature and are not as easily identified to the purpose, such as personnel costs in which people may perform many functions. In such cases, a reasonable allocation should be made.

Although a detailed discussion of allocation is outside the scope of this book, in general, allocations should be made on the basis of an appropriate measurement of the activity generating the expense. Typically, personnel costs are allocated based on time, and occupancy is allocated based on square footage or other appropriate measures. These allocation methods should be applied to the associated expense and then reported in Columns b through d, as appropriate. Many organizations already allocate their expenses by cost department or cost center. Organizations may reallocate the costs of these centers to the functional classification and report the results in Columns b through d.

For purposes of completing Part II, the IRS allows the organization to report the total departmental or cost center expenses in Column c (“Management and General”), allocate the total indirect costs by entering a negative amount on Line 43 (“Other Expenses”) and enter the appropriate allocated amounts as a positive number in Column b (“Program Services”) and Column d (“Fund-Raising”). Thus, the organization is spared the burden of reallocating by natural classification. The net result should be the same under either method; this arrangement does not allow the allocation of expenses properly classified as “management and general” to be reported as other functions. This same procedure may be used to allocate cost center expenses to costs properly reported in Part I, such as special events costs.

Joint Cost Reporting

Joint Cost Reporting section at the end of Part II is used to report joint costs incurred by the organization. If the organization has carried out a joint educational campaign and fund-raising solicitation, the costs of such a program are properly allocated between “program services” and “fund-raising.” This section of Part II requires disclosure of the amounts of such costs allocated to each function. Guidance from the IRS in the allocation of these costs is sparse, except to note that in no circumstance will expenses attributable to providing information regarding the organization itself, its use of past contributions, or its planned use of contributions received be reported as program services in Column b.

The IRS does indicate that allocation of costs must be reasonable and refers to the AICPA Statement of Position 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, as acceptable for reporting joint cost allocations in most states. SOP 87-2 provides that all joint costs are treated as “fund-raising” unless a bona fide “program services” or “management and general” function was conducted in conjunction with the appeal for funds, in which case the costs should be allocated.

Factors

SOP 87-2 indicates the following factors as indicative of whether a bona fide “program services” or “management and general” function is present, in addition to the fund-raising activity:

- Content of the non-fund-raising portion of the activity (i.e., is information about particular issues and what people can or should do about them, thus indicating a “program service,” or is it about the causes for which the organization exists, why funds are needed, and how they will be used, thus indicating a “fund-raising” effort);
- Audience targeted (i.e., was it selected primarily because of its perceived need for, or interest in, the information presented in the activity or because of its ability to support the organization);
- Action, if any, requested of the audience (i.e., was an appeal made for some action other than providing support); and
- Documented reasons for the activity (i.e., do minutes of the organization’s governing board or other documents of the organization reflect the reasons for the activity).

An exposure draft, outstanding since September 1993, may replace SOP 87-2. This exposure draft requires three criteria—purpose, audience, and content—to be satisfied before any costs of joint activities can be allocated to “program service” or to “management and general” expenses (rather than “fund-raising”). Presumably, the principles of this exposure draft and the provisions of SOP 87-2 will be acceptable for purposes of reporting joint cost allocations for Form 990, Part II.

Form 990—Part III: Statement of Program Service Accomplishments

Part III describes the organization’s accomplishments in accomplishing its exempt purpose. The program services of an exempt organization are the means through which this purpose is fulfilled. This area of the form should be used to highlight the organization’s achievements. Most of Form 990 is numbers and allocations, but this part is narrative and provides an opportunity to cast the organization in its most favorable light. Form 990 is open to public inspection and is easier to obtain than ever before because of the public disclosure requirements (discussed later in this chapter).

Potential donors as well as critics and the IRS can use this information to determine what the organization is doing and how well it is accomplishing its purpose. Failure to use this section of Form 990 to the organization’s best advantage is a lost opportunity. All organizations must complete descriptions of primary exempt purpose and individual achievements. Organizations required to allocate their costs by function in Part II must also provide the expenses associated with each achievement. All filers of Form 990 may include these costs. In any event, the total costs exhibited in Part III should equal the total of program service expenses listed in Column b of Part II.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

The primary purpose of the organization should be described in an attachment to the return. This information is contained in Part II of Form 1023 or Form 1024 as discussed earlier in this chapter. Unless the organization has expanded its activities, the description provided with the application for exemption is the best choice for describing the entity's primary exempt purpose, because the IRS has already approved the activities described in that write-up. If an organization has expanded its activities (and thus its purpose), the new or expanded activities should be included in the description of its primary exempt purpose and the IRS should be notified as more thoroughly discussed in Part VI.

Items a Through e

The organization's program service accomplishments should be listed in **Items a through e** of Part III. The four largest (by expense total) should be included in Items a through d and any additional items should be listed in an attachment. The four largest must include descriptions of the activities, whereas the remainder need not be described in detail. The organization may voluntarily provide detailed information for all program services and may benefit from doing so as described above.

Part III is also used to provide information regarding the value of donated services and the use of materials, equipment, and facilities. The dollar value of such items may be disclosed in Part VI but no information can be included in Part I ("Revenue") or Part II ("Expenses"). Consequently, Part III provides the only opportunity to illustrate the support received by the organization from volunteer activities and the use of materials, equipment, and facilities. These factors are important to potential donors and the IRS in determining the efforts of the organization in meeting its exempt purpose.

Form 990—Part IV: Balance Sheets

Generally, Part IV is prepared in accordance with the method of accounting used by the organization for financial reporting requirements. The format of Part IV requires specific classifications with regard to assets, liabilities, and net assets or fund balances, and it requires detailed schedules for much of the information. These schedules are required only to provide information regarding year-end balances. Much of the information reported is standard and requires no additional information; the lines having special requirements are noted below.

Line 46 should include amounts deposited in interest-bearing checking accounts, money market funds, commercial paper, certificates of deposit, and Treasury bills maturing in less than one year. The earnings from these accounts should be reported on Line 4 of **Part 1**.

Line 50 is used to report receivables from officers, directors, trustees, and key employees. A "key employee" is defined as any person having responsibilities or powers similar to those of officers, directors, or trustees and includes the chief management and administrative officials of an organization. The required schedule should include a separate schedule for each loan even if made to the same person. Amounts reported in this section include all secured and unsecured loans,

salary advances, and other advances for personal reasons. Travel advances must be included in this section in the aggregate; the detailed schedule is not required for these amounts.

Line 51 should report all notes and loans receivable not acquired for investment and not required to be reported on Line 50. The required schedule should include the same information as that reported for the notes on Line 50. The interest income from program-related investments should be reported on Line 2 of Part I. The interest income from all other notes reported on this line should be reported on Line 11 of Part I.

Line 54 is used to report investments in securities, including publicly traded stocks; publicly traded corporate bonds; other publicly traded securities (mutual funds); and U.S., state, and municipal government obligations that mature in one year or more. Such investments may be reported at cost or fair market value (cost equals fair market value on the date received for donated securities). The attached schedule should indicate the method of reporting and amount. Earnings from these securities should be reported on Line 5 of Part I.

Line 55 is used to report investments in land, buildings, and equipment. Typically, this is rental property. The attached schedule should include cost, accumulated depreciation, and book value for each asset.

Line 56 is used to report investments in assets not properly reportable elsewhere, including investments such as partnerships and mineral interests but *not* including program-related investments, which should be reported on Line 58. The required schedule should include the carrying value of the investment and whether this is cost or fair market value. Income from these investments should be reported on Line 7 of Part I.

Line 57 is used to report land, buildings, and equipment used by the organization in conducting its exempt activities. A schedule should be attached to Form 990 indicating each asset, the cost or other basis, accumulated depreciation, and book value.

Line 58 is used to report assets not properly reportable elsewhere. Typically, these assets are program service-related assets. Other assets reported here are: (1) receivables from employees other than officers, directors, trustees, and key employees; (2) significant claims; and (3) refundable deposits with suppliers. (Insignificant amounts should be reported on Line 47.) The attached schedule should show a description of the asset and the cost or other basis.

Line 62 is used to report the organization's deferred revenue. The IRS allows, but does not require, organizations to report deferred revenue in accordance with Statement of Financial Accounting Standard (SFAS) 116 and SFAS 117. Consequently, similar organizations may report similar items on different lines in Part IV. Organizations reporting under SFASs 116 and 117 report only unearned revenue received during the year on Line 62. "Deferred revenue" due to restrictions by the donor will be reported on Lines 68 and 69 for these organizations, whereas these same restrictions will be reported as deferred revenue on Line 62 to organizations that have not adopted SFASs 116 and 117.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

Line 63 requires the reporting of loans received from officers, directors, trustees, and key employees. (See the discussion of Line 50 above for a description of key employees.) The required schedule should indicate: (1) the name and title of the lender, (2) original amount, (3) balance due, (4) date of note, (5) maturity date, (6) repayment terms, (7) interest rate, (8) security provided, (9) purpose of loan, and (10) description and fair market value of the consideration furnished by the lender.

Line 64 is used to report tax-exempt bonds or direct or indirect obligations of the organization to repay liabilities issued on behalf of a state or local government. Indirect liabilities do not include a contingent liability. Tax-exempt bonds are any obligation whose interest is excluded from the income of the recipient under §103. A schedule must be included for any tax-exempt bonds outstanding at any time during the year.

As discussed above (under deferred revenue), the IRS neither prevents organizations from following SFAS 117 nor requires them to follow it.

Lines 67 Through 69

Organizations that do follow SFAS 117 must check the box indicating that they are doing so and complete **Lines 67 through 69** detailing unrestricted, temporarily restricted, and permanently restricted funds.

Line 68 is used to report temporarily restricted net assets. Such assets are restricted by the donor and relate to the time or purpose for which the assets can be used.

Line 69 is used to report permanently restricted net assets. Such assets are restricted by the donor, who either restricts the assets for a particular use and stipulates that they never can be sold or restricts the assets to being invested to provide a permanent source of income.

Lines 70 Through 72

Organizations that do not follow SFAS 117 must check the box indicating that SFAS 117 has not been followed and complete **Lines 70 through 72**.

Form 990—Part IV-A and IV-B: Reconciliation of Revenue and Expenses per Audited Financial Statements With Revenue per Return

These parts are the result of issuance of SFAS 117. Their purpose is to reconcile financial statements prepared in accordance with SFAS 117 with revenue and expenses per the return in much the same way that Schedule M-1 reconciles corporate book income with tax income on Form 1120. Organizations without audited financial statements should enter “n/a” on Line a of Parts IV-A and IV-B.

Part V—List of Officers, Directors, Trustees, and Key Employees

Column A of Part V is for the names and addresses of the organization’s officers, directors, trustees, and key employees. The addresses should be where the individuals prefer to be contacted and can even be the organization’s address or a post office box.

Column B should contain the title and average hours per week devoted to the position. A “key employee” is defined as one who has powers or responsibilities similar to an officer, director, or trustee of the organization and includes the chief management and administrative officials of the organization but does not include the heads of separate departments or smaller units within an organization.

Column C should contain the amounts of compensation paid to the individuals listed in Column A. Individuals who are otherwise required to be listed in this part must be listed even if no compensation is received. Compensation reported in this section must be reported on the cash basis. Consequently, total compensation reported in Part V may not match the amount reported in Part II, Line 25.

Column D lists contributions to employee benefit plans and deferred compensation, including all forms of deferred compensation, whether the plan is funded or unfunded, vested or unvested, or qualified or unqualified. Thus, deferred compensation reported in this column in one year will be included in Column C in the year paid. Consequently, compensation will be reported twice to the extent of deferred compensation plans; an organization may, but is not required to, attach a schedule indicating the amount of current compensation received and reported in Column C that was previously reported in Column D. The amounts reported in Column D should also include amounts paid to welfare benefit plans on behalf of the individual.

Column E should contain expense reimbursements to the extent they are taxable to the recipient. Also reported in Column E are other allowances paid by the organization to the individual.

Form 990 is open to public inspection, including the amounts reported in Part V, even though specific individual’s compensation is disclosed.

Line 75 is used to report compensation from related organizations. This information is reported to allow the IRS to determine the entire amount paid to a specific individual in determining excess compensation.

Form 990—Part VI: Other Information

The financial data derived from Form 990 are useful in providing information about the activities of an exempt organization. These data, however, are not able to provide all of the information required to determine the organization’s compliance with the laws and the operations and activities of the organization. Part VI comprises a list of questions and other information that completes the picture in terms of information not reported in the financial sections of Form 990.

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

Line 76 requests information regarding new activities of the exempt organization. Exempt organizations are required to inform the IRS regarding any new activities in which they engage. Insubstantial activities can be reported to the IRS as an attachment to Form 990. The problem with this approach is that it occurs well after the activity has commenced and the IRS will not respond to such notification so the organization has no assurance that the IRS will agree that the activity is within the organization's exempt purpose.

If the activity is clearly within the exempt organization's exempt purpose, a statement should be attached to the return providing information on when the activity started; where and by whom the activity will be conducted; and details regarding its purpose, standards, criteria, or procedures adopted or planned for carrying it out. Examples of new activities which can be reported with Form 990 are:

- Entering into joint ventures with other organizations exempt under the same Code section as the organization, and
- Creating affiliated organizations described in the same subsection of the Code as the organization and entering into an agreement to share costs and space with the affiliates.

An alternative to this method is to notify the key district director regarding significant new activities or activities for which the organization desires a response in regard to the IRS position on its new activity in relation to its exempt purpose. This letter should contain the same information as listed above. This notification will give the organization the opportunity to make changes to operations the IRS may require before the activity has advanced too far. Examples of new activities which should be reported by letter to the IRS are:

- Activity which takes the organization in a new direction,
- Creation of a for-profit subsidiary,
- Changes to the method of the governing board's election or appointment, and
- Entering into a joint venture with a for-profit entity or exempt entity not described in the same Code section as the organization.

The organization should also report discontinued activities to the IRS. Both reporting methods described above are available. Which one to use depends on the significance of the discontinued operations to the organization's exempt purpose.

Line 77 requires conformed copies of organizing documents when *any* changes are made. Changes to these documents may affect whether the organization continues to be organized and operated exclusively for its exempt purpose. Consequently, changes to these documents may affect the exempt status of the organization.

Line 79 requires notification to the IRS regarding a liquidation, dissolution, termination, or substantial contraction during the year. Many exempt organizations have specific requirements regarding the distribution of assets. A substantial contraction is a partial liquidation or other major disposition of assets except for full consideration or distributions from current income. A major disposition of assets is at least 25% of the fair market value of the organization's net assets at the beginning of the year or one of a series of related dispositions begun in earlier years that add up to at least 25% of the net assets the organization had at the beginning of the year in which the first disposition was made (Reg. §1.6043-3).

Line 80 requires disclosure of relationships with other organizations. This requirement is meant to provide notice of potentially exemption-threatening relationships with nonexempt entities and organizations not exempt under the same Code section as the organization.

Line 81 requires the amount of direct and indirect political expenditures be disclosed. Some exempt organizations are prohibited or limited in their political activity, and others are required to file Form 1120-POL if their political expenditures and investment income exceed \$100. A "political expenditure" for this purpose is defined as one that is intended to influence the selection, nomination, election, or appointment of anyone to a federal, state, or local public office or office in a political organization or the election of Presidential or Vice-Presidential electors.

Line 82 is optional and allows the organization its only opportunity other than Part III to illustrate its support from volunteer activities and the use of materials, equipment, and facilities at no charge. See Part III discussion for additional reporting opportunities.

Line 83 is where the organization indicates compliance with the quid pro quo and public disclosure requirements for annual returns as well as the application for exemption. The public disclosure requirements and associated penalties for failure to comply are discussed in detail later in this chapter. The quid pro quo notification rules require notification to donors in certain circumstances about the deductibility of contributions where the donor received something of value in return for the contribution.

Line 84 asks if the organization solicited nondeductible contributions. Organizations that are qualified to receive tax-deductible contributions should mark this box "n/a." Organizations that are not qualified to receive tax contributions should answer the question. Generally, the answer will either be that the organization did not solicit nondeductible contributions, thus Line 84b should be "n/a," or the organization did solicit nondeductible contributions and complied with the disclosure requirements.

Such organizations are not subject to the disclosure requirements if a fund-raising campaign targets no more than ten persons during the year or if the organization does not normally exceed \$100,000 in annual gross receipts. In this case, the organization should indicate that nondeductible contributions were solicited and the disclosure requirements were not met. It is advisable to attach a statement of explanation since these answers indicate noncompliance when the organization is not subject to the disclosure requirements.

Line 85 applies only to §501(c)(4), (5), and (6) exempt organizations and requests information regarding these organizations' political expenditures and ultimately the organizations' choices in complying with the requirements regarding political expenditures. This topic is outside the scope of this book. For a detailed discussion of rules concerning political expenditures, please see *A CPA's Guide to Tackling Tough Tax Issues for Nonprofit Organizations*, published by the AICPA.

Line 86 applies to §501(c)(7) social clubs. The information requested regards initiation fees and nonmember usage and is used to determine if the various limitations on social club activities have been met. (See Chapter 5 for a detailed discussion of social clubs.)

Line 87 requests information about §501(c)(12) organizations' gross income from members. In general, these organizations qualify for exemption only if 85% of their gross income is derived from members.

Line 88 requests information about controlled entities. Such ownership may be indicative of substantial activities outside the organization's exempt purpose and may show the possibility for private inurement.

Line 89 has been added to Form 990 for 1996 in response to the *Taxpayer Bill of Rights 2* which required §501(c)(3) and (4) organizations to disclose the amount of excise taxes paid during the year for prohibited acts.

Form 990—Part VII: Analysis of Income-Producing Activities

Part VII of Form 990 requires the organization to segregate its revenue-generating activities into those that are unrelated to its exempt purpose and subject to the unrelated business income tax (**Column b**); those that are not related but are not subject to unrelated business tax due to the specific legislative authority of §§512, 513, and 514 (**Column d**); **and** those activities that are carried out in support of the organization's exempt purpose (**Column e**).

Although no specific numerical tests can determine how much of each type is allowable or required, the information gathered here is useful in determining the direction of the organization and whether its activities have digressed from that of fulfilling its exempt purpose, not only in the expenditure of funds but also in the support the organization receives. Unrelated business income is discussed in detail in Chapter 4. The total of Column b should agree with the total reported on Form 990-T. Activities that are not related to the organization's exempt purpose, but nevertheless are not subject to the unrelated business income tax, must be listed in Column d.

Column c should provide the appropriate exclusion code which indicates the authority for such exclusion. The lowest numbered exclusion code should be used for activities that qualify in more than one category. Some organizations have income that is related to their exempt purpose and, thus, is exempt function income and is statutorily excluded by virtue of §512, §513, or §514. In this case, the income should be reported in Column e.

Column e

Also reported in Column e are amounts that are not statutorily excluded, not related to the exempt purpose, and not subject to the unrelated business income tax. Such income includes tax-exempt interest income from municipal bonds. Any amount reported in Column e requires an explanation of how the activity relates to the organization's exempt purpose. It is important to understand that exempt function income depends on the organization's purpose. What may be an unrelated business to one type of organization may be an activity related to another type of organization's exempt purpose. Revenue generated from public support is not included in the analysis of revenue-producing activities. The totals of Columns b, d, and e must equal the total nonpublic support reported on Line 12 of Part I.

Form 990—Part VIII: Relationship of Activities to the Accomplishment of Exempt Purpose

This section is used to describe the revenue-generating activities of the organization that are related to the exempt purpose of the organization. The revenue-generating activities listed here will also be described fully in Part III. (See the discussion in that section.)

Form 990—Part IX: Information Regarding Taxable Subsidiaries

Part IX must be completed if Question 88 in Part VI was answered "yes." Otherwise, nontaxable, passive income may be taxable when received from a controlled subsidiary, activities of a controlled subsidiary may be indicative of activities outside the scope of the organization's exempt purpose, and tax avoidance through the use of non-arm's-length agreements between the organizations may be an issue.

FILING FORM 990—EZ SHORT FORM RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX

Form 990-EZ may be filed in lieu of Form 990 if the following requirements are met:

- Gross receipts during the year are less than \$100,000, and
- Total assets at the end of the year are less than \$250,000.

As more fully discussed in Chapter 4, organizations with \$1,000 or more of gross income from an unrelated business must file Form 990-T, "Exempt Organization Business Income Tax Return." This requirement is in addition to the obligation to file the annual information return.

Organizations exempt from income tax have additional filing requirements, such as the requirement to provide contemporaneous written substantiation for charitable contributions of

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

\$250 or more, and other requirements similar to nonexempt organizations (for example, payroll tax returns) that are outside the scope of this book.

REVOCAION OF EXEMPTION

Although an organization's recognition of exempt status will generally remain in place indefinitely, it cannot be relied upon in the event of a material change in the organization if that change is inconsistent with exemption in the character, purpose, or method of operation of the organization.

If the organization's recognition of exempt status is revoked, the organization may be notified by the following means:

- Notice to the organization to which the ruling or determination letter was originally issued,
- Enactment of legislation or ratification of a tax treaty,
- Decision of the Supreme Court,
- Issuance of temporary or final regulations, or
- Issuance of a revenue ruling, a revenue procedure or other statement.

If the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented or in regard to organizations to which §503 applies, or engaged in a prohibited transaction, the revocation or modification may be retroactive.

If there is a material change, inconsistent with exemption, in the character, purpose, or method of operation of the organization, revocation or modification will ordinarily be effective as of the date of such material change.

If the organization's exemption is revoked, the organization has the right to protest such revocation within thirty days from the date of the adverse determination letter. The appeals process is described earlier in this chapter.

PUBLIC DISCLOSURE AND ACCESS TO INFORMATION

Tax-exempt organizations' annual returns and applications for recognition of exemption are a matter of public record. Any organization that is tax-exempt under §501(c) or (d) and that is not a §509(a) private foundation must have available for public inspection during the organization's business hours a copy of each annual information return filed during the three-year period beginning on the filing date for the return. These organizations are also required to make available for inspection their exemption application without regard to the three-year period. The organization must make available complete copies of Form 990 and all schedules and attachments,

including Schedule A, even though individuals' compensations may be revealed. Tax-exempt organizations are not required to make Forms 990-T or 1120-POL available for public inspection.

In addition to making the return available at its principal office, an organization is required to provide a copy of an annual information return to an individual who requests it, in person or in writing. The request must be made to an office required to make the return available as described above. For requests made in person, the return must be furnished immediately. For written requests, the return must be furnished within thirty days. Other than reasonable mailing and reproduction costs, the returns must be furnished without charge.

The organization will not be required to honor requests for annual information returns or exemption applications if the organization has made the requested copy widely available. An organization can make its returns and application widely available by disseminating them through the Internet or other electronic database, depositing copies at public libraries, and providing copies to third-party organizations that make copies available to the public for a reasonable fee. In the event of a harassment campaign, the organization can apply to the IRS for relief from compliance with the public inspection requirements.

Tax-exempt organizations, other than private foundations, are not required to make available to the public information that reveals the names and addresses of contributors or information that reveals the names, addresses, or amounts of contributions or bequests of persons who are not citizens of the United States. The tax-exempt organization may also request that any information relating to any trade secret, patent, process, style of work, or apparatus whose disclosure would adversely affect the organization be withheld from public inspection. Information adversely affecting national defense may also be withheld.

Annual Information Return

A private foundation's annual information return must be made available by the foundation's managers for inspection at the principal office of the foundation during regular business hours within 180 days after publication of notice of the return's availability. The notice must be published in a newspaper that has general circulation in the county in which the foundation's principal office is located. The notice must be published no later than the due date for filing the return (including extensions) and must state that the report is available for inspection, give the address and telephone number of the foundation's principal office, and give the name of the foundation's principal manager.

Foundation managers for private foundations with no principal office, or whose principal office is a personal residence, may satisfy this requirement by making the information available at a substitute location or by furnishing a copy free of charge (including postage and copying) to persons requesting inspection. For purposes of public inspection of information, the term "private foundation" includes trusts described in §4947(a)(1).

OBTAINING AND MAINTAINING TAX-EXEMPT STATUS

In the case of willful failure to comply with the public inspection requirements for annual information returns or exemption applications, the organization is subject to an additional penalty of \$1,000 for each return or application. If failure to comply with the above requirements is due to reasonable cause, no penalty will be assessed.

CHARITABLE ORGANIZATIONS—CONCEPTS AND DESIGNS

TABLE OF CONTENTS

INTRODUCTION 67

CONCEPTS AND DESIGNS 68

SANCTIONS 69

 SPECIAL PENALTY FOR LARGE TAX-EXEMPT ORGANIZATIONS 69

 COMPARISON BETWEEN PRIVATE FOUNDATIONS
 AND PUBLIC CHARITIES 69

 Section 509(a)(1)—Public Charitable Organizations
 Described in §170(b)(1)(A)(i)-(vi) 70

 Section 509(a)(2)—Publicly Supported Organizations 83

 Section 509(a)(3)—Supporting Organizations 84

 Section 509(a)(4)—Testing for Public Safety 89

 The Organizational and Operational Tests of §501(c)(3) 89

CHARITABLE ORGANIZATIONS—CONCEPTS AND DESIGNS

INTRODUCTION

Examining the meaning of “charitable” is similar to looking at light through a spectrum. You will get as many variations of light as the refraction of the spectrum permits. Because the concept of “charitable” is so broad, the Code provides no concise definition. For the most part, charitable organizations take on the tasks of relieving the “human condition” in such a fashion that the government is freed from the responsibility. In the event that the government is not altogether freed, at least it has the exempt organization to administer its programs at a fraction of the cost because of the availability of a mostly volunteer work force. This charitable status, however, is the product of a trade-off. The government places very strict operating requirements on charitable organizations to ensure that the “fruits of their labor” will benefit society in much the same way as if the government had administered the program itself.

To monitor the extensive financial benefit provided to charities by allowing a deduction for contributions by donors and tax-free receipt by charities, the government’s involvement goes beyond the mere authorization for deduction of contributions. The statutes, regulations, and administrative rulings issued by the government define in extensive detail not only the purposes that will satisfy the statute for exemption but also the vehicle by which those purposes can be achieved as well. It is important to note that a contribution, even for an approved purpose, is deductible *only* if it is made to an organization of the type specified in §170 and *only* if that organization has obtained an IRS ruling or letter of determination.

The list of organizations having received recognition of charitable status is published in a multivolume publication, *Cumulative List of Organizations* (Publication 78), which lists the organizations described under §170(c). Publication 78 is updated and reissued annually. Supplements containing additions and name changes are also published each year. Other changes (for example, changes in address) are reflected in the complete annual issuance in September. The only drawback to using the supplements is that they do not list deletions and changes of exempt status; however, when the IRS withdraws recognition of status or when an organization’s status changes, an announcement is made in the Internal Revenue Bulletin.

Any study of exempt organizations reveals from the beginning that the exempt world is divided into two groups: those that are charitable in nature and those that are not. Another subdivision is also necessary insofar as the concept of §501(c)(3) is concerned. This subdivision becomes relevant as a result of the 1969 Tax Act which placed severe restrictions on the activities of §501(c)(3) organizations that either elect or are forced to be treated as private foundations. In the 1969 Act, a “private foundation” is defined as any §501(c)(3) organization that does not qualify as a “public charity.” This chapter will cover the various aspects of public charity status and the ability to attract contributions; Chapter 7 will discuss private foundations in detail. The desirability of public charity status will become obvious in later chapters.

CONCEPTS AND DESIGNS

Congress established a very stringent set of controls to ensure compliance. It took the approach that all domestic or foreign corporations described in §501(c)(3) would be treated as private foundations (see Chapter 7) under these new rules except for a select group that would be treated as public charities. This might be defined as status by exception. The select group is described in §170(b)(1)(A)(i)-(vi) and consists of the following classifications:

- Church or a convention or association of churches;
- Educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;
- Organization that has the principal purpose or function of providing medical or hospital care or medical education or medical research, if the organization is a hospital, or if the organization is a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital;
- Organization that normally receives a substantial part of its support, exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function, constituting the basis for its exemption under §501(a);
- Governmental unit; or
- Organization that normally receives a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public.

These charities are specifically excluded from the classification of “private foundation” and are referred to as “50% charities.” (The 50% refers to the limit of the aggregate of such contributions not exceeding the donor’s contribution base for the year.)

SANCTIONS

In the past the only real recourse the IRS had against an exempt organization was to revoke its exemption. While this may have been an effective approach, it was not very efficient and, as such, where some form of legitimate sanction was merited it was passed. It was easy to see how many real and perceived abuses took place with exempt organizations. A recent far-reaching development with exempt organizations has been the imposition of sanctions. Intermediate sanctions and additional filing and public disclosure requirements were enacted as part of the Taxpayer Bill of Rights 2 (TBOR2) H.R. 2337; P.L. 104-168.

SPECIAL PENALTY FOR LARGE TAX-EXEMPT ORGANIZATIONS

Section 1314(b) of TBOR2 created a new special penalty for large organizations under §6652(c)(1)(A). Under this provision, a failure to timely file an annual information return, failure to include any of the information required to be shown on the return, or failure to show the correct information by an exempt organization with gross receipts exceeding \$1,000,000 for any year results in a penalty to be paid by the organization of \$100 per day for each day during which the failure occurs. The maximum penalty under §6652(c)(1) for an organization with gross receipts exceeding \$1,000,000 cannot exceed \$50,000.

The amended penalties apply to returns for taxable years ending on or after July 30, 1996.

COMPARISON BETWEEN PRIVATE FOUNDATIONS AND PUBLIC CHARITIES

Section 509(a) defines a private foundation (by exception) as a domestic or foreign organization described in §501(c)(3) other than the following:

- Exclusion under §509(a)(1)—An organization described in §170(b)(1)(A)(i)-(vi) (discussed above).
- Exclusion under §509(a)(2)—An organization that normally receives more than one-third of its support in each taxable year from any combination of the following sources:
 - Gifts, grants, contributions, or membership fees, and
 - Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity that is not an unrelated trade or business in any taxable year to the extent such receipts exceed the greater of \$5,000 or 1% of the organization's support during the year.

This income must be received from persons other than a disqualified person (see Chapter 4) with respect to the organization, from governmental units, or from organizations described in §170(b)(1)(A)(i)-(vi). In addition, the organization cannot receive more than one-third of its support during the year from the sum of the gross investment income and the excess of the amount of the unrelated business taxable income over the amount of tax imposed on the aforementioned income.

- Exclusion under §509(a)(3)—An organization that is:
 - Organized and at all times thereafter is operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in either §509(a)(1) or §509(a)(2).
 - Operated, supervised, or controlled by or in connection with one or more organizations described in either §509(a)(1) or §509(a)(2) and not controlled directly or indirectly by one or more disqualified persons.
- Exclusion under §509(a)(4)—An organization that is organized and operated exclusively for testing for public safety.

Section 509(a)(1)—Public Charitable Organizations Described in §170(b)(1)(A)(i)-(vi)

The first group discussed under §509(a)(1) is exempted from private foundation status because it falls within a group consisting of the following.

- Church or a convention or association of churches.
- Educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.
- Organization that has the principal purpose or function of providing medical or hospital care or medical education or medical research, if the organization is a hospital, or if the organization is a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital and during the calendar year in which the contribution is made, such organization is committed to spending that contribution for such research before January 1 of the fifth calendar year that begins after the date the contribution is made.
- Organization that normally receives a substantial part of its support [exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under §501(a)] or from direct or indirect contributions from the general public and which is organized and operated

exclusively to receive, hold, invest, and administer property and to make expenditures for the benefit of a college or university.

- Governmental unit.
- Corporation, trust, or community chest fund or foundation that normally receives a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public.

Note that an organization must operate under one of these categories to meet the requirements of §170(b)(1)(A) and subsequently §509(a)(1). The relationship must be specific and not casual in nature to meet the requirements of one of these specific sections (i through vi). In Rev. Rul. 56-262 (1956-1 CB 131), an organization whose activities were educational, religious, or charitable, in the broad sense of those words, and that, as a secondary or incidental activity, also maintained an educational institution in the nature of a school, or a church or association of churches, or a hospital, does not qualify under the classes of organizations established under §170(b)(1)(a) and, as such, did not qualify as a public charity under §509(a)(1).

Educational Organizations

The second general category described under §170(b)(1)(A) is found in subpart (ii) and is described as “Educational organization and organizations for the benefit of certain State and municipal colleges and universities.” Keep in mind that we are still considering exemption under §509(c)(1). This distinction takes on additional significance when looking at the “Application for Exemption” discussed in Chapter 2.

The concept of an “educational organization” is a bit more concisely described in the Code than is the concept of “church.” Section 170(b)(1)(A)(ii) recognizes an organization as “educational” if its primary function is the presentation of formal instruction, if its program maintains a regular faculty and curriculum, and if it normally has a regularly enrolled body of pupils or students in attendance at the place where the educational activities are regularly carried on.

The relevance to “primary function” was addressed prior to 1969. This concept was cited in an older ruling (Rev. Rul. 56-262, 1956-1 CB 131), which is still relied on today. In Rev. Rul. 56-262, “advice was requested whether contributions to an organization whose activities are educational, religious, or charitable, in the broad sense of the word, and which, as a secondary or incidental activity, also maintain an educational institution in the nature of a school, or a church or a hospital, will qualify for the deduction...” In the ruling, it was held that contributions to organizations whose activities are educational, religious, or charitable, in the broad senses of those words, and that, as a secondary or incidental activity, also maintained an educational institution in the nature of a school will not qualify as an educational organization.

According to the Regulations, the term “educational organization” includes institutions such as primary schools, secondary schools, preparatory, or high schools, as well as colleges and universities. It also includes federal, state, and other publicly supported schools. It does not

include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities.

Example 3-1:

- A recognized university that incidentally operates a museum or sponsors concerts is an educational organization within the meaning of §170(b)(1)(A)(ii).
- The operation of a school by a museum, however, does not necessarily qualify the museum as an educational organization within the meaning of the Code.

To qualify as an educational organization, three primary criteria must be met for exemption purposes: the organization must have a regular faculty, curriculum, and fully enrolled body of pupils.

Hospitals and Medical Research Organizations

Healthcare and related fields are currently the single most exposed area when it comes to IRS scrutiny. The IRS is currently in the midst of a special project designed to review almost every aspect of medical facilities and activities. Because of this increase in activity, tax advisors must exercise considerable care when either filing for exemption or providing annual information returns.

Even though hospitals and research organizations are both described under §170(b)(1)(a)(iii), they are distinct in nature and need to be considered separately.

Hospitals

The term “hospital” includes the following: a rehabilitation institution, out-patient clinic, or community mental health or drug treatment center, if its principal purpose or function is the providing of hospital or medical care. For these purposes, “medical care” includes, but is not necessarily limited to, the treatment of any physical or mental disability or condition, whether on an in-patient or out-patient basis.

Even though a definition was not developed for the purposes of this Code section, the Conference Report of the 1986 Act adopted a definition of the term “hospital.” Under the Conference Report, the term “hospital” is defined as a facility that meets all of the following requirements:

- It is accredited by the Joint Commission on Accreditation of Healthcare Organizations or is accredited or approved by a program of the qualified governmental unit in which such institution is located, if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the Joint Commission.

- It is primarily used to provide diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons as patients under the supervision of physicians.
- It has a requirement that every patient be under the care and supervision of a physician.
- It provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed nurse or registered nurse on duty at all times.

To develop an understanding of what a hospital is, it is also important to know what a hospital is *not*. According to Reg. §1.170A-9(c)(1), the term “hospital” does not include convalescent homes, homes for children or the aged, or institutions whose principal purpose or function is to train handicapped individuals to pursue some type of vocation. In addition, an organization whose principal purpose or function is to provide medical education or medical research will not be considered a “hospital” unless it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities, on an in-patient or out-patient basis. This care must be an integral part of the facility’s medical education or research function.

Medical Research Organizations

In addition to hospitals, medical research organizations also qualify under §170(b)(1)(A)(iii) as long as the principal purpose or function of the organization is medical research. In addition, it must also be directly and continuously engaged in the conduct of medical research in conjunction with a hospital. According to Reg. §1.170A-9(c)(2)(iii), medical research generally means the conduct of investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of physical or mental diseases and impairments.

For a facility to qualify as a research organization, the organization must have continuously available for its regular use the appropriate equipment and professional personnel necessary to carry out its research function. According to the Regulations subpart (iii), “medical research” encompasses the associated disciplines spanning the biological, social, and behavioral sciences. The Regulations list pertinent fields. The inherent danger of a list is that the IRS may rely on it as all-inclusive. It is intended as a *representative* listing and is not intended to be all-inclusive.

For an organization to be engaged primarily and directly in the continuous active conduct of medical research, the organization must either devote a substantial part of its assets to, or expend a significant percentage of its endowment for, research purposes. Whether an organization devotes a substantial part of its assets to, or makes significant expenditures for, research depends on facts and circumstances.

An organization will be treated as devoting a substantial part of its assets to, or expending a significant percentage of its endowment for, research purposes if it devotes more than one-half of its assets to the continuous active conduct of medical research. For purposes of the Regulations,

an organization that expends funds equaling 3.5% or more of the fair market value of its endowment for research purposes is considered to have met the test regarding the significant percentage of its endowment.

Example 3-2:

- N, an organization referred to in §170(c)(2), was created to promote human knowledge within the field of medical research and medical education.
- All of N’s assets were contributed to it by A and consist of a diversified portfolio of stocks and bonds.
- N’s endowment earns 3.5% annually, which N expends in the conduct of various medical research programs in conjunction with Y hospital.
- N is located adjacent to Y hospital; it makes substantial use of Y’s facilities; and the staffs of N and Y operate in close cooperation.

Result:

- N is directly engaged in the continuous active conduct of medical research in conjunction with a hospital, meets the principal purpose test described in subdivision (iv), and is therefore an organization described in §170(b)(1)(A)(iii).

One final note regarding qualifying medical research: the research must be carried on in conjunction with a hospital. The organization is not required to be formally affiliated with a hospital to be considered “primarily engaged directly in the continuous active conduct of medical research.” The parties must, however, show a close continuous working relationship. This close working relationship is normally evidenced by the sharing of space, staff, and resources.

University Endowment Funds

An organization is described in §170(b)(1)(A)(iv) if it is organized and operated exclusively to receive, hold, invest, and administer property for and to make expenditures to, or for the benefit of, a college or university. The concept of expenditure includes those made for the “normal” operations of the college or university, such as:

- Acquisition and maintenance of real property constituting part of the campus area;
- Erection of, or participation in the erection of, college or university buildings;
- Acquisition and maintenance of equipment and furnishings used for, or in conjunction with, the normal functions of a college and university.

Other types of expenditures include scholarships, libraries, and student loans.

To qualify under §170(b)(1)(A) and be excluded from private foundation status under §509(a)(1), an organization must meet the following requirements:

- Organization receiving the contribution must normally receive a substantial part of its support from the U.S. or any state or political subdivision or from the direct or indirect contributions from the general public.
 - The term “support” does not include income received in the exercise or performance by the organization of its charitable educational or other purpose.
- College or university, to be included, must be an educational organization that is an agency or instrumentality of a state or political subdivision.

Governmental Unit

It is possible for a governmental unit to be treated as a public charity pursuant to §170(b)(1)(A)(v) if it is referred to in §170(c)(1). This classification is limited to the U.S., states, possessions of the U.S., and District of Columbia and to any political subdivision of the aforementioned group. To qualify as deductible donations, contributions or gifts must be made exclusively for public purposes. The charitable activity must be set up along the same lines of all other §501(c)(3) activities insofar as the activities are to be organized and operated exclusively for purposes that are religious, charitable, scientific, etc.

The aspect that causes the greatest concern in regard to this section involves the definition of “political subdivision” under §170(b)(1)(A)(v). In *Texas Learning Technology Group v. Commissioner*, 96 T.C. 686 (1991), an exempt organization under §501(c)(3) was established under an agreement with the Texas school system to formulate, develop, and administer programs on behalf of group member school districts. The purpose of the organization was to help improve student learning and to further implement the purposes and objectives of the Texas Education Code. In so doing, it sought classification as a nonprivate foundation under §509(a)(1) on the grounds that it was a political subdivision of Texas as described in §§170(b)(1)(A)(v) and 170(c)(1).

The Court determined that the organization did not meet any of the prerequisite critical requirements necessary to be a “political subdivision”—the organization did not have the power to levy or collect taxes, the organization did not have any police powers, and the organization did not have the power of eminent domain.

Publicly Supported Organizations

The last group to be classified under §509(a)(1) as a nonprivate foundation is described in §§170(b)(1)(A)(vi) and 170(c)(2). These organizations are commonly referred to as “publicly

supported organizations.” An understanding of the concept of public support is important when it comes to obtaining an exemption, maintaining an exemption, and defending an exemption. The issue of public support becomes extremely important in preparing Schedule A of Form 990 (see Chapter 2). Most important, if a charitable organization does not meet the public support test, it will be reclassified as a private foundation.

Anyone making a serious study of exempt organizations should have a good understanding of the concept of public support and publicly supported organizations. According to Reg. §1.170A-9(e)(1)(ii), a “publicly supported” organization is one that normally receives a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public. An organization is treated as publicly supported if it meets a series of support tests. Examples of organizations that are normally publicly supported might include museums of history, art, or science; libraries; or community centers to promote the opera, ballet, or repertory drama or some other service to the public.

Public Support Test [§§509(a)(1); 170(b)(1)(A)(vi)]

There are two parts to this test, a mathematical test and a facts and circumstances test. Under the mathematical test, an organization will be considered “publicly supported” if the total amount of support that the organization “normally” receives from either the government or from direct or indirect public support or any combination of the three equals at least one-third of the total support “normally” received. The elements that constitute support will be discussed later in this section as will the actual calculations.

Under the facts and circumstances test, the organization will be considered publicly supported if it receives at least 10% of its support from governmental units or from either direct or indirect public contributions and if it meets a series of other requirements. To meet the requirements of public support in this case, two criteria must be met. The first criterion is that public support cannot be below 10%, and the second is that the organization must be making a real effort to increase the support level.

The first criterion is spelled out in Reg. §1.170A-9(e)(3)(i). According to subpart (i) the percentage (10%-of-support limitation) of support “normally” received by an organization from all sources must be “substantial.” To be considered substantial the combined support from “normal” sources received must equal at least 10% of the total support received by the organization.

The second criterion involves the attraction of the aforementioned public support. An organization must be organized and operated in such a manner that it will attract new and additional support from all three sources on a continuous basis. An organization meets this requirement if it maintains a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved in the organization’s activities.

In determining whether an organization maintains a continuous and bona fide program for solicitation of funds from all sources, consideration will be given to whether the scope of its fund-raising activities is reasonable in light of its charitable activities. It becomes a “facts and

circumstances” test. For instance, consideration is given to the fact that an organization may, in its early years of existence, limit the scope of its solicitation to persons deemed most likely to provide seed money in an amount sufficient to enable it to commence its charitable activities and expand its solicitation program. This focus becomes very important later on in the discussion concerning exemptions and charitable status.

For purposes of the 10%-of-support limitation, the higher the percentage of support goes above 10%, the lesser will be the burden of establishing the publicly supported nature of the organization. If the percentage of the organization’s support from public or governmental sources is low because it receives a high percentage of its total support from investment income on its endowment funds, such circumstances will be treated as evidence of compliance according to Reg. §1.170A-9(e)(3)(iii) if such funds were originally contributed by the general public. On the other hand, if the original funds were contributed by a few individuals, especially if they were all members of the same family, then those individuals will have to establish compliance with other facts and circumstances if they hope to maintain their public support status.

The following issues are taken into consideration when determining sources of support:

- Does the organization have broad base support from a significant number of individuals, thus indicating public support?
 - In determining whether a significant number of persons have contributed, consideration is given to the length of time the organization has been in existence, and whether it has limited its activities to a particular community or region thus limiting its numbers [Reg. §1.170A-9(e)(3)(iv)].
- Does the organization have a governing body that represents the broad interest of the public at large rather than the personal or private interests of a few donors? Such a demonstration of concern for the public will be considered in determining public support [Reg. §1.170A-9(e)(3)(v)].
- Does the organization have a governing body that is composed of public officials acting in their capacities as such or individuals having special knowledge or expertise in the particular field or discipline in which the organization is operated? If so, it will be considered as public supported [Reg. §1.170A-9(e)(3)(v)].
- Does the organization normally provide facilities or services directly for the benefit of the general public on a continuing basis (such as a museum)? If so, that service will be considered evidence that the organization is publicly supported [Reg. §1. 170A-9(e)(3)(vi)].

The fact that an organization is an educational or research institution that regularly publishes scholarly studies widely used by colleges and universities or by members of the general public will also be considered evidence that the organization is “publicly supported.”

Example 3-3:

- Botanical, Inc., was created to maintain public gardens containing rare plant specimens and displaying statuary and other art objects.
 - The facilities, works of art, and a large endowment were all contributed by a single contributor.
 - The members of the governing body of the organization are unrelated to its creator.
 - The gardens are open to the public without charge and attract a substantial number of visitors each year.
- For the four taxable years immediately preceding the current taxable year, 95% of the organization's total support was received from investment income from its original endowment.
- Botanical, Inc., also maintains a membership society, which is supported by members of the general public who wish to contribute to the upkeep of the gardens by paying a small annual membership fee.
- Over the four-year period in question, these fees from the general public constituted the remaining 5% of the organization's total support for such period.

Result:

- Under these circumstances, Botanical, Inc., does not meet the one-third-percent-of-support test for its current taxable year.
- Additionally, because only 5% of its total support, with respect to the current taxable year, is normally received from the general public, Botanical, Inc., does not satisfy the 10%-of-support limitation and cannot be classified as "publicly supported."
- For the current taxable year, Botanical, Inc., is not treated as a public charity described in §170(b)(1)(A)(vi). Because the 10%-of-support test was failed, nothing else in the case is considered.

Other miscellaneous factors that tend to indicate public support might include:

- Participation in, or sponsorship of, the programs of the organization by members of the public having special knowledge or expertise, public officials, or civic or community leaders;
- Maintenance of a definitive program by an organization to accomplish its charitable work in the community, such as slum clearance or developing employment opportunities; and

- Receipt of a significant part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant, contract, or contribution.

If the organization is a membership organization, the following additional factors should be considered:

- Whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community or area or in a particular profession or field of special interest;
- Whether membership dues for individual members have been fixed at rates designed to make membership available to a broad cross-section of the public; and
- Whether the activities of the organization will likely appeal to persons having some broad common interest or purpose.

Definition of Support

In Reg. §1.509(a)-3, the concept of “broad public support” is discussed in detail. Referring to §509(a)(2), certain types of support received by publicly supported organizations will not jeopardize their status. This safe-harbor support test is referred to as the “one-third-support test” as discussed above. An organization will meet this support test if it normally receives more than one-third of its support in each taxable year from any combination of:

- Gifts, grants, contributions, or membership fees; and
- Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity that is not an unrelated trade or business.

Determination of Public Support

The determination of public support, although appearing straightforward on the surface, can become quite complicated. In determining whether the one-third-support test or the 10%-of-support limitation is “normally” met, contributions by an individual, trust, or corporation will be considered support from direct or indirect contributions from the general public only to the extent that the total amount of the contributions by any such individual, trust, or corporation during the period does not exceed 2% of the organization’s total support for the period.

Therefore, any contribution by one individual will be included in full in the denominator of the fraction determining the one-third-of-support or the 10%-of-support limitation but will only be allowable in the numerator of the fraction to the extent that such amount does not exceed 2% of the denominator. Reg. §1.170A-9(e)(6)(i) lists a series of rules in applying the support equation:

CHARITABLE ORGANIZATIONS—CONCEPTS AND DESIGNS

- In applying the 2% limitation, all contributions made by a donor and by any person or persons related to the donor are accounted for as a single donation.
- The 2% limitation shall not apply to support received from governmental units.
- Indirect contributions from the general public include contributions received by the organization from organizations that normally receive a substantial part of their support from direct contributions from the general public.

Example 3-4:

- M is an organization referred to in §170(c)(2). For the years 1992 through 1995 (the applicable period with respect to the taxable year 1996). M received support of \$600,000 from the following sources:

Investment income	\$300,000
City “Y” (governmental unit)	40,000
United Fund	40,000
Direct public support	<u>220,000</u>
Total Support	<u>\$600,000</u>

- With respect to the taxable year 1996, M “normally” received in excess of one-third of its support from a governmental unit referred to in §170(c)(1) and from direct and indirect contributions from the general public computed as follows:

One-third of total support	<u>\$200,000</u>
Support from a governmental unit	\$ 40,000
Indirect contributions from general public	40,000
Contributions by various donors (no one having made contributions that total in excess of \$12,000, 2% of total support)	50,000
Six contributions in excess of 2%	<u>72,000</u>
	<u>\$202,000</u>

Result:

- Because the amount of support from governmental units and from direct and indirect contributions from the general public with respect to the taxable year 1996 “normally” exceeds one-third of M’s total support for the applicable period (1992-1995), M meets the one-third-of-support test.
- Therefore, it is treated as satisfying the requirements for classification as a “publicly supported” organization.

Example 3-5:

- The application of the 10%-of-support limitation is illustrated by the following scenario.
- Q is an organization referred to in §170(c)(2). It is a philanthropic organization founded in 1990 for the purpose of making annual contributions to worthy charities.
 - Q was created as a charitable trust and was established by the transfer of \$500,000 worth of marketable securities from a donor.
- Pursuant to the agreement, the organizer and two members of his family are the sole trustees and are vested with the right to appoint successor trustees.
- In each of its four most recent taxable years, Q received \$15,000 in investment income from its original endowment.
 - Each year, Q makes a solicitation for funds by operating a charity ball at the organizer's residence. Guests are invited and requested to make contributions of \$100 per couple.
 - During the four-year period involved, \$15,000 was received from the proceeds of these events.
- The founder and his family have also made contributions of \$25,000 over the course of the organization's four most recent taxable years.
- Q makes disbursements each year of substantially all of its net income to the public charities chosen by the trustees.
- With respect to Q's current taxable year, Q's sources of support are computed on the basis of the immediately preceding years as follows:

Investment income	\$60,000
Contributions	<u>40,000</u>
Total Support	<u>\$100,000</u>

Q's support is computed as follows:

Contributions from the general public	\$ 15,000
One contribution (in excess of \$2,000, 2% of total support)	
1 x \$2,000	<u>\$ 2,000</u>
Total	<u>\$ 17,000</u>

(continued)

Example 3-5: (Continued)

Result:

- Q's support from the general public does not meet the one-third-of-support test. As such, Q's classification as a "publicly supported" organization depends on whether it meets the requirements previously discussed.
- Even though it satisfies the 10%-of-support limitation, its method of solicitation brings into question whether Q satisfies the requirements.
- Because of its method of operating, Q has a greater burden of establishing its publicly supported nature.
- In this example, Q did not receive favorable consideration and, as such, did not satisfy the requirements for public support.

Contributions received from a governmental unit or from a publicly supported organization are not subject to the 2% limitation unless such contributions represent amounts that have been earmarked, either expressly or by implication, by a donor to such governmental unit or charity as being for the benefit of the organization.

Exclusion of Unusual Grants

The exclusion of unusual grants is the one important exception to the rules above. For the purpose of applying the 2% limitation to either the one-third- or 10%-of-support test, one or more contributions may be excluded from both the numerator and the denominator of the applicable percent-of-support fraction if the contributions are substantial and received from disinterested parties. The contributions or bequests in question:

- Are attracted by reason of the publicly supported nature of the organization;
- Are unusual or unexpected with respect to the amount; and
- Would, by reason of their size, adversely affect the status of the organization as normally being publicly supported.

In the case of a grant, if the terms of the granting instrument require that the funds be paid to the recipient organization over a period of years, the amount received by the organization each year pursuant to the terms of the grant may be excluded for each year.

Concept of “Normalcy”

The concept of normalcy of support does not rest on one year’s activities alone because revenues may vary from year to year. The IRS uses a four-year floating average to determine if the organization is “normally” publicly supported within the meaning of §170(b)(1)(A)(vi). If the organization satisfies the one-third and the 10% test on an aggregate basis for the four preceding taxable years, the organization will be treated as being “publicly supported” for the current year and the immediate four years following the current year.

Example 3-6:

- Civic, Inc., which is an organization described in §170(c)(2), meets the one-third-of-support test in taxable year 1996 on the basis of support received during the taxable years 1992, 1993, 1994, and 1995.
- The IRS uses a special rule for new organizations to determine if they meet the public support test.
 - If an organization has been in existence for at least one taxable year consisting of at least eight months, but less than five years, the number of years for which the organization has been in existence immediately preceding each current taxable year being tested will be substituted for the four-year period.

Section 509(a)(2)—Publicly Supported Organizations

The next group of organizations, those that fall under §509(a)(2), are similar in nature to those found under §170(b)(1)(A)(vi) and, in fact, fall under many of the same rules. After reviewing §509(a)(2), a comparison can be made to show the subtle differences.

Under §509(a)(2), an organization must meet various requirements to qualify as a public charity. First, the organization is required to receive more than one-third of its support from:

- Gifts, grants, contributions, and membership fees; and
- Gross receipts from admission fees, sales of merchandise, performance of services or furnishing of facilities, to the extent that they do not create unrelated taxable income.

Note that the gross receipts from the second category above are not considered support to the extent that they come from any person or from any bureau or similar agency of a governmental unit in any taxable year to the extent such receipts exceed the greater of \$5,000 or 1% of the organization’s support during the taxable year. Additionally, the organization cannot receive more than one-third of its support in each taxable year from the sum of:

- Gross investment income, and
- Excess of the amount of the unrelated business taxable income over the amount of the tax imposed by §511.

In determining whether the organization meets the support test under §509(a)(2)(A), the following items are a partial listing of potential levels of support as defined in §509(d):

- Gifts, grants contributions, or membership fees;
- Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity that is not an unrelated trade or business;
- Net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business; and
- Gross investment income.

In general, it is more advantageous to be treated under §170(b)(1)(A)(vi), and, thus, §509(a)(1), rather than under §509(a)(2) for the following reasons:

- A heavily endowed organization may encounter difficulty meeting the gross investment income limitation of §509(a)(2)(B).
- Contributions from a single donor are disregarded in determining public support under §170(b)(1)(A)(vi) only to the extent that such donor supplies more than 2% of the organization's support for any taxable year, whereas under §509(a)(2) all contributions from a donor contributing the greater of \$5,000 or 2% of all contributions are excluded from the calculation of the organization's public support for all succeeding taxable periods.
- Since gross receipts from the performance of exempt functions are included in support for purposes of §509(a)(2)(A) by reason of §509(d), but are excluded from support for purposes of §170(b)(1)(A)(vi), there is a smaller denominator to satisfy for purposes of the support fraction under §170(b)(1)(A)(vi) than under §509(a)(2).
- Under §170(b)(1)(A)(vi), contributions from other §170(b)(1)(A)(vi) organizations are not subject to the 2% donor limitation in determining the percentage of public support or the \$5,000 or 1% limitation on gross receipts from certain sources for purposes of determining the percentage of public support under §509(a)(2)(A).

Section 509(a)(3)—Supporting Organizations

The third type of organization excluded from the definition of “private foundation” is described in §509(a)(3), which provides that an organization operating under this section must be organized,

and at all times operated, exclusively for the benefit of and to carry out the purpose of organizations covered by §§509(a)(1) and 509(a)(2) (discussed above). To qualify under this section and avoid private foundation status, an organization must meet the following requirements discussed in §509(a)(2)(A)-(C):

- Be organized and at all times operate exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in §509(a)(1) or §509(a)(2).
- Be operated, supervised, or controlled by or in connection with one or more organizations described above.
- Not be controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one or more organizations described above.

Organizational and Operational Test

To qualify as a supporting organization, an exempt organization must be both organized and operated exclusively “for the benefit of, to perform the functions of, or to carry out the purposes of” one or more specified publicly supported organizations. If an organization fails to meet this test it would be precluded from operating as a supporting organization.

An organization is considered as being organized for one or more of the above listed purposes—that is, for the benefit of, to perform the functions of, or to carry out the purposes of—only if the organization’s articles of incorporation:

- Limit the purposes of the organization to one or more of the purposes referred to above;
- Do not expressly empower the organization to engage in activities that are not in furtherance of the aforementioned purpose;
- State the specified publicly supported organizations on whose behalf the organization is to be operated; and
- Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organization.

The definition of purpose referred to above can generally be fairly broad as long as it is referred to in the articles of incorporation. As such, an organization that, by the terms of the articles, is formed *for the benefit of* one or more specified publicly supported organizations will normally be considered to have met the organizational test. By way of example, articles that state that an organization is formed “to perform the publishing functions” of a specified university are sufficient to comply with the organizational test as well. Other terminology that might be found may include organizations that are *operated, supervised, or controlled by or supervised or controlled “in connection with”* one or more exempt purposes specified in §509(a)(1) or §509(a)(2). The

powers granted in the articles of the supporting organization can be no broader than those allowed for in the supported organization.

One Important Warning: An organization is not organized exclusively for the purposes of §509(a)(3)(A) if its articles expressly permit it to operate to support or benefit any organization other than those specified above.

Operated, Supervised, and Controlled

Each of the expressions “operated by,” “supervised by,” and “controlled by” as used in §509(a)(3)(B) presupposes a substantial degree of direction over the policies, programs, and activities of the supporting organizations. The relationship required under any one of these terms is comparable to that which might be found in a parent-subsidiary relationship, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is normally established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the:

- Governing body;
- Members of the governing body;
- Officers acting in their official capacity; or
- Membership of one or more publicly supported organizations.

Supervised or Controlled “In Connection With”

Under this relationship test, common supervision or control by the persons supervising or controlling the supporting organization and the publicly supported organization must be evident. This common supervision is generally established by the control or management of each organization being vested in the same persons. It was pointed out in *Cockerline Memorial Fund v. Commissioner*, 86 T.C. 59, that “In such a situation, the supporting and publicly supported organizations are compared to brother and sister organizations subject to common control.”

To meet the requirements of Reg. §1.509(a)-4(h) whereby an organization is “supervised or controlled in connection with” one or more publicly supported organizations, there has to be common supervision or control by the persons supervising or controlling both the supporting and the supported organizations to make sure that the supporting organization will be responsive to the needs of the supported organization. The Regulations require that the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organization.

Control must be real and not imagined. In this case, the mere payment of money is not sufficient to establish control. In fact, control does not exist even if state law requires that payment be made to the named beneficiary.

“Operated In Connection With”

Reg. §1.509(a)-4(f)(4) provides that the distinguishing feature of the “operated in connection with” relationship is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization as described in Reg. §1.509(a)-4(i)(2) and the “integral part test” defined in Reg. §1.509(a)-4(i)(3).

Responsiveness Test. The “responsiveness test” is designed to ensure that the supported organization will have the ability to influence the activities of the supporting organization. The responsiveness test can be met by one of several alternatives:

- One or more officers, directors, or trustees of the supporting organization are also officers, directors, or trustees of, or hold other important offices in, the supporting organization;
- One or more members of the governing bodies of the publicly supported organization are also officers, directors, or trustees of, or hold other important offices in, the supporting organization;
- Officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organization; or
- By virtue of any of the aforementioned relationships, the officers, directors, or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by the supporting organization.

Integral Part Test. This test is considered to be met if the organization maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organizations for the type of support that is provided. These concepts are best exhibited in the following examples.

Two cases, not found in the Regulations, give valuable insight into the practical application of the organization and operational aspects of §509(a)(3). In the first case, *Goodspeed Scholarship Fund v. Commissioner*, 70 T.C. 520, a will provided that the net income of a charitable trust be used for paying “the education ... at Yale of such graduates of Duxbury, Mass., High School” as were chosen, according to the procedures set forth in the will.

The IRS argued that the governing instrument failed to name a publicly supported organization for purposes of the “organizational test” of Reg. §1.509(a)-4(c)(1) because the pupils themselves were clearly not within this meaning, and the trust was therefore a private foundation. The Court

held that although the document failed to use the magic language “for the benefit of Yale,” it was clear that this was the intent of the will language and the trust was a supporting organization under §509(a)(3).

Example 3-7:

- X, an organization exempt under §501(c)(3), pays all of its annual net income to Y, a museum meeting the requirements of §509(a)(2).
- X meets the responsiveness test discussed above. Y has earmarked the income to underwrite the cost of carrying on a chamber music series consisting of twelve performances a year, which are performed for the general public free of charge at the museum.
- Because of the expense involved in carrying on these recitals, Y is dependent upon the income from X for their continuation.

Result:

- Under these circumstances, X will be treated as providing Y with a sufficient portion of Y’s total support to ensure Y’s attentiveness to X’s operations, even though the chamber music series is not the primary part of Y’s activities.

Example 3-8:

- M, an organization described in §501(c)(3), pays all of its annual net income to the Law School of N University, a publicly supported organization.
- M meets the responsiveness test. M has earmarked the income paid to N’s Law School to endow a chair in its Department of International Law.
- Without M’s continued support, N might not continue to maintain this chair.

Result:

- Under these circumstances, M will be treated as providing N with a sufficient portion of N’s total support to ensure N’s attentiveness to M’s operations.

In another more complicated case, the overall approach taken by the Court was clearly expressed. In *Nellie Callahan Scholarship Fund v. Commissioner*, 73 T.C. 628, the trust instrument stated that the income from the trust would be used each year “to finance, or aid in financing, the education of a pupil or pupils...from the...Winterset Community High School...to assist any of the eligible...graduates in attending any college or university within the state of Iowa.” In regard to

the responsiveness test in this case, the Court relied on Rev. Rul. 75-436, 1975-2 C.B. 217, which states:

In granting scholarships to the graduating class of the public high schools, the trust is benefiting individual members of the charitable class benefited by the city [a §170(c)(1) organization] through its public school system. Thus, the requirement of §1.509(a)-4(e) of the regulations that the supporting organization be operated exclusively to support or benefit one or more publicly supported organizations is also satisfied.

If pursuant to the “operational test” of §509(a)(3)(B), the payments to the high school students constituted an activity benefiting the school, then the high school should similarly be a named beneficiary under the “responsiveness test” because the “municipality” (of which Winterset Community High School is an integral part) was the beneficiary organization. The Court noted that:

Under Reg. §1.509(a)-4(e), the making of payments to graduates of Winterset High School constitutes an activity which supports or benefits the high school for purposes of the operational test. The Court failed to perceive the rationale underlying any different results in the operational test and the one before us. If under the regulations, the making of payments to the high school graduates comprises an activity which benefits the high school for purposes of the operational test, then the high school should similarly be considered a named beneficiary under the “responsiveness test.”

Even though it was not stated in the trust agreement, the Court determined that the “responsiveness test” was also aided by relevant state law, which provided that the trustees would be accountable to the local District Court and required to make a detailed annual report to the Court, which would become part of the public record. The records could be examined by the school district in the event of default by the trustees.

Control by Disqualified Persons

If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of the publicly supported organization, then such person will be regarded as disqualified.

Section 509(a)(4)—Testing for Public Safety

Under §509(a)(4), organizations are exempted from private foundation status if they are organized and operated exclusively for testing for public safety.

The Organizational and Operational Tests of §501(c)(3)

The “organizational” and “operational” requirements, pursuant to Reg. §1.501(c)(3)-l(a)(1), are much broader than those previously discussed under §509(a)(3). The application of these tests, under §509(a)(3), deal more with the substance of the organization’s activities than the

mechanics. In addition, the penalty for failure to meet the requirements under §509(a)(3) is reclassification as a private foundation. The penalty under §501(c)(3) can be loss of exemption.

According to Reg. §1.501(c)(3)-1(a)(1), to be exempt as an organization described in §501(c)(3) an organization must be both *organized* and *operated* exclusively for *one or more exempt purposes*. The Regulations are very clear: if the organization fails to meet either the organizational or operational test, it is not considered exempt as a charity. In general, the organizational test refers to the mechanics of how the organization was set up, i.e., the organization's articles of incorporation and bylaws, whereas the operational test refers to how the organization manages its affairs.

The third element refers to the organization's exempt purpose. For these purposes, "exempt purpose" refers to any activity specified in §501(c)(3) as discussed below.

Organizational Test

According to §501(c)(3), only corporations, community chest funds, and foundations can qualify for exemption. By virtue of the Code's silence on the matter, it can be assumed that individuals, limited liability companies, and partnerships cannot obtain exemption as charitable organizations. For the most part, charitable organizations are formed as corporations under the laws of the respective states. Status as a nonprofit organization comes under the laws of a given state whereas tax exemption comes from the IRS.

Generally, an organization is organized exclusively for one or more exempt purposes only if its articles of organization:

- Limit the purposes of the organization to one or more exempt purposes, and
- Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities that in themselves are not in furtherance of one or more exempt purposes.

When meeting the organizational test, the organization's purpose or purposes can generally be as broad as, or more specific than, those listed under §501(c)(e). As an example, an organization that is formed by the terms of its articles "for literary and scientific purposes" will, if it otherwise meets the requirements, be considered to have met the organizational test. In another example, articles stating that the organization is created solely to receive contributions and pay them to other organizations exempt under §501(c)(3) is also sufficient for the organizational test.

By contrast, an organization is not organized exclusively for one or more exempt purposes if the articles expressly allow it to carry on anything other than an insubstantial part of its activities not in furtherance of the exempt purpose, even though the organization is by the terms of its organizational papers created for purposes specific in §501(c)(3).

Articles of Organization

To meet the organizational test discussed above, the articles of organization must limit the purpose of the organization to one or more exempt activities and must prohibit any substantial activity that is not exempt. Articles of organization can include the following:

- Trust instruments,
- Corporate charter,
- Articles of association, or
- Any other governing written instrument.

Prohibition Against Political Activity

Involvement in any form of political activity can be potentially risky at best. An organization is not organized exclusively for one or more exempt purposes if the articles empower the organization to do the following:

- Devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise;
- Directly or indirectly to participate in, or intervene in, any political campaign on behalf of or in opposition to any candidate for public office; or
- Have objectives and engage in activities that characterize it as an “action” organization.

It is important to understand the concept of an “action” organization if for no other purpose than to avoid the classification. By definition, an organization is an “action” organization if its primary purpose is to influence legislation. Influencing legislation can take on several postures including, but not limited to, such activities as contacting or urging the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation. Permissible activity and “grass-roots” lobbying will be covered in the next section.

Distribution of Assets on Dissolution

One final significant requirement for all nonprofit organizations is the plan in place for distribution of assets when the organization is dissolved. An organization is not considered to be organized for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization’s assets will be considered dedicated to an exempt purpose, for example, if upon dissolution the assets of the organization would be distributed to one or more similar exempt organizations for public use. Even if the articles of organization are quiet on the subject, if state law requires these assets to be distributed to another exempt organization, the requirement of distribution will have been met.

Operational Test

The operational aspect of exemption is much more basic than are the organizational elements, which are often outside the accountant's sphere of influence. An organization is considered to be operating exclusively for one or more exempt purposes only if it engages in the activities enumerated in §501(c)(3). Activity must evolve around one or more of the following activities:

- Religious activities,
- Charitable activities,
- Scientific activities,
- Testing for public safety,
- Literary activities,
- Educational activities, or
- Prevention of cruelty to children or animals.

In regard to the above, exemption will only be allowed if the organization is being operated for a charitable public good rather than a private interest. One of the major reasons for the "Application for Exemption" (Form 1023) is to establish to the IRS's satisfaction that the organization was not organized for the benefit of any private interest, such as a designated individual, the creator, or a family member. As will be seen by example, it does not preclude exemption if the organizer's family benefits as a member of a class of individuals, as long as they are not the primary recipient.

The concept of "charity" is used in this case in its generally accepted legal sense and may, in fact, have a broader definition than that provided in §501(c)(3). For example, the following activities usually fall within this classification:

- Relieving the poor and distressed or the underprivileged, advancing religion, or advancing education or scientific activity;
- Erecting or maintaining public buildings, monuments, or works;
- Lessening of the burdens of government;
- Promoting social welfare;
- Lessening neighborhood tensions;
- Eliminating prejudice and discrimination;

- Defending human and civil rights secured by law; and
- Combating community deterioration and juvenile delinquency.

Application of Lobbying Rules to Exempt Organizations

Exempt organizations, in general, have faced considerable change over the past several years in regard to lobbying activities. The biggest and most far-reaching changes affect organizations other than those exempt under §501(c)(3). The subject matter surrounding lobbying for other than §501(c)(3) organizations is discussed in *A CPA's Guide to Tackling Tough Tax Issues for Nonprofit Organizations* published by the AICPA, and which is beyond the scope of this book; but because most accountants work with charitable organizations, the concepts surrounding political activity have been covered in this book.

As indicated above, §501(c)(3) public charities (other than churches and related religious organizations) remain under pre-1993 rules. These organizations have the option of electing an objective allocation rule rather than a subjective measure of value. The subjective rule, in its simplest form, says that an organization exempt under §501(c)(3) will lose its exemption if too many of its activities involve political or legislative action.

Historically, very few organizations have made use of electing this subjective rule. In most cases, charities and their advisors did not understand the implication or impact of making the election. In some cases, where the organizations or their advisors were aware of the rule, they made a conscious decision not to make the election because they felt the required information was more than they wanted to provide. Many charities should consider electing this subjective rule as a method of ensuring the protection of their exemption.

Section 501(h) Election

Public charities exempt under §501(c)(3) are faced with whether to make the election under §501(h) referred to above. In general, for organizations not making the election, lobbying is allowed as long as it is not a substantial part of their activities. A problem arises, however, because of the lack of guidance about what is “substantial.” The IRS will normally not address the issue until the “too much” has been reached—and in that case it may be “too late.

Section 501(h) permits certain eligible public charities to spend a portion of their funds identified as “exempt purpose expenditures” to influence legislation. Organizations exempt under §501(c)(3) can make this election if Form 5768 [“Election/Revocation of Election by an Eligible §501(c)(3) Organization to Make Expenditures to Influence Legislation”] has been filed with and accepted by the IRS. This form is reproduced at the end of this chapter.

Eligibility Requirements

To determine whether an organization is eligible to make the election, a two-part test is used:

CHARITABLE ORGANIZATIONS—CONCEPTS AND DESIGNS

1. The organization must not be a disqualified organization and must fall into one of the following classifications:
 - Educational institution under §170(b)(A)(ii), having a regular faculty and curriculum used for the presentation of formal instruction (i.e., a primary school).
 - Hospital and medical research organization under §170(b)(A)(iii) working to provide medical care, education, or research.
 - Organization supporting government schools under §170(b)(A)(iv), such as a university endowment fund.
 - Organization publicly supported by charitable contributions under §170(b)(A)(vi), such as a library.
 - Organization publicly supported by fee income under §509(a)(2). An example of this might be a symphony orchestra for which membership includes season tickets and total dues paid approximate the fair market price for the concert series.
 - Organization supporting certain types of public charities as described by §509(a)(3). An example might be a trust whose income is used only for scholarships to a specific university, and scholarship recipients are named by the university.
2. Section 501(h) also lists the types of organizations that are disqualified from making the elections:
 - Churches as defined by §170(b)(1)(A)(i).
 - Integrated auxiliaries of churches, associations of churches, or conventions of churches.
 - Members of affiliated groups composed of other disqualified organizations.

Lobbying Expenditures

Public charities making the election must report all lobbying expenditures on Part VI-A, Schedule A, of its Form 990. Lobbying costs must be designated as either direct lobbying or grass-roots lobbying.

Direct Lobbying. Direct lobbying is defined as communication with legislators, government officials, or their staff for the purpose of expressing views on specific legislation.

Grass-Roots Lobbying. Grass-roots lobbying involves the same type of communication with the general public, including:

- Public comments by the organization regarding the merits/demerits of specific legislation;
- Requests to the general public to contact legislators, except for public referenda or actions where the general public acts as a legislative body; and
- Mass media communications (even if no specific action is requested).

Disclosures by Nonelecting Public Charities

Nonelecting public charities are required to disclose information on their lobbying activities by completing Part VI-B, Schedule A, of their Form 990. Based on this information, the IRS determines the allowable amount of lobbying expenses. As stated before, such organizations may participate in lobbying only if it does not constitute a “substantial part” of their overall activities. In making this determination, the IRS interprets the “specific facts and circumstances” for the organization involved.

Some factors that may be considered by the IRS are:

- How closely the organization’s lobbying activities relate to its tax-exempt purpose,
- Percentage of the organization’s total spending and amount spent on lobbying,
- Amount of the organization’s staff time devoted to lobbying activities, and
- Impact of the organization’s lobbying activities on public opinion or current legislation.

Penalties for Exceeding Limitation

If activities of a nonelecting §501(c)(3) organization are found to exceed the “substantial” limitation, the IRS may impose severe penalties. These penalties are:

- Loss of tax exemption,
- Revocation of ability to solicit contributions,
- Excise tax of 5% for all lobbying costs incurred, and
- 5% tax, in some cases, for all lobbying costs on the organization’s managers.

Lobbying Limits for Electing Charities

<i>Exemption Purpose Expenditures</i>	<i>Total Lobbying Limit</i>	<i>Total Grass-Roots Lobbying Limit</i>
Up to \$500,000	20%	5%
\$500,000 to \$1 M	\$100,000 + 15% of excess over \$500,000	\$25,000 + 3.75% of excess over \$500,000
\$1 M to \$1.5 M	\$175,000 + 10% of excess over \$1 M	\$43,750 + 2.5% of excess over \$1 M
\$1.5 M to \$17 M	\$225,000 + 5% of excess over \$1.5 M	\$56,250 + 1.25% of excess over \$1.5 M
Over \$17,000,000	\$1,000,000	\$250,000

Limitations on Expenditures for Grass-Roots Lobbying

When an elective nonprofit charity spends more than one-quarter of allowable lobbying expenditures, it is subject to a 25% excise tax on excess expenditures. Flagrant violations of excess expenditures can result in the loss of tax exemption.

Form **5768**

(Rev. December 1996)

Department of the Treasury
Internal Revenue Service

**Election/Revocation of Election by an Eligible
Section 501(c)(3) Organization To Make
Expenditures To Influence Legislation**

(Under Section 501(h) of the Internal Revenue Code)

For IRS
Use Only ▶

Name of organization	Employer identification number
Number and street (or P.O. box no., if mail is not delivered to street address)	Room/suite
City, town or post office, and state	ZIP + 4

1 Election—As an eligible organization, we hereby elect to have the provisions of section 501(h) of the Code, relating to expenditures to influence legislation, apply to our tax year endingand all subsequent tax years until revoked. (Month, day, and year)

Note: This election must be signed and postmarked within the first taxable year to which it applies.

2 Revocation—As an eligible organization, we hereby revoke our election to have the provisions of section 501(h) of the Code, relating to expenditures to influence legislation, apply to our tax year ending (Month, day, and year)

Note: This revocation must be signed and postmarked before the first day of the tax year to which it applies.

Under penalties of perjury, I declare that I am authorized to make this (check applicable box) ▶ election revocation on behalf of the above named organization.

(Signature of officer or trustee)	(Type or print name and title)	(Date)
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General Instructions

Section references are to the Internal Revenue Code.

Section 501(c)(3) states that an organization exempt under that section will lose its tax-exempt status and its qualification to receive deductible charitable contributions if a substantial part of its activities are carried on to influence legislation. Section 501(h), however, permits certain eligible 501(c)(3) organizations to elect to make limited expenditures to influence legislation. An organization making the election will, however, be subject to an excise tax under section 4911 if it spends more than the amounts permitted by that section. Also, the organization may lose its exempt status if its lobbying expenditures exceed the permitted amounts by more than 50% over a 4-year period. For any tax year in which an election under section 501(h) is in effect, an electing organization must report the actual and permitted amounts of its lobbying expenditures and grass roots expenditures (as defined in section 4911(c)) on its annual return required under section 6033. See Schedule A (Form 990). Each electing member of an affiliated group must report these amounts for both itself and the affiliated group as a whole.

To make or revoke the election, enter the ending date of the tax year to which the election or revocation applies in item 1 or 2, as applicable, and sign and date the form in the spaces provided.

Eligible Organizations.—A section 501(c)(3) organization is permitted to make the election if it is not a disqualified organization (see below) and is described in:

1. Section 170(b)(1)(A)(ii) (relating to educational institutions),
2. Section 170(b)(1)(A)(iii) (relating to hospitals and medical research organizations),
3. Section 170(b)(1)(A)(iv) (relating to organizations supporting government schools),
4. Section 170(b)(1)(A)(vi) (relating to organizations publicly supported by charitable contributions),
5. Section 509(a)(2) (relating to organizations publicly supported by admissions, sales, etc.), or
6. Section 509(a)(3) (relating to organizations supporting certain types of public charities other than those section 509(a)(3) organizations that support section 501(c)(4), (5), or (6) organizations).

Disqualified Organizations.—The following types of organizations are not permitted to make the election:

- a. Section 170(b)(1)(A)(i) organizations (relating to churches),

- b. An integrated auxiliary of a church or of a convention or association of churches, or

- c. A member of an affiliated group of organizations if one or more members of such group is described in a or b of this paragraph.

Affiliated Organizations.—Organizations are members of an affiliated group of organizations only if (1) the governing instrument of one such organization requires it to be bound by the decisions of the other organization on legislative issues, or (2) the governing board of one such organization includes persons (i) who are specifically designated representatives of another such organization or are members of the governing board, officers, or paid executive staff members of such other organization, and (ii) who, by aggregating their votes, have sufficient voting power to cause or prevent action on legislative issues by the first such organization.

For more details, see section 4911 and section 501(h).

Note: A private foundation (including a private operating foundation) is not an eligible organization.

Where To File.—Mail Form 5768 to the Internal Revenue Service Center, Ogden, UT 84201-0027.

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

TABLE OF CONTENTS

INTRODUCTION	101
FILING REQUIREMENTS	102
WHO MUST FILE	102
Regularly Carried On	103
Substantially Related.....	104
EXCLUSIONS	104
ALLOCATION OF EXPENSES ASSOCIATED WITH UNRELATED BUSINESS INCOME.....	106
DIRECTLY CONNECTED EXPENSES	106
RELATIONSHIP BETWEEN EXPENSES AND ACTIVITY	107
CRITIQUE OF FORM 990-T, EXEMPT ORGANIZATION BUSINESS INCOME TAX RETURN [AND PROXY TAX UNDER §6033(e)]	108
WHEN TO FILE	108
CHANGE IN YEAR-END	108
EXTENSIONS	109
AMENDED RETURNS.....	109
ESTIMATED TAXES	109
WHERE TO FILE	110

COMPLETING THE RETURN	110
ACCOUNTING METHODS.....	111
PART I—UNRELATED TRADE OR BUSINESS INCOME.....	111
Line 1a—Gross Receipts or Sales	111
Line 4(a)—Capital Gain Net Income.....	111
Line 5—Income (or Loss) From Partnerships.....	112
Line 12—Other Income	112
Other Lines.....	112
PART II—DEDUCTIONS NOT TAKEN ELSEWHERE	112
Limitations	113
Net Operating Losses	116
Specific Deduction.....	116
PART III—TAX COMPUTATION	117
PART IV—TAX AND PAYMENTS.....	117
PART V—STATEMENTS REGARDING CERTAIN ACTIVITIES AND OTHER INFORMATION	118
SCHEDULES AND RELATED ISSUES.....	118
Schedule C—Rental Income	118
Schedule E—Unrelated Debt-Financed Income.....	120
Schedule F—Interest, Annuities, Royalties, and Rents From Controlled Organizations	122
Schedule G—Investment Income of §501(c)(7), (9), or (17).....	125
Schedule I—Exploited Exempt Activity Income, Other Than Advertising	125
Schedule J—Advertising Income	126

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

INTRODUCTION

Unrelated business income accounts for more problems, when dealing with the IRS in the area of exempt organizations, than any other area. Most taxpayers, although not necessarily understanding the mechanics, have a general concept of tax exemption as it applies to the “ordinary” activities of a charity. When it comes to activities that are not related to the exempt purpose, however, most organizations have a difficult time grasping the concept of taxability as it applies to a charity.

The primary misconception with many charities is that as long as they use the income from unrelated activities for an exempt purpose that will be sufficient to maintain their tax-free status. This is obviously not the case. For this purpose, the relevant question is “How was the money *earned*?” not “How was the money *used*?” As a rule, if an organization engages in an unrelated business activity and makes a profit, it will have unrelated business income and may be subject to tax. Exceptions to the rule, referred to as “modifications,” are discussed later in the chapter.

In GCM 39891, it was ruled that payment to an exempt organization under a noncompete agreement was not UBIT.

The income from an unrelated trade or business activity of an otherwise tax-exempt organization is generally taxable. But what constitutes a trade or business? In 1991, the IRS concluded in *GCM 39865* that refraining from competition under a covenant not to compete was an unrelated trade or business activity subject to UBIT.

In *Ohio Farm Bureau Fed, Inc., v. Commr*, 106 TC 222 (1996), however, the Tax Court held that noncompetition is not the equivalent of the affirmative performance of services in the context of UBIT. Thus, a one-time payment received by a tax-exempt organization in consideration for an agreement not to compete with or sponsor another exempt organization did not constitute income from a trade or business. The Government did not appeal this decision, so the IRS revoked *GCM 39865*.

FILING REQUIREMENTS

For the most part, Form 990-T, “Exempt Organization Business Income Tax Return,” is associated with unrelated business income as defined in §512 for organizations exempt from federal income tax. These types of organizations are normally associations or activities defined in §501(c)(2) through §501(c)(27). Unrelated business income, however, can be an issue in other types of activities. The following briefly summarizes the types of entities that may be associated with unrelated business income:

- Trusts, corporations, and other organizations exempt under §501(c), excluding U.S. instrumentalities;
- Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include in their gross income their entire pro rata share, whether distributed or not, of the taxable income of the association or corporation for such year;
- Qualified pension, profit-sharing, and stock-bonus plans described in §401(a); and
- Colleges that are agencies or instrumentalities of any government or any political subdivision thereof or agencies or instrumentalities of one or more governments or political subdivisions.

Conversely, the following types of organizations are *not* subject to the unrelated income tax rules:

- U.S. instrumentalities described in §501(c)(1);
- Farmers’ cooperatives;
- Shipowners’ protection and indemnity associations;
- Political organizations; and
- Homeowners’ associations.

WHO MUST FILE

The filing requirements are quite basic: any domestic or foreign organization exempt under §501(a) must file Form 990-T if it has gross income of \$1,000 or more from an unrelated trade or business. For this purpose, the term “unrelated trade or business” means any trade or business *regularly carried on* by an exempt organization, the conduct of which is not *substantially related* (aside from the need of such organization for income or funds or the use it makes of the profits

derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

In virtually every discussion concerning unrelated business income, an issue is made of the use of the funds. As noted above, the *use is relevant in regard to exemption, but it is not relevant in regard to unrelated business income*. This differentiation gets to the rudiments of the rules regarding unrelated business income. The primary objective of adoption of the UBIT was to eliminate a source of unfair competition by placing the unrelated business activities of various exempt organizations on the same tax basis as the nonexempt business activities with which they compete.

The rationale for this is that a “for-profit” entity must charge enough to cover tax liability whereas the exempt organization could theoretically charge less because it has no tax requirement. On the other hand, when an activity does not possess the general characteristics of a trade or business, such as when low-cost items are sent out in exchange for contributions, the UBIT does not apply because the organization is not in competition with the taxable organization.

Often, the business activity is carried on in the midst of an otherwise exempt activity. The unrelated activity does not lose its identity as a business venture just because it is carried on as part of a larger activity. Reg. §1.513-1(b) gives the following example:

The regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose....Similarly, activities of soliciting, selling, publishing, and commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.

Two elements in the definition of “trade or business” need further explanation: “regularly carried on” and “substantially related.” These elements are the basis of taxability of the unrelated business income. If these elements are not present on an otherwise “normal” unrelated business activity, the venture will not be taxable.

Regularly Carried On

In determining whether a business is regularly carried on, the tax advisor must look to the frequency and continuity with which the activities are carried on and at the manner in which they are pursued, and these elements should be scrutinized in light of the exempt activity. The concept can produce some rather strange results. Even if an activity is the same as a commercial venture, if it is conducted infrequently, it will not produce unrelated business income. Frequency is in relationship to the commercial counterpart:

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

- Normal time span—This concept measures the frequency of the activity to a commercial venture.
 - Consider the example of a commercial parking lot opened every Saturday throughout the year. Even though the lot was open one day a week, it was done on a predetermined periodic time frame.
- Intermittent activity—This concept measures activities engaged in only discontinuously or periodically in relation to their commercial counterparts, and it measures activities conducted without the competitive and promotional efforts typical of commercial endeavors.
 - The publication of advertising in programs for sports events or music or drama performances not regularly carried on would be an example of intermittent activity.
- Infrequent activities—These are activities that are so infrequent and unplanned they cannot be compared to a commercial counterpart for measurement purposes.

Substantially Related

The presence or lack of this requirement necessitates an examination of the relationship between the business activities that generate the particular income in question. A trade or business is “related” to an exempt purpose, in the relevant sense, only when the conduct of the business activities has causal relationship to the achievement of the exempt purpose. In determining whether the activities are substantially related, consideration must also be given to the size and extent of the activity in relation to the exempt purpose. Even though an activity may be directly related, if it is being done on a commercial basis beyond the needs of the organization, then it would be considered unrelated.

For example, if an exempt organization was formed to meet the needs of senior citizens by providing medical supplies at an affordable cost, then the sale of supplies would not create unrelated business income. On the other hand, if the American Association of Retired Persons decided to sell supplies as a money-raising project to seniors, the income would not be specifically related to their exempt purpose and would be considered to be conducted on a large scale even if every cent of profit were directed to the exempt activity.

EXCLUSIONS

The Code outlines a series of exclusions and modifications. Even though substantial income is produced by an activity, if it falls within an area of exclusion or modification, it is not taxable. The following is a fairly comprehensive listing of the exclusions that fall outside the concept of trade or business for this purpose. The term does not include the following:

-
- A trade or business in which substantially all the work is performed for the organization without compensation.
 - An example is often seen where volunteers sell advertising for an exempt organization's publications. Even though this activity might bring in substantial revenues, it is still not taxable as long as "substantially" all the work is done by volunteers.
 - A trade or business that is carried on by a §501(c)(3) or §511(a)(2)(B) organization mainly for the convenience of its members, students, patients, officers, or employees.
 - A trade or business that sells items of work-related equipment and clothes and items normally sold through vending machines, at food dispensing facilities, or by snack bars, if the sales are for the convenience of its members at their usual place of employment.
 - A trade or business that sells merchandise, substantially all of which was received by the organization as gifts or contributions. (Goodwill Industries and church thrift shops are examples of this type of activity.)
 - A trade or business that consists of qualified public entertainment activities regularly carried on by a §501(c)(e), (4), or (5) organization as one of its substantial exempt purposes.
 - A trade or business that consists of qualified convention or trade show activities regularly conducted by a §501(c)(3), (4), (5), or (6) organization as one of its substantial exempt purposes.
 - A trade or business that includes activities relating to the distribution of low-cost articles, each costing \$6.70 (1996) or less by an organization described in §501 and contributions which are deductible under §170(c)(2) or (3), if the distribution is incidental to the solicitation of charitable contributions.
 - A trade or business that includes the exchange or rental of donor or membership lists between organizations described in §501 and contributions which are deductible under §170(c)(2) or (3).
 - A trade or business that consists of bingo games as defined in §513(f). Generally, bingo is not included in any unrelated trade or business if:
 - Wagers are placed, winners determined, and prizes distributed in the presence of all persons wagering in that game;
 - Game does not compete with bingo games conducted by for-profit businesses in the same jurisdiction; and
 - Game does not violate state or local law.

- A trade or business that consists of conducting any game of chance by a nonprofit organization in North Dakota and the game does not violate any state or local law.

ALLOCATION OF EXPENSES ASSOCIATED WITH UNRELATED BUSINESS INCOME

One of the most difficult issues in preparing Form 990-T is the allocation of expenses associated with unrelated business income. To the extent that an exempt organization has unrelated business income, it operates in much the same fashion as its for-profit counterpart, so it must match revenues with related expenses including depreciation, pay state income taxes, and contend with such issues as alternative minimum tax and business credits.

Like a regular business, if a loss is created for the year, it is treated as a net operating loss and carries back and over in the same manner as a commercial enterprise. Technically, for a net operating loss to be available for carryover or carryback, the business must be operated with a profit motive. If the business shows a loss year after year, the IRS may question the profit motive of the business venture.

The biggest problem with net operating loss involves how it comes about. It can be created by one of two means. The first is by a legitimate operating loss in a business with proper allocation, and the second is by generating an improper overallocation of cost. One of the most blatant examples of operating loss is in the area of advertising discussed later in this chapter. Under the guise of an “honest” mistake, misallocation most often comes about in the area of indirect cost, such as the sharing of facilities. Floor space (square footage) is often a method used to allocate facilities including related cost of repairs, maintenance, utilities, etc.

Unfortunately, the only guidance offered is that the allocations must be applied on a reasonable basis. The problem is, reasonable to whom? Reg. §1.512(a)-1(c) points out that any portion of any item that has been used or set aside for the benefit of the commercial activity has to be related to the commercial business. The portion of any item that is attributable to the unrelated business income is allowed as a deduction in computing taxable income.

DIRECTLY CONNECTED EXPENSES

The best example of a thorough study on the *reasonableness* of *directly connected expenses* is the case of *Rensselaer Polytechnic Institute v. Commissioner*, 79 T.C. 967, 732 F.2d 1058 (2d Cir. 1984). The Court addressed the use of facilities between exempt and unrelated business use. A thorough study of this case is beyond the scope of this book, but certain points are relevant when examining the importance of allocation.

In *Rensselaer*, the IRS argued that fixed expenses must be allocated not on the time of actual use but on the time available for use. The IRS’s position was that the denominator of the use fraction should be the number of hours in the year. The Tax Court agreed with Rensselaer Polytechnic

Institute's method of allocation based on actual use. It was deemed to be *reasonable* within the meaning of the Code.

The concept of reasonableness was covered in IRM 7(10)69-172, "Dual Use of Facilities or Personnel." When facilities or personnel are used both to carry on exempt functions and to conduct an unrelated trade or business, organizations must determine whether expenses, depreciation, and similar items are allocated between the two uses on a *reasonable basis*. Deductible items must bear a proximate and primary relationship to the business activity to which they are allocated.

RELATIONSHIP BETWEEN EXPENSES AND ACTIVITY

The courts and the IRS put a significant amount of time on the issue of "connectability" of expenses to an activity. In regard to "directly connected with," the Code and related Regulations appear to be unbending. Section 512 defines unrelated business taxable income as gross income derived from unrelated business activities less deductions "directly connected with" the activity. Reg. §1.512(a)-1(a) defines "directly connected with" in terms of a trade or business as an item of deduction that has a proximate and primary relationship to the conduct of that business.

The Regulations review "proximate" and "primary" in relation to expenses attributable solely to unrelated business activities and to the dual use of facilities or personnel, both which were applicable to *Rensselaer* discussed above. When expenses relate solely to either a related or unrelated activity, the matter is not in question. The point of confusion comes with mixed use of either facilities or personnel.

Reg. §1.512(a)-1(c), which deals with dual use of facilities or personnel, is not clear. The Regulations provide that, when facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation, and similar items attributable to such facilities (as, for example, items of overhead) *shall be allocated between the two uses on a reasonable basis*.

In addition, in cases where personnel are used by both the exempt and nonexempt activities, expenses and similar items attributable to personnel (such as salaries) *shall be allocated between the two uses on a reasonable basis*. The Regulations go on to state further that the portion of any such items so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity and shall be allowable as a deduction in computing UBIT in a manner consistent with the Code.

When deciding how to allocate expenses between exempt and nonexempt activities, the tax advisor would be well advised to remember that the "directly connected with" language in the Regulations is an additional requirement imposed on tax-exempt organizations that is not imposed on organizations subject only to Chapter 1 of the Code. The additional requirement is reinforced by its definition of the deduction as one that must have a "proximate" and "primary" relationship—a far greater requirement than merely being "pertinent" to business operations.

CRITIQUE OF FORM 990-T, EXEMPT ORGANIZATION BUSINESS INCOME TAX RETURN [AND PROXY TAX UNDER §6033(e)]

As the heading implies, this form is used for a dual purpose. The primary use of the form remains reporting unrelated business income, but with the advent of the new lobbying rules, the form is also used to report and pay the proxy tax associated with political and legislative involvement for exempt organizations other than those associated with charitable activities, which was covered in Chapter 3.

WHEN TO FILE

Form 990-T is normally filed along with Form 990, which is due on the fifteenth day of the fifth month following the close of the normal business year. (See the discussion below in regard to change in year-end.) An employees' trust, defined in §401(a), and an Individual Retirement Account, however, must file Form 990-T by the fifteenth day of the fourth month after the end of the tax year. If the regular due date falls on a Saturday, Sunday, or legal holiday, the return is due on the next business day. If the return is filed late, it will be subject to a series of penalties including interest. The penalties and interest are a result of failing to file along with failing to pay a tax when due. This deadline, of course, includes the making of federal and state estimates when appropriate.

Penalties and interest are determined on essentially the same basis as on a "normal" corporate return. The organization can be subject to a penalty of 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax, unless it can show reasonable cause for the delay. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or \$100. In addition to the penalty for late filing, a penalty for the late payment of tax is imposed, normally $\frac{1}{2}$ of 1% of the unpaid tax for each month or part of a month the tax is unpaid. This penalty does not exceed 25% of the amount due.

CHANGE IN YEAR-END

Treatment of year-end changes, depends, in part, on the type of organization and, in part, on whether the organization has had a previous change in years. Rev. Proc. 85-58, 1985-2 CB 740, describes procedures for the expeditious change in year-ends. Except as noted below, organizations desiring to change their annual account periods may effect the change by "timely filing" the applicable information return, Form 990, 990-PF (in this case, the 990-T follows the Form 990) with the IRS center for the short period for which a return is required.

The form should indicate on the top that a change of accounting period is being made. (It would be appropriate to write a statement at the top of the return such as, "This return is being filed for a short period under the requirements of Rev. Proc. 85-58." This wording is only a suggestion and not all-inclusive.)

According to the Rev. Proc. annual information returns, Forms 990, 990-PF, and 990-BL must be filed by the fifteenth day of the fifth month following the close of the short period. If an organization is not required to file an annual information return but files a Form 990-T, it can change its annual accounting period by timely filing Form 990-T with the IRS center. If neither an information return nor a Form 990-T is required, it is not necessary to notify the IRS that a change of accounting period is being made.

If an organization has previously changed its annual accounting period at any time within the ten calendar years ending with the calendar year that includes the beginning of the short period resulting from the change of an annual accounting period, and if it had a filing requirement at any time during that ten-year period, it must file a Form 1128 (“Application for Change in Accounting Period”) with the IRS center with its timely filed annual information return or Form 990-T. Form 1128 must be filed by the fifteenth day of the fifth month following the close of the short period.

The procedures discussed above do not apply to farmers’ cooperatives exempt from federal income tax under §521 or to organizations described in §§526, 527, or 528. For these organizations, reference should be made to Rev. Proc. 92-13, 1992-3 IRB 28 (1/6/91). This Rev. Proc. contains one other subtle issue. It notes that the return must be filed by the due date for the short period. No reference is made to extensions. Presumably, the language should be taken literally to mean without extension.

EXTENSIONS

Form 990-T extension requirements follow “normal” corporate extension procedures. Corporations may request an automatic six-month extension of time to file Form 990-T by using Form 7004, “Application for Automatic Extension of Time to File Corporation Income Tax Return.”

AMENDED RETURNS

To correct errors or change a previously filed return, write “Amended Return” at the top of the return. Generally, the amended return must be filed within three years after the date the original return was due or three years after the date the organization filed it, whichever is later. Here, the need for a return is noted. The period of limitations does not begin to run until a return is filed. For organizations required to file Form 990-T but who do not, either by choice or out of ignorance, there is no period of limitations.

ESTIMATED TAXES

An organization filing Form 990-T must make installment payments of estimated tax if its estimated tax is expected to be \$500 or more. Both corporate and trust organizations use Form 990-W.

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

The tendency of waiting until the last minute to file exempt organization tax returns can place the exempt organization in a penalty situation if the preparer is not careful. Even though the return is not due until the fifteenth day of the fifth month, the estimated payments are due on the fifteenth day of the fourth, sixth, ninth, and twelfth months. The first estimated payment is due before the return is due.

Due dates present another set of problems with the state. For the most part, UBIT is reported on a statewide basis as if it were a normal corporate return. In many cases, this requirement means a return may be due anywhere from the fifteenth day of the third month, to the first day of the fourth month to the fifteenth day of the fifth month depending on the state requirements. Check the individual state requirements for unrelated business income and related estimated tax payments.

Note: If the organization owes tax when it files Form 990-T, do not include the payment with the tax return. Instead, send the payment with Form 8109 to a qualified depository or Federal Reserve Bank or use the EFT system, if applicable.

WHERE TO FILE

File all forms with the IRS Center, Ogden, Utah 84201-0027.

COMPLETING THE RETURN

Before reviewing the return on a section-by-section basis, the preparer should be familiar with the overall aspects of completing the return. If the necessary information is not included in the return, the IRS will treat it as an incomplete return not properly filed. On the other hand, oversupplying information is not in the client's best interest and, in general, deals with the professionalism of completing the return.

Generally, all filers must complete the applicable items in the heading area including name and address along with the Employer Identification Number of the organization. Read over the heading very carefully to avoid undue correspondence with the IRS. Remember also that all returns must be signed and preparer information provided where applicable.

In completing Part I, note the special instructions for "small filers." Organizations complete Part I, Column A, Lines 1 through 13, on Page 1. If the "Total" amount at the bottom of Line 13, Column A, is \$10,000 or less, the organization need only supply totals in Line 13 of Columns B and C, Lines 29 through 34 of Part II, and Parts III through V. Organizations with \$10,000 or less on Line 13 ("Total" line), Column A ("Income"), do not complete Schedules A through K.

Note: Refer to applicable schedules when completing Column A and in determining the deductible expenses to include on Line 13 of Column B.

If the amount on Line 13 (“Total”) Column A, Part I, is more than \$10,000, the remainder of the return must be filled out.

Organizations liable for the proxy tax on lobbying and political expenditures that are required to file Form 990-T only because of the proxy tax should complete the year, name, address, and Employer Identification Number at the top of the form. Enter the proxy tax on Line 37 and complete Part IV. Fill in the signature and paid preparer’s areas and attach a schedule showing the computation of the proxy tax.

ACCOUNTING METHODS

Exempt organizations with average annual gross receipts of more than \$5,000,000 must generally use the accrual method of accounting for their unrelated business activities. An organization changing to the accrual method because of this provision must complete Form 3115 and attach it to Form 990-T for the year of the change. In addition, an organization must also show on a statement accompanying Form 3115 the period over which the §481(a) adjustment will be taken into account and provide the basis for that conclusion.

PART I — UNRELATED TRADE OR BUSINESS INCOME

Part I, along with Part II, is designed to resemble Form 1120 and also capture information specific to exempt organizations. Some specific areas the preparer might address concern the following.

Line 1a—Gross Receipts or Sales

This line is where the gross income from the exempt organization’s trade or business is reported so long as it involves the sales of goods and services. In the case of a social club [§501(c)(7)], only the income for facility use from nonmembers would be reported here. Investment income, which requires special treatment, would be reported on Schedule G.

Line 4(a)—Capital Gain Net Income

Generally, organizations required to file Form 990-T [except organizations described in §501(c)(7), (9), and (17)] are not taxed on the net gains from the sale, exchange, or other disposition of property, but net capital gains on debt-financed property, capital gains on cutting timber, and ordinary gains on §§1245, 1250, 1252, 1254, and 1255 property are taxed. (See Form 4797, “Sales of Business Property,” and its instructions for additional information.)

If organizations described in §501(c)(7), (9), (17), or (20) sell property, §512(a)(3)(D) affects the treatment in the event of a gain on disposition. If property that is used directly in the performance

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

of the exempt function of an organization referred to above is sold by the organization and if within a period of one year before the date of the sale and ending three years after the date other property is purchased and used by the organization directly in the performance of its exempt function, gain from the sale is recognized only to the extent that the organization's selling price of the old property exceeds the cost of the new property.

A fairly common example of this type of transaction appears when a social club disposes of some of its property. If the property is not replaced within the replacement period, then it will be taxed based on the aforementioned section.

Capital gains and losses should be reported by a trust on Schedule D (Form 1041), "Capital Gains and Losses," and by a corporation on Schedule D (Form 1120).

Line 5—Income (or Loss) From Partnerships

If the organization is a partner in a partnership carrying on an unrelated trade or business, the partner's share of the unrelated business income (or loss) is entered. It is also necessary to attach a statement to the return showing the organization's share of the partnership's gross income from the unrelated trade or business and its share of the partnership deductions directly connected with the unrelated gross income. (See Chapter 6 concerning joint ventures.)

Line 12—Other Income

Enter on Line 12 any item of unrelated business income that is not reportable elsewhere on the return. In this section, include recoveries of bad debts deducted in earlier years under the specific charge-off method.

Other Lines

All other lines in Part I refer to a detailed schedule in the return. Discussions concerning these sections are covered below.

PART II — DEDUCTIONS NOT TAKEN ELSEWHERE

As noted above, preparation of Part II is dependent on the level of revenue shown on Part I, Line 13, Column A. If the total income is \$10,000 or less, then the detail shown in the body of Part II (Lines 14 through 28) can be omitted, leaving Lines 29 through 34. When given the option to omit line items, it is prudent to do so. This choice also has to do with the professionalism of how the return is prepared.

In completing Part II, refer to the discussion concerning “directly connected with.” Only expenses directly connected with unrelated trade or business income (except contributions) can be deducted in this section. Contributions are an exception and can be deducted even though not directly connected. Like regular corporations, however, the total amount that can be shown cannot be more than 10% of unrelated business income before the charitable contribution deduction.

Most of the deductions in Part II will require some allocation. Every one of these expenses has already appeared on Form 990, presumably in Part II. Allocation needs to be made on a reasonable *consistent* basis. The IRS will question a methodology that is changed every year particularly when the results produce a consistent advantage to a client. Remember, allocation is not only between exempt and nonexempt activities but can also be between various nonexempt activities. The best example to show this distinction is the allocation of salary. The nonexempt portion of salary may have to be allocated between activity reported in Part II and Schedule J, for example, where salary associated with advertising is reported.

Reg. §1.512(a)-1(c) is quite vague concerning the methodology for allocation, but this vagueness does not relieve the organization from the responsibility of substantiating allocation methods and amounts. In *Core Special Purpose Fund*, TCM 1985-48, the organization was denied a business expense deduction in computing unrelated advertising income because of its failure to substantiate that expenses were incurred for or directly connected with an unrelated advertising activity. Information developed from an independent auditor’s report was not considered sufficient substantiation, even though the auditors had reviewed the documents. In this case, the IRS disallowed all of the deductions claimed by the fund as advertising expenses, except for certain printing expenses.

The Tax Court agreed with the IRS, stating that the organization’s burden of proof extended beyond merely showing that it actually incurred expenses during the period. It also must show that the expenses were deductible business expenses under §§162 and 167 and, most important, that the expenses were “directly connected with” the organization’s unrelated activity.

Limitations

Social Clubs

Like a “regular” business return, certain deductions have limitations. In addition, certain limitations are peculiar to exempt organizations. One of the most common of these deductions is an activity that lacks a profit motive. The two areas where this most often appears concern either publications or nonmember usage of club facilities in regard to social clubs. The effect of publications and related advertising not being operated with a profit motive is discussed in the review of Schedule J. It is possible to aggregate activities and avoid the problem, but aggregation will not help in the area of social clubs.

The typical social club operates for the benefit of its members. It is not uncommon, however, for the clubs to allow outsiders to use the facilities at a cost or for members to use the club for

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

weddings, parties, seminars, etc.—activities that are technically classified as nonmember usage of the club facilities. Invariably, this usage, although covering direct cost, does not normally cover indirect cost, thus putting the club in a lose–lose situation. Without the normal profit motive, the IRS questions the allowability of losses as a means of offsetting investment income, which is taxable in the case of a social club.

The federal appellate courts were not able to agree on the scope of deductions allowed to be offset against the taxable income of §501(c)(7). In Rev. Rul. 81-69, 1981-1 CB 351, the IRS prohibited exempt social clubs from deducting from net investment income losses from sales of food or beverages to nonmembers. The rationale was that if a club did not intend to make a profit from sales to nonmembers, expenses could not be deducted as business expenses under §162. The IRS's position was upheld in *The Brook, Inc., v. Commissioner*, 58 AFTR 2d 5628 (2d Cir., 1986).

In *North Ridge Country Club v. Commissioner*, 877 F.2d 750 (9 Cir., 1989), rev'g 89 T.C. 563 (1987), the Ninth Circuit agreed with the decision in *Brook*. In *Cleveland Athletic Club, Inc., v. U.S.*, 57 AFTR 2d 470 (6th Cir., Dec. 1985), the U.S. Court of Appeals for the Sixth Circuit rejected the IRS's position in *Brook* and held that social clubs may take business deductions for expenditures associated with activities engaged in with a “basic purpose of economic gain.”

The U.S. Supreme Court decision in *Portland Golf Club*, 65 AFTR 2d 90-1162, No. 89-530, June 21, 1990, established that social clubs must be motivated by profit in undertaking nonmember activities (unanimous decision) and that the allocation of fixed costs between member and nonmember activities must be consistent with methods used to compute actual profit or loss. This decision places the burden of proof on the nonprofit social club to justify the economic reality of any losses from nonmember activities, such as an offset of losses from sales of food against investment income. The method of allocation of fixed costs by Portland Golf Club in the preparation of its 1980 and 1981 tax returns could not be adequately substantiated and resulted in an unfavorable Supreme Court decision.

Other Limitations

Meals, Entertainment, and Travel Expenses. The amount deductible for meals and entertainment expenses is generally limited to 50% of the amount otherwise allowable. Meals cannot be lavish or extravagant; a bona fide business discussion must occur during, immediately before, or immediately after the meal, and an employee of the organization must be present for the entire meal.

Club Dues. Deductions are not allowed for the following:

- Country clubs,
- Golf and athletic clubs,

- Airline and hotel clubs, and
- Clubs operated to provide meals under conditions favorable to business discussion.

Deductions are allowed for the following:

- Civic or public service organizations,
- Professional organizations (such as bar and medical associations),
- Business leagues,
- Trade associations,
- Chambers of commerce,
- Boards of trade, and
- Real estate boards, unless a primary purpose for the gathering is entertainment.

IRS Expands Special Membership-Dues Procedure

Over the past several years, a controversy has brewed over whether exempt organizations that offer special “associate memberships” must pay UBIT on those dues. The dispute has focused largely on whether some dues are in fact entry fees to take advantage of low group term life or health insurance or other benefits.

Rev. Proc. 95-21 partially solved the problem, but only for exempt labor, agricultural and horticultural organizations. Now, the IRS has expanded this favorable procedure to include §501(c)(6) organizations (tax-exempt business leagues, chambers of commerce, real estate boards, etc.). Under the procedure, dues do not generate unrelated business income as long as the associate member category has been formed principally to further the organization’s exempt purpose (Rev. Proc. 97-12, 1997-4 IRB).

Dependent Travel. The IRS takes the position, noted in §274(m)(3), that no travel expense deduction is allowed for a spouse, dependent, or other individual accompanying an organization’s officer or employee unless that person is an employee of the organization traveling for a bona fide business purpose that would otherwise be deductible. From a purely practical matter, this position is not always the case. In assisting nonprofit clients, the area of dependent travel is a significant issue, particularly for trade associations where the spouse is expected to travel with the executive.

In general, to deduct an employee’s travel expenses, the trip must have a bona fide business purpose. In determining this purpose, the relevant question is, “Is the spouse’s presence *necessary*

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

to the conduct of business?” not “Is it *helpful?*” The performance of some incidental service by a spouse does not meet the bona fide purpose rule.

When the employee goes on a business trip, and no bona fide business purpose for the spouse’s presence exists, the amount deductible as a business expense of the taxpayer for the transportation and lodging costs incurred is the single-rate cost of those items. The amount by which the total expense is increased by the spouse’s presence and the entire cost of the spouse’s meals are not deductible (Rev. Rul. 56-168, 1956-1 CB 93).

Entertainment Facilities. No deduction is allowed for a facility (such as a yacht or hunting lodge) used for an activity that is usually considered entertainment, amusement, or recreation.

Note: The organization may be able to deduct travel and entertainment expenses if the amounts are treated as compensation and reported on Form W-2 for an employee or on Form 1099–Miscellaneous for an independent contractor.

Net Operating Losses

The net operating loss deduction that appears on the return is the total of the net operating loss carryovers and carrybacks that can be deducted in any given tax year. To be deductible, a net operating loss must have been incurred in an unrelated trade or business, which again brings up the issue of profit motive. Like a “regular” business, the amount of the carryover or carryback is determined under Code §172.

Specific Deduction

A specific deduction of \$1,000 is allowed (except for computing the net operating loss deduction). Note that only *one* specific deduction may be taken, regardless of the number of unrelated businesses conducted. Under a specific set of circumstances, an exception is made.

A diocese, province of a religious order, or convention or association of churches is allowed one specific deduction for *each* parish, individual church, district, or other local unit that regularly conducts an unrelated trade or business. This provision applies only to those parishes, districts, or other local units that are not separate legal entities but are components of a larger entity. Each specific deduction will be the smaller of \$1,000 or the gross income from any unrelated trade or business the local unit conducts.

The diocese, province of a religious order, or convention or association of churches must file a return reporting the gross income and deductions of all its units that are not separately incorporated. Local units that are separately incorporated must file their own returns and cannot be included with any other entity except for a title holding company.

PART III—TAX COMPUTATION

At this point, an exempt organization's unrelated business income most closely approximates a C corporation. For the most part all the same rules are in effect, including:

- Participating as a member of a controlled group,
- Sharing in the allocation of surtax exemptions,
- Being subject to the application of alternative minimum tax, and
- Taking advantage of the related tax credits.

The only unusual area in this section is the part referring to “proxy tax.” To pay the §6033(e)(2) proxy tax on nondeductible lobbying and political expenditures, the organization will enter on the appropriate line the amount of tax and attach a schedule showing computations. The discussion of lobbying rules is beyond the scope of this book. The proxy tax is determined by multiplying the appropriate amount of inclusion by 35%. (No deductions are allowed for the amount of tax paid.)

PART IV—TAX AND PAYMENTS

Tax and payments are handled in generally the same manner as domestic corporations. Domestic organizations owing less than \$500 and foreign organizations that do not have an office or place of business in the U.S. should enclose a check or money order made payable to the IRS. In the event that the amount is over \$500, the depository method should be used.

One other area that affects exempt organizations is the refund of erroneous backup withholding. As a rule, recipients of dividends or interest payments must generally certify their correct Tax Identification Number to the bank or other payer on Form W-9. If the payer does not get this information, it is required to withhold part of the payments to the exempt organization as “backup withholding.” If the organization was subject to erroneous backup withholding because the payer did not realize the organization was exempt and not subject to the withholding, the organization can claim credit for the amount withheld by including it on Line 44e and writing “Erroneous Backup Withholding” to the left of the entry space.

If the organization's only reason for filing Form 990-T is to claim a refund of the withholding, then complete the year, name, address, and Employer Identification Number at the top of the form and complete Line 44e (“Other Credits and Payments”) as described here. Also, complete Lines 45 (“Total Payments”) and 48 (“Overpayment”). Additionally, the organization needs to fill in the signature and paid preparer's area and attach a copy of Form 1099 showing the withholding.

PART V—STATEMENTS REGARDING CERTAIN ACTIVITIES AND OTHER INFORMATION

Part V does not require any additional explanation other than a reminder that if the organization has any exempt interest or dividends, the amount goes on Line 3.

SCHEDULES AND RELATED ISSUES

The schedules relate to specific areas in unrelated business income that need additional attention beyond what might be possible through Part I. In some cases, these are referred to as “modifications.” Whether a particular item of income falls within any of the modifications is determined by all the facts and circumstances of each case.

For example, if a payment termed “rent” by the parties is, in fact, a return of profits by a person operating the property for benefit of an exempt organization or is a share of the profits retained by the organization as a partner or a joint venture, then the payment is not within the modification for rents. Thus, it is not enough that an item be classified as rent for the sake of reporting; it must, in fact, be true rental income.

To the extent a source of income is truly rent, royalties, or investment income [from other than a §501(7), (9), or (17) organization], it does not normally generate unrelated business income and is a “modification” to the normal rule of taxability of these types of income. On the other hand, a normally exempt source will be taxable if certain conditions are met. This, for the most part, creates the need for the various schedules.

Schedule C—Rental Income

With some exceptions, rents from property of a specific type and the related deductions directly connected with those rents are excluded in computing UBIT. Notwithstanding these specific types of rents listed in the regulations, certain rents and related deductions in connection with debt-financed property or property rented to controlled organizations will also give rise to UBIT.

Section 512(b)(3)(A) excludes certain types of rent from unrelated business income. Excluded rents generally fall into one of two categories: real property and personal property. Rents from personal property leased with real property, if the rent is attributable to the personal property, are an incidental amount of the total rents received or accrued under a lease. This breakdown is determined at the time the personal property is first placed in service by the lessee, but a question arises about the meaning of “incidental.” For these purposes, rents attributable to personal property generally are not an incidental amount of the total rents if the rents exceed 10% of the total rents from all the leased property.

An exception to the aforementioned rules applies under certain circumstances. The exception does not apply if personal property rents show an excess. “Excess” is defined as more than 50% of the

total rents attributable to personal property, determined at the time the personal property is first placed in service.

A second exception is referred to as the “net-profit” exception. The determination of this amount depends in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage of the gross receipt or sales.

Example 4-1:

- A, an exempt organization, owns a printing factory that consists of a building housing two printing presses and other equipment necessary for printing.
- On January 1, 19X1, A rents the building and the printing equipment to B for \$10,000 a year.
 - The lease states that \$9,000 of such rent is for the building and \$1,000 for the printing equipment.
 - It is determined, however, that notwithstanding the terms of the lease, \$4,000 (40%) of the rent is actually attributable to the printing equipment.
- During 19X1, A has \$3,000 of deductions, all properly allocable to the land and building.

Result:

- Under these circumstances, A shall not take into account in computing its UBIT the \$6,000 of rent attributable to the building and the \$3,000 of deductions directly connected with such rent, but the \$4,000 of rent attributable to the printing equipment is not excluded from the computation of A’s UBIT under §512(b)(3)(A)(ii) because the rents in question represented more than an incidental portion of the total rents.

The relationship between personal and the total is normally determined at the time the property is placed in service; a requirement for redetermination applies under certain conditions. A redetermination of the percentage of rent for personal property is required when either:

- Placing additional or substitute personal property in service causes an increase of 100% or more, or
- Codification of the lease changes the amount of rent charged.

The exclusion of certain rents assumes no performance of personal service in regard to the rental property. Payments for the use of space where services are also rendered to an occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, spaces in parking lots, etc., do not constitute rent within the meaning of the exclusion. Generally, services are

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

considered rendered to the occupant if they are primarily for the tenant's convenience and are other than those usually or customarily rendered in connection with the rental. Supplying maid service, for example, constitutes such service, but furnishing heat and light and cleaning public entrances, exits, and lobbies are not considered services rendered to any particular tenant.

Keep in mind that rents from both real and personal property not otherwise taxable may be taxable on Line 8, if the income is from a controlled organization, or on Line 7, if the property is debt-financed. Taxability of the rents has to be considered in that order.

Schedule E—Unrelated Debt-Financed Income

This schedule applies to all organizations except §501(c)(7), (9) and (17) organizations. As noted above, rents of real property are “normally” excluded in the determination of UBIT. One of the exceptions to this rule applies to dual-use property that is used for both exempt and nonexempt purposes. If the property is used *primarily* for exempt purposes, then it is not subject to these rules.

Debt-Financed Property

By definition, any property held to produce income is debt-financed property if at any time during the tax year the organization showed acquisition indebtedness outstanding for the property. When any property held for the production of income by an organization is disposed of at a gain during the tax year, and there was acquisition indebtedness outstanding for that property at any time during the 12-month period before the date of disposition, the property is debt-financed property. Many practitioners are surprised to find out that these rules apply not only to real property but to investments such as securities purchased on margin, which are considered debt-financed property if the liability incurred in purchasing them remains outstanding.

Section 514(b)(1)(A) defines an exception to the term “debt-financed property” when substantially all (85%) of the use of the property is for the organization's exempt purpose or the income from the property is otherwise taxed by some other section. This concept combined with the 12-month window discussed above becomes relevant when considering the disposition of the property. To the extent that the property is debt-financed and is used on a dual basis, it will be subject to the determination of gain. If an organization has the foresight to terminate the leases or reduce the space to less than 15% before a year is up, it may be possible to avoid tax on a portion of the gain, depending, of course, on the facts and circumstances of the leases and a determination of the amount of potential tax. Organizations have also applied §1031, like-kind exchanges, to avoid the tax.

Acquisition Indebtedness

Acquisition indebtedness is the key to taxability under this section. Acquisition indebtedness is defined as the outstanding amount of principal debt incurred by the organization to acquire or improve the property:

- Before the property was acquired or improved, if the debt was incurred because of the acquisition or improvement of the property; or
- After the property was acquired or improved, if the debt was incurred because of the acquisition or improvement, and the organization could reasonably foresee the need to incur the debt at the time the property was acquired or improved.

Likewise, the definition of acquisition indebtedness has certain exceptions. It does not include the following:

- Qualified (§401) trust in acquiring or improving real property;
- Tax-exempt school [§170(b)(1)(A)(ii)] and its affiliated support organizations [§509(a)(3)] for indebtedness incurred after July 18, 1984; or
- Organization described in §501(c)(25) in tax years beginning after Dec. 31, 1986.

In reporting gross income on Schedule E, do not include income reported on any other schedule. For example, do not report rents from personal property reported on Schedule C or rents and interest from controlled organizations shown in Schedule F. As far as Column 2, Schedule E, is concerned, report the gross income from the debt-financed property. There is nothing unusual concerning the allocation and reporting of deductions directly connected with the debt-financed property other than that depreciation must be reported on a straight-line basis.

The concepts of average acquisition indebtedness and average adjusted basis, as it relates to this section, are not as easy to understand as the concept of directly connected expenses. For this purpose, “average acquisition indebtedness” for any tax year is the average amount of the outstanding principal debt during the part of the tax year the property is held by the organization. To determine the average amount of acquisition debt, determine the amount of the outstanding principal debt on the first day of each calendar month during that part of the tax year that the organization holds the property. Add these amounts together, and divide the result by the total number of months during the tax year that the organization held the property. The application of this calculation will become clearer in the examples that follow this section.

Average Adjusted Basis

The concept of “average adjusted basis” as it relates to debt-financed income can likewise be hard to follow. The average adjusted basis for debt-financed property is the average of the adjusted basis of the property on the first and last days during the tax year that the organization holds the property. It will be necessary to adjust the basis of the property by the depreciation for all earlier tax years, whether or not the organization was exempt from tax for any of these years. Additionally, for tax years during which the organization is subject to tax on unrelated business taxable income, it will be necessary to adjust the basis of the property by the entire amount of allowable depreciation, even though only a part of the deduction for depreciation is taken into account in figuring UBIT.

The remainder of the calculation is mathematical and can be seen in the examples at the end of this section, but, generally, the amount of income from debt-financed property included in unrelated trade or business income is figured by multiplying the property's gross income by the percentage obtained from dividing the property's average acquisition indebtedness for the tax year by the property's average adjusted basis during the period it is held in the tax year.

Note: The percentage cannot total more than 100.

Schedule F—Interest, Annuities, Royalties, and Rents From Controlled Organizations

If you have two organizations, one in control of the other, as defined below, the controlling organization has to include items of gross income (interest, annuities, royalties, and rents) from the controlled organization in its income. These rules apply whether or not the activity conducted by the controlling organization to derive income represents a trade or business or whether it is regularly carried on. As such, amounts received by a controlling organization from the rental of its real property to a controlled organization may be included in the UBIT of the controlling organization, even though the rental of the property is not an activity “regularly carried on” by the controlling organization. The treatment of these activities is partly dependent on whether the organization is exempt or nonexempt.

Exempt Controlled Organizations

If the controlled organization is exempt from taxation, the amount includable is an amount that bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the UBIT of the controlled organization bears to whichever of the following amounts is greater:

- Taxable income of the controlled organization, computed as though the controlled organization were not exempt from tax, or
- UBIT of the controlled organization.

Both are determined without regard to any amounts paid directly or indirectly to the controlling organization; and all deductions directly connected with amounts included in gross income are allowed.

Nonexempt Controlled Organizations

If the controlled organization is not exempt from taxation, the amount included is an amount that bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the “excess taxable income” of the controlled organization bears to whichever of the following amounts is the greater:

- Taxable income of the controlled organization, or
- Excess taxable income of the controlled organization.

Example 4-2:

- On July 10, 19X1, Alpha, Inc., an exempt educational organization, purchased an office building for \$510,000 using \$300,000 of acquisition indebtedness.
 - During 19X1 the only adjustment to basis is \$20,000 for depreciation.
- As of December 31, 19X1, the adjusted basis of the building is \$490,000 (at acquisition \$510,000 and at December 31, \$490,000 = \$500,000 average) and the indebtedness decreased as follows:

July.....	\$300,000
August.....	280,000
September	260,000
October	240,000
November.....	220,000
December	<u>200,000</u>
	\$1,500,000

Alpha, Inc., files its return on a calendar-year basis. During the short period, the organization receives rental income of \$20,000 per month (six months) and, as indicated above, makes a principal payment of \$20,000 a month plus interest of \$1,000 per month.

- Average acquisition indebtedness: \$250,000 ($\$1,500,000/6$ months = \$250,000).
- Debt/basis percentage: Average acquisition indebtedness/Average adjusted basis
 $\$250,000/\$500,000 = 50\%$.
- Rental income: $\$120,000/50\% = \$60,000$.

Expenses:

Depreciation	$\$20,000/50\% = \$10,000$
Other expenses	$6,000/50\% = \underline{3,000}$
Total expenses	<u>\$13,000</u>

- Both the \$60,000 rental income and the \$13,000 allocable expenses are reported in Part I of Form 990-T.

Both are determined without regard to any amount paid directly or indirectly to the controlling organization. As with other modifications, the controlling organization is allowed deductions that are directly connected with amounts included in gross income. The “excess taxable income” referred to above means the excess of the controlled organization’s taxable income over the

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

amount of such taxable income that, if derived directly by the controlling organization, would not be unrelated business income.

Control

The concept of control, as used in this case, is dependent on whether the organization is a stock or nonstock organization. If the organization is a “stock” corporation, the term “control” has the traditional meaning of ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. In the case of “nonstock” organizations, the term “control” means at least 80% of the directors or trustees of the organization are either representatives of or directly or indirectly controlled by the exempt organization.

The following example is taken from Reg. §1.512(b)-1(1)(3)(iii).

Example 4-3:

- A, an exempt university described in §501(c)(3), owns all the stock of M, a nonexempt organization. During 1971, M leases a factory and a dormitory from A for a total annual rental of \$100,000.
- During the taxable year, M has \$500,000 of taxable income, disregarding the rent paid to A, \$150,000 from a dormitory for students of A university, and \$350,000 from the operation of a factory which is a business unrelated to A’s exempt purpose.
- A’s deductions for 1971 with respect to the leased property are \$4,000 for the dormitory and \$16,000 for the factory.
- Under these circumstances, \$56,000 of the rent paid by M will be included by A as net rental income in determining its UBIT, computed as follows:

M’s taxable income (disregarding rent paid to A)	\$500,000
Less taxable income from dormitory	<u>150,000</u>
Excess taxable income	<u>\$350,000</u>
Ratio (\$350,000/\$500,000)	7/10
Total rent paid to A	\$100,000
Total deductions (\$4,000 + \$16,000)	20,000
Rental income treated as gross income from an unrelated trade or business (7/10 x \$100,000)	70,000
Less deductions directly connected with such income (7/10 x \$20,000)	<u>14,000</u>
Net rental income included by A in computing its UBIT	<u>\$56,000</u>

Schedule G—Investment Income of §501(c)(7), (9), or (17)

This section is used to report gross income from nonmembers for social clubs, Voluntary Employees' Beneficiary Associations, and unemployment trust on unrelated business income. From a purely practical sense, it is used to report investment income earned by social clubs. Schedule G is used for all income from investments in securities and other similar investment income from nonmembers including 100% of income and directly connected expenses from debt-financed property.

Although organizations have little control over the income reported on Schedule G (generally reported on 1099s), they tend to take considerable liberties with the related expenses as a means of reducing income. In actuality, organizations are allowed to deduct only expenses that are directly connected to the net investment income. The tax preparer should allocate deductions between exempt activities and other activities whenever necessary.

In the event that the income is set aside for various charitable and benevolent purposes, these organizations may not be taxed. Generally, these organizations will avoid tax on:

- Set-asides to religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals;
- Payment of life, sick, accident, or other benefits by §501(c)(9) or (17) organizations; and
- Reasonable administration costs directly connected to the above.

As a rule, when an exempt organization sells property used in its exempt purpose, there is normally no taxable gain to report. In the case of organizations exempt under §501(c)(7), (9) or (17), however, this generality does not hold true. If these organizations sell property that was used for the exempt function and not replaced, then they will be taxed on the gain. If they dispose of property and buy other property used for the organization's exempt function within a period beginning one year before the date of the sale and ending three years after the date of the sale, the gain from the sale will be recognized only to the extent that the selling price of the old property is more than the cost of the replacement property. Organizations notify the IRS of the rollover by attaching a detailed schedule of the transaction to the return in the year of sale.

Schedule I—Exploited Exempt Activity Income, Other Than Advertising

Activities are reported on Schedule I if they are an exploitation of exempt functions. Although the concept is relatively simple, the practical application is quite difficult and has been the subject of much controversy. In certain cases, activities carried on by an organization in the performance of exempt functions may generate goodwill or other intangibles that are capable of being exploited or taken advantage of. When an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part on an exempt function of the organization

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

does not make it gross income for exempt purposes. In Reg. §1.513-1(d)(4)(iv), the following examples are given.

Example 4-4:

- U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research.
 - It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers.
 - The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U.
- Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.

Example 4-5:

- W is an exempt business league with a large membership.
- Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets, and other commercial advertising materials to its members, for which service W charges the agency an agreed-upon amount per enclosure.
 - The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose of which W is granted exemption.
- Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

This subject is far broader than indicated in this book. Everything from mailing list rentals to affinity card royalties is involved in this area and is generally beyond the scope of this book.

Schedule J—Advertising Income

Advertising probably affects more organizations than any other source of unrelated business income. Anytime an exempt organization publishes a journal, periodical, or any publication reaching a wide variety of readers, chances are good that advertising is being sold. Unless the

advertising bears directly on the exempt purpose of the organization, the sale of advertising in the publication is unrelated business income.

The sale of commercial advertising in an organization's journal is an example of exploitation when the business exploits the circulation and readership of the publication that was developed to disburse editorial comment to the members. In addition, the publication of articles and other content is an activity normally carried on by profit-motivated businesses that sell advertising space. Expenses associated with advertising income will be deducted in computing the UBIT of the organization.

The mechanics of Schedule J are not difficult to understand once the respective columns are understood. To understand the columns, the preparer must to distinguish between advertising activities and circulation and readership cost.

Gross Advertising Income

"Gross advertising income" refers to all amounts derived from the unrelated advertising activities of the periodical.

Circulation Income

"Circulation income" refers to the income (other than advertising income) related to the production, distribution, or circulation of a periodical. This term also encompasses all of the amounts realized from or attributable to the sale or distribution of the readership content of the publication. Circulation income also includes any amount realized from the reprinting or republishing of articles in the journal or periodical articles and amounts earned from the sale of back issues.

When the right to receive an exempt organization's periodical is associated with membership or similar status in the organization for which members are paying dues, fees, or for which other charges are received, circulation income includes the portion of such membership receipts allocable to the periodical. Allowable membership receipts are the amounts that would have been charged and paid if:

- Periodical was that of a taxable organization,
- Periodical was published for profit, or
- Member was an unrelated party dealing with the taxable organization at arm's length.

Allocable Membership Receipts

Reg. §1.512(a)-1(f)(4) provides three methods of determining the allocable membership receipts of an exempt organization's periodical. The use of the methods are progressive because if it is not

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

possible to apply the first method, the next method is applied, and so on. The methods are applied as follows:

- *Subscription price charged to nonmembers*—If 20% or more of the total circulation of a periodical consists of sales to nonmembers, the subscription price charged to these nonmembers will determine the price of the periodical for purposes of allocation.
- *Subscription price to nonmembers*—If the first method does not apply, and if the membership dues from 20% or more of the members of an exempt organization are less than those received from the other members because the former members do not receive the periodical, the amount of the reduction in membership dues for a member not receiving the periodical will determine the price of the periodical for purposes of allocating membership receipts to the periodical.
- *Pro rata allocation*—The last method is based on the pro rata allocation of membership receipts. Because it can generally be assumed that membership receipts and gross advertising income are equally available for all the exempt activities of the organization, the share of membership receipts allocated to the periodical is an amount equal to the organization's membership receipts multiplied by a fraction, the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization.

Deductions Attributable to Periodicals

The concept of “total periodical cost” refers to the total deductions attributable to the periodical. The total periodical costs are made up of the sum of the direct advertising costs and readership costs. Based on the aforementioned regulations, only those deductions directly related to the periodical are allowable as a periodical cost. If an element of cost could be associated with both the periodical and other exempt activities of the same organization, the cost must be allocated on a “reasonable basis.” The method of allocation depends on what type of expense is being allocated. Reg. §1.512(A)-(1)(6)(i) suggests these allocations:

- Salaries may generally be allocated among various activities on the basis of the time devoted to each activity.
- Occupancy, such as rent, heat, and electricity, may be allocated on the basis of the portion of space devoted to each activity.
- Depreciation may be allocated on the basis of space occupied and the portion of the particular asset used in each activity.

According to the regulations, allocations based on dollar receipts from various exempt activities will generally not be reasonable because such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations.

Direct Advertising Cost

The direct advertising costs of an exempt organization's periodical include all expenses including depreciation and similar items of deduction that are directly connected with the sale and publication of advertising. These items are allowable as deductions in the computation of unrelated business income of the organization for the taxable year to the extent they meet the concept of "ordinary and necessary." No expenses attributable to readership cost would be deductible under direct advertising cost.

The following expenses are normally attributable to direct advertising cost:

- Agency commission;
- Direct selling cost;
- Transportation and travel expenses;
- Office salaries;
- Promotion and research expense;
- Direct office overhead directly connected with the sale of advertising; and
- Other direct advertising costs including artwork, copy preparation, telephone, telegraph, postage, and similar costs.

The portion of the mechanical and distribution costs attributable to advertising lineage of the periodical will be determined on the basis of the ratio of advertising lineage to total lineage of the periodical and the application of the ratio to the total mechanical and distribution cost of the periodical. When records do not reflect more accurately the allocation of mechanical and distribution cost to advertising lineage of the periodical and when no factor in the character of the periodical indicates that such an allocation would be unreasonable, then the above method is applied as long as it does not appear to be unreasonable.

Readership Cost

Readership cost of an exempt organization's periodical comprises operating expenses including depreciation where applicable or similar items directly connected to the production and distribution of the readership content of the periodical.

Excessive Advertising Costs

Advertising cost and income along with readership cost and circulation income have to be navigated before it is possible to determine if there is income or loss to be reported between the

UNRELATED BUSINESS INCOME AND RELATED ACTIVITIES

advertising activities and the circulation activities. The final resolution as far as advertising is concerned depends on the following:

Gross Advertising Revenues Greater Than Direct Advertising Cost. If the gross advertising income from an exempt organization's periodical exceeds the direct advertising cost, the readership cost may be deductible when computing UBIT subject to several limitations [Reg. §1.512(A)-1(f)(2)(ii)]:

- Readership costs are deductible in computing UBIT only to the extent these costs exceed the circulation income derived from the production and distribution of the periodical.
- Readership costs cannot be used to the extent the deduction of such items would result in a loss, a loss carryover, or a loss carryback with respect to the unrelated advertising activity.
- Readership costs cannot be taken into account in computing UBIT attributable to any unrelated business activity other than the advertising activity.

If the circulation income equals or exceeds readership costs, the readership costs cannot be used in the determination of UBIT from advertising. The UBIT attributable to the advertising business is then the excess for the gross advertising income over the direct advertising costs. Alternatively, if readership costs exceed the circulation income, UBIT attributable to the periodical is the excess of the total income of the periodical over the periodical cost.

Direct Advertising Costs Greater Than Gross Advertising Income. If the direct advertising costs of the exempt organization's periodical exceeds the gross advertising income, Reg. §1.512(A)-1(f)(2)(i) allows the excess advertising cost to be used in determining UBIT, but one limitation must be noted—the losses from the sale of advertising can be used only if the organization is involved in the advertising on a regular and continual basis and the activity is engaged in with a determination to make a profit.

Accordingly, if the circulation income to be reported from the periodical equals or exceeds its readership cost, the UBIT attributable to the periodical is the excess of the gross advertising income of the periodical over its direct costs. A problem can arise when readership costs of the periodical exceed circulation income. The UBIT is the excess, if any, of the total income attributable to the periodical over the total periodical cost [Reg. §1.512(A)-1(f)(2)(ii)(b)].

Consolidation

If an organization publishes more than one periodical with unrelated business income, the Code provides that the organization can effectively combine all income and deductions from the periodicals on a consolidated basis as if such periodicals were combined in determining the amount of the UBIT derived from the sale of advertising. Once an organization has adopted consolidated treatment for multiple periodicals, that treatment must be applied consistently and is binding without IRS consent [Reg. §1.512(A)-1(f)(7)(i)].

Example 4-6:

- X, an exempt trade, publishes a single periodical, which carries advertising.
- During 1995, X realizes a total of \$40,000 from the sale of advertising in the periodical (gross advertising income) and \$60,000 from the sale of the periodical to members and nonmembers (circulation income).
- Total periodical costs are \$90,000, of which \$50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and \$40,000 is attributable to the production and distribution of the readership content (readership costs).
- Because the direct costs of the periodical (\$50,000) exceed gross advertising income (\$40,000), the UBIT attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:

Gross Advertising Revenue	\$ 40,000
Direct Advertising	<u>(50,000)</u>
Loss Attributable to Advertising	<u><u>\$(10,000)</u></u>

X has realized a loss of \$10,000 from its advertising activity.

Discussion:

- The loss is an allowable deduction in computing X's UBIT derived from any other unrelated or business activity.

Example 4-7:

- Assume the same facts as in Example 4-6, except that the circulation income of X's periodical is \$100,000 instead of \$60,000 and, of the total periodical costs, \$25,000 is direct advertising costs and \$65,000 is readership costs.

Discussion:

- Because the circulation income (\$100,000) exceeds the total readership costs (\$65,000), the UBIT attributable to the advertising activity is \$15,000, the excess of gross advertising income \$40,000, over direct advertising costs of \$25,000.

Example 4-8:

- Assume the same facts as in Example 4-6, except that of the total periodical costs, \$20,000 is direct advertising costs and \$70,000 is readership costs.

Discussion:

- Because the readership costs of the periodical (\$70,000) exceed the circulation income (\$60,000), the UBIT attributable to advertising is the excess of the total income attributable to the periodical over the total periodical costs.
- Thus, X has UBIT attributable to the advertising activity of \$10,000 (\$100,000 total income attributable to the periodical less \$90,000 total periodical costs).

Regarding the consolidation of publications, a periodical is only considered to be published for the production of income if the following conditions are met:

- Organization generally receives gross advertising income from the periodical equal to at least 20% of the readership costs of the periodical.
- Publication of the periodicals is an activity engaged in for profit.

OTHER TYPES OF EXEMPT ORGANIZATIONS

TABLE OF CONTENTS

INTRODUCTION 135

OTHER TYPES OF ORGANIZATIONAL ENTITIES 135

 TITLE HOLDING COMPANIES—§§501(c)(2) AND 501(c)(25) 135

 Section 501(c)(2) Organizations 135

 Section 501(c)(25) Companies 136

 CIVIC LEAGUES OPERATED FOR SOCIAL WELFARE AND

 LOCAL EMPLOYEES’ ORGANIZATIONS—§501(C)(4) 136

 LABOR ORGANIZATIONS—§501(C)(5) 137

 CASES AND RULINGS 137

 ASSOCIATIONS AND BUSINESS LEAGUES—§501(C)(6) 138

 Trade Association 139

 SOCIAL AND RECREATIONS CLUBS—§501(c)(7) 139

 Community Service 140

 Established Membership 140

 General Public Income 141

 Inurement 142

 Sales of Property 142

 FRATERNAL BENEFICIARY SOCIETIES—§501(C)(8) 143

 VOLUNTARY EMPLOYEES’ BENEFICIARY ASSOCIATIONS (VEBAS)—§501(c)(9)..... 144

 Benefits 145

 Membership..... 145

 Controversy Over Geographic Requirements 146

DOMESTIC FRATERNAL SOCIETIES—§501(C)(10)	148
POLITICAL ORGANIZATIONS (§527).....	149

OTHER TYPES OF EXEMPT ORGANIZATIONS

INTRODUCTION

This book's focus is mainly on charitable organizations. Although these charities are the most prolific in terms of actual numbers and come to mind most quickly when considering the concept of a nonprofit organization, a number of other types of organizations also have been granted tax-exempt status.

These “other” organizations have been granted exemption for many reasons, including public policy. Chief among the justifications for exemption for these other entities is the “inherent tax theory”; that is, individuals (and businesses) who band together to accomplish a purpose should not be subject to any different scheme of taxation than if they had acted on their own.

This reasoning is largely reflected in exemption for the various membership organizations. Often the rationale for exemption can be explained only by the legislation that created the exemption. This can be seen in the exemptions provided for the employee benefit-type exemptions. Literally, it would not have accomplished the purpose of providing the specific benefit had the vehicle created to accomplish the purpose been subject to taxation. Some of the more significant “other” organizations are discussed below.

OTHER TYPES OF ORGANIZATIONAL ENTITIES

TITLE HOLDING COMPANIES—§§501(C)(2) AND 501(C)(25)

Section 501(c)(2) Organizations

Title holding companies as described in §501(c)(2) must be organized as corporations for the exclusive purpose of holding title to property, collecting income from that property, and turning over the entire amount collected, less expenses, to an organization that itself is exempt under §501(a).

OTHER TYPES OF EXEMPT ORGANIZATIONS

Title holding companies are prohibited from accumulating income. Retention of income that is required to be used for the tax-exempt organization's benefit will violate this restriction. A title holding company is allowed to maintain reasonable reserves for expected expenses and depreciation and may retain part of its income to apply to indebtedness on property to which it holds title. The income retained is treated as if it had been distributed to the tax-exempt organization, which in turn contributed this income to the capital of the title holding company to apply to the indebtedness.

Section 501(c)(25) Companies

Title holding companies under §501(c)(25) are exempt if they are organized for the exclusive purpose of acquiring real property and holding title to it, collecting income from it, and remitting the entire amount of that income, less expenses, to one or more organizations described in §501(c)(25)(C), which are shareholders of such corporation or beneficiaries of such trust, have no more than 35 shareholders, and have only one class of stock.

As indicated by the above definition, these title companies are relieved of many of the burdens imposed on §501(c)(2) organizations. These title holding companies are permitted to be organized as corporations or trusts, and they may have as many as thirty-five shareholders, all of which must be exempt as described below. Section 501(c)(2) title holding companies are restricted to distributing their net income to organizations exempt under §501(a). Pooled real estate investment funds eligible shareholders are:

- Qualified pension, profit-sharing, or stock bonus plans meeting the requirements of §401(a);
- Governmental plans described in §414(d);
- U.S., any state or political subdivision of the U.S., or any agency or instrumentality of the foregoing; or
- Any organization described in §501(c)(3).

CIVIC LEAGUES OPERATED FOR SOCIAL WELFARE AND LOCAL EMPLOYEES' ORGANIZATIONS—§501(c)(4)

Civic leagues or organizations not organized for profit are exempt from taxation if:

- They operate exclusively for the promotion of social welfare;
- No part of the net earnings inures to the benefit of any private shareholder or individual; and
- No substantial part of the organization's activities consists of providing commercial-type insurance.

To operate exclusively for the promotion of social welfare, an organization must primarily engage in promoting the common good and general welfare of the people of the community or be operated primarily for the purpose of bringing about civic betterments. The activities of the organization must be for the welfare of the community rather than for the benefit of certain individuals. An organization that restricts the use of its facilities to employees of selected corporations and their guests is primarily benefiting a private group rather than the community and, therefore, does not qualify for exemption as a social welfare organization.

Organizations that benefit only their members, rather than all residents of a particular geographic area, do not qualify for exempt status. For example, an organization formed to represent just member-tenants of an apartment complex does not qualify for exemption, whereas an organization formed to promote the legal rights of all tenants in a particular community may qualify as a social welfare organization. A “community” is defined as a geographic area recognizable as a governmental unit, subdivision, or district.

LABOR ORGANIZATIONS—§501(c)(5)

Labor organizations are exempt if no part of their income inures to the benefit of any member and if the organization’s objectives are to improve the conditions of those engaged in labor pursuits, to improve the grade of their products, and to develop a higher degree of efficiency in their respective occupations.

Typically, a labor union is an association of workers, usually in the form of a union, council, or committee that is organized to protect and promote the interests of labor in connection with employment. The members of a labor union must primarily be employees. Consequently, an organization that consists primarily of entrepreneurs and self-employed individuals will not qualify for exemption, although some self-employed individuals may be part of an exempt labor organization.

The requirement that the organization’s objectives be to improve conditions, products, or efficiency is mandatory. A group composed of workers will not qualify for exemption on the basis of its composition alone. For example, an organization that was formed to provide strike benefits to members, funded by the members, and controlled by individuals in their private capacity did not qualify for exemption [Rev. Rul. 76-420 (1976-2 CB 153)].

Appropriate activities of a labor union include acting as a collective bargaining agent, processing member grievances, sponsoring training seminars, promoting working conditions, conducting apprenticeship programs, and negotiating the terms of retirement plans and other post-retirement benefits.

CASES AND RULINGS

The Second Circuit Court has held that a trust organized to manage pension plan funds under a collective bargaining agreement between a union and multiple employers qualifies as an exempt

OTHER TYPES OF EXEMPT ORGANIZATIONS

labor organization because the union jointly established and administered the trust and half the members of the plan's board were employees. The plan was similar to a union and, thus, qualified for exemption. The Court also held that the IRS failed to prove that the payment of retirement benefits is not an appropriate activity for a labor union [*Morganbesser, Marvin v. United States* (1993, CA2)].

The IRS has nonacquiesced the decision in *Morganbesser* and has revoked a General Counsel's Memorandum (GCM 39889 revoked GCM 35862) relied on in that decision by the Court. The IRS subsequently issued Temporary Regulations [Prop. Reg. §1.501(c)(5)-1] specifying that such a trust would not qualify as an exempt labor organization. Thus, an organization whose primary activity is the managing of pension or other benefit plans will not be recognized as exempt, though the providing of such benefits will not preclude an otherwise qualifying organization from gaining exemption.

ASSOCIATIONS AND BUSINESS LEAGUES—§501(c)(6)

Business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players) are exempt from taxation if they are not organized for profit and if 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 association's primary purpose must be to promote that interest and not to engage in a regular business carried on for profit. A business league is an organization of the same general class as a chamber of commerce or a board of trade. A chamber of commerce is usually composed of the merchants and traders of a city; a board of trade often consists of persons engaged in similar lines of business. A real estate board consists of members interested in improving the business conditions in the real estate field.

The activities of a business league must be devoted to the improvement of business conditions of one or more lines of business in furtherance of its primary purpose to promote the common business interest, as opposed to the performance of services for individual persons. A line of business means an entire industry or all components of an industry within a geographic area. Tax exemption as a business league "is not available to aid one group in competition with another within an industry" [*National Muffler Dealers Association, Inc., v. U. S.*, 440 U.S. 472, 477-479 (1979)].

The National Muffler Dealers Association represented only franchisees of Midas International Corporation. Thus, an association that represents a particular brand or franchise does not qualify for tax-exempt status under §501(c)(6). Activities promoting the common interest include promoting fairness, honesty, improved business standards and methods, fair bidding practices, and uniform business practices; advocating the "open-shop" principle in a specific industry; and influencing legislation related to members' common business interests.

Professional organizations typically qualify for exemption as business leagues. These organizations have multiple purposes, including promoting the common business interests of their profession through promotion of goodwill among members, legislative advocacy, common standards, public relations efforts, etc. Many such organizations perform functions, such as charitable or educational activities, that would otherwise qualify for exemption under §501(c)(3) but fail to qualify for exemption as such because their activities are not exclusively charitable or educational.

Trade Association

The most prevalent type of business league is the trade association. Typically, members of a particular industry band together to promote their common interests in regard to standardization, legislative activities, public relations, etc. Organizations whose principal purpose is to serve their members, rather than promote the common business interest, will not be considered tax-exempt. For example, a trade association whose principal purpose was to promote its members' products was denied exemption (Rev. Rul. 70-80, 1970-1 CB 130), but a trade association that promoted the industry as a whole was recognized as exempt (Rev. Rul. 55-444, 1955-2 CB 258).

Though organized as nonprofit entities, organizations exempt under §501(c)(6) are allowed to engage in activities carried on for profit, as long as the purpose for tax-exempt status (promoting common business interests) remains the principal activity of the organization. As discussed in Chapter 4, these activities are subject to UBIT.

Although many tax-exempt organizations are limited or even prohibited from engaging in political activity, business leagues are allowed to promote the common business interest by influencing legislation (lobbying). In fact, lobbying is one of the criteria for satisfying the requirement to promote the common business interest. The cost of these activities is subject to special treatment. A discussion of lobby tax rules is outside the scope of this book, but, in general, the organization must either pay an excise tax on lobbying expenditures or notify their members of the portion of their dues that are nondeductible because they were spent on lobbying.

SOCIAL AND RECREATION CLUBS—§501(c)(7)

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, are exempt from taxation subject to the restrictions and limitations discussed below.

The following are examples of clubs that have qualified for tax-exempt status:

- College alumni associations [may also qualify under §501(c)(3) if requirements are otherwise met];

OTHER TYPES OF EXEMPT ORGANIZATIONS

- College fraternities [these are not fraternal organizations as defined by §501(c)(8) and (10), discussed later in this chapter];
- Country clubs;
- Amateur hunting, fishing, tennis, swimming, and other sport clubs;
- Dinner clubs that provide a meeting place, library, and dining room for members;
- Hobby clubs;
- Garden and variety clubs; and
- Organizations promoting closer ties among members of a family.

Community Service

The rationale for the tax-exempt status of most tax-exempt organizations is based on the concept of community service or public policy. Social and recreational clubs are granted exemption based on the concept of inherent tax theory. That is, merely changing the method by which money is expended should not change the way in which it is taxed. As membership organizations, social and recreational clubs merely collect money from their members and, as a convenience, spend it on their behalf. Had the members spent the money directly, they would have incurred no tax and, thus, should not incur tax to attain this convenience. The Treasury justified this rationale in this way:

The tax exemption for social clubs is designed to allow individuals to join together to provide recreational or social facilities on a mutual basis, without further tax consequence....[Where] the sources of income of the organization are limited to receipts from the membership...the individual is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening separate organization [Treasury, *Tax Reform Studies and Proposals* (Comm. Print), 91st Cong., 1st Sess. (1969) at 317].

In accordance with this rationale, social and recreational clubs are subject to UBIT on investment income and on nonmember use of the facilities.

Established Membership

A club must have an established membership of individuals, personal contacts, and fellowship cooperating in an effort to reach a common objective. Artificial entities are not able to fulfill this requirement. Thus, individuals *must* be part of any club, but artificial entities *can* also be members. In one instance, a club issued corporate memberships, in which the corporation designated which

officers and employees could use the club. This arrangement was designated nonmember use of the club, and the income derived from it was subject to the rules and limitations regarding nonmember income (Rev. Rul. 74-489, 1974-2 CB 169). In another instance, a club admitted corporate-sponsored memberships in which the individuals were subject to the same admittance requirements as all members. In this case, the usage of the club by corporate-sponsored members was deemed member usage (Rev. Rul. 74-168, 1974-1 CB 139).

A social club must be organized for pleasure, recreation, and other similar nonprofitable purposes. Thus, when the primary purpose is for business or other nonsocial activities, exemption will be denied. An actual commingling of members is required for the club to qualify as a social club. Each and every member need not commingle as long as the requisite fellowship constitutes a material part of the membership.

Membership must be limited in some manner. If the facility is open to the general public, the club is not really a club at all and will not be recognized as exempt. Solicitation by advertisement or otherwise for public patronage is evidence that the club is engaging in business and being operated for pleasure, recreation or social purposes.

Clubs may allow limited usage of the club by the general public. An exempt organization under §501(c)(7) is allowed to receive up to 35% of its gross receipts, including investment income, from sources outside of its membership without losing its tax-exempt status. Of the 35%, not more than 15% of the gross receipts may be derived from the use of the club's facilities or services by the general public or from other activities not furthering social or recreational purposes for members.

These are safe-harbor percentages; for clubs whose percentages are higher than these, determination of exempt status will be made on the facts and circumstances. Initiation fees and capital contributions as well as unusual amounts of income, such as gain from the one-time sale of property, are not included in the percentages. The allowance of the 15% and 35% amounts does allow for any income from the conduct of an active trade or business not traditionally carried on by clubs.

If an organization fails to maintain exempt status, §277 ensures the club will pay taxes on nonmember income while disallowing losses from member activities. Thus, §277 prevents a taxable club from claiming overall losses from operations.

General Public Income

In determining the tax-exempt status (as well as UBIT) of a social club, income derived from the general public is the critical factor, as indicated above. Income from the general public does not include income from the use of facilities by guests of members. This exception is not unlimited. The rules for determining which nonmembers are considered guests of the members are as follows:

OTHER TYPES OF EXEMPT ORGANIZATIONS

- When a group of eight or fewer individuals, at least one of whom is a member, uses club facilities, it will be assumed for audit purposes that the nonmembers are the guests of the member, provided that payment for such use is received by the club directly from the member or the member's employer.
- When 75% or more of a group using club facilities are members, it will, likewise, be assumed for audit purposes that the nonmembers in the group are guests of members, provided payment for such use is received by the club directly from one or more of the members or the member's employer.
- Solely for purposes of these two scenarios, payment by a member's employer will be assumed to be for a use that serves a direct business objective of the employee-member.
- In all other situations, a host-guest relationship will not be assumed but must be substantiated.

Recordkeeping requirements to establish status of nonmembers are as follows. To substantiate the assumptions above, the club must maintain adequate records establishing: (1) the number of people in the group, (2) the percentage who are members, and (3) that payment was received by the club directly from members or their employers. When payment is made directly to the club by the member, the club is under no obligation to inquire about reimbursement. With respect to all other occasions involving use by nonmembers, the club must maintain books and records of each use and the amount derived from the use. This requirement applies even though the member pays initially for the use.

Inurement

No net earnings of a social club may inure to the benefit of any private shareholder. This restriction does not prevent net earnings from inuring to the members in the form of increased services without an increase in dues or an increase in assets distributable to members upon dissolution. This test is not violated when a social club redeems a member's stock at the book value of the shares at the time of redemption and the shareholder realizes a gain on the redemption.

Payment to a member for each member who brings in a new member is not a violation causing loss of exemption if the amount is reasonable compensation for a necessary administrative service. Small amounts of private inurement can cause loss of tax exemption. A motorcycle club lost its exempt status when food was provided to members out of the profits from the sale of tickets, goods, and services to the general public during club-sponsored events. Private inurement will occur if a variable dues structure is in place and all members have the same rights and privileges.

Sales of Property

Incidental sales of property will not cause loss of exemption even if the profits are large. The purpose of the transaction controls whether the sale is incidental. If the sale is for the purpose of a

profit, the sale becomes taxable, but the sale will not cause loss of exemption if the income is nonrecurrent and the sale is incidental to the general purpose of the club. All the facts and circumstances of a sale are considered in determining the club's primary purpose in making the sale, including:

- Purpose of the club in purchasing the property,
- Use the club makes of the property,
- Reasons for the sale, and
- Method used in making the sale.

An example of a sale that did not affect a club's exempt status is cited in the Revenue Rulings. A golf club owned land on which taxes and maintenance had increased. The facilities were also antiquated. The club, therefore, sold the property at a profit and used the proceeds to build a new golf club. The primary purpose of the sale wasn't to make a profit but to decrease expenses and improve facilities (Rev. Rul. 69-232, 1969-1 CB 154).

Another club lost its exemption through the purchase and sale of property. A club needed a site for a golf course and other facilities but had to buy a larger tract than it needed because the owner refused to sell less than the entire parcel. After the course and facilities were built, excess land remained and, although the club could have sold the property in a single unit, it subdivided the land into building lots, made improvements, and sold the lots at a profit. Since the only purpose in subdividing was to increase the profit on the sale of the land, the sale wasn't incidental, and the club lost its exempt status.

A sale upon dissolution will not cause an organization to lose its exempt status. A social club will not qualify for tax-exempt status for any taxable year if, at any time during that taxable year, its charter, bylaws, or other governing instrument, or any written policy statement contains a provision that provides for discrimination against any person on the basis of race, color, or religion. This ruling does not include an auxiliary of a fraternal beneficiary society, if such society is an exempt organization described in §501(c)(8), which limits its membership to the members of a particular religion, or a club, which in good faith limits its membership to the members of a particular religion in order to further the teachings or principles of that religion, and if the purpose of either the fraternal beneficiary society or the club is not to exclude individuals of a particular race or color.

FRATERNAL BENEFICIARY SOCIETIES—§501(c)(8)

Fraternal beneficiary societies are exempt from taxation if they operate under the lodge system and provide for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents. An organization that provides these benefits to an organization operating under the lodge system also qualifies.

OTHER TYPES OF EXEMPT ORGANIZATIONS

It is important to understand what a “fraternal beneficiary society” is to determine whether an organization qualifies for exemption. In *National Union v. Marlow* [74 F. 775, 778 (8th Cir. 1896)], the U.S. Court of Appeals for the Eighth Circuit provided the following, which stands today as the preeminent definition of “fraternal beneficiary society”:

A fraternal beneficial society would be one whose members have adopted the same, or a very similar calling, avocation, or profession or who are working in union to accomplish some worthy object, and who for that reason have banded themselves together as an association or society to aid and assist one another, and to promote the common cause. The term “fraternal” can properly be applied to such an association, for the reason that the pursuit of a common object, calling, or profession usually has a tendency to create a brotherly feeling among those who are thus engaged....Many of these associations make a practice of assisting their sick and disabled members, and of extending substantial aid to the families of deceased members. Their work is at the same time of a beneficial and fraternal character, because they aim to improve the condition of a class of persons who are engaged in a common pursuit, and to unite them by a stronger bond of sympathy and interest.

To qualify for exemption, it is imperative that both the condition of providing for the payment of life, sick, accident, or other benefits and operation under the lodge system be met; mere provision for these features in the organization documents is not sufficient. The organization must actually provide the benefits. A fraternal beneficiary society operating under the lodge system that arranged for optional insurance to be provided to its members through an insurance company did not qualify for exemption (Rev. Rul. 76-457, 1976-2 CB 155).

The fraternal beneficiary society must also operate under the lodge system. Reg. §1.501(c)(8)-1 defines operating under the lodge system as carrying on activities under a form of organization that comprises local branches (called “lodges, “ “chapters, “ or the like), which, though chartered by a parent organization, are largely self-governing. Although both features must be present, neither needs to predominate (Rev. Rul. 73-165, 1973-1 CB 224).

Although required to provide life, sick, accident, or other benefits to members and dependents, fraternal beneficiary societies are not precluded from other activities provided they are incidental to the organization’s exempt purpose. A fraternal society operating an insurance operation in all 50 states for its members did not lose its exemption for participating in a reinsurance pool to protect itself from excess losses (Rev. Rul. 78-87, 1978-1 CB 160). Even farther afield, a fraternal society that provided a cash bar and catering services to the general public remained exempt because the activities were not a substantial portion of the society’s activities.

VOLUNTARY EMPLOYEES’ BENEFICIARY ASSOCIATIONS (VEBAs) — §501(c)(9)

VEBAs are exempt from taxation if they provide for the payment of life, sick, accident, or other benefits to the members, or their dependents or designated beneficiaries, if none of the net

earnings inure to any private shareholder or individual, other than through the payment of such benefits. Substantially all of the activity of the association must be to provide such benefits.

Benefits

A VEBA may provide life, sick, accident, or other benefits to its members. “Other benefits” means benefits similar to life, sick, and accident benefits. The courts have held that the provision of medical malpractice insurance (*Anesthesia Service Medical Group, Inc., Employee Protective Trust v. Commissioner*, 85 T.C. 1031), retirement benefits [*Canton Police Benevolent Association of Canton, Ohio v. United States*, 61 AFTR 2d 88-1065, 844 F2d 1231, 88-1 USTC ¶ 9285 (CA6, 4/19/88)], and severance pay [*Lima Surgical Associates, Inc., Voluntary Employees’ Beneficiary Association Plan Trust v. U.S.*, 68 AFTR 2d 91-5632 944 F2d 855, 91-2 USTC ¶ 50,473 (CA FedCir, 9/23/91)] are not permissible benefits.

Permissible benefits include term life insurance, group whole life insurance, accidental death and dismemberment insurance, medical and dental insurance, disability insurance, vacation pay, vacation facilities, recreational expenses, child care, job readjustment allowances, income maintenance payments in time of economic dislocation, temporary living expense loans and grants in time of disaster, supplemental unemployment compensation benefits, education or training benefits or courses for members, and personal legal services if made through a §501(c)(20) organization [§501(c)(20) expired in 1992; Reg. §1.501(c)(9)-3(b), (c), (d), and (e)].

Collectively bargained VEBAs may provide these additional benefits: educational or training benefits for dependents of members, personal legal service benefits [other than through a §501(c)(20)], and organization and workmen’s compensation benefits [Reg. §1.501(c)(9)-3(e)].

Membership

As an association, a VEBA must consist of more than one individual, and at least 90% of the total membership on one day each quarter of its taxable year must consist of employees. Thus, up to 10% of the membership can consist of members that are not employees, such as a sole-proprietor whose employees qualify for membership. VEBA members must have an “employment-related common bond.” This term generally refers to the employees of a company or affiliated companies or to employees who are related by membership in a union; but employees of one or more companies can share an “employment-related common bond” if the companies are engaged in the same line of work in the same geographic locale [Reg. §1.501(c)(9)-2(a)(1)].

Membership in a VEBA may be restricted by objective conditions or limitations reasonably related to employment, such as a limitation based on a reasonable classification of workers. Such criteria may not discriminate in favor of officers, shareholders, or highly compensated individuals. Permissible restrictions on membership include: (1) excluding employees covered by another employer-funded plan offering similar benefits; (2) excluding employees or limiting benefits

OTHER TYPES OF EXEMPT ORGANIZATIONS

subject to a collectively bargained plan; (3) requiring members to contribute to the cost of benefits, or allowing different, but comparable, benefits based on difference in contributions; (4) imposing reasonable health standards for eligibility for a particular benefit; and (5) establishing life or disability benefits as a uniform percentage of compensation of the covered individual.

Reg. §1.501(c)(9)-2(a)(2) and §505(b)(2) provide that an employer may exclude certain employees from consideration in applying the nondiscrimination rules as follows:

- Employees who have not completed three years of service,
- Employees who have not attained the age of 21,
- Seasonal employees or less than half-time employees,
- Employees not included in the plan who are included in a unit of employees covered by an agreement between the employee representative and one or more employers which the IRS finds to be a collective bargaining agreement if the class of benefits involved was the subject of good-faith bargaining between such employee representatives and such employer or employers, and
- Employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from source within the U.S.

Furthermore, the nondiscrimination rules of §505 will not apply to benefits provided by a VEBA that are subject to alternative discrimination rules provided by another Code section if the nondiscrimination rules of that section are met. For example, a VEBA may provide educational assistance as described in §127, and that assistance is not subject to the §505 nondiscrimination rules if the nondiscrimination rules contained in §127 are satisfied.

Controversy Over Geographic Requirements

The Seventh Circuit Court has rejected the IRS position by eliminating the requirement that companies be in the same geographic locale. The Court found that §501(c)(9) placed no such restrictions on VEBAs and noted that geography is not determinative of an employment-related bond [*Water Quality Association Employees' Benefit Corporation v. U.S.* (1986, CA7)].

The IRS responded with proposed regulations setting forth recognition of three contiguous states as a single geographic locale and allowing for recognition of a larger locale if:

- It would not be economically feasible to cover employees of employers engaged in that line of business in that area under two or more VEBAs, each extending over fewer states, and

- Either the states to be included are all contiguous or the employment characteristics in that line of business, population characteristics, or other regional factors support the inclusion of the particular states [Prop. Reg. §1.501(c)(9)-(2)(d)].

The proposed regulations provide the following examples illustrating their application.

Example 5-1:

- Association Y's members are employers whose business consists of shipping freight by barge on the Mississippi and Ohio Rivers.
 - Some of Y's members conduct their business out of ports in Louisiana, while others operate out of ports in Arkansas, Missouri, and Ohio.
- Y establishes Y Trust to provide life, sick, accident, and other benefits to the employees of its members. Y Trust applies for recognition of exemption as a VEBA, stating that it intends to permit employees of any of Y's members to join the VEBA.
- In its application, Y Trust sets forth facts tending to show:
 - That there are so few members of Y in each of the four states that any division of those states into two or more separate regions would result in creating VEBAs that would be too small to be economically feasible,
 - That all of Y's members are engaged in river shipping between inland and gulf ports that are united by the existence of a natural waterway, and
 - That the labor force engaged in providing transportation by river barge is distinct from that engaged in providing other means of transportation.

Result:

- Even though Ohio doesn't share a land or river border with any of the other three states, the IRS would have the discretion to recognize Y Trust as a VEBA based on its showing that the establishment of separate VEBAs would not be economically feasible and that the characteristics of the river shipping business justify permitting a VEBA to cover the scattered concentration of employees in that business located in the four states.

The IRS position regarding geographic locale imposes additional requirements on VEBAs not contemplated by §501(c)(9). Consequently, the IRS may have overstepped its bounds by changing the law rather than implementing the law.

Example 5-2:

- Association Z's members are employers whose business consists of the retail sale of agricultural implements in the states west of the Mississippi River except California, Alaska, and Hawaii. There are 21 states in the region covered by Z.
- Z establishes the Z1 Trust, the Z2 Trust, and the Z3 Trust to provide life, sick, accident or other benefits to the employees of its members.
 - The trusts cover different subregions, which were formed by dividing the Z region into three areas each consisting of seven contiguous states.
 - Each trust applies for recognition of exemption as a VEBA, stating that it intends to permit the employees of any employer that is a member of Z located within its subregion to join its proposed VEBA.
 - Each trust sets forth facts in its application tending to show that four states within its particular subregion would be needed to create a VEBA large enough to be economically feasible, so that any further division of its seven-state subregion would leave employees of at least some of Z's employer-members located in the subregion in an area too small to support an economically feasible VEBA.
 - The applications contain no justification for the choice of three seven-state subregions.

Result:

- The IRS would not have the discretion to recognize the Z1, Z2, and Z3 Trusts as tax-exempt VEBAs, since the applicants have not shown that it would not be economically feasible to divide the Z region into smaller subregions (e.g., four containing four states and one containing five states).

DOMESTIC FRATERNAL SOCIETIES—§501(c)(10)

Domestic fraternal societies are exempt from taxation if they operate under the lodge system; if their net earnings are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes; and if their net earnings do not provide for the payment of life, sick, accident, or other benefit.

Domestic fraternal societies are close cousins to the fraternal beneficiary societies of §501(c)(8). In fact, the major difference is that domestic fraternal societies do not provide life, sick, accident, or other benefits. The requirements for operating as a lodge are the same. In fact, both fraternal

and domestic societies are eligible to receive deductible charitable contributions (subject to the 30% Adjusted Gross Income limitation) pursuant to §170(c)(4). The contribution must be used exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals.

POLITICAL ORGANIZATIONS (§527)

A political organization is considered a tax-exempt organization and is subject to tax only on nonexempt income. Exempt income includes contributions, membership dues, proceeds from a political fund-raising or entertainment event, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of business, to the extent such amount is segregated for use only for the exempt function of the political organization.

Nonexempt income is taxed as though the political organization were a corporation. Amounts expended for the personal use of an individual are gross income to that person. Excess funds at the end of a campaign or election are treated as expended for the personal use of the individual in control of the funds. Amounts given to other political organizations, newsletter funds, tax-exempt charitable organizations, or the general fund of the Treasury or any state or local government are not considered as amounts expended for personal use.

Taxable income of a political organization is gross income (excluding exempt income) less deductions that are directly connected with producing that gross income. Though otherwise taxed at the highest corporate rate, a political organization is not allowed a deduction for dividends received, net operating losses, or other special corporate deductions, but it is allowed a \$100 specific deduction. Expenses that are directly connected with both the production of taxable income and exempt function income must be reasonably allocated between the two. No deduction is allowed for general administrative and other indirect expenses.

A “political organization” is defined as a party, committee, association, fund, or other organization organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures for the purpose of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individuals or electors are selected, nominated, elected, or appointed. A political organization must file Form 1120-POL annually if it has more than \$100 of taxable income.

THE USE OF JOINT VENTURES AND ALTERNATIVE STRUCTURES

TABLE OF CONTENTS

INTRODUCTION 153

GENERAL DESIGN OF PARTNERSHIPS AND JOINT VENTURES 153

LIMITED PARTNERSHIP/LIMITED LIABILITY COMPANY
VS. GENERAL PARTNER 154

 GENERAL PARTNER 155

EXEMPT ORGANIZATION AND ITS ROLE AS GENERAL PARTNER 156

 ADVERSE RULING 156

 COMMERCIAL VENTURE 157

THE IMPACT OF *PLUMSTEAD* 158

 PARTNERSHIPS IN GENERAL 159

 GCM 36,293 159

 EXEMPT PURPOSE 160

THE EXEMPT ORGANIZATION AND ITS ROLE AS A LIMITED PARTNER 160

 SERVING PUBLIC INTEREST 161

USE OF SUBSIDIARIES 162

CAPITALIZATION 163

PARENTAL ACTIVITIES 163

THE USE OF JOINT VENTURES AND ALTERNATIVE STRUCTURES

INTRODUCTION

For a variety of reasons, exempt organizations have participated in an increasing number of joint ventures with both exempt and taxable entities over the past several years. With an ever-increasing need for funding, exempt organizations are looking for ways to raise funds both from their charitable activities and from participation as a partner in profit-seeking ventures. They are increasing their entrepreneurial activities, in part, because of the decrease in government involvement in the nonprofit sector as well as a general decrease in the contribution base.

An exempt organization has a variety of techniques available when associating itself with another organization or company. Depending on whether the other organization is taxable or nontaxable, the exempt organization must assess the risk of such alternatives as serving as the general or limited partner or incorporating the activity and participating as a shareholder.

As recently as 1996, a major change came about to permit exempt organizations described in §501(c)(3) (“qualified tax-exempt shareholder”) to be shareholders in S corporations. For purposes of determining the number of shareholders of an S corporation, a qualified exempt shareholder will count as one shareholder.

S corporation income or loss will flow through to qualified tax-exempt shareholders as unrelated business income, without regard to the nature of the income. In addition, gain or loss on the sale or other disposition of stock in the S corporation will be treated as unrelated business income when sold by the exempt shareholder.

GENERAL DESIGN OF PARTNERSHIPS AND JOINT VENTURES

Section 7701(a)(2) defines a partnership to include a “syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is no...trust or estate or a corporation. “ For the most part, it is assumed that the parties have entered into a working arrangement for some type of financial benefit.

The concept of a joint venture is usually synonymous with a partnership. Some fine differences, however, should be noted. In *Whiteford v. U.S., et al.*, 61-1 USTC 9301, it is noted that a

partnership has been defined as a contract of two or more persons to place their money, effects, labor, and skill, or some or all of them, in lawful commerce or business, and to divide the profit and bear the loss in definite proportions.

Similarly, a joint venture has been defined as an association of two or more persons with intent to carry out a single business venture for joint profit, for which purpose they combine their efforts, property, money, skill, and knowledge, but they do so without creating a formal partnership or corporation. In this regard, two distinct differences between the entities are evident. First, the joint venture appears to have a much narrower focus than does the partnership, and, second, the partnership arrangement is normally considerably less formal.

LIMITED PARTNERSHIP/LIMITED LIABILITY COMPANY VS. GENERAL PARTNER

Although this is not a partnership course, some brief comments on partnership operations are in order because of their relevance to the relationship with exempt organizations. The following briefly covers the alternative structures within the framework of the partnership environment.

- *General Partnership—Conduit* through which various items of partnership income, gains, losses, deductions, and credits are passed to the respective partners. The impact of these items is felt at the partner level because the partnership serves as a pass-through entity that is in itself tax-exempt insofar as no taxes are paid at the partnership level.
 - The most notable disadvantage to conducting business through a general partnership is that it subjects all the general partners to joint and several liability for the debts of the partnership.
- *Limited partnership—Conduit* that provides investors protection normally offered through the corporate form. This form offers the same basic advantages of pass-through that the general partnership offers while limiting the liability for debts.
 - The potential for loss is limited to the partner's investment, guarantees, or any additional amount obligated under the terms of the partnership agreement.
- *Limited Liability Company (LLC)*—Considered a cross between a corporation and a limited partnership. All states have adopted some form of an LLC statute. For the most part, these acts mirror the state's corporate acts. The biggest advantage to the LLC is that all members have limited liability.
 - This arrangement is differentiated from the limited partnership where at least one member must be a general partner with unlimited liability. For tax purposes, the LLC resembles a partnership in its filing requirements.

An exempt organization, in its present text, can operate in conjunction with any of the three forms referred to above. Most arrangements, however, are conducted either through general partnerships or joint ventures as outlined above.

One strong word of caution must be noted for tax-exempt organizations that enter into either a partnership or joint venture agreement: the IRS is increasingly viewing joint ventures and partnership arrangements as methods of tax avoidance. The issue expands well beyond one of unrelated business income to one of potential loss of tax exemption.

GENERAL PARTNER

One common characteristic of all partnerships is the need for a general partner. Further, normally one or more limited partners assumes limited amounts of risk (see discussion below regarding GCM 39,005). This structure can place the exempt organization at risk if it is serving as the general partner because that general partnership can raise the question of the board's placing the organization's assets in jeopardy.

The IRS has taken the position for some time that when an exempt organization is a partner in a joint venture, it has to include its share of income in its unrelated business income. Income from the sale of an exempt organization's interest in a publicly traded partnership is unrelated business income. Both the courts and the IRS have rejected the argument that as a limited partner the exempt organization does not have the ability to enter actively into the management of the partnership, allowing for passive income.

In the Tax Court decision on *Service Bolt and Nut Company Profit-Sharing Trust*, 78 TC 812 (1982), aff'd 724 F.2d 519 (6th Cir. 1994), the Court noted that "While...a 'silent partner' is not necessarily the same thing as a 'limited partner,' we think...Congress intended to include exempt organizations' distributive shares of partnership income...regardless of whether, as partners, they behaved in an active or passive manner with regard to the management of the partnership's unrelated trades or businesses." In the text of the case, the Court used the following example:

If an exempt educational institution is a silent partner in a partnership which runs a barrel factory and such partnership also holds stock in a pottery manufacturing corporation, the exempt organization would include in its unrelated business income its share of the barrel factory income, but not its proportionate share of any dividends received by the partnership from the pottery corporation.

The IRS noted a formidable exception to the aforementioned rules, however. This exception applies to a partnership or joint venture whose activities are substantially related to the purpose of a limited partner. A private exempt university and a for-profit hospital entered into a partnership to build and operate an eighty-eight bed hospital. The university was in need of the facility as part of its medical school program. The IRS noted that the tax-exempt organization was a limited partner with the general partner bearing the risk of loss. As noted in PLR 8432014, the IRS

concluded that the joint venture did not endanger the exempt organization's tax status and that its income to the tax-exempt organization was substantially related and not taxable.

Normally, when a tax-exempt organization is the general partner in a taxable venture, the IRS takes the position that the organization is giving up its exemption by default. The single exception is when the joint venture furthers the organization's exemption purpose. An organization can lose its tax-exempt status if the charitable organization/general partner is not adequately insulated from the day-to-day management responsibility of the partnership and/or if the limited partners receive any form of private inurement.

EXEMPT ORGANIZATION AND ITS ROLE AS GENERAL PARTNER

Without a doubt, some areas of the study of exempt organizations lend themselves more to an analytical study of the relevant Code and Regulations, whereas other areas, because of their controversy, rely more heavily on a combination of case law, Revenue Rulings, General Council Memorandums, etc. The relationship between the status of general partner and that of a nonprofit organization is one such area that relies on these supplemental sources rather than the pure use of Code and Regulations. Obviously, case law relies on the Code and Regulations; however, it is more a question of interpretation than pure fact.

Historically, taking on the role of general partner in a limited partnership meant instant death for the charitable organization where there was either a sharing of profits or participation of private investors, but this inevitability changed as a result of *Plumstead Theatre Society, Inc., v. Commissioner*, 675 F.2d 244 (1982) (per curiam), aff'g 74 T.C. 1324 (1980).

Plumstead was a nonprofit corporation formed to promote and foster the performing arts, particularly the theater. During its formation, it proposed activities including the presentation of dramatic theater productions, the formation of a workshop for new American playwrights, and the establishment of a fund to assist new and established playwrights. As one of its projects, *Plumstead* co-produced with the Kennedy Center for the Performing Arts a play entitled *First Monday in October*. The IRS first took the position that *Plumstead* did not qualify for exemption as a charitable or educational organization under §501(c)(3). Secondly, the IRS questioned the nature of their working relationship with a limited partnership.

ADVERSE RULING

Concerning the first issue, the IRS issued a final adverse ruling denying *Plumstead* exempt status. The reason given by the IRS was:

You are not operated exclusively for charitable or educational purposes within the meaning of §501(c)(3). A substantial purpose of your organization is a commercial purpose which is not an exempt purpose. Additionally, part of your net earnings will

inure to the benefit of a private individual or shareholder. Furthermore, you are operated for private interest rather than public interest.

Included in the Article of Incorporation was the provision that *Plumstead* was not organized and could not be operated for “pecuniary” gain; that no part of its net earnings could inure to the benefit of any private member or individual; that upon dissolution, any remaining assets would be distributed to a nonprofit organization organized for the same purpose under §501(c)(3).

Plumstead planned to enter into a series of productions with joint-venture, nonprofit partners, one of these being the co-financing and co-production of *First Monday in October*. Before the play opened, *Plumstead* experienced financial difficulty raising its share of the production cost.

On advice from its financial advisors, *Plumstead* formed a limited partnership to fund the production. It served as general partner with two individuals and a for-profit corporation serving as limited partners. Under the partnership agreement, the limited partners were required to contribute \$100,000. For this investment, the limited partners received a 63½ % share in the profits or losses from the play. The play lost money at the point of its closure.

COMMERCIAL VENTURE

As noted above, the IRS denied *Plumstead* its exemption on the grounds that it did not conduct its affairs within the meaning of §501(c)(3). The IRS took the position that *Plumstead* was conducting its affairs in much the same manner as a commercial venture with the same investment and, as such, was operating for the benefit of private, rather than public, interest.

In support of the private rather than public interest, the IRS argued that because of the partnership *Plumstead* entered into with the two private individuals and the corporation, in which the limited partners provided capital in exchange for an interest in the profits and losses, *Plumstead* was operated for private rather than public interest. Fortunately, the Court did not agree with the IRS’s contention, and the Court’s decision left *Plumstead* qualified for tax-exempt status.

In reviewing the partnership agreement, the Court determined that the limited partners had no control over the way *Plumstead* operated or managed its affairs and did not overly serve a private interest over a public good. The Tax Court placed a heavy emphasis on the partnership agreement, which insulated the organization from the partnership and any potential conflict with *Plumstead’s* exempt purpose. The Court took the following into consideration when reviewing the partnership agreement:

- Sale of the interest was at arm’s length, for a reasonable price.
- Organization was under no obligation to repay the limited partners from its own funds.
- Limited partner lacked control.
- Partnership had no interest in future productions.

As an afternote, the case was appealed by the IRS. The Court of Appeals for the Ninth Circuit affirmed the Tax Court's holding.

THE IMPACT OF *PLUMSTEAD*

As a result of *Plumstead*, GCM 39,005 was issued to clarify the IRS position regarding an exempt organization serving as a general partner in limited partnerships. The result of this GCM was to define an analytical approach to be used by the IRS and taxpayers to determine if the organization's tax-exempt status was in jeopardy.

In GCM 39,005, it was determined that an exempt organization may qualify under §501(c)(3) notwithstanding its participation in a limited partnership as one of several general partners if the partnership arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted. In GCM 39,005, the IRS felt that both the federally imposed restrictions and the structure of the partnership agreement were sufficient to protect the nonprofit organization from any potential conflict between the partnership obligations as a general partner and its exempt purpose.

The issue in GCM 39,005 was whether a nonprofit organization that enters into a limited partnership as one of several general partners for the purpose of constructing, owning, and operating a federally assisted apartment complex for handicapped and elderly individuals of limited income may qualify as an organization described in §501(c)(3). In this case, a qualified tenant must be either handicapped or at least 62 years old and meet certain income limitations, ensuring that only moderate- or low-income persons will be eligible.

Included in the pertinent facts is that the contract with Housing and Urban Development (HUD) is for a term of five years, renewable by the partnership in five-year increments for a maximum period of twenty years. (The partnership indicated that it intended to renew the contract for the full twenty-year term.) The federally insured mortgage on the project, however, will be amortized over forty years. Thus, the housing assistance payments will cease prior to any substantial amortization of the principal amount of the mortgage. This fact is relevant because of the apparent exposure during most of the amortization period. Another fact, for the purpose of this discussion, is relevant to the nature of the project: programs with outside agencies such as Meals on Wheels and the Visiting Nurse Program were to be developed.

The most pertinent issue in this GCM, like most memorandums, rulings, cases, etc., evolves from the fact that §§501(a) and 501(c)(3) provide for the exemption from federal income tax of organizations organized and operated *exclusively* for charitable purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual. The only way an entity can meet these requirements is if they are organized and operated exclusively for any of the purposes specified in §501(c)(3) (i.e., charitable, religious, scientific, educational, etc.), and, as such, serve a public rather than a private interest.

PARTNERSHIPS IN GENERAL

The following, taken directly from the GCM, summarizes the government's position not only in this case but with its approach regarding partnerships in general.

The partnership arrangement, however, should be closely scrutinized to assure that the statutorily imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable goals. Thus, *in all partnership cases, the initial focus should be on whether the organization is serving a charitable purpose.* Once the charity has been established, the partnership arrangement itself should be examined to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of the limited partners.

In the case of GCM 39,005, the corporation's participation in the building and management of a government-financed housing project for the handicapped and elderly serves to further charitable purposes. As a direct result of the corporation's participation, 100% of the units will be held open to elderly or handicapped individuals with limited income. Additionally, the corporation will conduct numerous programs to meet the physical, social, and recreational needs of the participants, and those programs meet the requirement of relieving the human condition. In this case, the IRS determined that the project itself met all the necessary requisites for a charitable organization.

GCM 36,293

This ruling is in contrast to another GCM with many of the same facts but a different result. In GCM 36,293, the organization could not establish that its participation in the government-sponsored housing project would have actually served a recognizable §501(c)(3) purpose.

In analyzing the project, the IRS determined that a limited portion of the project was for the benefit of low-income persons. As such, the project could not be said to be relieving the poor or distressed. Additionally, the project was to be located in an affluent, predominantly white suburb consisting exclusively of single-family dwellings with no indication of decay or community tension. Therefore, the project could not have been characterized as charitable on the basis of combating community deterioration or relieving neighborhood tensions.

In regard to partnerships in general—notwithstanding an established charitable purpose, however—conflicts with charitable goals can nevertheless arise in a limited partnership situation because certain statutory obligations are imposed on a general partner. Included in these obligations is an assumption of all liabilities by the general partner and a basic profit orientation in the interest of the limited partners. Unless an exempt organization, acting as general partner, can insulate itself from these obligations, conflicts exist and will preclude exemption.

EXEMPT PURPOSE

GCM 39,005 produced a stringent set of guidelines to be followed by exempt organizations when writing a partnership agreement whereby the exempt organization is to serve as general partner. First and foremost, the partnership must have an exempt purpose and that exempt purpose cannot create a conflict of interest between the obligations of the general partner and the charitable purpose. In light of the GCM, the following should be considered in drafting a partnership agreement:

- The responsibilities of the exempt general partner should be as limited as practical and allowable by law.
- There should be at least one other general partner.
- The exempt organization has the right of first refusal if the property is offered for sale.
- Liability should be limited to the greatest extent possible for any exposure to debt.
- The agreement should be drafted stipulating that the exempt general partner have as little exposure as possible to the limited partners.
- Participation in the partnership *must* be based on some other reason besides a profit motive.

An additional important element that came from the GCM was the distinction made between profit motive and reasonable compensation. The IRS stated that “a reasonable percentage compensation agreement is not inconsistent with the pursuit of exempt purposes.” Compensation would be considered “reasonable” as long as payments were directly related to services rendered. Moreover, in the case of the housing project, all tenants were of limited means and the government guidelines restricted the profits from the project.

THE EXEMPT ORGANIZATION AND ITS ROLE AS A LIMITED PARTNER

In some circumstances, the IRS has a more liberal opinion regarding the exempt organization’s role in a limited partnership. In PLR 9207033, the IRS ruled that an exempt organization’s share of the gain under a timber-cutting contract would not be unrelated business income as long as the contract met all of the conditions of §512(b)(5) regarding capital gains treatment for disposition of investments.

In the ruling, a limited partnership invested in timber and timberland. The limited partnership was managed and operated exclusively by the general partner. The partnership intended to hold and manage the timberland and dispose of the timber under timber-cutting contracts. Under the contracts, the partnership would retain an economic interest in the timber with the intent that the

gain would be treated as gain from the sale of timber under §631 (b). One of the limited partners was an organization that had been created under §501(c)(3).

In Rev. Rul. 79-222, 1979-2 CB 236, the IRS noted that, in relevant part, for purposes of determining the applicability of the unrelated trade or business rules, the law did not distinguish between general and limited partnership interest. In fact, it falls back on a buildup of criteria, which is applicable to all exempt activity when determining unrelated business income.

Section 501(c)(3) provides for the exemption of organizations that are organized and operated exclusively for religious, charitable, educational, scientific, or literary purposes, *no part of the net earnings of which inures to the benefit of any private shareholder or individual*. Reg. §1. 501(c)(3)-1(a)(1) further provides that to be exempt as an organization described in §501(c)(3) an organization must be organized and operated exclusively for one or more of the purposes specified in the section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

SERVING PUBLIC INTEREST

The IRS has tried to rely on Reg. §1.501(c)(3)-1(d)(1)(ii) which states, in part, that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of the Regulations, an organization must establish that it is not organized or operated for the benefit of private interest such as designated individuals, the creator, the creator's family, shareholders of the organization, or persons controlled directly or indirectly by such private interests.

Establishing that it is not acting on behalf of private interests presumably would be very difficult for any exempt organization to do in regard to the partnership since, by its definition, it is providing an economic benefit to one or more partners. This is distinct from the issue of unrelated business income. Unrelated business income, in this case, is concerned with how the money is being earned not how it is used. For example, in Rev. Rul. 85-110, 1985-2 CB 166, it was determined in the ruling that the performance of diagnostic laboratory testing on referred specimens from private patients of hospital staff physicians, by a hospital exempt under §501(c)(3), is unrelated trade or business if such services are otherwise available in the community.

Analysis of PLR 9109066 gives insight into the IRS position regarding limited as well as general partnership arrangements:

- Both are structured to make clear that the partnership is set up so that the exempt organization continues to serve the charitable purpose of the organization.
- The exempt organization desired, by pooling resources, to provide better services to the public in the area served.

THE USE OF JOINT VENTURES AND ALTERNATIVE STRUCTURES

- There is no indication in the partnership that profits and losses will be allocated on a basis other than that of the capital contributions and risks assumed by the partners.
- The partnership agreement clearly does not generate private inurement or more than incidental private benefit to the nonexempt partners or to any individual.
- The benefits available to both limited and general partners, both qualitatively and quantitatively, are incidental to the public purposes served by the exempt organization.
- Participation in all cases is consistent with exempt purpose.

USE OF SUBSIDIARIES

Significant business- and tax-motivated reasons often lead exempt organizations to transact business through a subsidiary. Some of the more significant reasons might include the following:

- Exempt organization can use the subsidiary to protect either its assets or its name. Assets can be protected from business risks and liabilities incurred during the course of business if a separate corporate identity is used.
 - Additionally, the exempt organization may wish to create a barrier between the activity and the general public by hiding its identity.
- Financial markets may not always be available to an exempt organization. In those situations, the organization may need to form a subsidiary for financing arrangements.
- Medicare and Medicaid reimbursement planning may cause the tax-exempt healthcare provider to place nonreimbursable activities in a separate entity to maximize reimbursement to the parent.
- Separate accounting may be possible, depending on the ownership, management, and capital structures of the tax-exempt entity and the affiliate.

Other reasons may have more of an impact on tax than on general business implications:

- Separate entities are often used to protect the tax exemption of the parent. An organization will not be considered to be organized and operated for exempt purposes if its primary purpose is the conduct of a trade or business unrelated to its exempt purpose. By placing the trade or business in a subsidiary, the tax exemption of the parent may be better protected.
- More favorable tax treatment of unrelated business activities may be obtained by using a subsidiary corporation because it is possible to avoid restrictions on certain types of deductions. If an unrelated trade or business is conducted by the tax-exempt entity itself, it is permitted only deductions that are directly connected with the income.

- Thus, the overall loss of an exempt organization as a result of the conduct of its exempt purpose is not deductible against income generated by an unrelated trade or business. In a taxable corporation, separate activities may be netted either in a single corporate return or in a consolidated return.

CAPITALIZATION

No gain or loss is recognized on the transfer of property to a subsidiary if the transferor possesses 80% control of the transferee under §351. In this case, control becomes the key issue. Control is defined in §368 as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

A problem can arise when dealing with a controlled subsidiary. Under §512(b)(13), if a tax-exempt organization has 80% control of a subsidiary, then certain payments made to the tax-exempt organization will constitute unrelated business income. Such payments include interest, rents, royalties, and annuities, but not dividends. This provision is contrary to the modifications listed in §512(b) and catches many advisors off-guard.

If a tax-exempt organization owns less than a controlling interest in a taxable subsidiary, however, then payments of interest, annuities, royalties, and certain rents may be deductible by the subsidiary and not includable in unrelated business income by the parent tax-exempt organization. The problem is fairly easy to avoid if the exempt organization maintains the level of ownership of the interest at 79%. Maintaining this ownership level leaves the way open for some creative accounting to address the other 21%. Note that any discussion of dividends has been left out of the discussion. Dividends are not deductible on the one side so they can continue to be excluded on the other.

PARENTAL ACTIVITIES

To qualify for tax exemption, an organization must be owned and operated for an exempt purpose, as previously discussed. In general, a subsidiary's activities will not be attributed to its exempt parent in determining whether the parent is owned and operated for an exempt purpose where the subsidiary is formed for a bona fide business purpose and the parent has little day-to-day contact. This structure includes limiting contact between the parent and the subsidiary by virtue of maintaining a separate identity. Contact should be limited in the following areas:

- *Officers and Directors*—Common officers and directors should be avoided. Board representation may be used, but it should be kept to a minimum.

THE USE OF JOINT VENTURES AND ALTERNATIVE STRUCTURES

- *Employees*—When an affiliated organization shares employees with the parent, it may indicate that the two organizations are too closely associated. Rank-and-file employees are not as much an issue as key individuals.
- *Facilities*—In and of itself, facilities have traditionally not been an issue as long as floor space, rents, etc., are accounted for separately.

THE APPLICATION AND PRINCIPLES OF PRIVATE FOUNDATIONS

TABLE OF CONTENTS

INTRODUCTION	167
RULES	167
TAX IMPLICATION TO DONORS OF PRIVATE FOUNDATIONS	168
ORGANIZATIONS NOT CLASSIFIED AS PRIVATE FOUNDATIONS	168
TYPES OF PRIVATE FOUNDATIONS	169
PRIVATE OPERATING FOUNDATIONS.....	169
Income Test	170
Alternative Tests	173
Benefits of Private Operating Foundation Status	175
EXEMPT OPERATING FOUNDATIONS	176
PRIVATE NONOPERATING FOUNDATIONS DISTRIBUTING ALL CONTRIBUTIONS RECEIVED	176
PRIVATE FOUNDATIONS MAINTAINING A COMMON FUND	177
NONEXEMPT TRUSTS	177
TAXATION OF PRIVATE FOUNDATIONS	177
UBIT	177
EXCISE TAX ON NET INVESTMENT INCOME.....	178
EXCISE TAXES ON PROHIBITED ACTS	178
Disqualified Persons	179

Self-Dealing Tax	185
Tax on Failure to Distribute Income	186
Tax on Excess Business Holdings	188
Tax on Jeopardizing Investments	189
Program-Related Investments	191
Tax on Taxable Expenditures	191

THE APPLICATION AND PRINCIPLES OF PRIVATE FOUNDATIONS

INTRODUCTION

A private foundation is defined as a §501(c)(3) organization, other than an organization described in §509(a)(1), (2), (3), or (4). Since those sections describe organizations that are publicly supported, actively benefit publicly supported charities, or do not receive deductible contributions (public safety testing organizations), private foundations, by contrast, can be defined as all charities that are not public. In many respects, a “private foundation” can be looked at as either a pass-through or a go-between. A “private foundation” is a charitable organization—formed in much the same way as a “public charity”—and it receives contributions from sources such as individuals (normally a single family), corporations, other foundations and passes them on in the form of grants and other contributions to other charitable organizations. Although some foundations operate their own programs, they tend to be “public” in nature rather than “private” and are operated on a much larger scale than the typical family foundation.

From the very start, it is important to point out that not every foundation is private. In fact, many entities that call themselves foundations are, in fact, publicly supported organizations. Basically, the concept of “private” deals with the nature of the financial support rather than with the nature of its ability to control.

RULES

Even though private foundations are considered charitable and, as such, are generally exempt from tax, they are, like their publicly supported counterparts, subject to tax on UBIT. Also, Chapter 42 imposes a set of rules that are unique to foundations alone, including:

- Private foundations, with certain limited exceptions, are subject to an excise tax on net investment income (§4940).
- Private foundations are subject to two tiers of excise taxes on prohibited acts.

TAX IMPLICATION TO DONORS OF PRIVATE FOUNDATIONS

Although the taxes listed above constitute an important element of the difference between public charities and private foundations, income tax consequences to donors are equally important. Generally, donors to public charities are allowed to deduct cash contributions up to 50% of their adjusted gross income. Deductions for cash donations to private foundations, with certain exceptions noted below, are limited to 30% of the donor's adjusted gross income. Contributions of appreciated property to public charities are deductible at their fair market value. That same property donated to a private foundation is usually limited to cost basis (the Small Business Job Protection Act of 1996 provided a window from July 1, 1996 through May 31, 1997, during which time donors of appreciated stock to private foundations are allowed a deduction at fair market value).

ORGANIZATIONS NOT CLASSIFIED AS PRIVATE FOUNDATIONS

Based on a combination of current judicial interpretation and specific exclusion, the following types of organizations are excluded from the definition of private foundation under §509:

- Church or a convention or association of churches;
- School;
- Organization operated for the benefit of certain state and municipal colleges and universities;
- Hospital;
- Medical research organization (operated in conjunction with a hospital);
- Governmental unit;
- Publicly supported organization;
- Organization that normally receives no more than one-third of its support from gross investment income and income after tax from UBIT and receives more than one-third of its support from contributions, membership fees, and gross receipts from activities relating to its exempt function (subject to certain exceptions);
- Organization operated, supervised, or controlled by or in connection with one or more of the organizations described above but not controlled (directly or indirectly) by disqualified persons other than foundation managers;
- Organization operated solely for the benefit of one or more organizations that are exempt, including:

- Civic leagues or social welfare organizations;
 - Local associations of employees;
 - Labor, agricultural, or horticultural organizations; and
 - Business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues.
 - Exempt organization benefited, however, must meet the support tests and the organization operated to benefit such organization must meet the control tests and must not be controlled by disqualified persons other than foundation managers) or
- Organization organized and operated to test for public safety.

Any organization, including those listed above, described in §501(c)(3), regardless of when it was organized, will be presumed to be a private foundation unless it gives timely notice to the IRS that it is not a private foundation, and proves it meets one of the exceptions listed above. The only exceptions to this requirement apply to those organizations that are excepted from filing Form 1023. The following organizations do not have to file Form 1023:

- Churches, their integrated auxiliaries, and conventions or associations of churches (see Chapter 3), and
- Any organization that is not a private foundation and that has gross receipts in each taxable year of normally not more than \$5,000.

TYPES OF PRIVATE FOUNDATIONS

PRIVATE OPERATING FOUNDATIONS

Private operating foundations, defined in §4942(j)(3), are really a hybrid mixture. For the purposes of receiving charitable contributions, they are treated as a “public charity,” but for private foundation purposes, they are subject to a stringent set of restrictions found in the following sections:

- Termination of private foundation status (§504),
- Special rules with respect to §501(c)(3) organizations (§508),
- Taxes on self-dealing (§4941),
- Taxes on failure to distribute income (§4942),

- Taxes on excess business holding (§4943),
- Taxes on investments that jeopardize charitable purpose (§4944), and
- Taxes on taxable expenditures (§4945).

Private operating foundations differ from the typical private nonoperating foundation because they typically employ foundation assets in the conduct of a charitable purpose and not as a passthrough by making grants, etc. Organizations of this type often have difficulty meeting the public support requirements of §509(a)(2) and §170(b)(1)(A)(vi) (see Chapter 3), particularly if they have large endowments, because investment income is not categorized as public support. The advantage to private operating foundations is that they are not subject to the excise tax imposed on undistributed income of private foundations.

Although many foundations cannot meet the public charity requirements, they can often meet the requirements for private operating foundation status if they can meet specific requirements, which are generally under the founders' control. In general, a private operating foundation is any private foundation that meets the *income test* and, in addition, meets one of the following three tests (which are discussed later in this section): the assets test, the endowment test, or the support test.

Income Test

To qualify as an operating foundation, the organization must make qualifying distributions directly for the active conduct of its exempt activities equal to *substantially all* (at least 85%) of the lesser of its adjusted net income or its minimum investment return.

If a private foundation's qualifying distributions exceed its minimum investment return (defined below) for the tax year but are less than its adjusted net income, *substantially all* of the total qualified distributions must be made directly for the active conduct of the foundation's exempt activities. If, however, the foundation's minimum investment return is less than its adjusted net income and its qualified distributions equal or exceed the adjusted net income, only that part of the qualified distributions equal to substantially all of the foundation's adjusted net income must be made directly for the active conduct of the foundation's exempt activities.

“Substantially All”

The concept of “substantially all,” defined above as 85% or more, leaves a window of opportunity for other types of payouts. As such, if a foundation makes qualifying distributions directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount equal to at least 85% of its “adjusted net income,” it will be considered as having satisfied the income test *even if it makes grants to organizations or engages in other activities with the remainder (15%) of its adjusted net income.*

Example 7-1:

- N, an exempt museum described in §501(c)(3), was founded by the gift of an endowment from a single contribution.
 - N uses 90% of its adjusted net income to operate the museum.
- If N satisfies one of the tests set out above, it may be classified as an operating foundation since substantially all of the qualifying distributions made by N are used directly for the active conduct of its exempt purpose.

Qualifying Distributions

Another element of the income test, a “qualifying distribution,” is defined as the following:

- Any amount paid to accomplish religious, charitable, scientific, literary, or other public purposes is considered to be a qualifying distribution.
 - Qualifying distributions do not include, however, contributions to organizations controlled by the contributing foundation or by one or more disqualified persons with respect to the foundation or to private nonoperating foundations.
- Any amount paid to buy an asset used directly to carry out a charitable or other public purpose is considered to be a qualifying distribution, but depreciation is not classified as a qualifying distribution.
- Any qualifying amount set aside can be considered a qualifying distribution if, at the time of the set-aside, the foundation establishes to the satisfaction of the IRS that:
 - Amount will actually be paid for the specific project within sixty months from the date of the first set-aside, and
 - Set-aside satisfies the suitability test or the cash distribution test.

Suitability Test. The foundation must show that the specific project for which the amount is set aside is one that can be better accomplished by the set-aside than by the immediate payment of funds. For good cause shown, the period for paying the amount set aside may be extended by the IRS. To qualify under the suitability test, a set-aside must be approved by the IRS.

Cash Distribution Test. The foundation satisfies the cash distribution test if:

- Specific project for which the amount is set aside will not be completed before the end of the tax year in which the set-aside is made;

- Foundation actually distributes for exempt purposes, in cash or its equivalent, the start-up period minimum amount during the foundation's start-up period (*i.e., the first four tax years following the tax year in which the foundation was created*); and
- Foundation actually distributes the full-payment period minimum amount in each tax year of the foundation's full-payment period (*i.e., each tax year after the start-up period*).

Adjusted Net Income

Adjusted net income is the excess of gross income for the tax year (including gross income from any unrelated trade or business) determined with certain modifications over the total deduction (including deductions directly connected with carrying on any unrelated trade or business) that would be allowed a taxable corporation determined with certain modifications.

Gross income does not include gifts, grants, or contributions received by the private operating foundation but does include income from a functionally related business. Gross income and the total deductions allowable from that income will be figured as they are normally figured for income tax purposes except as otherwise provided. For figuring adjusted net income, no exclusions, deduction, or credits are taken unless provided under income and deduction modifications.

Interest income, but not principal payments, received after 1969 on loans made before 1970 is includable in gross income.

Income Modifications. To determine adjusted net income, certain modifications must be made to gross income. Generally, the organization must start with gross income, including three types of income: (1) amounts received or accrued as repayments of amounts taken into account as qualifying distributions for any tax year, (2) amounts received or accrued from the sale or other disposition of property (if the acquisition of the property was considered a qualifying distribution for any tax year), and (3) any amount set aside for a specific project (if the amount allocated was not necessary for the purposes for which it was set aside).

Gross income must then be modified to include interest on government obligations normally excluded under §103. Amounts *not* included in gross income are the excess of fair market value on the date of distribution over adjusted basis of property distributed to any of seven entities: (1) a state, (2) a U.S. possession, (3) any political subdivision of either of those two, (4) the U.S., (5) D.C., (6) a charitable trust, or (7) a corporation. (Distribution to all but the last two of these entities would be for public purposes.) Also *not* included in gross income is the income received from an estate during the administration period, unless the estate is considered terminated for income tax purposes because of a prolonged administration period.

Further income modifications are required to determine the capital gains and losses from the disposition of property. Only net short-term capital gains are included in gross income. Long-term capital gains and losses are not included. Neither are net §1231 gains included, but net §1231 losses may be included if the losses are otherwise deductible. Net short-term capital loss may not

be deducted for the year in which it occurs but can be carried back or forward. Capital gain dividends received from a regulated investment company are excluded from adjusted net income. For property held as of Dec. 31, 1969, the adjusted basis for determining gain or loss will be the greater of:

- Fair market value of the property on Dec. 31, 1969, plus or minus all adjustments to basis after 1969, using straight-line depreciation and cost depletion, or
- Adjusted basis as normally determined using straight-line depreciation or cost depletion.

Deduction Modifications. Deductions are generally limited to ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of income. These expenses include the part of a private foundation's operating expenses paid or incurred for the production or collection of gross income. Operating expenses include compensation of officers, other salaries and wages of employees, interest, rent, and taxes.

When only part of the property is income-producing or held for the production of income subject to the provisions of §4942 and the remainder is used for exempt purposes, the allowable deductions must be divided between exempt and nonexempt uses. If the expenses for property used for exempt purposes are more than the income received from the property, the excess may not be deducted. Allowances for straight-line depreciation and depletion (other than percentage depletion) are deductible. Deductions will be allowed for expenses and interest paid or incurred to carry tax-exempt obligations, but no deduction will be allowed for amounts not paid or incurred for purposes described earlier. For example, no deduction will be allowed for charitable contributions, net operating losses, or the special deduction for corporations.

Minimum Investment Return

The minimum investment return for any private foundation is 5% of the excess of the combined fair market value of all assets of the foundation, other than those used or held for use directly in the active conduct of its exempt purpose, over the amount of Code §514(c)(1) acquisition indebtedness associated with those assets.

Alternative Tests

Along with the income test discussed above, a private operating foundation has to meet one of the three alternative tests: the assets test, the endowment test, or the support test. Even though unquestionably all three tests can be used, more often than not if the income test is met, the Endowment test will be met as well.

Assets Test

A private foundation will meet the assets test if substantially more than half (65% or more) of its assets are used for the foundation's exempt purpose, that is, if 65% or more of the assets:

THE APPLICATION AND PRINCIPLES OF PRIVATE FOUNDATIONS

- Are devoted directly to the active conduct of its exempt activity or to a functionally related business or to a combination of the two;
- Consist of stock of a corporation that is controlled by the foundation (by ownership of at least 80% of the total voting power of all classes of stock entitled to vote and at least 80% of the total shares of all other classes of stock) and at least 85% of the assets of which are so devoted; or
- Are a combination of the two.

An asset is devoted directly to the foundation's exempt purpose only if it is used by the foundation in actually carrying on the function that gives the foundation its exempt status. Assets, including endowment funds, when held primarily for the production of income, for investment, or for some similar use are not devoted directly to the active conduct of the foundation's exempt function, even though income from the assets is used to pursue the foundation's exempt function.

There is a catch, however, in the determination of value referred to above. Under Reg. §53.4942(b)-2(a)(4) and §53.4942(a)-2(c)(4), valuation of assets must be made by some specific rules:

- For listed securities where a market quote is available, any reasonable method can be used as long as it is consistently applied.
- For cash, valuation is on a monthly basis by averaging the amount of cash on hand as of the first day of each month and as of the last day each month.
- For common trust funds, the value can be based on the average of the valuations reported during the year.
- For purposes of this section, assets must be valued annually except for real estate (including improvements), which must be valued every five years.
- For assets devoted to the organization, with no stated value, the original cost should be used unless proven otherwise.

Endowment Test

A foundation will meet the endowment test if it normally makes qualifying distributions directly for the active conduct of its exempt activities of at least two-thirds of its minimum investment return (3.5%).

Section §4942(j)(5) provides that any organization (1) that, on May 26, 1969, and at all times thereafter before the close of the taxable year, operated and maintained as its principal functional purpose facilities for the long-term care, comfort, maintenance, or education of permanently and

totally disabled persons, elderly persons, or children and (2) that meets the endowment test will qualify as a private operating foundation for purposes of the distribution requirements only.

Support Test

A private foundation will meet the support test if

- At least 85% of its support (other than gross investment income) is normally received from the general public and five or more unrelated exempt organizations;
- Not more than 25% of its support (other than gross investment income) is normally received from any one exempt organization; and
- Not more than 50% of its support is normally received from gross investment income.

For these purposes, support is defined in §509(d) to mean (but not limited to) gifts, grants, contributions, membership fees, performance of services, net income from unrelated activities, and gross investment income. If supported by exempt organizations, at least five organizations must contribute support for any of them to count. In the event of individual support, it can be counted only to the extent that it does not exceed 1% of total noninvestment support. (*Government support is considered public support but is not subject to the 1% referred to above.*)

Benefits of Private Operating Foundation Status

Private operating foundation status has five benefits.

First, private operating foundations may treat the payment of the tax on net investment income as a qualifying distribution made directly for the active conduct of activities constituting the foundation's exempt purpose.

Second, private operating foundations are not subject to the excise tax on failure to distribute income.

Third, contributions to private operating foundations are deductible by donors to the extent of 50% of the donor's adjusted gross income, as opposed to the 30% limit on contributions to most private foundations.

Fourth, one private operating foundation may receive qualifying distributions from another private foundation if the private foundation does not control the private operating foundation.

Fifth, a private operating foundation may qualify as an exempt private operating foundation, thus relieving the burden of taxation on its net investment income. (See "Exempt Operating Foundations" immediately below for qualification criteria.)

EXEMPT OPERATING FOUNDATIONS

Exempt operating foundations are not subject to taxation on net investment income. To qualify as an exempt operating foundation, a private foundation must meet all the following requirements:

- It must be a private operating foundation.
- It has to have been publicly supported for at least ten years.
- Its governing body, at all times during the tax year, must have consisted of individuals, fewer than 25% of whom are disqualified individuals, and the governing body must have been broadly representative of the general public.
- It must have no officer who is a disqualified individual at any time during the year.

The foundation must obtain a ruling letter from the IRS determining that it has met the four specific requirements of this special status. The request for a ruling letter must include supporting documents and materials that demonstrate that requirements listed above are met. These materials must include a list of all officers and members of its governing board and indicate any that are disqualified individuals.

PRIVATE NONOPERATING FOUNDATIONS DISTRIBUTING ALL CONTRIBUTIONS RECEIVED

Contributions to a private nonoperating foundation may qualify for the benefit of the 50% contribution deduction limit and donors may deduct the full value of appreciated property, if the private nonoperating foundation:

- Distributes an amount equal in value to 100% of all contributions received in the tax year by the fifteenth day of the third month after the close of its tax year,
- Has no remaining undistributed income for the year, and
- Distributes only qualifying distributions that are treated as distributions out of corpus.

Qualifying distributions cannot be made to an organization controlled directly or indirectly by the foundation or by one or more disqualified persons or to a private foundation that is not an operating foundation.

A taxpayer claiming a deduction for a charitable contribution to a private nonoperating foundation must obtain adequate records or other sufficient evidence from the foundation showing that the foundation made the required qualifying distributions in the time prescribed. Records or other

evidence must be attached to the taxpayer's return for the year the charitable contribution deduction is claimed.

PRIVATE FOUNDATIONS MAINTAINING A COMMON FUND

Donors to a private foundation that pools all contributions received in a common fund are also eligible for the 50% contribution deduction limit and may deduct the full value of appreciated property if the foundation meets certain requirements. The foundation must be described as a supporting organization of a public charity, except for the fact that any donor (or donor's spouse) who is a substantial contributor has the right to designate annually the public charities that are to receive the income from the donor's contribution to the fund and to direct the payment to public charities of the corpus in the common fund from the donor's contribution.

To qualify, the private foundation must be required by its governing instrument to distribute and must actually distribute (including administrative expenses):

- All of the adjusted net income of the common fund to one or more public charities by the fifteenth day of the third month after the close of the tax year in which the income is realized by the fund, and
- All the corpus from any donor's contribution to the fund to one or more public charities not later than one year after the donor's death or after the death of the donor's surviving spouse if the surviving spouse has the right to designate the recipients of the corpus.

A private foundation will not fail to qualify if a substantial contributor fails to designate the recipients of income or corpus as long as the income and corpus are distributed as required.

NONEXEMPT TRUSTS

Trusts that are not exempt from tax are generally subject to the same requirements and restrictions that apply to private foundations if the trust has any unexpired interests devoted to charitable purposes (§4797). This stipulation is designed to prevent a trust from being used to avoid the requirements and restrictions that apply to private foundations.

TAXATION OF PRIVATE FOUNDATIONS

UBIT

Private foundations are subject to the same rules as other charitable entities in regard to taxation of activities unrelated to the exempt purpose of the organization. (See Chapter 4.)

EXCISE TAX ON NET INVESTMENT INCOME

Section §4940 imposes an excise tax of 2% on the net investment income of most domestic tax-exempt private foundations, including private operating foundations, but these exceptions apply:

- An exempt operating foundation is not subject to the tax.
- The tax is reduced from 2% to 1% for any private foundation that meets two requirements.
 - First, the foundation must make qualifying distributions during the tax year at least equal to the sum of (1) the net fair market value of the foundation's non-charitable use assets for the tax year multiplied by the foundation's average percentage payout for the base period plus (2) 1% of the foundation's net investment income for the tax year.
 - The second distribution requirement is that the foundation was not liable for Chapter 42 excise taxes for any year of the base period.

This tax must be reported on Form 990-PF, "Return of Private Foundation." Payment of the tax is subject to estimated tax requirements and underpayment penalties are imposed when foundations fail to make timely quarterly payments. Nonexempt private foundations are also subject to this tax, but only to the extent that the sum of the 2% tax plus tax on unrelated business income, applied as if the foundation were tax-exempt, is greater than income tax liability for the year.

EXCISE TAXES ON PROHIBITED ACTS

The Code contains five provisions that impose two-tier excise taxes (initial tax and additional tax) on private foundations, foundation managers, or other disqualified persons (defined below) that engage in certain prohibited acts:

- Self-dealing (§4941),
- Failing to distribute income (§4942),
- Claiming excess business withholdings (§4943),
- Making jeopardizing investments (§4944), and
- Having taxable expenditures (§4945).

The initial tax is automatically imposed if the foundation engages in a prohibited act. For prohibited acts (except self-dealing) occurring after 1984, the initial tax may be abated if it is established that the prohibited act was due to reasonable cause and not to willful neglect and if the act was corrected within the correction period. If the prohibited act is not corrected by the end of

the taxable period, the additional tax is imposed. Generally, the taxable period ends on the earlier of the date a notice of deficiency for the initial tax is mailed or the date the initial tax is assessed.

If the prohibited act is corrected during the correction period, the additional tax will not be assessed. The correction period begins on the date the prohibited act occurs and ends ninety days after a notice of deficiency for the additional tax is mailed, extended by any period the IRS determines is reasonable and necessary to correct the prohibited act.

Disqualified Persons

Before proceeding with any discussion regarding prohibited transactions, an understanding of what constitutes a “disqualified person” is necessary because of that individual’s role in the transaction. The following is a list of disqualified persons pursuant to §4946.

Definition of a Disqualified Person

All Substantial Contributors to the Foundation. A substantial contributor includes any person who contributed or bequeathed a total amount of more than \$5,000 to the private foundation if the amount is more than 2% of the total contributions and bequests received by the foundation from its creation through the close of the tax year of the foundation in which the contribution or bequest is received from that person. For a trust, a substantial contributor includes the creator of the trust. In no case, however, does the term include a governmental unit.

In determining whether the total contributions and bequests from a person are more than 2% of the total contributions and bequests received by a private foundation, both the total of the amounts received by the foundation and the total of the amounts contributed and bequeathed by the person are determined as of the last day of each tax year. Although the determination is made on the last day of the foundation’s tax year, a donor is a substantial contributor as of the first day the foundation receives a gift large enough to make the donor a substantial contributor. Each contribution or bequest is valued at its fair market value on the date it is received by the foundation. Gifts by an individual include all contributions and bequests made by that individual and his or her spouse.

A determination must be made concerning whether a person is a substantial contributor as of the end of each of the foundation’s tax years, based on the respective totals of all contributions received and the total amount received from a particular person by that date. Status as a substantial contributor will date from the time the donor first met the \$5,000–2% test. Once a person is a substantial contributor to a private foundation, generally that person becomes a substantial contributor even though the individual might not be so classified if a determination were made at some later date.

A person ceases to be a substantial contributor as of the end of a private foundation’s tax year if:

THE APPLICATION AND PRINCIPLES OF PRIVATE FOUNDATIONS

- That person (and all related persons) have not made any contributions to the foundation during the 10-year period ending with that tax year,
- That person (or any related person) was not a foundation manager at any time during that 10-year period, and
- Total contributions made by that person (and related persons) are determined by the IRS to be insignificant compared to the total contributions to the foundation by one other person.
 - For purposes of this comparison, appreciation on contributions while held by the foundation is taken into account.

A substantial contributor does not include an entity that is described in §509(a)(1), (2), or (3) (public charities) or any organization wholly owned by such an entity. In addition, only for purposes of §4941 (excise taxes on self-dealing), a substantial contributor does not include any other organization described in §501(c)(3) [other than public safety testing organizations described in §509(a)(4)]. Entities excluded from the definition of substantial contributor are also excluded from the definition of disqualified person.

A Foundation Manager. A foundation manager is defined as an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees) or, for any act or failure to act, any employee of the foundation who has final authority or responsibility (either officially or effectively) for the act or failure to act.

A person who is specifically designated as an officer under the incorporation certificate, bylaws, or other documents of the foundation or who regularly exercises general authority to make administrative and policy decisions for a foundation is considered to be an officer of the foundation.

An Owner of More Than 20 Percent. An owner of more than 20% refers to someone who owns more than 20% of:

- Total combined voting power of a corporation,
- Profits interest of a partnership, or
- Beneficial interest of a trust or unincorporated enterprise, which is (during the ownership) a substantial contributor to the foundation.

A Member of the Family of Any of the Individuals Described Above. A member of the family includes a spouse, ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren. A brother or sister of an individual is not a member of the family for this purpose. A legally adopted child of an individual will be treated as a child by blood.

Other Disqualified Persons. Several other individuals and groups are defined as being disqualified:

- Corporation of which more than 35% of the total combined voting power is owned by persons describe above;
- Partnership of which more than 35% of the profits interest is owned by persons described above;
- Trust, estate, or unincorporated enterprise of which more than 35% of the beneficial interest is owned by persons described above; and
- For purposes of the tax on excess business holdings only, another private foundation which either:
 - Is effectively controlled, directly or indirectly, by the same person or persons who control the private foundation, or
 - Receives substantially all of its contributions, directly or indirectly, from the same persons described above, or members of their families, who made, directly or indirectly, substantially all the contributions to the private foundation, and
 - For purposes of the tax on self-dealing only, a government official.

Tax on Self-Dealing

Self-dealing is unique in that it is immaterial whether a transaction results in a benefit or a detriment. For other types of penalties, often a transaction is sanctioned based on benefit or, by contrast, penalties and interest are determined based on the loss of measurable benefits. In the case of the tax on self-dealing, however, a benefit is just as problematic as a detriment. Additionally, self-dealing cannot arise in a vacuum. For any determination of sanctions regarding self-dealing, there must be participation in the transaction between the private foundation and a disqualified person, and there must be an act of self-dealing between the parties.

It is not enough to classify a transaction as self-dealing, however, without also addressing the issue of whether it is direct or indirect. For purposes of §4941, the term “self-dealing” can mean either direct or indirect. Again, keep in mind that it does not matter whether the direct or indirect transaction produces either a benefit or detriment. Additionally, the concept discussed here does not include a transaction between a private foundation and a disqualified person where the disqualified person status arose only as a result of the transaction.

From a purely practical point of view, various business transactions do not fall within the meaning of “indirect self-dealing.” This term does not include any transaction between a “disqualified person” and an organization controlled by a private foundation if:

THE APPLICATION AND PRINCIPLES OF PRIVATE FOUNDATIONS

- Transaction results from a business relationship which was established before the transaction constituted an act of self-dealing;
- Transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated persons; and
- Either (1) the organization controlled by the foundation could have engaged in the transaction with someone other than the disqualified person at a severe economic hardship to the organization or (2) because of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else or could have done so only by incurring severe economic hardship.

The following example shows a practical application of these rules.

Example 7-2:

- Private foundation W owns the controlling interest of the voting stock of corporation X, a manufacturer of certain electronic computers.
- Corporation Y, a disqualified person with respect to W, owns the patent for, and manufactures, one of the essential component parts used in the computer.
 - X has been making regular purchases of the patented component from Y since 1965, subject to the same terms as all other purchasers of such component parts. X could not buy similar components from another source.
 - Consequently, X would suffer severe economic hardship if it could not continue to purchase these components from Y, since it would then be forced to develop a computer which could be constructed with other components.

Result:

- Under these circumstances, the continued purchase by X from Y of these components would not be an *indirect* act of self-dealing between W and Y.

Self-Dealing—A Transactional Analysis

Self-dealing includes the following transactions, whether direct or indirect.

- Any sale or exchange of property between a private foundation and a disqualified person is an act of self-dealing.

-
- The transfer of real or personal property by a disqualified person to a private foundation is treated as a sale or exchange if the foundation assumes or takes property subject to a mortgage or similar lien, which was placed on the property before the transfer by a disqualified person in the ten-year period ending on the date of transfer.
 - The leasing of property between a disqualified person and a private foundation, unless the property is leased by the disqualified person to the private foundation without charge, is an act of self-dealing.
 - Lending money or extending credit between a private foundation and a disqualified person is an act of self-dealing.
 - Not included, however, is a loan of money by a disqualified person to a private foundation without interest or other charge if the proceeds of the loan are used exclusively for charitable purposes. For these purposes, a below-market interest rate loan is treated as an act of self-dealing to the same extent as a loan at market interest rates.
 - Providing goods, services, or facilities is an act of self-dealing. Exceptions are as follows:
 - It is not considered self-dealing when a disqualified person provides, without charge, goods, services, or facilities that are used exclusively for purposes specified in §501(c)(3).
 - Providing goods, services, or facilities to a foundation manager, to an employee, or to an unpaid worker, is not an act of self-dealing if the value of the items provided is reasonable and necessary to the performance of the tasks involved in carrying out the exempt purpose of the foundation and not excessive.
 - Providing goods, services, or facilities by a private foundation to a disqualified person is also not self-dealing if the goods, services, or facilities are made available to the general public on terms at least as favorable as they are made to the disqualified person and they are functionally related to the exercise or performance by a private foundation of its exempt purpose.
 - Paying compensation or reimbursing expenses by a private foundation to a disqualified person is an act of self-dealing.
 - If the payments are for personal services and are reasonable and necessary to carry out the exempt purpose of the private foundation, however, these payments are not considered self-dealing unless made to a government official.
 - Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation is an act of self-dealing.

Other Self-Dealing Transactions

Indemnification by the foundation of its managers against reasonable expenses (other than taxes, penalties, and expenses of correction) incurred in an IRS or court proceeding involving the imposition of the excise taxes on the foundation manager will *not* be an act of self-dealing if the manager is successful in the defense or if the proceeding is ended by settlement, and if the manager has not acted willfully and without reasonable cause in the act or failure to act giving rise to liability for the excise taxes.

Incidental benefits to a disqualified person from the use by a foundation of its income or assets will *not*, by itself, make the use an act of self-dealing. For example, the public recognition that a substantial contributor may receive from charitable activities of a private foundation does not in itself result in an act of self-dealing.

Similarly, a scholarship or fellowship grant to a person other than a disqualified person that is paid or incurred by a private foundation will *not* be an act of self-dealing merely because a disqualified person indirectly receives a benefit from the grant if the grant is consistent with:

- Requirements of the foundation's exempt status as a charitable, educational, or other Code-defined organization;
- Requirements for allowance of deduction for charitable contributions made to the foundation; and
- Requirements of scholarship and fellowship grants awarded on an objective and nondiscriminatory basis under procedures approved by the IRS.

A scholarship or fellowship grant made by a private foundation under a program to award scholarship or fellowship grants to the children of employees of a substantial contributor will *not* be an act of self-dealing under these conditions:

- The agreement by a private foundation to make any payment of money or other property to a government official is an act of self-dealing, *except* for the following:
 - Prize or award that does not have to be included in gross income if the official receiving the prize or award is selected from the general public;
 - Scholarship or fellowship grant that is to be used for study at a recognized educational organization;
 - Any annuity or other payment (forming part of a stock-bonus, pension, or profit-sharing plan) from a qualified trust;
 - Any annuity or other payment under an employees' annuity plan;

- Any contribution or gift (other than money) or services or facilities made available, if the total value is not more than \$25 during any calendar year;
- Any payment made under a government employees' training program;
- Any payment or reimbursement of travel expenses, including meals and lodging, for travel only from one point in the U.S. to another in connection with charitable purposes, but only if the payment or reimbursement is not more than the actual cost of transportation plus an amount for all other traveling expenses not greater than 125% of the maximum payable for similar travel by U.S. government employees; and
- Cost of a government official's attendance or participation in a conference sponsored by the foundation in furtherance of its exempt purposes, including:
 - Official's share of the cost of the conference,
 - Professional and other nonmonetary benefits of an intellectual or psychological nature received by the official from attending or participating in the conference.
- Benefits to the official resulting from publication or distribution of the conference record to conference participants are *not* considered an act of self-dealing.
- Payments, reimbursements, or reasonable advance made to the official for expenses in attending the conference are *not* considered an act of self-dealing.

Correction of Self-Dealing

Correction of a self-dealing transaction sounds simple on the surface: make the transaction go away. In practice, this correction is made by undoing the transaction to the extent possible and returning the private foundation to a financial position at least as favorable as if the disqualified person had acted under the highest fiduciary standards. This includes *reversion* of the prohibited transaction, generally at terms favorable to the private foundation. Once corrected, it is as if the transaction had never taken place.

Self-Dealing Tax

Initial Tax

The initial tax on a self-dealing transaction is imposed on the disqualified person, other than a foundation manager acting only as a manager, for each year or part of a year in the taxable period, in the amount of 5% of the amount involved. A foundation manager who knowingly participates in an act of self-dealing, unless participation is not willful and is due to reasonable cause, is subject to an initial tax of 2.5% of the amount involved for the same period.

Additional Tax

An additional tax in the amount of 200% of the amount involved is imposed on the disqualified person, other than a foundation manager acting only as a manager, who participated in the act of self-dealing, if the act of self-dealing is not corrected within the taxable period. The additional tax will not be assessed if the act of self-dealing is corrected in the correction period. If the additional tax is imposed on the disqualified person, an excise tax of 50% of the amount involved is imposed on any foundation manager who refuses to agree to part or all of the correction of the self-dealing act.

The maximum initial tax imposed on the foundation manager is \$10,000, and the maximum additional tax is \$10,000 for any one act. There is no maximum on the liability of the self-dealer, including one who is a foundation manager. If more than one person is liable for the initial and additional taxes imposed for any act of self-dealing, all parties are jointly and severally liable for those taxes.

The amount involved is the greater of the amount of money and the fair market value of other property given or the amount of money and fair market value of other property received. For payments made for services performed (to persons other than government officials), the amount involved is only the excess compensation paid by the private foundation.

For purposes of determining the amount involved with regard to the fair market value of property or the use thereof, as the case may be, such value is to be determined as of the date on which the act of self-dealing occurred for purposes of the first-tier taxes imposed by §4941(a) and is to be the highest fair market value during the taxable period for purposes of the second-tier taxes imposed by §4941(b).

An example of this taxation is found in Reg. §53.4941(e)-1(b)(4), (Example 4):

For a transaction that would not have been an act of self-dealing had the private foundation received fair market value, the amount involved is the excess of the fair market value of property transferred by the foundation over the amount received by the foundation, but only if the parties have made a good faith effort to determine fair market value.

Tax on Failure to Distribute Income

A private foundation must make qualifying distributions to the extent of its minimum investment return for the year. A foundation may set aside funds for periods up to sixty months for certain major projects. Excess qualifying distributions may be carried forward for a period of five tax years immediately following the tax year in which the excess was created.

Example 7-3:

- D, a disqualified person with respect to private foundation T, purchased 100 shares of stock from T for \$5,000 on June 15, 19X1. The fair market value of the 100 shares of stock at that time was \$4,800.
- D sells the 100 shares of stock on December 20, 19X2, for \$6,000. Subsequently, D received a notice of deficiency with respect to taxes imposed under Code §4941(a) and (b), at which time D had not yet corrected the transaction.
- Between June 15, 19X2, and the date of mailing of the notice of deficiency, the stock was quoted on the Stock Exchange at a high of \$67 per share.
- The amount involved with respect to the tax imposed by §4941(a) is \$5,000, and the amount involved with respect to the tax imposed by §4941(b) for failure to correct is \$6,700 (100 shares at \$67 per share), the highest fair market value during the taxable period.

Initial Tax

An excise tax of 15% is imposed on the undistributed income of a private foundation that has not been distributed before the first day of the second (or any succeeding) tax year following the year earned, if the first day falls within the taxable period. A short tax year is considered a tax year. The initial tax may be abated if the foundation can show that the failure was due to reasonable cause, and not to willful neglect, and that the failure to distribute was corrected within the correction period.

Additional Tax

The additional tax of 100% of the amount remaining undistributed will be imposed if the initial tax is imposed and the undistributed income has not been distributed by the end of the taxable period. The tax will not be assessed if the undistributed income is reduced to zero during the correction period. Payment of the excise tax is in addition to, rather than in lieu of, making required distributions of undistributed income.

The correction period begins the first day of the tax year in which the foundation failed to distribute income and ends ninety days after a notice of deficiency for the additional tax is mailed. The correction period is extended by any period during which a deficiency cannot be assessed. In addition, this period may be extended by any period that the IRS determines is reasonable and necessary to make distributions of undistributed income as required to comply with §4942.

Tax on Excess Business Holdings

Pursuant to §4943, the combined holdings of a private foundation and all of its disqualified persons are limited to 20% of the voting stock in a business enterprise that is a corporation. The 20% limitation also applies to holdings in business ventures that are partnerships, joint ventures, or other unincorporated enterprises. For a partnership or joint venture, profits interest is substituted for voting stock, and for any other unincorporated enterprise, beneficial interest is substituted for voting stock. The amount of the excess holdings is determined as of the day during the tax year when the foundation's excess holdings in the business were the greatest.

Initial Tax

An initial tax of 5% of the value of the excess holdings is imposed on the foundation that has excess business holdings. The tax is imposed on the last day of each tax year that ends during the taxable period. The initial tax may be abated if the foundation can show that the excess holdings were due to reasonable cause and not to willful neglect and that the excess holdings were disposed of within the correction period.

Additional Tax

An additional tax, in the amount of 200% of the excess holdings is imposed on the foundation if it has not disposed of the remaining excess business holdings by the end of the taxable period. The additional tax will not be assessed if the excess business holdings are reduced to zero during the correction period.

Active Conduct of Trade or Business

A business enterprise includes the active conduct of a trade or business including any activity that is regularly carried on for the production of income from the sale of goods or the performance of services and that constitutes an unrelated trade or business under §513. The term does not include a functionally related business, a trade or business that obtains at least 95% of its gross income from passive sources, or program-related investments.

A functionally related business is:

- Trade or business, the conduct of which is substantially related to the exercise or performance by the private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption;
- Trade or business, in which substantially all the work is performed for the foundation without compensation;
- Business carried on by the foundation primarily for the convenience of its members, students, patients, officers, or employees;

- Business that consists of the selling of merchandise, substantially all of which has been received by the foundation as gifts or contributions; or
- Activity carried on within a larger combination of similar activities or within a larger complex of other endeavors that is related to the exempt purpose of the foundation.

Exceptions to the excess holdings tax are as follows:

- If one or more third persons, who are not disqualified persons, have effective control of a corporation, the private foundation and all disqualified persons together may own up to 35% of the corporation's voting stock.
- A private foundation that owns not more than 2% of the voting stock and not more than 2% of the value of all outstanding shares of all classes of stock is not subject to the excess holdings tax.

The taxable period begins on the first day the foundation has excess business holdings and ends on the earlier of either the date a notice of deficiency for the initial tax is mailed or the date the initial tax is assessed. The correction period begins on the first day that the foundation has excess business holdings and ends ninety days after a notice of deficiency for the additional tax is mailed.

If the foundation's business holdings (other than by a purchase by the foundation or disqualified persons) change, such as through gift or bequest, and the additional holdings result in the foundation having excess business holdings, the foundation in effect has five years to reduce these holdings or those of its disqualified persons to permissible levels. The excess business holdings resulting from the gift or bequest are treated as being held by a disqualified person, rather than by the foundation itself during the five-year period on the date the foundation obtains the holdings.

Tax on Jeopardizing Investments

Section 4944 provides that both the foundation and the individual foundation managers may become liable for taxes on jeopardizing investments if the private foundation makes any investments that would financially jeopardize the carrying out of its exempt purpose.

Initial Tax

The initial tax, 5% of the amount involved (the jeopardizing investment), is imposed on the foundation for each tax year, or part of a year, in the taxable period. The foundation will not be liable for the tax if it can show that the jeopardizing investment was due to reasonable cause and willful neglect and that the jeopardizing investment was corrected within the correction period. Foundation managers are also responsible for an excise tax of 5% of the amount involved, if the

manager knowingly, willfully, and without reasonable cause participated in making the jeopardizing investment.

Additional Tax

An additional tax is imposed on the private foundation if the initial tax is imposed and the foundation has not removed the investment from jeopardy within the taxable period. The additional tax is 25% of the amount involved. The additional tax will not be assessed if the investment is removed from jeopardy within the correction period.

If more than one individual manager is liable for the excise tax on jeopardizing investments, all parties will be jointly and severally liable. For any one jeopardizing investment, the maximum initial tax is \$5,000 and the maximum additional tax is \$10,000. Jeopardizing investments are those that show a lack of reasonable business care and prudence in providing for the long- and short-term financial needs of the foundation for it to carry out its exempt function. No single factor determines a jeopardizing investment.

No category of investment is treated as an intrinsic violation, but careful scrutiny is applied to:

- Trading in securities on margin,
- Trading in commodity futures,
- Investing in working interests in oil and gas wells,
- Buying “puts,” “calls,” and “straddles,”
- Buying warrants, and
- Selling short.

In deciding whether the investment jeopardizes the carrying out of the exempt purposes, the determination must be made on an investment-by-investment basis taking into account the foundation’s portfolio as a whole. To avoid the tax on jeopardizing investments, a careful analysis of potential investments must be made and good judgment must be exercised.

Whether an investment jeopardizes the foundation’s exempt purposes is determined when making the investment. If the investment is proper when made, it will not be considered a jeopardizing investment even if it later results in a loss. The tax on jeopardizing investments does not apply to investments originally made by a person who later transferred them as gifts to the foundation. Additionally, the tax does not apply to investments that are acquired by the foundation as a result of a corporate reorganization.

Program-Related Investments

Program-related investments are not subject to the tax on jeopardizing investments. Program-related investments are those in which:

- Primary purpose is to accomplish one or more of the foundation's exempt purposes,
- Production of income or appreciation of property is not a significant purpose, and
- Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose.

Program-related investments must significantly further the foundation's exempt activities. They must be investments that would not have been made except for their relationship to the exempt purposes. The investments include those made in functionally related activities that are carried on within a larger combination of similar activities related to the exempt purpose.

Tax on Taxable Expenditures

A private foundation that makes any taxable expenditures becomes liable for taxes on these expenditures under §4945. These taxes are imposed on both the foundation and any foundation manager who knowingly and willfully agrees to the expenditures.

Initial Tax

The initial tax on the foundation is 10% of the amount expended. The foundation will not be liable for the tax if it can show that the expenditure was due to reasonable cause and not to willful neglect and that the expenditure was corrected within the correction period. A foundation manager who knowingly, willfully, and without reasonable cause agrees to the taxable expenditure is subject to an initial tax of 2.5% of the amount expended up to a maximum of \$5,000 for any one expenditure. A foundation manager who acts on advice of counsel, given in a reasoned legal opinion in writing, is not liable for the tax.

Additional Tax

An additional tax of 100% of the amount expended is imposed on the foundation if the expenditure is not corrected within the taxable period. The tax will not be assessed if corrected within the correction period. Any foundation manager who refuses to agree to part or all of the correction must pay an additional tax of 50% of the expenditure up to a maximum of \$10,000. If more than one foundation manager is liable for either the initial or additional tax, all are jointly and severally liable.

A taxable expenditure is an amount paid or incurred for the following:

THE APPLICATION AND PRINCIPLES OF PRIVATE FOUNDATIONS

- Any amount used to carry on propaganda or otherwise attempt to influence legislation is considered to be a taxable expenditure.
- Any amount used to influence the outcome of any specific public election or carry on any voter registration drive is considered to be a taxable expenditure unless the following requirements are satisfied:
 - The organization making the expenditure is described in §501(c)(3) and is exempt from tax.
 - Its activities are nonpartisan, are not confined to one specific election period, and are carried on in at least five states.
 - The organization spends at least 85% of its income directly for the active conduct of the exempt purposes or functions for which it is organized and operated.
 - The organization receives 85% of its support (other than from investment income) from exempt organizations, the general public, governmental units, or any combination of these; it does not receive more than 25% of its support (other than gross investment income) from any one exempt organization; and it does not receive more than 50% of its support from gross investment income.
 - Contributions to the organization for voter registration drives are not subject to conditions that they may be used only in specified states or other localities of the U.S., or that they may be used in only one specific election period.
- Any amount used to make a grant to an individual for travel, study, or other similar purposes is considered to be a taxable expenditure unless the following requirements are satisfied:
 - The grant must be awarded on an objective and nondiscriminatory basis under a procedure approved in advance by the IRS.
 - It must be shown to the satisfaction of the IRS that one of the following requirements is met:
 - The grant is a scholarship or fellowship and is to be used for study at an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where the educational activities are carried on.
 - The grant qualifies as a prize or award under §74(b) if the recipient is selected from the general public.

- The grant's purpose is to achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or similar capacity, skill, or talent of the grantee.
- Any amount used to make a grant to an organization [other than an organization described in §509(a)(1), (2), or (3) or an exempt operating foundation] is considered to be a taxable expenditure unless the foundation exercises expenditure responsibility with respect to the grant.
- Any amount used to carry out any purpose other than a religious, charitable, scientific, literary, or educational purpose, the fostering of national or international amateur sports competition or the prevention of cruelty to children or animals is considered to be a taxable expenditure.

The correction period begins on the date of the taxable expenditure and ends ninety days after a notice of deficiency for the additional tax is mailed.

APPENDIX

Form **1023**
(Rev. September 1998)
Department of the Treasury
Internal Revenue Service

**Application for Recognition of Exemption
Under Section 501(c)(3) of the Internal Revenue Code**

OMB No. 1545-0056

Note: If exempt status is approved, this application will be open for public inspection.

Read the instructions for each Part carefully.
A User Fee must be attached to this application.
If the required information and appropriate documents are not submitted along with Form 8718 (with payment of the appropriate user fee), the application may be returned to you.
Complete the Procedural Checklist on page 8 of the instructions.

Identification of Applicant

1a Full name of organization (as shown in organizing document)		2 Employer identification number (EIN) (If none, see page 3 of the Specific Instructions .)
1b c/o Name (if applicable)		3 Name and telephone number of person to be contacted if additional information is needed ()
1c Address (number and street)	Room/Suite	
1d City, town, or post office, state, and ZIP + 4. If you have a foreign address, see Specific Instructions for Part I, page 3.		4 Month the annual accounting period ends
1e Web site address		5 Date incorporated or formed
		6 Check here if applying under section: a <input type="checkbox"/> 501(e) b <input type="checkbox"/> 501(f) c <input type="checkbox"/> 501(k) d <input type="checkbox"/> 501(n)
7 Did the organization previously apply for recognition of exemption under this Code section or under any other section of the Code? <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," attach an explanation.		
8 Is the organization required to file Form 990 (or Form 990-EZ)? <input type="checkbox"/> N/A <input type="checkbox"/> Yes <input type="checkbox"/> No If "No," attach an explanation (see page 3 of the Specific Instructions).		
9 Has the organization filed Federal income tax returns or exempt organization information returns? . . . <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," state the form numbers, years filed, and Internal Revenue office where filed.		

10 Check the box for the type of organization. ATTACH A CONFORMED COPY OF THE CORRESPONDING ORGANIZING DOCUMENTS TO THE APPLICATION BEFORE MAILING. (See **Specific Instructions** for Part I, Line 10, on page 3.) See also Pub. 557 for examples of organizational documents.)

a Corporation— Attach a copy of the Articles of Incorporation (including amendments and restatements) showing approval by the appropriate state official; also include a copy of the bylaws.

b Trust— Attach a copy of the Trust Indenture or Agreement, including all appropriate signatures and dates.

c Association— Attach a copy of the Articles of Association, Constitution, or other creating document, with a declaration (see instructions) or other evidence the organization was formed by adoption of the document by more than one person; also include a copy of the bylaws.

If the organization is a corporation or an unincorporated association that has not yet adopted bylaws, check here

I declare under the penalties of perjury that I am authorized to sign this application on behalf of the above organization and that I have examined this application, including the accompanying schedules and attachments, and to the best of my knowledge it is true, correct, and complete.

Please Sign Here _____
(Signature) (Type or print name and title or authority of signer) (Date)

Activities and Operational Information

1 Provide a detailed narrative description of all the activities of the organization—past, present, and planned. **Do not merely refer to or repeat the language in the organizational document.** List each activity separately in the order of importance based on the relative time and other resources devoted to the activity. Indicate the percentage of time for each activity. Each description should include, as a minimum, the following: **(a)** a detailed description of the activity including its purpose and how each activity furthers your exempt purpose; **(b)** when the activity was or will be initiated; and **(c)** where and by whom the activity will be conducted.

2 What are or will be the organization's sources of financial support? List in order of size.

3 Describe the organization's fundraising program, both actual and planned, and explain to what extent it has been put into effect. Include details of fundraising activities such as selective mailings, formation of fundraising committees, use of volunteers or professional fundraisers, etc. Attach representative copies of solicitations for financial support.

Activities and Operational Information (Continued)

4 Give the following information about the organization's governing body:

a Names, addresses, and titles of officers, directors, trustees, etc.

b Annual compensation

c Do any of the above persons serve as members of the governing body by reason of being public officials or being appointed by public officials? Yes No
If "Yes," name those persons and explain the basis of their selection or appointment.

d Are any members of the organization's governing body "disqualified persons" with respect to the organization (other than by reason of being a member of the governing body) or do any of the members have either a business or family relationship with "disqualified persons"? (See **Specific Instructions** for Part II, Line 4d, on page 3.) Yes No
If "Yes," explain.

5 Does the organization control or is it controlled by any other organization? Yes No
Is the organization the outgrowth of (or successor to) another organization, or does it have a special relationship with another organization by reason of interlocking directorates or other factors? Yes No
If either of these questions is answered "Yes," explain.

6 Does or will the organization directly or indirectly engage in any of the following transactions with any political organization or other exempt organization (other than a 501(c)(3) organization): **(a)** grants; **(b)** purchases or sales of assets; **(c)** rental of facilities or equipment; **(d)** loans or loan guarantees; **(e)** reimbursement arrangements; **(f)** performance of services, membership, or fundraising solicitations; or **(g)** sharing of facilities, equipment, mailing lists or other assets, or paid employees? Yes No
If "Yes," explain fully and identify the other organizations involved.

7 Is the organization financially accountable to any other organization? Yes No
If "Yes," explain and identify the other organization. Include details concerning accountability or attach copies of reports if any have been submitted.

Activities and Operational Information (Continued)

8 What assets does the organization have that are used in the performance of its exempt function? (Do not include property producing investment income.) If any assets are not fully operational, explain their status, what additional steps remain to be completed, and when such final steps will be taken. If none, indicate "N/A."

9 Will the organization be the beneficiary of tax-exempt bond financing within the next 2 years? Yes No

10a Will any of the organization's facilities or operations be managed by another organization or individual under a contractual agreement? Yes No

b Is the organization a party to any leases? Yes No
If either of these questions is answered "Yes," attach a copy of the contracts and explain the relationship between the applicant and the other parties.

11 Is the organization a membership organization? Yes No

If "Yes," complete the following:

a Describe the organization's membership requirements and attach a schedule of membership fees and dues.

b Describe the organization's present and proposed efforts to attract members and attach a copy of any descriptive literature or promotional material used for this purpose.

c What benefits do (or will) the members receive in exchange for their payment of dues?

12a If the organization provides benefits, services, or products, are the recipients required, or will they be required, to pay for them? N/A Yes No
If "Yes," explain how the charges are determined and attach a copy of the current fee schedule.

b Does or will the organization limit its benefits, services, or products to specific individuals or classes of individuals? N/A Yes No
If "Yes," explain how the recipients or beneficiaries are or will be selected.

13 Does or will the organization attempt to influence legislation? Yes No

If "Yes," explain. Also, give an estimate of the percentage of the organization's time and funds that it devotes or plans to devote to this activity.

14 Does or will the organization intervene in any way in political campaigns, including the publication or distribution of statements? Yes No

If "Yes," explain fully.

Technical Requirements

1 Are you filing Form 1023 within 15 months from the end of the month in which your organization was created or formed? Yes No
 If you answer "Yes," do not answer questions on lines 2 through 6 below.

2 If one of the exceptions to the 15-month filing requirement shown below applies, check the appropriate box and proceed to question 7.

Exceptions—You are not required to file an exemption application within 15 months if the organization:

- a** Is a church, interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church. See **Specific Instructions**, Line 2a, on page 4;
- b** Is not a private foundation and normally has gross receipts of not more than \$5,000 in each tax year; or
- c** Is a subordinate organization covered by a group exemption letter, but only if the parent or supervisory organization timely submitted a notice covering the subordinate.

3 If the organization does not meet any of the exceptions on line 2 above, are you filing Form 1023 within 27 months from the end of the month in which the organization was created or formed? Yes No

If "Yes," your organization qualifies under Regulation section 301.9100-2, for an automatic 12-month extension of the 15-month filing requirement. Do not answer questions 4 through 6.

If "No," answer question 4.

4 If you answer "No" to question 3, does the organization wish to request an extension of time to apply under the "reasonable action and good faith" and the "no prejudice to the interest of the government" requirements of Regulations section 301.9100-3? Yes No

If "Yes," give the reasons for not filing this application within the 27-month period described in question 3. See **Specific Instructions**, Part III, Line 4, before completing this item. Do not answer questions 5 and 6.

If "No," answer questions 5 and 6.

5 If you answer "No" to question 4, your organization's qualification as a section 501(c)(3) organization can be recognized only from the date this application is filed. Therefore, do you want us to consider the application as a request for recognition of exemption as a section 501(c)(3) organization from the date the application is received and not retroactively to the date the organization was created or formed? Yes No

6 If you answer "Yes" to question 5 above and wish to request recognition of section 501(c)(4) status for the period beginning with the date the organization was formed and ending with the date the Form 1023 application was received (the effective date of the organization's section 501(c)(3) status), check here and attach a completed page 1 of Form 1024 to this application.

Technical Requirements (Continued)

- 7 Is the organization a private foundation?
 Yes (Answer question 8.)
 No (Answer question 9 and proceed as instructed.)

- 8 If you answer "Yes" to question 7, does the organization claim to be a private operating foundation?
 Yes (Complete Schedule E.)
 No

After answering question 8 on this line, go to line 14 on page 7.

- 9 If you answer "No" to question 7, indicate the public charity classification the organization is requesting by checking the box below that most appropriately applies:

THE ORGANIZATION IS NOT A PRIVATE FOUNDATION BECAUSE IT QUALIFIES:

- | | | |
|---|---|--|
| a | <input type="checkbox"/> As a church or a convention or association of churches
(CHURCHES MUST COMPLETE SCHEDULE A.) | Sections 509(a)(1)
and 170(b)(1)(A)(i) |
| b | <input type="checkbox"/> As a school (MUST COMPLETE SCHEDULE B.) | Sections 509(a)(1)
and 170(b)(1)(A)(ii) |
| c | <input type="checkbox"/> As a hospital or a cooperative hospital service organization, or a
medical research organization operated in conjunction with a
hospital (These organizations, except for hospital service
organizations, MUST COMPLETE SCHEDULE C.) | Sections 509(a)(1)
and 170(b)(1)(A)(iii) |
| d | <input type="checkbox"/> As a governmental unit described in section 170(c)(1). | Sections 509(a)(1)
and 170(b)(1)(A)(v) |
| e | <input type="checkbox"/> As being operated solely for the benefit of, or in connection with,
one or more of the organizations described in a through d, g, h, or i
(MUST COMPLETE SCHEDULE D.) | Section 509(a)(3) |
| f | <input type="checkbox"/> As being organized and operated exclusively for testing for public
safety. | Section 509(a)(4) |
| g | <input type="checkbox"/> As being operated for the benefit of a college or university that is
owned or operated by a governmental unit. | Sections 509(a)(1)
and 170(b)(1)(A)(iv) |
| h | <input type="checkbox"/> As receiving a substantial part of its support in the form of
contributions from publicly supported organizations, from a
governmental unit, or from the general public. | Sections 509(a)(1)
and 170(b)(1)(A)(vi) |
| i | <input type="checkbox"/> As normally receiving not more than one-third of its support from
gross investment income and more than one-third of its support from
contributions, membership fees, and gross receipts from activities
related to its exempt functions (subject to certain exceptions). | Section 509(a)(2) |
| j | <input type="checkbox"/> The organization is a publicly supported organization but is not sure
whether it meets the public support test of h or i. The organization
would like the IRS to decide the proper classification. | Sections 509(a)(1)
and 170(b)(1)(A)(vi)
or Section 509(a)(2) |

**If you checked one of the boxes a through f in question 9, go to question
14. If you checked box g in question 9, go to questions 11 and 12.
If you checked box h, i, or j, in question 9, go to question 10.**

Technical Requirements (Continued)

- 10** If you checked box **h**, **i**, or **j** in question 9, has the organization completed a tax year of at least 8 months?
 Yes—Indicate whether you are requesting:
 A definitive ruling. (Answer questions 11 through 14.)
 An advance ruling. (Answer questions 11 and 14 and attach two Forms 872-C completed and signed.)
 No—You must request an advance ruling by completing and signing two Forms 872-C and attaching them to the Form 1023.
- 11** If the organization received any unusual grants during any of the tax years shown in Part IV-A, **Statement of Revenue and Expenses**, attach a list for each year showing the name of the contributor; the date and the amount of the grant; and a brief description of the nature of the grant.

- 12** If you are requesting a definitive ruling under section 170(b)(1)(A)(iv) or (vi), check here and:
a Enter 2% of line 8, column (e), Total, of Part IV-A _____
b Attach a list showing the name and amount contributed by each person (other than a governmental unit or "publicly supported" organization) whose total gifts, grants, contributions, etc., were more than the amount entered on line **12a** above.

- 13** If you are requesting a definitive ruling under section 509(a)(2), check here and:
a For each of the years included on lines 1, 2, and 9 of Part IV-A, attach a list showing the name of and amount received from each "disqualified person." (For a definition of "disqualified person," see **Specific Instructions**, Part II, Line 4d, on page 3.)
b For each of the years included on line 9 of Part IV-A, attach a list showing the name of and amount received from each payer (other than a "disqualified person") whose payments to the organization were more than \$5,000. For this purpose, "payer" includes, but is not limited to, any organization described in sections 170(b)(1)(A)(i) through (vi) and any governmental agency or bureau.

	Yes	No	If "Yes," complete Schedule:
14 Indicate if your organization is one of the following. If so, complete the required schedule. (Submit only those schedules that apply to your organization. Do not submit blank schedules.)			
Is the organization a church?			A
Is the organization, or any part of it, a school?			B
Is the organization, or any part of it, a hospital or medical research organization?			C
Is the organization a section 509(a)(3) supporting organization?			D
Is the organization a private operating foundation?			E
Is the organization, or any part of it, a home for the aged or handicapped?			F
Is the organization, or any part of it, a child care organization?			G
Does the organization provide or administer any scholarship benefits, student aid, etc.?			H
Has the organization taken over, or will it take over, the facilities of a "for profit" institution? . . .			I

Financial Data

Complete the financial statements for the current year and for each of the 3 years immediately before it. If in existence less than 4 years, complete the statements for each year in existence. If in existence less than 1 year, also provide proposed budgets for the 2 years following the current year.

A. Statement of Revenue and Expenses

		Current tax year	3 prior tax years or proposed budget for 2 years			(e) TOTAL
		(a) From to	(b)	(c)	(d)	
Revenue	1 Gifts, grants, and contributions received (not including unusual grants—see page 6 of the instructions)					
	2 Membership fees received					
	3 Gross investment income (see instructions for definition)					
	4 Net income from organization's unrelated business activities not included on line 3					
	5 Tax revenues levied for and either paid to or spent on behalf of the organization					
	6 Value of services or facilities furnished by a governmental unit to the organization without charge (not including the value of services or facilities generally furnished the public without charge)					
	7 Other income (not including gain or loss from sale of capital assets) (attach schedule)					
	8 Total (add lines 1 through 7)					
	9 Gross receipts from admissions, sales of merchandise or services, or furnishing of facilities in any activity that is not an unrelated business within the meaning of section 513. Include related cost of sales on line 22					
	10 Total (add lines 8 and 9)					
	11 Gain or loss from sale of capital assets (attach schedule)					
	12 Unusual grants					
	13 Total revenue (add lines 10 through 12)					
Expenses	14 Fundraising expenses					
	15 Contributions, gifts, grants, and similar amounts paid (attach schedule)					
	16 Disbursements to or for benefit of members (attach schedule)					
	17 Compensation of officers, directors, and trustees (attach schedule)					
	18 Other salaries and wages					
	19 Interest					
	20 Occupancy (rent, utilities, etc.)					
	21 Depreciation and depletion					
22 Other (attach schedule)						
23 Total expenses (add lines 14 through 22)						
24 Excess of revenue over expenses (line 13 minus line 23)						

Financial Data (Continued)

B. Balance Sheet (at the end of the period shown)		Current tax year Date
Assets		
1 Cash		1
2 Accounts receivable, net		2
3 Inventories		3
4 Bonds and notes receivable (attach schedule)		4
5 Corporate stocks (attach schedule)		5
6 Mortgage loans (attach schedule)		6
7 Other investments (attach schedule)		7
8 Depreciable and depletable assets (attach schedule)		8
9 Land		9
10 Other assets (attach schedule)		10
11 Total assets (add lines 1 through 10)		11
Liabilities		
12 Accounts payable		12
13 Contributions, gifts, grants, etc., payable		13
14 Mortgages and notes payable (attach schedule)		14
15 Other liabilities (attach schedule)		15
16 Total liabilities (add lines 12 through 15)		16
Fund Balances or Net Assets		
17 Total fund balances or net assets		17
18 Total liabilities and fund balances or net assets (add line 16 and line 17)		18
If there has been any substantial change in any aspect of the organization's financial activities since the end of the period shown above, check the box and attach a detailed explanation		▶ <input type="checkbox"/>

Schedule A. Churches

1 Provide a brief history of the development of the organization, including the reasons for its formation.

2 Does the organization have a written creed or statement of faith? **Yes** **No**
If "Yes," attach a copy.

3 Does the organization require prospective members to renounce other religious beliefs or their membership in other churches or religious orders to become members? **Yes** **No**

4 Does the organization have a formal code of doctrine and discipline for its members? **Yes** **No**
If "Yes," describe.

5 Describe the form of worship and attach a schedule of worship services.

6 Are the services open to the public? **Yes** **No**
If "Yes," describe how the organization publicizes its services and explain the criteria for admittance.

7 Explain how the organization attracts new members.

8 (a) How many active members are currently enrolled in the church?

(b) What is the average attendance at the worship services?

9 In addition to worship services, what other religious services (such as baptisms, weddings, funerals, etc.) does the organization conduct?

Schedule A. Churches (Continued)

10 Does the organization have a school for the religious instruction of the young? **Yes** **No**

11 Were the current deacons, minister, and/or pastor formally ordained after a prescribed course of study? **Yes** **No**

12 Describe the organization's religious hierarchy or ecclesiastical government.

13 Does the organization have an established place of worship? **Yes** **No**

If "Yes," provide the name and address of the owner or lessor of the property and the address and a description of the facility.

If the organization has no regular place of worship, state where the services are held and how the site is selected.

14 Does (or will) the organization license or otherwise ordain ministers (or their equivalent) or issue church charters? **Yes** **No**

If "Yes," describe in detail the requirements and qualifications needed to be so licensed, ordained, or chartered.

15 Did the organization pay a fee for a church charter? **Yes** **No**

If "Yes," state the name and address of the organization to which the fee was paid, attach a copy of the charter, and describe the circumstances surrounding the chartering.

16 Show how many hours a week the minister/pastor and officers each devote to church work and the amount of compensation paid to each of them. If the minister or pastor is otherwise employed, indicate by whom employed, the nature of the employment, and the hours devoted to that employment.

Schedule A. Churches (Continued)

- 17** Will any funds or property of the organization be used by any officer, director, employee, minister, or pastor for his or her personal needs or convenience? Yes No

If "Yes," describe the nature and circumstances of such use.

-
- 18** List any officers, directors, or trustees related by blood or marriage.

-
- 19** Give the name of anyone who has assigned income to the organization or made substantial contributions of money or other property. Specify the amounts involved.
-

Instructions

Although a church, its integrated auxiliaries, or a convention or association of churches is not required to file Form 1023 to be exempt from Federal income tax or to receive tax-deductible contributions, such an organization may find it advantageous to obtain recognition of exemption. In this event, you should submit information showing that your organization is a church, synagogue, association or convention of churches, religious order or religious organization that is an integral part of a church, and that it is carrying out the functions of a church.

In determining whether an admittedly religious organization is also a church, the IRS does not accept any and every assertion that such an organization is a church. Because beliefs and practices vary so widely, there is no single definition of the word "church" for tax purposes. The IRS considers the facts and circumstances of each organization applying for church status.

The IRS maintains two basic guidelines in determining that an organization meets the religious purposes test:

1. That the particular religious beliefs of the organization are truly and sincerely held, and
2. That the practices and rituals associated with the organization's religious beliefs or creed are not illegal or contrary to clearly defined public policy.

In order for the IRS to properly evaluate your organization's activities and religious purposes, it is important that all questions in Schedule A be answered.

The information submitted with Schedule A will be a determining factor in granting the "church" status requested by your organization. In completing the schedule, consider the following points:

1. The organization's activities in furtherance of its beliefs must be exclusively religious, and
 2. An organization will not qualify for exemption if it has a substantial nonexempt purpose of serving the private interests of its founder or the founder's family.
-

Schedule B. Schools, Colleges, and Universities

1 Does, or will, the organization normally have: **(a)** a regularly scheduled curriculum, **(b)** a regular faculty of qualified teachers, **(c)** a regularly enrolled student body, and **(d)** facilities where its educational activities are regularly carried on? Yes No
 If "No," do not complete the rest of Schedule B.

2 Is the organization an instrumentality of a state or political subdivision of a state? Yes No
 If "Yes," document this in Part II and do not complete items 3 through 10 of Schedule B. (See instructions on the back of Schedule B.)

3 Does or will the organization (or any department or division within it) discriminate in any way on the basis of race with respect to:

a Admissions? Yes No
b Use of facilities or exercise of student privileges? Yes No
c Faculty or administrative staff? Yes No
d Scholarship or loan programs? Yes No
 If "Yes" for any of the above, explain.

4 Does the organization include a statement in its charter, bylaws, or other governing instrument, or in a resolution of its governing body, that it has a racially nondiscriminatory policy as to students? Yes No
 Attach whatever corporate resolutions or other official statements the organization has made on this subject.

5a Has the organization made its racially nondiscriminatory policies known in a manner that brings the policies to the attention of all segments of the general community that it serves? Yes No
 If "Yes," describe how these policies have been publicized and how often relevant notices or announcements have been made. If no newspaper or broadcast media notices have been used, explain.

b If applicable, attach clippings of any relevant newspaper notices or advertising, or copies of tapes or scripts used for media broadcasts. Also attach copies of brochures and catalogs dealing with student admissions, programs, and scholarships, as well as representative copies of all written advertising used as a means of informing prospective students of the organization's programs.

6 Attach a numerical schedule showing the racial composition, as of the current academic year, and projected to the extent feasible for the next academic year, of: **(a)** the student body, and **(b)** the faculty and administrative staff.

7 Attach a list showing the amount of any scholarship and loan funds awarded to students enrolled and the racial composition of the students who have received the awards.

8a Attach a list of the organization's incorporators, founders, board members, and donors of land or buildings, whether individuals or organizations.

b State whether any of the organizations listed in **8a** have as an objective the maintenance of segregated public or private school education, and, if so, whether any of the individuals listed in **8a** are officers or active members of such organizations.

9a Enter the public school district and county in which the organization is located.

b Was the organization formed or substantially expanded at the time of public school desegregation in the above district or county? Yes No

10 Has the organization ever been determined by a state or Federal administrative agency or judicial body to be racially discriminatory? Yes No

If "Yes," attach a detailed explanation identifying the parties to the suit, the forum in which the case was heard, the cause of action, the holding in the case, and the citations (if any) for the case. Also describe in detail what changes in the organization's operation, if any, have occurred since then.

For more information, see back of Schedule B.

Schedule C. Hospitals and Medical Research Organizations

- Check here if claiming to be a hospital; complete the questions in Section I of this schedule; and write "N/A" in Section II.
- Check here if claiming to be a medical research organization operated in conjunction with a hospital; complete the questions in Section II of this schedule; and write "N/A" in Section I.

Hospitals

- 1a** How many doctors are on the hospital's courtesy staff? _____
- b** Are all the doctors in the community eligible for staff privileges? Yes No
If "No," give the reasons why and explain how the courtesy staff is selected.

- 2a** Does the hospital maintain a full-time emergency room? Yes No
- b** What is the hospital's policy on administering emergency services to persons without apparent means to pay?

- c** Does the hospital have any arrangements with police, fire, and voluntary ambulance services for the delivery or admission of emergency cases? Yes No
Explain.

- 3a** Does or will the hospital require a deposit from persons covered by Medicare or Medicaid in its admission practices? Yes No
If "Yes," explain.
- b** Does the same deposit requirement, if any, apply to all other patients? Yes No
If "No," explain.

- 4** Does or will the hospital provide for a portion of its services and facilities to be used for charity patients? Yes No
Explain the policy regarding charity cases. Include data on the hospital's past experience in admitting charity patients and arrangements it may have with municipal or government agencies for absorbing the cost of such care.

- 5** Does or will the hospital carry on a formal program of medical training and research? Yes No
If "Yes," describe.

- 6** Does the hospital provide office space to physicians carrying on a medical practice? Yes No
If "Yes," attach a list setting forth the name of each physician, the amount of space provided, the annual rent, the expiration date of the current lease and whether the terms of the lease represent fair market value.

Medical Research Organizations

- 1** Name the hospitals with which the organization has a relationship and describe the relationship.

- 2** Attach a schedule describing the organization's present and proposed (indicate which) medical research activities; show the nature of the activities, and the amount of money that has been or will be spent in carrying them out. (Making grants to other organizations is not direct conduct of medical research.)

- 3** Attach a statement of assets showing their fair market value and the portion of the assets directly devoted to medical research.

For more information, see back of Schedule C.

Schedule D. Section 509(a)(3) Supporting Organizations

1a Organizations supported by the applicant organization: Name and address of supported organization	b Has the supported organization received a ruling or determination letter that it is not a private foundation by reason of section 509(a)(1) or (2)?
.....	<input type="checkbox"/> Yes <input type="checkbox"/> No
.....	<input type="checkbox"/> Yes <input type="checkbox"/> No
.....	<input type="checkbox"/> Yes <input type="checkbox"/> No
.....	<input type="checkbox"/> Yes <input type="checkbox"/> No
.....	<input type="checkbox"/> Yes <input type="checkbox"/> No

c If "No" for any of the organizations listed in 1a, explain.

2 Does the supported organization have tax-exempt status under section 501(c)(4), 501(c)(5), or 501(c)(6)? Yes No
 If "Yes," attach: (a) a copy of its ruling or determination letter, and (b) an analysis of its revenue for the current year and the preceding 3 years. (Provide the financial data using the formats in Part IV-A (lines 1-13) and Part III (lines 11, 12, and 13).)

3 Does your organization's governing document indicate that the majority of its governing board is elected or appointed by the supported organizations? Yes No
 If "Yes," skip to line 9.
 If "No," you must answer the questions on lines 4 through 9.

4 Does your organization's governing document indicate the common supervision or control that it and the supported organizations share? Yes No
 If "Yes," give the article and paragraph numbers. If "No," explain.

5 To what extent do the supported organizations have a significant voice in your organization's investment policies, in the making and timing of grants, and in otherwise directing the use of your organization's income or assets?

6 Does the mentioning of the supported organizations in your organization's governing instrument make it a trust that the supported organizations can enforce under state law and compel to make an accounting? Yes No
 If "Yes," explain.

7a What percentage of your organization's income does it pay to each supported organization?

b What is the total annual income of each supported organization?

c How much does your organization contribute annually to each supported organization?

For more information, see back of Schedule D.

Schedule D. Section 509(a)(3) Supporting Organizations (Continued)

8 To what extent does your organization conduct activities that would otherwise be carried on by the supported organizations? Explain why these activities would otherwise be carried on by the supported organizations.

9 Is the applicant organization controlled directly or indirectly by one or more "disqualified persons" (other than one who is a disqualified person solely because he or she is a manager) or by an organization that is not described in section 509(a)(1) or (2)? Yes No
If "Yes," explain.

Instructions

For an explanation of the types of organizations defined in section 509(a)(3) as being excluded from the definition of a private foundation, see Pub. 557, Chapter 3.

Line 1

List each organization that is supported by your organization and indicate in item **1b** if the supported organization has received a letter recognizing exempt status as a section 501(c)(3) public charity as defined in section 509(a)(1) or 509(a)(2). If you answer "No" in **1b** to any of the listed organizations, please explain in **1c**.

Line 3

Your organization's governing document may be articles of incorporation, articles of association, constitution, trust indenture, or trust agreement.

Line 9

For a definition of a "disqualified person," see **Specific Instructions**, Part II, Line 4d, on page 3 of the application's instructions.

Schedule E. Private Operating Foundations

Income Test	Most recent tax year
1a Adjusted net income, as defined in Regulations section 53.4942(a)-2(d)	1a _____
b Minimum investment return, as defined in Regulations section 53.4942(a)-2(c)	1b _____
2 Qualifying distributions:	
a Amounts (including administrative expenses) paid directly for the active conduct of the activities for which organized and operated under section 501(c)(3) (attach schedule)	2a _____
b Amounts paid to acquire assets to be used (or held for use) directly in carrying out purposes described in section 170(c)(1) or 170(c)(2)(B) (attach schedule)	2b _____
c Amounts set aside for specific projects that are for purposes described in section 170(c)(1) or 170(c)(2)(B) (attach schedule).	2c _____
d Total qualifying distributions (add lines 2a, b, and c)	2d _____
3 Percentages:	
a Percentage of qualifying distributions to adjusted net income (divide line 2d by line 1a)	3a _____ %
b Percentage of qualifying distributions to minimum investment return (divide line 2d by line 1b). (Percentage must be at least 85% for 3a or 3b)	3b _____ %
Assets Test	
4 Value of organization's assets used in activities that directly carry out the exempt purposes. Do not include assets held merely for investment or production of income (attach schedule)	4 _____
5 Value of any stock of a corporation that is controlled by applicant organization and carries out its exempt purposes (attach statement describing corporation)	5 _____
6 Value of all qualifying assets (add lines 4 and 5)	6 _____
7 Value of applicant organization's total assets	7 _____
8 Percentage of qualifying assets to total assets (divide line 6 by line 7—percentage must exceed 65%)	8 _____ %
Endowment Test	
9 Value of assets not used (or held for use) directly in carrying out exempt purposes:	
a Monthly average of investment securities at fair market value	9a _____
b Monthly average of cash balances	9b _____
c Fair market value of all other investment property (attach schedule).	9c _____
d Total (add lines 9a, b, and c).	9d _____
10 Acquisition indebtedness related to line 9 items (attach schedule)	10 _____
11 Balance (subtract line 10 from line 9d)	11 _____
12 Multiply line 11 by 3 1/2% (2/3 of the percentage for the minimum investment return computation under section 4942(e)). Line 2d above must equal or exceed the result of this computation	12 _____
Support Test	
13 Applicant organization's support as defined in section 509(d)	13 _____
14 Gross investment income as defined in section 509(e)	14 _____
15 Support for purposes of section 4942(j)(3)(B)(iii) (subtract line 14 from line 13)	15 _____
16 Support received from the general public, five or more exempt organizations, or a combination of these sources (attach schedule).	16 _____
17 For persons (other than exempt organizations) contributing more than 1% of line 15, enter the total amounts that are more than 1% of line 15	17 _____
18 Subtract line 17 from line 16	18 _____
19 Percentage of total support (divide line 18 by line 15—must be at least 85%)	19 _____ %
20 Does line 16 include support from an exempt organization that is more than 25% of the amount of line 15?	<input type="checkbox"/> Yes <input type="checkbox"/> No
21 Newly created organizations with less than 1 year's experience: Attach a statement explaining how the organization is planning to satisfy the requirements of section 4942(j)(3) for the income test and one of the supplemental tests during its first year's operation. Include a description of plans and arrangements, press clippings, public announcements, solicitations for funds, etc.	
22 Does the amount entered on line 2a above include any grants that the applicant organization made? If "Yes," attach a statement explaining how those grants satisfy the criteria for "significant involvement" grants described in section 53.4942(b)-1(b)(2) of the regulations.	<input type="checkbox"/> Yes <input type="checkbox"/> No

For more information, see back of Schedule E.

Schedule F. Homes for the Aged or Handicapped

1 What are the requirements for admission to residency? Explain fully and attach promotional literature and application forms.

2 Does or will the home charge an entrance or founder's fee? Yes No
If "Yes," explain and specify the amount charged.

3 What periodic fees or maintenance charges are or will be required of its residents?

4a What established policy does the home have concerning residents who become unable to pay their regular charges?

b What arrangements does the home have or will it make with local and Federal welfare units, sponsoring organizations, or others to absorb all or part of the cost of maintaining those residents?

5 What arrangements does or will the home have to provide for the health needs of its residents?

6 In what way are the home's residential facilities designed to meet some combination of the physical, emotional, recreational, social, religious, and similar needs of the aged or handicapped?

7 Provide a description of the home's facilities and specify both the residential capacity of the home and the current number of residents.

8 Attach a sample copy of the contract or agreement the organization makes with or requires of its residents.

For more information, see back of Schedule F.

Schedule G. Child Care Organizations

1 Is the organization's primary activity the providing of care for children away from their homes? **Yes** **No**

2 How many children is the organization authorized to care for by the state (or local governmental unit), and what was the average attendance during the past 6 months, or the number of months the organization has been in existence if less than 6 months?

3 How many children are currently cared for by the organization?

4 Is substantially all (at least 85%) of the care provided for the purpose of enabling parents to be gainfully employed or to seek employment? **Yes** **No**

5 Are the services provided available to the general public? **Yes** **No**
If "No," explain.

6 Indicate the category, or categories, of parents whose children are eligible for the child care services (check as many as apply):

- low-income parents
- any working parents (or parents looking for work)
- anyone with the ability to pay
- other (explain)

Instructions

Line 5

If your organization's services are not available to the general public, indicate the particular group or groups that may utilize the services.

REMINDER—If this organization claims to operate a school, then it must also fill out Schedule B.

Schedule H. Organizations Providing Scholarship Benefits, Student Aid, etc., to Individuals

1a Describe the nature and the amount of the scholarship benefit, student aid, etc., including the terms and conditions governing its use, whether a gift or a loan, and how the availability of the scholarship is publicized. If the organization has established or will establish several categories of scholarship benefits, identify each kind of benefit and explain how the organization determines the recipients for each category. Attach a sample copy of any application the organization requires individuals to complete to be considered for scholarship grants, loans, or similar benefits. (Private foundations that make grants for travel, study, or other similar purposes are required to obtain advance approval of scholarship procedures. See Regulations sections 53.4945-4(c) and (d).)

b If you want this application considered as a request for approval of grant procedures in the event we determine that the organization is a private foundation, check here

c If you checked the box in **1b** above, check the box(es) for which you wish the organization to be considered.

4945(g)(1) 4945(g)(2) 4945(g)(3)

2 What limitations or restrictions are there on the class of individuals who are eligible recipients? Specifically explain whether there are, or will be, any restrictions or limitations in the selection procedures based upon race or the employment status of the prospective recipient or any relative of the prospective recipient. Also indicate the approximate number of eligible individuals.

3 Indicate the number of grants the organization anticipates making annually

4 If the organization bases its selections in any way on the employment status of the applicant or any relative of the applicant, indicate whether there is or has been any direct or indirect relationship between the members of the selection committee and the employer. Also indicate whether relatives of the members of the selection committee are possible recipients or have been recipients.

5 Describe any procedures the organization has for supervising grants (such as obtaining reports or transcripts) that it awards and any procedures it has for taking action if the terms of the grant are violated.

For more information, see back of Schedule H.

Schedule I. Successors to "For Profit" Institutions

1 What was the name of the predecessor organization and the nature of its activities?

2 Who were the owners or principal stockholders of the predecessor organization? (If more space is needed, attach schedule.)

Name and address	Share or interest
.....	
.....	
.....	
.....	

3 Describe the business or family relationship between the owners or principal stockholders and principal employees of the predecessor organization and the officers, directors, and principal employees of the applicant organization.

4a Attach a copy of the agreement of sale or other contract that sets forth the terms and conditions of sale of the predecessor organization or of its assets to the applicant organization.

b Attach an appraisal by an independent qualified expert showing the fair market value at the time of sale of the facilities or property interest sold.

5 Has any property or equipment formerly used by the predecessor organization been rented to the applicant organization or will any such property be rented? Yes No
If "Yes," explain and attach copies of all leases and contracts.

6 Is the organization leasing or will it lease or otherwise make available any space or equipment to the owners, principal stockholders, or principal employees of the predecessor organization? Yes No
If "Yes," explain and attach a list of these tenants and a copy of the lease for each such tenant.

7 Were any new operating policies initiated as a result of the transfer of assets from a profit-making organization to a nonprofit organization? Yes No
If "Yes," explain.

Additional Information

A "for profit" institution for purposes of Schedule I includes any organization in which a person may have a proprietary or partnership interest, hold corporate

stock, or otherwise exercise an ownership interest. The institution need not have operated for the purpose of making a profit.



Form **1024**
(Rev. September 1998)
Department of the Treasury
Internal Revenue Service

**Application for Recognition of Exemption
Under Section 501(a)**

OMB No. 1545-0057

If exempt status is approved,
this application will be open
for public inspection.

Read the instructions for each Part carefully. **A User Fee must be attached to this application.**
If the required information and appropriate documents are not submitted along with Form 8718 (with payment of the appropriate user fee), the application may be returned to the organization.

Complete the Procedural Checklist on page 6 of the instructions.

Part I. Identification of Applicant (Must be completed by all applicants; also complete appropriate schedule.)
Submit only the schedule that applies to your organization. Do not submit blank schedules.

Check the appropriate box below to indicate the section under which the organization is applying:

- a Section 501(c)(2)—Title holding corporations (Schedule A, page 7)
- b Section 501(c)(4)—Civic leagues, social welfare organizations (including certain war veterans' organizations), or local associations of employees (Schedule B, page 8)
- c Section 501(c)(5)—Labor, agricultural, or horticultural organizations (Schedule C, page 9)
- d Section 501(c)(6)—Business leagues, chambers of commerce, etc. (Schedule C, page 9)
- e Section 501(c)(7)—Social clubs (Schedule D, page 11)
- f Section 501(c)(8)—Fraternal beneficiary societies, etc., providing life, sick, accident, or other benefits to members (Schedule E, page 13)
- g Section 501(c)(9)—Voluntary employees' beneficiary associations (Parts I through IV and Schedule F, page 14)
- h Section 501(c)(10)—Domestic fraternal societies, orders, etc., not providing life, sick, accident, or other benefits (Schedule E, page 13)
- i Section 501(c)(12)—Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations (Schedule G, page 15)
- j Section 501(c)(13)—Cemeteries, crematoria, and like corporations (Schedule H, page 16)
- k Section 501(c)(15)—Mutual insurance companies or associations, other than life or marine (Schedule I, page 17)
- l Section 501(c)(17)—Trusts providing for the payment of supplemental unemployment compensation benefits (Parts I through IV and Schedule J, page 18)
- m Section 501(c)(19)—A post, organization, auxiliary unit, etc., of past or present members of the Armed Forces of the United States (Schedule K, page 19)
- n Section 501(c)(25)—Title holding corporations or trusts (Schedule A, page 7)

1a Full name of organization (as shown in organizing document)	2 Employer identification number (EIN) (if none, see Specific Instructions on page 2) : : :			
1b c/o Name (if applicable)	3 Name and telephone number of person to be contacted if additional information is needed ()			
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">1c Address (number and street)</td> <td style="width: 50%;">Room/Suite</td> </tr> </table>		1c Address (number and street)	Room/Suite	
1c Address (number and street)		Room/Suite		
1d City, town or post office, state, and ZIP + 4 If you have a foreign address, see Specific Instructions for Part I, page 2.				
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">1e Web site address</td> <td style="width: 30%;">4 Month the annual accounting period ends</td> <td style="width: 40%;">5 Date incorporated or formed</td> </tr> </table>	1e Web site address	4 Month the annual accounting period ends	5 Date incorporated or formed	
1e Web site address	4 Month the annual accounting period ends	5 Date incorporated or formed		

6 Did the organization previously apply for recognition of exemption under this Code section or under any other section of the Code? Yes No
If "Yes," attach an explanation.

7 Has the organization filed Federal income tax returns or exempt organization information returns? Yes No
If "Yes," state the form numbers, years filed, and Internal Revenue office where filed.

8 Check the box for the type of organization. ATTACH A CONFORMED COPY OF THE CORRESPONDING ORGANIZING DOCUMENTS TO THE APPLICATION BEFORE MAILING.

- a Corporation— Attach a copy of the Articles of Incorporation (including amendments and restatements) showing approval by the appropriate state official; also attach a copy of the bylaws.
- b Trust— Attach a copy of the Trust Indenture or Agreement, including all appropriate signatures and dates.
- c Association— Attach a copy of the Articles of Association, Constitution, or other creating document, with a declaration (see instructions) or other evidence that the organization was formed by adoption of the document by more than one person. Also include a copy of the bylaws.

If this is a corporation or an unincorporated association that has not yet adopted bylaws, check here

I declare under the penalties of perjury that I am authorized to sign this application on behalf of the above organization, and that I have examined this application, including the accompanying schedules and attachments, and to the best of my knowledge it is true, correct, and complete.

PLEASE SIGN HERE _____
 (Signature) (Type or print name and title or authority of signer) (Date)

For Paperwork Reduction Act Notice, see page 5 of the instructions.

Part II. Activities and Operational Information (Must be completed by all applicants)

- 1 Provide a detailed narrative description of all the activities of the organization—past, present, and planned. Do not merely refer to or repeat the language in the organizational document. List each activity separately in the order of importance based on the relative time and other resources devoted to the activity. Indicate the percentage of time for each activity. Each description should include, as a minimum, the following: (a) a detailed description of the activity including its purpose and how each activity furthers your exempt purpose; (b) when the activity was or will be initiated; and (c) where and by whom the activity will be conducted.

-
- 2 List the organization's present and future sources of financial support, beginning with the largest source first.
-

Part II. Activities and Operational Information (continued)

3 Give the following information about the organization's governing body:

a Names, addresses, and titles of officers, directors, trustees, etc.	b Annual compensation

4 If the organization is the outgrowth or continuation of any form of predecessor, state the name of each predecessor, the period during which it was in existence, and the reasons for its termination. Submit copies of all papers by which any transfer of assets was effected.

5 If the applicant organization is now, or plans to be, connected in any way with any other organization, describe the other organization and explain the relationship (e.g., financial support on a continuing basis; shared facilities or employees; same officers, directors, or trustees).

6 If the organization has capital stock issued and outstanding, state: **(1)** class or classes of the stock; **(2)** number and par value of the shares; **(3)** consideration for which they were issued; and **(4)** if any dividends have been paid or whether your organization's creating instrument authorizes dividend payments on any class of capital stock.

7 State the qualifications necessary for membership in the organization; the classes of membership (with the number of members in each class); and the voting rights and privileges received. If any group or class of persons is required to join, describe the requirement and explain the relationship between those members and members who join voluntarily. Submit copies of any membership solicitation material. Attach sample copies of all types of membership certificates issued.

8 Explain how your organization's assets will be distributed on dissolution.

Part II. Activities and Operational Information (continued)

9 Has the organization made or does it plan to make any distribution of its property or surplus funds to shareholders or members? Yes No
If "Yes," state the full details, including: (1) amounts or value; (2) source of funds or property distributed or to be distributed; and (3) basis of, and authority for, distribution or planned distribution.

10 Does, or will, any part of your organization's receipts represent payments for services performed or to be performed? Yes No
If "Yes," state in detail the amount received and the character of the services performed or to be performed.

11 Has the organization made, or does it plan to make, any payments to members or shareholders for services performed or to be performed? Yes No
If "Yes," state in detail the amount paid, the character of the services, and to whom the payments have been, or will be, made.

12 Does the organization have any arrangement to provide insurance for members, their dependents, or others (including provisions for the payment of sick or death benefits, pensions, or annuities)? Yes No
If "Yes," describe and explain the arrangement's eligibility rules and attach a sample copy of each plan document and each type of policy issued.

13 Is the organization under the supervisory jurisdiction of any public regulatory body, such as a social welfare agency, etc.? Yes No
If "Yes," submit copies of all administrative opinions or court decisions regarding this supervision, as well as copies of applications or requests for the opinions or decisions.

14 Does the organization now lease or does it plan to lease any property? Yes No
If "Yes," explain in detail. Include the amount of rent, a description of the property, and any relationship between the applicant organization and the other party. Also, attach a copy of any rental or lease agreement. (If the organization is a party, as a lessor, to multiple leases of rental real property under similar lease agreements, please attach a single representative copy of the leases.)

15 Has the organization spent or does it plan to spend any money attempting to influence the selection, nomination, election, or appointment of any person to any Federal, state, or local public office or to an office in a political organization? Yes No
If "Yes," explain in detail and list the amounts spent or to be spent in each case.

16 Does the organization publish pamphlets, brochures, newsletters, journals, or similar printed material? Yes No
If "Yes," attach a recent copy of each.

Part III. Financial Data (Must be completed by all applicants)

Complete the financial statements for the current year and for each of the 3 years immediately before it. If in existence less than 4 years, complete the statements for each year in existence. If in existence less than 1 year, also provide proposed budgets for the 2 years following the current year.

A. Statement of Revenue and Expenses

Revenue	(a) Current Tax Year	3 Prior Tax Years or Proposed Budget for Next 2 Years			(e) Total
	From _____ To _____	(b)	(c)	(d)	
1 Gross dues and assessments of members					
2 Gross contributions, gifts, etc.					
3 Gross amounts derived from activities related to the organization's exempt purpose (attach schedule) (Include related cost of sales on line 9.)					
4 Gross amounts from unrelated business activities (attach schedule)					
5 Gain from sale of assets, excluding inventory items (attach schedule)					
6 Investment income (see page 3 of the instructions)					
7 Other revenue (attach schedule).					
8 Total revenue (add lines 1 through 7)					
Expenses					
9 Expenses attributable to activities related to the organization's exempt purposes.					
10 Expenses attributable to unrelated business activities					
11 Contributions, gifts, grants, and similar amounts paid (attach schedule).					
12 Disbursements to or for the benefit of members (attach schedule)					
13 Compensation of officers, directors, and trustees (attach schedule)					
14 Other salaries and wages.					
15 Interest					
16 Occupancy					
17 Depreciation and depletion					
18 Other expenses (attach schedule)					
19 Total expenses (add lines 9 through 18)					
20 Excess of revenue over expenses (line 8 minus line 19)					

B. Balance Sheet (at the end of the period shown)

		Current Tax Year as of _____
Assets		
1 Cash		1
2 Accounts receivable, net		2
3 Inventories		3
4 Bonds and notes receivable (attach schedule)		4
5 Corporate stocks (attach schedule).		5
6 Mortgage loans (attach schedule)		6
7 Other investments (attach schedule)		7
8 Depreciable and depletable assets (attach schedule)		8
9 Land		9
10 Other assets (attach schedule)		10
11 Total assets		11
Liabilities		
12 Accounts payable		12
13 Contributions, gifts, grants, etc., payable		13
14 Mortgages and notes payable (attach schedule)		14
15 Other liabilities (attach schedule)		15
16 Total liabilities.		16
Fund Balances or Net Assets		
17 Total fund balances or net assets		17
18 Total liabilities and fund balances or net assets (add line 16 and line 17)		18

If there has been any substantial change in any aspect of the organization's financial activities since the end of the period shown above, check the box and attach a detailed explanation.

Part IV. Notice Requirements (Sections 501(c)(9) and 501(c)(17) Organizations Only)

1 Section 501(c)(9) and 501(c)(17) organizations:

Are you filing Form 1024 within 15 months from the end of the month in which the organization was created or formed as required by section 505(c)? Yes No

If "Yes," skip the rest of this Part.

If "No," answer question 2.

2 If you answer "No" to question 1, are you filing Form 1024 within 27 months from the end of the month in which the organization was created or formed? Yes No

If "Yes," your organization qualifies under Regulation section 301.9100-2 for an automatic 12-month extension of the 15-month filing requirement. Do not answer questions 3 and 4.

If "No," answer question 3.

3 If you answer "No" to question 2, does the organization wish to request an extension of time to apply under the "reasonable action and good faith" and the "no prejudice to the interest of the government" requirements of Regulations section 301.9100-3? Yes No

If "Yes," give the reasons for not filing this application within the 27-month period described in question 2. See Specific Instructions, Part IV, Line 3, page 4, before completing this item. Do not answer question 4.

If "No," answer question 4.

4 If you answer "No" to question 3, your organization's qualification as a section 501(c)(9) or 501(c)(17) organization can be recognized only from the date this application is filed. Therefore, does the organization want us to consider its application as a request for recognition of exemption as a section 501(c)(9) or 501(c)(17) organization from the date the application is received and not retroactively to the date the organization was created or formed? Yes No

Organizations described in section 501(c)(2) or 501(c)(25) (Title holding corporations or trusts)

1 State the complete name, address, and EIN of each organization for which title to property is held and the number and type of the applicant organization's stock held by each organization.

2 If the annual excess of revenue over expenses has not been or will not be turned over to the organization for which title to property is held, state the purpose for which the excess is or will be retained by the title holding organization.

3 In the case of a corporation described in section 501(c)(2), state the purpose of the organization for which title to property is held (as shown in its governing instrument) and the Code sections under which it is classified as exempt from tax. If the organization has received a determination or ruling letter recognizing it as exempt from taxation, please attach a copy of the letter.

4 In the case of a corporation or trust described in section 501(c)(25), state the basis whereby each shareholder is described in section 501(c)(25)(C). For each organization described that has received a determination or ruling letter recognizing that organization as exempt from taxation, please attach a copy of the letter.

5 With respect to the activities of the organization.

a Is any rent received attributable to personal property leased with real property? Yes No

If "Yes," what percentage of the total rent, as reported on the financial statements in Part III, is attributable to personal property?

b Will the organization receive income which is incidentally derived from the holding of real property, such as income from operation of a parking lot or from vending machines? Yes No

If "Yes," what percentage of the organization's gross income, as reported on the financial statements in Part III, is incidentally derived from the holding of real property?

c Will the organization receive income other than rent from real property or personal property leased with real property or income which is incidentally derived from the holding of real property? Yes No

If "Yes," describe the source of the income.

Instructions

Line 1.—Provide the requested information on each organization for which the applicant organization holds title to property. Also indicate the number and types of shares of the applicant organization's stock that are held by each.

Line 2.—For purposes of this question, "excess of revenue over expenses" is all of the organization's income for a particular tax year less operating expenses.

Line 3.—Give the exempt purpose of each organization that is the basis for its exempt status and the Internal Revenue Code section

that describes the organization (as shown in its IRS determination letter).

Line 4.—Indicate if the shareholder is one of the following:

1. A qualified pension, profit-sharing, or stock bonus plan that meets the requirements of the Code;
2. A government plan;
3. An organization described in section 501(c)(3); or
4. An organization described in section 501(c)(25).

Organizations Described in Section 501(c)(4) (Civic leagues, social welfare organizations (including posts, councils, etc., of veterans' organizations not qualifying or applying for exemption under section 501(c)(19)) or local associations of employees.)

- 1 Has the Internal Revenue Service previously issued a ruling or determination letter recognizing the applicant organization (or any predecessor organization listed in question 4, Part II of the application) to be exempt under section 501(c)(3) and later revoked that recognition of exemption on the basis that the applicant organization (or its predecessor) was carrying on propaganda or otherwise attempting to influence legislation or on the basis that it engaged in political activity? Yes No

If "Yes," indicate the earliest tax year for which recognition of exemption under section 501(c)(3) was revoked and the IRS district office that issued the revocation.

- 2 Does the organization perform or plan to perform (for members, shareholders, or others) services, such as maintaining the common areas of a condominium; buying food or other items on a cooperative basis; or providing recreational facilities or transportation services, job placement, or other similar undertakings? Yes No

If "Yes," explain the activities in detail, including income realized and expenses incurred. Also, explain in detail the nature of the benefits to the general public from these activities. (If the answer to this question is explained in Part II of the application (pages 2, 3, and 4), enter the page and item number here.)

- 3 If the organization is claiming exemption as a homeowners' association, is access to any property or facilities it owns or maintains restricted in any way? Yes No

If "Yes," explain.

- 4 If the organization is claiming exemption as a local association of employees, state the name and address of each employer whose employees are eligible for membership in the association. If employees of more than one plant or office of the same employer are eligible for membership, give the address of each plant or office.

Organizations described in section 501(c)(5) (Labor, agricultural, including fishermen's organizations, or horticultural organizations) or section 501(c)(6) (business leagues, chambers of commerce, etc.)

1 Describe any services the organization performs for members or others. (If the description of the services is contained in Part II of the application, enter the page and item number here.)

2 Fishermen's organizations only.—What kinds of aquatic resources (not including mineral) are cultivated or harvested by those eligible for membership in the organization?

3 Labor organizations only.—Is the organization organized under the terms of a collective bargaining agreement? . . . Yes No

If "Yes," attach a copy of the latest agreement.

Organizations described in section 501(c)(7) (Social clubs)

1 Has the organization entered or does it plan to enter into any contract or agreement for the management or operation of its property and/or activities, such as restaurants, pro shops, lodges, etc.? Yes No

If "Yes," attach a copy of the contract or agreement. If one has not yet been drawn up, please explain the organization's plans.

2 Does the organization seek or plan to seek public patronage of its facilities or activities by advertisement or otherwise? Yes No

If "Yes," attach sample copies of the advertisements or other requests. If the organization plans to seek public patronage, please explain the plans.

3a Are nonmembers, other than guests of members, permitted or will they be permitted to use the club facilities or participate in or attend any functions or activities conducted by the organization? Yes No

If "Yes," describe the functions or activities in which there has been or will be nonmember participation or admittance. (Submit a copy of the house rules, if any.)

b State the amount of nonmember income included in Part III of the application, lines 3 and 4, column (a) _____
c Enter the percent of gross receipts from nonmembers for the use of club facilities _____ %
d Enter the percent of gross receipts received from investment income and nonmember use of the club's facilities _____ %

4a Does the organization's charter, bylaws, other governing instrument, or any written policy statement of the organization contain any provision that provides for discrimination against any person on the basis of race, color, or religion? Yes No

b If "Yes," state whether or not its provision will be kept.

c If the organization has such a provision that will be repealed, deleted, or otherwise stricken from its requirements, state when this will be done. _____

d If the organization formerly had such a requirement and it no longer applies, give the date it ceased to apply _____

e If the organization restricts its membership to members of a particular religion, check here and attach the explanation specified in the instructions

See reverse side for instructions

Instructions

Line 1.—Answer “Yes,” if any of the organization’s property or activities will be managed by another organization or company.

Lines 3b, c, and d.—Enter the figures for the current year. On an attached schedule, furnish the same information for each of the prior tax years for which you completed Part III of the application.

Line 4e.—If the organization restricts its membership to members of a particular religion, the organization must be:

1. An auxiliary of a fraternal beneficiary society that:

- a. Is described in section 501(c)(8) and exempt from tax under section 501(a), and

- b. Limits its membership to members of a particular religion; or

2. A club that, in good faith, limits its membership to the members of a particular religion in order to further the teachings or principles of that religion and not to exclude individuals of a particular race or color.

If you checked **4e**, your explanation must show how the organization meets one of these two requirements.

Organizations described in section 501(c)(8) or 501(c)(10) (Fraternal societies, orders, or associations)

- 1 Is the organization a college fraternity or sorority, or chapter of a college fraternity or sorority? Yes No
 If "Yes," read the instructions for Line 1, below, before completing this schedule.
-
- 2 Does or will your organization operate under the lodge system? Yes No
 If "No," does or will it operate for the exclusive benefit of the members of an organization operating under the lodge system? Yes No
-
- 3 Is the organization a subordinate or local lodge, etc.? Yes No
 If "Yes," attach a certificate signed by the secretary of the parent organization, under the seal of the organization, certifying that the subordinate lodge is a duly constituted body operating under the jurisdiction of the parent body.
-
- 4 Is the organization a parent or grand lodge? Yes No
 If "Yes," attach a schedule for each subordinate lodge in active operation showing: (a) its name and address; (b) the number of members in it; and (c) how often it holds periodic meetings.

Instructions

Line 1.—To the extent that they qualify for exemption from Federal income tax, college fraternities and sororities generally qualify as organizations described in section 501(c)(7). Therefore, if the organization is a college fraternity or sorority, refer to the discussion of section 501(c)(7) organizations in Pub. 557. If section 501(c)(7) appears to apply to your organization, complete Schedule D instead of this schedule.

Line 2.—Operating under the lodge system means carrying on activities under a form of organization that is composed of local branches, chartered by a parent organization, largely self-governing, and called lodges, chapters, or the like.

Organizations described in section 501(c)(9) (Voluntary employees' beneficiary associations)

1 Describe the benefits available to members. Include copies of any plan documents that describe such benefits and the terms and conditions of eligibility for each benefit.

2 Are any employees or classes of employees entitled to benefits to which other employees or classes of employees are not entitled? Yes No
If "Yes," explain.

3 Give the following information for each plan as of the last day of the most recent plan year and enter that date here. If there is more than one plan, attach a separate schedule / /
(mo.) (day) (yr.)

a Total number of persons covered by the plan who are highly compensated individuals (See instructions below.) . . . _____

b Number of other employees covered by the plan _____

c Number of employees not covered by the plan _____

d Total number employed* _____

* Should equal the total of **a**, **b**, and **c**—if not, explain any difference. Describe the eligibility requirements that prevent those employees not covered by the plan from participating.

4 State the number of persons, if any, other than employees and their dependents (e.g., the proprietor of a business whose employees are members of the association) who are entitled to receive benefits ►

Instructions

Line 3a.—A "highly compensated individual" is one who:

(a) Owned 5% or more of the employer at any time during the current year or the preceding year.

(b) Received more than \$80,000 (adjusted for inflation) in compensation from the employer for the preceding year, and

(c) Was among the top 20% of employees by compensation for the preceding year. However, the employer can choose not to have **(c)** apply.

Organizations described in section 501(c)(12) (Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations)

- 1 Attach a schedule in columnar form for each tax year for which the organization is claiming exempt status. On each schedule:
 - a Show the total gross income received from members or shareholders.
 - b List, by source, the total amounts of gross income received from other sources.

- 2 If the organization is claiming exemption as a local benevolent insurance association, state:
 - a The counties from which members are accepted or will be accepted.

- b Whether stipulated premiums are or will be charged in advance, or whether losses are or will be paid solely through assessments.

- 3 If the organization is claiming exemption as a "like organization," explain how it is similar to a mutual ditch or irrigation company, or a mutual or cooperative telephone company.

- 4 Are the rights and interests of members in the organization's annual savings determined in proportion to their business with it? Yes No
 If "Yes," does the organization keep the records necessary to determine at any time each member's rights and interests in such savings, including assets acquired with the savings? Yes No

- 5 If the organization is a mutual or cooperative telephone company and has contracts with other systems for long-distance telephone services, attach copies of the contracts.

Instructions

Mutual or cooperative electric or telephone companies should show income received from qualified pole rentals separately. Mutual or cooperative telephone companies should also show separately the gross amount of income received from nonmember telephone companies for performing services that

involve their members and the gross amount of income received from the sale of display advertising in a directory furnished to their members.

Do not net amounts due or paid to other sources against amounts due or received from those sources.

Organizations described in section 501(c)(13) (Cemeteries, crematoria, and like corporations)

- 1** Attach the following documents:
- a** Complete copy of sales contracts or other documents, including any "debt" certificates, involved in acquiring cemetery or crematorium property.
 - b** Complete copy of any contract your organization has that designates an agent to sell its cemetery lots.
 - c** A copy of the appraisal (obtained from a disinterested and qualified party) of the cemetery property as of the date acquired.
-
- 2** Does your organization have, or does it plan to have, a perpetual care fund? Yes No
If "Yes," attach a copy of the fund agreement and explain the nature of the fund (cash, securities, unsold land, etc.)

-
- 3** If your organization is claiming exemption as a perpetual care fund for an organization described in section 501(c)(13), has the cemetery organization, for which funds are held, established exemption under that section? Yes No
If "No," explain.

Organizations described in section 501(c)(15) (Small insurance companies or associations)

1 Is the organization a member of a controlled group of corporations as defined in section 831(b)(2)(B)(ii)? (Disregard section 1563(b)(2)(B) in determining whether the organization is a member of a controlled group.) Yes No

If "Yes," include on lines 2 through 5 the total amount received by the organization and all other members of the controlled group.

If "No," include on lines 2 through 5 only the amounts that relate to the applicant organization.

	(a) Current Year	3 Prior Tax Years		
	From _____ To _____	(b)	(c)	(d)
2 Direct written premiums				
3 Reinsurance assumed				
4 Reinsurance ceded				
5 Net written premiums ((line 2 plus line 3) minus line 4)				

6 If you entered an amount on line 3 or line 4, attach a copy of the reinsurance agreements the organization has entered into.

Instructions

Line 1.— Answer "Yes," if the organization would be considered a member of a controlled group of corporations if it were not exempt from tax under section 501(a). In applying section 1563(a), use a "more than 50%" stock ownership test to determine whether the applicant or any other corporation is a member of a controlled group.

Line 2.— In addition to other direct written premiums, include on line 2 the full amount of any prepaid or advance premium in the year the prepayment is received. For example, if a \$5,000 premium for a 3-year policy was received in the current year, include the full \$5,000 amount in the Current Year column.

Organizations described in section 501(c)(17) (Trusts providing for the payment of supplemental unemployment compensation benefits)

1 If benefits are provided for individual proprietors, partners, or self-employed persons under the plan, explain in detail.

2 If the plan provides other benefits in addition to the supplemental unemployment compensation benefits, explain in detail and state whether the other benefits are subordinate to the unemployment benefits.

3 Give the following information as of the last day of the most recent plan year and enter that date here
a Total number of employees covered by the plan who are shareholders, officers, self-employed persons, or highly compensated (See Schedule F instructions for line 3a on page 14.)
b Number of other employees covered by the plan
c Number of employees not covered by the plan
d Total number employed*.
* Should equal the total of a, b, and c—if not, explain the difference. Describe the eligibility requirements that prevent those employees not covered by the plan from participating.

4 At any time after December 31, 1959, did any of the following persons engage in any of the transactions listed below with the trust: the creator of the trust or a contributor to the trust; a brother or sister (whole or half blood), a spouse, an ancestor, or a lineal descendant of such a creator or contributor; or a corporation controlled directly or indirectly by such a creator or contributor?

Note: If you know that the organization will be, or is considering being, a party to any of the transactions (or activities) listed below, check the "Planned" box. Give a detailed explanation of any "Yes" or "Planned" answer in the space below.

- a Borrow any part of the trust's income or corpus? Yes No Planned
- b Receive any compensation for personal services? Yes No Planned
- c Obtain any part of the trust's services? Yes No Planned
- d Purchase any securities or other properties from the trust? Yes No Planned
- e Sell any securities or other property to the trust? Yes No Planned
- f Receive any of the trust's income or corpus in any other transaction? Yes No Planned

5 Attach a copy of the Supplemental Unemployment Benefit Plan and related agreements.

Form **990**

Return of Organization Exempt From Income Tax
 Under section 501(c) of the Internal Revenue Code (except black lung benefit trust or private foundation) or section 4947(a)(1) nonexempt charitable trust

OMB No. 1545-0047

1999

Department of the Treasury
 Internal Revenue Service

Note: The organization may have to use a copy of this return to satisfy state reporting requirements.

This Form is
 Open to Public
 Inspection

A For the 1999 calendar year, OR tax year period beginning _____, 1999, and ending _____

- B** Check if:
- Change of address
 - Initial return
 - Final return
 - Amended return (required also for state reporting)

Please use IRS label or print or type. See Specific Instructions.

C Name of organization _____

Number and street (or P.O. box if mail is not delivered to street address) Room/suite _____

City or town, state or country, and ZIP+4 _____

D Employer identification number _____

E Telephone number _____

F Check if exemption application is pending

G Type of organization— Exempt under section 501(c)() (insert number) OR section 4947(a)(1) nonexempt charitable trust
Note: Section 501(c)(3) exempt organizations and 4947(a)(1) nonexempt charitable trusts MUST attach a completed Schedule A (Form 990).

H(a) Is this a group return filed for affiliates? Yes No
(b) If "Yes," enter the number of affiliates for which this return is filed: _____
(c) Is this a separate return filed by an organization covered by a group ruling? Yes No
I If either box in H is checked "Yes," enter four-digit group exemption number (GEN) ▶ _____
J Accounting method: Cash Accrual Other (specify) ▶ _____

K Check here if the organization's gross receipts are normally not more than \$25,000. The organization need not file a return with the IRS; but if it received a Form 990 Package in the mail, it should file a return without financial data. **Some states require a complete return.**

Note: Form 990-EZ may be used by organizations with gross receipts less than \$100,000 and total assets less than \$250,000 at end of year.

Revenue, Expenses, and Changes in Net Assets or Fund Balances (See Specific Instructions on page 15.)

Revenue	1 Contributions, gifts, grants, and similar amounts received:			
	a Direct public support	1a		
	b Indirect public support	1b		
	c Government contributions (grants)	1c		
	d Total (add lines 1a through 1c) (attach schedule of contributors) (cash \$ _____ noncash \$ _____)	1d		
	2 Program service revenue including government fees and contracts (from Part VII, line 93)	2		
	3 Membership dues and assessments	3		
	4 Interest on savings and temporary cash investments	4		
	5 Dividends and interest from securities	5		
	6a Gross rents	6a		
	b Less: rental expenses	6b		
	c Net rental income or (loss) (subtract line 6b from line 6a)	6c		
7 Other investment income (describe ▶ _____)	7			
	8a Gross amount from sales of assets other than inventory	(A) Securities		(B) Other
			8a	
			8b	
			8c	
d Net gain or (loss) (combine line 8c, columns (A) and (B))	8d			
	9 Special events and activities (attach schedule)	a Gross revenue (not including \$ _____ of contributions reported on line 1a)	9a	
		b Less: direct expenses other than fundraising expenses	9b	
		c Net income or (loss) from special events (subtract line 9b from line 9a)	9c	
	10a Gross sales of inventory, less returns and allowances		10a	
		b Less: cost of goods sold	10b	
		c Gross profit or (loss) from sales of inventory (attach schedule) (subtract line 10b from line 10a)	10c	
11 Other revenue (from Part VII, line 103)	11			
12 Total revenue (add lines 1d, 2, 3, 4, 5, 6c, 7, 8d, 9c, 10c, and 11)	12			
Expenses	13 Program services (from line 44, column (B))	13		
	14 Management and general (from line 44, column (C))	14		
	15 Fundraising (from line 44, column (D))	15		
	16 Payments to affiliates (attach schedule)	16		
	17 Total expenses (add lines 16 and 44, column (A))	17		
Net Assets	18 Excess or (deficit) for the year (subtract line 17 from line 12)	18		
	19 Net assets or fund balances at beginning of year (from line 73, column (A))	19		
	20 Other changes in net assets or fund balances (attach explanation)	20		
	21 Net assets or fund balances at end of year (combine lines 18, 19, and 20)	21		

For Paperwork Reduction Act Notice, see page 1 of the separate instructions.

Cat. No. 11282Y

Form **990** (1999)

Statement of Functional Expenses All organizations must complete column (A). Columns (B), (C), and (D) are required for section 501(c)(3) and (4) organizations and section 4947(a)(1) nonexempt charitable trusts but optional for others. (See Specific Instructions on page 19.)

<i>Do not include amounts reported on line 6b, 8b, 9b, 10b, or 16 of Part I.</i>		(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
22	Grants and allocations (attach schedule) (cash \$ _____ noncash \$ _____)	22			
23	Specific assistance to individuals (attach schedule)	23			
24	Benefits paid to or for members (attach schedule).	24			
25	Compensation of officers, directors, etc.	25			
26	Other salaries and wages	26			
27	Pension plan contributions	27			
28	Other employee benefits	28			
29	Payroll taxes	29			
30	Professional fundraising fees	30			
31	Accounting fees	31			
32	Legal fees	32			
33	Supplies	33			
34	Telephone	34			
35	Postage and shipping	35			
36	Occupancy	36			
37	Equipment rental and maintenance	37			
38	Printing and publications	38			
39	Travel	39			
40	Conferences, conventions, and meetings	40			
41	Interest	41			
42	Depreciation, depletion, etc. (attach schedule)	42			
43	Other expenses (itemize): a	43a			
	b	43b			
	c	43c			
	d	43d			
	e	43e			
44	Total functional expenses (add lines 22 through 43). Organizations completing columns (B)-(D), carry these totals to lines 13- 15	44			

Reporting of Joint Costs. Did you report in column (B) (Program services) any joint costs from a combined educational campaign and fundraising solicitation? Yes No
 If "Yes," enter (i) the aggregate amount of these joint costs \$ _____; (ii) the amount allocated to Program services \$ _____; (iii) the amount allocated to Management and general \$ _____; and (iv) the amount allocated to Fundraising \$ _____

Statement of Program Service Accomplishments (See Specific Instructions on page 22.)

What is the organization's primary exempt purpose? ▶	Program Service Expenses (Required for 501(c)(3) and (4) orgs. and 4947(a)(1) trusts, but optional for others.)
a (Grants and allocations \$ _____)	
b (Grants and allocations \$ _____)	
c (Grants and allocations \$ _____)	
d (Grants and allocations \$ _____)	
e Other program services (attach schedule) (Grants and allocations \$ _____)	
f Total of Program Service Expenses (should equal line 44, column (B), Program services) ▶	

Balance Sheets (See Specific Instructions on page 22.)

Note: Where required, attached schedules and amounts within the description column should be for end-of-year amounts only.		(A) Beginning of year	(B) End of year
Assets	45 Cash—non-interest-bearing		45
	46 Savings and temporary cash investments		46
	47a Accounts receivable	47a	
	b Less: allowance for doubtful accounts	47b	47c
	48a Pledges receivable	48a	
	b Less: allowance for doubtful accounts	48b	48c
	49 Grants receivable		49
	50 Receivables from officers, directors, trustees, and key employees (attach schedule)		50
	51a Other notes and loans receivable (attach schedule).	51a	
	b Less: allowance for doubtful accounts	51b	51c
	52 Inventories for sale or use		52
	53 Prepaid expenses and deferred charges		53
	54 Investments—securities (attach schedule)		54
	55a Investments—land, buildings, and equipment: basis	55a	
	b Less: accumulated depreciation (attach schedule).	55b	55c
56 Investments—other (attach schedule)		56	
57a Land, buildings, and equipment: basis	57a		
b Less: accumulated depreciation (attach schedule).	57b	57c	
58 Other assets (describe ► _____)		58	
59 Total assets (add lines 45 through 58) (must equal line 74)		59	
Liabilities	60 Accounts payable and accrued expenses		60
	61 Grants payable		61
	62 Deferred revenue		62
	63 Loans from officers, directors, trustees, and key employees (attach schedule).		63
	64a Tax-exempt bond liabilities (attach schedule)		64a
	b Mortgages and other notes payable (attach schedule)		64b
	65 Other liabilities (describe ► _____)		65
66 Total liabilities (add lines 60 through 65)		66	
Net Assets or Fund Balances	Organizations that follow SFAS 117, check here ► <input type="checkbox"/> and complete lines 67 through 69 and lines 73 and 74.		
	67 Unrestricted		67
	68 Temporarily restricted		68
	69 Permanently restricted		69
	Organizations that do not follow SFAS 117, check here ► <input type="checkbox"/> and complete lines 70 through 74.		
	70 Capital stock, trust principal, or current funds		70
	71 Paid-in or capital surplus, or land, building, and equipment fund		71
	72 Retained earnings, endowment, accumulated income, or other funds		72
73 Total net assets or fund balances (add lines 67 through 69 OR lines 70 through 72; column (A) must equal line 19 and column (B) must equal line 21)		73	
74 Total liabilities and net assets / fund balances (add lines 66 and 73)		74	

Form 990 is available for public inspection and, for some people, serves as the primary or sole source of information about a particular organization. How the public perceives an organization in such cases may be determined by the information presented on its return. Therefore, please make sure the return is complete and accurate and fully describes, in Part III, the organization's programs and accomplishments.

Other Information (See Specific Instructions on page 25.)		Yes	No
76	Did the organization engage in any activity not previously reported to the IRS? If "Yes," attach a detailed description of each activity	76	
77	Were any changes made in the organizing or governing documents but not reported to the IRS? If "Yes," attach a conformed copy of the changes.	77	
78a	Did the organization have unrelated business gross income of \$1,000 or more during the year covered by this return?	78a	
78b	b If "Yes," has it filed a tax return on Form 990-T for this year?	78b	
79	Was there a liquidation, dissolution, termination, or substantial contraction during the year? If "Yes," attach a statement	79	
80a	Is the organization related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization?	80a	
80b	b If "Yes," enter the name of the organization ▶ _____ and check whether it is <input type="checkbox"/> exempt OR <input type="checkbox"/> nonexempt.		
81a	a Enter the amount of political expenditures, direct or indirect, as described in the instructions for line 81. 81a _____	81a	
81b	b Did the organization file Form 1120-POL for this year?	81b	
82a	a Did the organization receive donated services or the use of materials, equipment, or facilities at no charge or at substantially less than fair rental value?	82a	
82b	b If "Yes," you may indicate the value of these items here. Do not include this amount as revenue in Part I or as an expense in Part II. (See instructions for reporting in Part III.) 82b _____	82b	
83a	a Did the organization comply with the public inspection requirements for returns and exemption applications?	83a	
83b	b Did the organization comply with the disclosure requirements relating to quid pro quo contributions?	83b	
84a	a Did the organization solicit any contributions or gifts that were not tax deductible?	84a	
84b	b If "Yes," did the organization include with every solicitation an express statement that such contributions or gifts were not tax deductible?	84b	
85a	85 501(c)(4), (5), or (6) organizations. a Were substantially all dues nondeductible by members?	85a	
85b	b Did the organization make only in-house lobbying expenditures of \$2,000 or less? If "Yes" was answered to either 85a or 85b, do not complete 85c through 85h below unless the organization received a waiver for proxy tax owed for the prior year.	85b	
85c	c Dues, assessments, and similar amounts from members 85c _____	85c	
85d	d Section 162(e) lobbying and political expenditures 85d _____	85d	
85e	e Aggregate nondeductible amount of section 6033(e)(1)(A) dues notices 85e _____	85e	
85f	f Taxable amount of lobbying and political expenditures (line 85d less 85e) 85f _____	85f	
85g	g Does the organization elect to pay the section 6033(e) tax on the amount in 85f?	85g	
85h	h If section 6033(e)(1)(A) dues notices were sent, does the organization agree to add the amount in 85f to its reasonable estimate of dues allocable to nondeductible lobbying and political expenditures for the following tax year?	85h	
86a	86 501(c)(7) orgs. Enter: a Initiation fees and capital contributions included on line 12 86a _____	86a	
86b	b Gross receipts, included on line 12, for public use of club facilities 86b _____	86b	
87a	87 501(c)(12) orgs. Enter: a Gross income from members or shareholders 87a _____	87a	
87b	b Gross income from other sources. (Do not net amounts due or paid to other sources against amounts due or received from them.) 87b _____	87b	
88	88 At any time during the year, did the organization own a 50% or greater interest in a taxable corporation or partnership, or an entity disregarded as separate from the organization under Regulations sections 301.7701-2 and 301.7701-3? If "Yes," complete Part IX	88	
89a	89a 501(c)(3) organizations. Enter: Amount of tax imposed on the organization during the year under: section 4911 ▶ _____ ; section 4912 ▶ _____ ; section 4955 ▶ _____		
89b	b 501(c)(3) and 501(c)(4) orgs. Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year? If "Yes," attach a statement explaining each transaction. 89b		
89c	c Enter: Amount of tax imposed on the organization managers or disqualified persons during the year under sections 4912, 4955, and 4958. ▶ _____		
89d	d Enter: Amount of tax on line 89c, above, reimbursed by the organization. ▶ _____		
90a	90a List the states with which a copy of this return is filed ▶ _____		
90b	b Number of employees employed in the pay period that includes March 12, 1999 (See inst.) 90b _____	90b	
91	91 The books are in care of ▶ _____ Telephone no. ▶ (_____) _____ Located at ▶ _____ ZIP + 4 ▶ _____		
92	92 Section 4947(a)(1) nonexempt charitable trusts filing Form 990 in lieu of Form 1041- Check here <input type="checkbox"/> and enter the amount of tax-exempt interest received or accrued during the tax year ▶ 92 _____		

Form 990-EZ Department of the Treasury Internal Revenue Service	Short Form Return of Organization Exempt From Income Tax Under section 501(c) of the Internal Revenue Code (except black lung benefit trust or private foundation) or section 4947(a)(1) nonexempt charitable trust ▶ For organizations with gross receipts less than \$100,000 and total assets less than \$250,000 at the end of the year. ▶ The organization may have to use a copy of this return to satisfy state reporting requirements.	OMB No. 1545-1150 1999 This Form is Open to Public Inspection
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A For the 1999 calendar year, OR tax year beginning _____, 1999, and ending _____

B Check if:
 Change of address
 Initial return
 Final return
 Amended return (required also for state reporting)

C Name of organization _____
 Number and street (or P.O. box, if mail is not delivered to street address) Room/suite _____
 City or town, state or country, and ZIP + 4 _____

D Employer identification number _____

E Telephone number _____

F Check if exemption application is pending

H Enter four-digit group exemption number (GEN) _____

G Accounting method: Cash Accrual Other (specify) ▶ _____

I Type of organization— Exempt under section 501(c)() ◀ (insert number) OR section 4947(a)(1) nonexempt charitable trust
Note: Section 501(c)(3) organizations and section 4947(a)(1) nonexempt charitable trusts MUST attach a completed Schedule A (Form 990).

J Check if the organization's gross receipts are normally not more than \$25,000. The organization need not file a return with the IRS; but if the organization received a Form 990 Package in the mail, the organization should file a return without financial data. **Some states require a complete return.**

K Enter the organization's 1999 gross receipts (add back lines 5b, 6b, and 7b, to line 9) ▶ \$ _____
If \$100,000 or more, the organization must file Form 990 instead of Form 990-EZ.

Revenue, Expenses, and Changes in Net Assets or Fund Balances (See Specific Instructions on page 32.)		
Revenue	1 Contributions, gifts, grants, and similar amounts received (attach schedule of contributors)	1
	2 Program service revenue including government fees and contracts	2
	3 Membership dues and assessments	3
	4 Investment income	4
	5a Gross amount from sale of assets other than inventory	5a
	5b Less: cost or other basis and sales expenses	5b
	5c Gain or (loss) from sale of assets other than inventory (line 5a less line 5b) (attach schedule)	5c
	6 Special events and activities (attach schedule):	
	6a Gross revenue (not including \$ _____ of contributions reported on line 1)	6a
6b Less: direct expenses other than fundraising expenses	6b	
6c Net income or (loss) from special events and activities (line 6a less line 6b)	6c	
7a Gross sales of inventory, less returns and allowances	7a	
7b Less: cost of goods sold	7b	
7c Gross profit or (loss) from sales of inventory (line 7a less line 7b)	7c	
8 Other revenue (describe ▶ _____)	8	
9 Total revenue (add lines 1, 2, 3, 4, 5c, 6c, 7c, and 8) ▶	9	
Expenses	10 Grants and similar amounts paid (attach schedule)	10
	11 Benefits paid to or for members	11
	12 Salaries, other compensation, and employee benefits	12
	13 Professional fees and other payments to independent contractors	13
	14 Occupancy, rent, utilities, and maintenance	14
	15 Printing, publications, postage, and shipping	15
	16 Other expenses (describe ▶ _____)	16
17 Total expenses (add lines 10 through 16) ▶	17	
Net Assets	18 Excess or (deficit) for the year (line 9 less line 17)	18
	19 Net assets or fund balances at beginning of year (from line 27, column (A)) (must agree with end-of-year figure reported on prior year's return)	19
	20 Other changes in net assets or fund balances (attach explanation)	20
	21 Net assets or fund balances at end of year (combine lines 18 through 20) ▶	21

Balance Sheets—If Total assets on line 25, column (B) are \$250,000 or more, file Form 990 instead of Form 990-EZ.
 (See Specific Instructions on page 36.)

	(A) Beginning of year	(B) End of year
22 Cash, savings, and investments	22	
23 Land and buildings	23	
24 Other assets (describe ▶ _____)	24	
25 Total assets	25	
26 Total liabilities (describe ▶ _____)	26	
27 Net assets or fund balances (line 27 of column (B) must agree with line 21)	27	

Statements About Activities		Yes	No
1	During the year, has the organization attempted to influence national, state, or local legislation, including any attempt to influence public opinion on a legislative matter or referendum? If "Yes," enter the total expenses paid or incurred in connection with the lobbying activities ► \$ _____ Organizations that made an election under section 501(h) by filing Form 5768 must complete Part VI-A. Other organizations checking "Yes," must complete Part VI-B AND attach a statement giving a detailed description of the lobbying activities.		
2	During the year, has the organization, either directly or indirectly, engaged in any of the following acts with any of its trustees, directors, officers, creators, key employees, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary:		
a	Sale, exchange, or leasing of property?	2a	
b	Lending of money or other extension of credit?	2b	
c	Furnishing of goods, services, or facilities?	2c	
d	Payment of compensation (or payment or reimbursement of expenses if more than \$1,000)?	2d	
e	Transfer of any part of its income or assets? If the answer to any question is "Yes," attach a detailed statement explaining the transactions.	2e	
3	Does the organization make grants for scholarships, fellowships, student loans, etc.?	3	
4a	Do you have a section 403(b) annuity plan for your employees?	4a	
b	Attach a statement to explain how the organization determines that individuals or organizations receiving grants or loans from it in furtherance of its charitable programs qualify to receive payments. (See page 2 of the instructions.)		

Reason for Non-Private Foundation Status (See pages 2 through 4 of the instructions.)

The organization is not a private foundation because it is: (Please check only **ONE** applicable box.)

- 5** A church, convention of churches, or association of churches. Section 170(b)(1)(A)(i).
- 6** A school. Section 170(b)(1)(A)(ii). (Also complete Part V, page 4.)
- 7** A hospital or a cooperative hospital service organization. Section 170(b)(1)(A)(iii).
- 8** A Federal, state, or local government or governmental unit. Section 170(b)(1)(A)(v).
- 9** A medical research organization operated in conjunction with a hospital. Section 170(b)(1)(A)(iii). **Enter the hospital's name, city, and state** ►
- 10** An organization operated for the benefit of a college or university owned or operated by a governmental unit. Section 170(b)(1)(A)(iv). (Also complete the **Support Schedule** in Part IV-A.)
- 11a** An organization that normally receives a substantial part of its support from a governmental unit or from the general public. Section 170(b)(1)(A)(vi). (Also complete the **Support Schedule** in Part IV-A.)
- 11b** A community trust. Section 170(b)(1)(A)(vi). (Also complete the **Support Schedule** in Part IV-A.)
- 12** An organization that normally receives: **(1) more than 33 1/3%** of its support from contributions, membership fees, and gross receipts from activities related to its charitable, etc., functions—subject to certain exceptions, and **(2) no more than 33 1/3%** of its support from gross investment income and unrelated business taxable income (less section 511 tax) from businesses acquired by the organization after June 30, 1975. See section 509(a)(2). (Also complete the **Support Schedule** in Part IV-A.)
- 13** An organization that is not controlled by any disqualified persons (other than foundation managers) and supports organizations described in: **(1)** lines 5 through 12 above; or **(2)** section 501(c)(4), (5), or (6), if they meet the test of section 509(a)(2). (See section 509(a)(3).)

Provide the following information about the supported organizations. (See page 4 of the instructions.)

(a) Name(s) of supported organization(s)	(b) Line number from above

- 14** An organization organized and operated to test for public safety. Section 509(a)(4). (See page 4 of the instructions.)

Support Schedule (Complete only if you checked a box on line 10, 11, or 12.) *Use cash method of accounting.*

Note: You may use the worksheet in the instructions for converting from the accrual to the cash method of accounting.

Calendar year (or fiscal year beginning in) . ▶	(a) 1998	(b) 1997	(c) 1996	(d) 1995	(e) Total
15 Gifts, grants, and contributions received. (Do not include unusual grants. See line 28.)					
16 Membership fees received					
17 Gross receipts from admissions, merchandise sold or services performed, or furnishing of facilities in any activity that is not a business unrelated to the organization's charitable, etc., purpose					
18 Gross income from interest, dividends, amounts received from payments on securities loans (section 512(a)(5)), rents, royalties, and unrelated business taxable income (less section 511 taxes) from businesses acquired by the organization after June 30, 1975					
19 Net income from unrelated business activities not included in line 18					
20 Tax revenues levied for the organization's benefit and either paid to it or expended on its behalf					
21 The value of services or facilities furnished to the organization by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge.					
22 Other income. Attach a schedule. Do not include gain or (loss) from sale of capital assets					
23 Total of lines 15 through 22.					
24 Line 23 minus line 17.					
25 Enter 1% of line 23					
26 Organizations described on lines 10 or 11: a Enter 2% of amount in column (e), line 24. ▶					26a
b Attach a list (which is not open to public inspection) showing the name of and amount contributed by each person (other than a governmental unit or publicly supported organization) whose total gifts for 1995 through 1998 exceeded the amount shown in line 26a. Enter the sum of all these excess amounts. ▶					26b
c Total support for section 509(a)(1) test: Enter line 24, column (e) ▶					26c
d Add: Amounts from column (e) for lines: 18 _____ 19 _____ 22 _____ 26b _____ ▶					26d
e Public support (line 26c minus line 26d total) ▶					26e
f Public support percentage (line 26e (numerator) divided by line 26c (denominator)) ▶					26f %
27 Organizations described on line 12: a For amounts included in lines 15, 16, and 17 that were received from a "disqualified person," attach a list to show the name of, and total amounts received in each year from, each "disqualified person." Enter the sum of such amounts for each year: (1998) _____ (1997) _____ (1996) _____ (1995) _____					
b For any amount included in line 17 that was received from a nondisqualified person, attach a list to show the name of, and amount received for each year, that was more than the larger of (1) the amount on line 25 for the year or (2) \$5,000. (Include in the list organizations described in lines 5 through 11, as well as individuals.) After computing the difference between the amount received and the larger amount described in (1) or (2), enter the sum of these differences (the excess amounts) for each year: (1998) _____ (1997) _____ (1996) _____ (1995) _____					
c Add: Amounts from column (e) for lines: 15 _____ 16 _____ 17 _____ 20 _____ 21 _____ ▶					27c
d Add: Line 27a total _____ and line 27b total _____ ▶					27d
e Public support (line 27c total minus line 27d total). ▶					27e
f Total support for section 509(a)(2) test: Enter amount on line 23, column (e) ▶					27f
g Public support percentage (line 27e (numerator) divided by line 27f (denominator)) ▶					27g %
h Investment income percentage (line 18, column (e) (numerator) divided by line 27f (denominator)) ▶					27h %
28 Unusual Grants: For an organization described in line 10, 11, or 12 that received any unusual grants during 1995 through 1998, attach a list (which is not open to public inspection) for each year showing the name of the contributor, the date and amount of the grant, and a brief description of the nature of the grant. Do not include these grants in line 15. (See page 4 of the instructions.)					

Private School Questionnaire (See page 4 of the instructions.)
(To be completed ONLY by schools that checked the box on line 6 in Part IV)

	Yes	No
29 Does the organization have a racially nondiscriminatory policy toward students by statement in its charter, bylaws, other governing instrument, or in a resolution of its governing body?		
30 Does the organization include a statement of its racially nondiscriminatory policy toward students in all its brochures, catalogues, and other written communications with the public dealing with student admissions, programs, and scholarships?		
31 Has the organization publicized its racially nondiscriminatory policy through newspaper or broadcast media during the period of solicitation for students, or during the registration period if it has no solicitation program, in a way that makes the policy known to all parts of the general community it serves? If "Yes," please describe; if "No," please explain. (If you need more space, attach a separate statement.)		
32 Does the organization maintain the following:		
a Records indicating the racial composition of the student body, faculty, and administrative staff?		
b Records documenting that scholarships and other financial assistance are awarded on a racially nondiscriminatory basis?		
c Copies of all catalogues, brochures, announcements, and other written communications to the public dealing with student admissions, programs, and scholarships?		
d Copies of all material used by the organization or on its behalf to solicit contributions? If you answered "No" to any of the above, please explain. (If you need more space, attach a separate statement.)		
33 Does the organization discriminate by race in any way with respect to:		
a Students' rights or privileges?		
b Admissions policies?		
c Employment of faculty or administrative staff?		
d Scholarships or other financial assistance?		
e Educational policies?		
f Use of facilities?		
g Athletic programs?		
h Other extracurricular activities? If you answered "Yes" to any of the above, please explain. (If you need more space, attach a separate statement.)		
34a Does the organization receive any financial aid or assistance from a governmental agency?		
b Has the organization's right to such aid ever been revoked or suspended? If you answered "Yes" to either 34a or b, please explain using an attached statement.		
35 Does the organization certify that it has complied with the applicable requirements of sections 4.01 through 4.05 of Rev. Proc. 75-50, 1975-2 C.B. 587, covering racial nondiscrimination? If "No," attach an explanation		

Lobbying Expenditures by Electing Public Charities (See page 6 of the instructions.)
(To be completed **ONLY** by an eligible organization that filed Form 5768)

Check here **a** if the organization belongs to an affiliated group.
Check here **b** if you checked "a" above and "limited control" provisions apply.

Limits on Lobbying Expenditures		(a) Affiliated group totals	(b) To be completed for ALL electing organizations
(The term "expenditures" means amounts paid or incurred.)			
36	Total lobbying expenditures to influence public opinion (grassroots lobbying)	36	
37	Total lobbying expenditures to influence a legislative body (direct lobbying)	37	
38	Total lobbying expenditures (add lines 36 and 37)	38	
39	Other exempt purpose expenditures	39	
40	Total exempt purpose expenditures (add lines 38 and 39).	40	
41	Lobbying nontaxable amount. Enter the amount from the following table— If the amount on line 40 is— The lobbying nontaxable amount is— Not over \$500,000 20% of the amount on line 40. Over \$500,000 but not over \$1,000,000 . . . \$100,000 plus 15% of the excess over \$500,000 Over \$1,000,000 but not over \$1,500,000 . \$175,000 plus 10% of the excess over \$1,000,000 Over \$1,500,000 but not over \$17,000,000 . \$225,000 plus 5% of the excess over \$1,500,000 Over \$17,000,000 \$1,000,000	41	
42	Grassroots nontaxable amount (enter 25% of line 41)	42	
43	Subtract line 42 from line 36. Enter -0- if line 42 is more than line 36	43	
44	Subtract line 41 from line 38. Enter -0- if line 41 is more than line 38	44	

Caution: If there is an amount on either line 43 or line 44, you must file Form 4720.

4-Year Averaging Period Under Section 501(h)

(Some organizations that made a section 501(h) election do not have to complete all of the five columns below.
See the instructions for lines 45 through 50 on page 7 of the instructions.)

Calendar year (or fiscal year beginning in) ▶	Lobbying Expenditures During 4-Year Averaging Period				
	(a) 1999	(b) 1998	(c) 1997	(d) 1996	(e) Total
45 Lobbying nontaxable amount					
46 Lobbying ceiling amount (150% of line 45(e)).					
47 Total lobbying expenditures					
48 Grassroots nontaxable amount					
49 Grassroots ceiling amount (150% of line 48(e))					
50 Grassroots lobbying expenditures					

Lobbying Activity by Nonelecting Public Charities

(For reporting only by organizations that did not complete Part VI-A) (See page 8 of the instructions.)

During the year, did the organization attempt to influence national, state or local legislation, including any attempt to influence public opinion on a legislative matter or referendum, through the use of:	Yes	No	Amount
a Volunteers			
b Paid staff or management (Include compensation in expenses reported on lines c through h.)			
c Media advertisements			
d Mailings to members, legislators, or the public			
e Publications, or published or broadcast statements			
f Grants to other organizations for lobbying purposes			
g Direct contact with legislators, their staffs, government officials, or a legislative body			
h Rallies, demonstrations, seminars, conventions, speeches, lectures, or any other means			
i Total lobbying expenditures (add lines c through h).			

If "Yes" to any of the above, also attach a statement giving a detailed description of the lobbying activities.

Form **990-T** **Exempt Organization Business Income Tax Return**
(and proxy tax under section 6033(e))
 For calendar year 1999 or other tax year beginning _____, and ending _____
 ▶ See separate instructions.

OMB No. 1545-0687

1999

Department of the Treasury
Internal Revenue Service

A Check box if address changed

B Exempt under section
 501(c)()
 408(e) 220(e)
 408A 530(a)
 529(a)

Please Print or Type

Name of organization _____

Number, street, and room or suite no. (If a P.O. box, see page 6 of instructions.) _____

City or town, state, and ZIP code _____

D Employer identification number (Employees' trust, see instructions for Block D on page 6.) _____

E NEW unrelated bus. activity codes (See instructions for Block E on page 6.) _____

C Book value of all assets at end of year _____

F Group exemption number (see instructions for Block F on page 6) ▶ _____

G Check organization type ▶ 501(c) corporation 501(c) trust 401(a) trust Other trust

H Describe the organization's primary unrelated business activity. ▶ _____

I During the tax year, was the corporation a subsidiary in an affiliated group or a parent-subsidary controlled group? . . . ▶ Yes No
 If "Yes," enter the name and identifying number of the parent corporation. ▶ _____

J The books are in care of ▶ _____ Telephone number ▶ () _____

Unrelated Trade or Business Income		(A) Income	(B) Expenses	(C) Net
1a Gross receipts or sales				
b Less returns and allowances				
c Balance ▶	1c			
2 Cost of goods sold (Schedule A, line 7)	2			
3 Gross profit (subtract line 2 from line 1c)	3			
4a Capital gain net income (attach Schedule D)	4a			
b Net gain (loss) (Form 4797, Part II, line 18) (attach Form 4797)	4b			
c Capital loss deduction for trusts	4c			
5 Income (loss) from partnerships and S corporations (attach statement)	5			
6 Rent income (Schedule C)	6			
7 Unrelated debt-financed income (Schedule E)	7			
8 Interest, annuities, royalties, and rents from controlled organizations (see page 8 of instructions)	8			
9 Investment income of a section 501(c)(7), (9), or (17) organization (Schedule G)	9			
10 Exploited exempt activity income (Schedule I)	10			
11 Advertising income (Schedule J)	11			
12 Other income (see page 8 of the instructions—attach schedule)	12			
13 TOTAL (combine lines 3 through 12)	13			

Deductions Not Taken Elsewhere (See page 9 of the instructions for limitations on deductions.)
 (Except for contributions, deductions must be directly connected with the unrelated business income.)

14 Compensation of officers, directors, and trustees (Schedule K)	14		
15 Salaries and wages	15		
16 Repairs and maintenance	16		
17 Bad debts	17		
18 Interest (attach schedule)	18		
19 Taxes and licenses	19		
20 Charitable contributions (see page 10 of the instructions for limitation rules)	20		
21 Depreciation (attach Form 4562)	21		
22 Less depreciation claimed on Schedule A and elsewhere on return	22a		22b
23 Depletion	23		
24 Contributions to deferred compensation plans	24		
25 Employee benefit programs	25		
26 Excess exempt expenses (Schedule I)	26		
27 Excess readership costs (Schedule J)	27		
28 Other deductions (attach schedule)	28		
29 Total deductions (add lines 14 through 28)	29		
30 Unrelated business taxable income before net operating loss deduction (subtract line 29 from line 13)	30		
31 Net operating loss deduction	31		
32 Unrelated business taxable income before specific deduction (subtract line 31 from line 30)	32		
33 Specific deduction (Generally \$1,000, but see line 33 instructions for exceptions)	33		
34 Unrelated business taxable income (subtract line 33 from line 32). If line 33 is greater than line 32, enter the smaller of zero or line 32	34		

Tax Computation			
35	Organizations Taxable as Corporations (see instructions for tax computation on page 12). Controlled group members (sections 1561 and 1563)—check here <input type="checkbox"/> . See instructions and:		
a	Enter your share of the \$50,000, \$25,000, and \$9,925,000 taxable income brackets (in that order): (1) \$ _____ (2) \$ _____ (3) \$ _____		
b	Enter organization's share of: (1) additional 5% tax (not more than \$11,750) \$ _____ (2) additional 3% tax (not more than \$100,000) \$ _____		
c	Income tax on the amount on line 34		35c
36	Trusts Taxable at Trust Rates (see instructions for tax computation on page 12) Income tax on the amount on line 34 from: <input type="checkbox"/> Tax rate schedule or <input type="checkbox"/> Schedule D (Form 1041)		36
37	Proxy tax (see page 12 of the instructions)		37
38	Total (add line 37 to line 35c or 36, whichever applies)		38

Tax and Payments			
39a	Foreign tax credit (corporations attach Form 1118; trusts attach Form 1116)	39a	
b	Other credits. (see page 13 of the instructions)	39b	
c	General business credit—Check if from: <input type="checkbox"/> Form 3800 or <input type="checkbox"/> Form (specify) ▶	39c	
d	Credit for prior year minimum tax (attach Form 8801 or 8827)	39d	
e	Total credits (add lines 39a through 39d)		39e
40	Subtract line 39e from line 38		40
41	Recapture taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611		41
42	Alternative minimum tax		42
43	Total tax (add lines 40, 41, and 42)		43
44	Payments: a 1998 overpayment credited to 1999	44a	
b	1999 estimated tax payments	44b	
c	Tax deposited with Form 7004 or Form 2758	44c	
d	Foreign organizations—Tax paid or withheld at source (see instructions)	44d	
e	Backup withholding (see instructions)	44e	
f	Other credits and payments (see instructions)	44f	
45	Total payments (add lines 44a through 44f)		45
46	Estimated tax penalty (see page 3 of the instructions). Check <input type="checkbox"/> if Form 2220 is attached		46
47	Tax due —If line 45 is less than the total of lines 43 and 46, enter amount owed		47
48	Overpayment —If line 45 is larger than the total of lines 43 and 46, enter amount overpaid		48
49	Enter the amount of line 48 you want: Credited to 2000 estimated tax ▶ Refunded ▶		49

Statements Regarding Certain Activities and Other Information (See instructions on page 14.)		Yes	No
1	At any time during the 1999 calendar year, did the organization have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," the organization may have to file Form TD F 90-22.1. If "Yes," enter the name of the foreign country here ▶		
2	During the tax year, did the organization receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," see page 14 of the instructions for other forms the organization may have to file.		
3	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ \$		

SCHEDULE A—COST OF GOODS SOLD (See instructions on page 15.)

Method of inventory valuation (specify) ▶

1	Inventory at beginning of year	1		6	Inventory at end of year	6	
2	Purchases	2		7	Cost of goods sold. Subtract line 6 from line 5. (Enter here and on line 2, Part I.)	7	
3	Cost of labor	3		8	Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the organization?		Yes No
4a	Additional section 263A costs (attach schedule)	4a					
b	Other costs (attach schedule)	4b					
5	Total —Add lines 1 through 4b	5					

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Please Sign Here	Signature of officer or fiduciary	Date	Title
	Preparer's signature	Date	Check if self-employed <input type="checkbox"/> Preparer's SSN or PTIN
Paid Preparer's Use Only	Firm's name (or yours, if self-employed) and address	EIN	ZIP code

SCHEDULE C—RENT INCOME (FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY)
(See instructions on page 15.)

1 Description of property		2 Rent received or accrued		3 Deductions directly connected with the income in columns 2(a) and 2(b) (attach schedule)
(a) From personal property (if the percentage of rent for personal property is more than 10% but not more than 50%)	(b) From real and personal property (if the percentage of rent for personal property exceeds 50% or if the rent is based on profit or income)			
(1)				
(2)				
(3)				
(4)				
Total		Total		Total deductions. Enter here and on line 6, column (B), Part I, page 1. ▶
Total income (Add totals of columns 2(a) and 2(b). Enter here and on line 6, column (A), Part I, page 1.) ▶				

SCHEDULE E—UNRELATED DEBT-FINANCED INCOME (See instructions on page 15.)

1 Description of debt-financed property	2 Gross income from or allocable to debt-financed property	3 Deductions directly connected with or allocable to debt-financed property		4 Amount of average acquisition debt on or allocable to debt-financed property (attach schedule)	5 Average adjusted basis of or allocable to debt-financed property (attach schedule)	6 Column 4 divided by column 5	7 Gross income reportable (column 2 × column 6)	8 Allocable deductions (column 6 × total of columns 3(a) and 3(b))
		(a) Straight line depreciation (attach schedule)	(b) Other deductions (attach schedule)					
(1)								
(2)								
(3)								
(4)								
Totals. ▶							Enter here and on line 7, column (A), Part I, page 1.	Enter here and on line 7, column (B), Part I, page 1.
Total dividends-received deductions included in column 8 ▶								

SCHEDULE F—INTEREST, ANNUITIES, ROYALTIES, AND RENTS FROM CONTROLLED ORGANIZATIONS
(See instructions on page 16.)

1 Name and address of controlled organization(s)	2 Gross income from controlled organization(s)	3 Deductions of controlling organization directly connected with column 2 income (attach schedule)	4 Exempt controlled organizations		
			(a) Unrelated business taxable income	(b) Taxable income computed as though not exempt under sec. 501(a), or the amount in col. (a), whichever is larger	(c) column (a) divided by column (b)
(1)					%
(2)					%
(3)					%
(4)					%
5 Nonexempt controlled organizations			6 Gross income reportable (column 2 × column 4(c) or column 5(c))	7 Allowable deductions (column 3 × column 4(c) or column 5(c))	
(a) Excess taxable income	(b) Taxable income, or amount in column (a), whichever is larger	(c) Column (a) divided by column (b)			
(1)		%			
(2)		%			
(3)		%			
(4)		%			
Totals. ▶			Enter here and include on line 8, column (A), Part I, page 1.	Enter here and include on line 8, column (B), Part I, page 1.	

SCHEDULE G—INVESTMENT INCOME OF A SECTION 501(c)(7), (9), OR (17) ORGANIZATION

(See instructions on page 17.)

1 Description of income	2 Amount of income	3 Deductions directly connected (attach schedule)	4 Set-asides (attach schedule)	5 Total deductions and set-asides (col. 3 plus col. 4)
(1)				
(2)				
(3)				
(4)				
Totals	Enter here and on line 9, column (A), Part I, page 1.			Enter here and on line 9, column (B), Part I, page 1.

SCHEDULE I—EXPLOITED EXEMPT ACTIVITY INCOME, OTHER THAN ADVERTISING INCOME

(See instructions on page 17.)

1 Description of exploited activity	2 Gross unrelated business income from trade or business	3 Expenses directly connected with production of unrelated business income	4 Net income (loss) from unrelated trade or business (column 2 minus column 3). If a gain, compute cols. 5 through 7.	5 Gross income from activity that is not unrelated business income	6 Expenses attributable to column 5	7 Excess exempt expenses (column 6 minus column 5, but not more than column 4).
(1)						
(2)						
(3)						
(4)						
Column totals	Enter here and on line 10, col. (A), Part I, page 1.	Enter here and on line 10, col. (B), Part I, page 1.				Enter here and on line 26, Part II, page 1.

SCHEDULE J—ADVERTISING INCOME (See instructions on page 18.)

Income From Periodicals Reported on a Consolidated Basis

1 Name of periodical	2 Gross advertising income	3 Direct advertising costs	4 Advertising gain or (loss) (col. 2 minus col. 3). If a gain, compute cols. 5 through 7.	5 Circulation income	6 Readership costs	7 Excess readership costs (column 6 minus column 5, but not more than column 4).
(1)						
(2)						
(3)						
(4)						
Column totals (carry to Part II, line (5))						

Income From Periodicals Reported on a Separate Basis (For each periodical listed in Part II, fill in columns 2 through 7 on a line-by-line basis.)

(1)						
(2)						
(3)						
(4)						
(5) Totals from Part I	Enter here and on line 11, col. (A), Part I, page 1.	Enter here and on line 11, col. (B), Part I, page 1.				Enter here and on line 27, Part II, page 1.
Column totals, Part II						

SCHEDULE K—COMPENSATION OF OFFICERS, DIRECTORS, AND TRUSTEES (See instructions on page 18.)

1 Name	2 Title	3 Percent of time devoted to business	4 Compensation attributable to unrelated business
		%	
		%	
		%	
		%	
Total —Enter here and on line 14, Part II, page 1.			



Form 8718
 (Rev. January 1998)
 Department of the Treasury
 Internal Revenue Service

**User Fee for Exempt Organization
 Determination Letter Request**

▶ Attach this form to determination letter application.
 (Form 8718 is NOT a determination letter application.)

For IRS Use Only

Control number _____
 Amount paid _____
 User fee screener _____

1 Name of organization	2 Employer Identification Number
------------------------	----------------------------------

Caution: Do not attach Form 8718 to an application for a pension plan determination letter. Use Form 8717 instead.

3 Type of request Fee

- a Initial request for a determination letter for:
- An exempt organization that has had annual gross receipts averaging not more than \$10,000 during the preceding 4 years, or
 - A new organization that anticipates gross receipts averaging not more than \$10,000 during its first 4 years ▶ \$150
- Note:** If you checked box 3a, you must complete the Certification below.

Certification

I certify that the annual gross receipts of _____
name of organization

have averaged (or are expected to average) not more than \$10,000 during the preceding 4 (or the first 4) years of operation.

Signature ▶ _____ Title ▶ _____

- b Initial request for a determination letter for:
- An exempt organization that has had annual gross receipts averaging more than \$10,000 during the preceding 4 years, or
 - A new organization that anticipates gross receipts averaging more than \$10,000 during its first 4 years . ▶ \$500
- c Group exemption letters ▶ \$500

Instructions

The law requires payment of a user fee with each application for a determination letter. The user fees are listed on line 3 above. For more information, see Rev. Proc. 98-8, 1998-1, I.R.B. 225.

Check the box on line 3 for the type of application you are submitting. If you check box 3a, you must complete and sign the certification statement that appears under line 3a.

Attach to Form 8718 a check or money order payable to the Internal Revenue Service for the full amount of the user fee. If you do not include the full amount, your application will be returned. Attach Form 8718 to your determination letter application.

Send the determination letter application and Form 8718 to:
 Internal Revenue Service
 P.O. Box 192
 Covington, KY 41012-0192

If you are using express mail or a delivery service, send the application and Form 8718 to:

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Attach Check or Money Order Here



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