

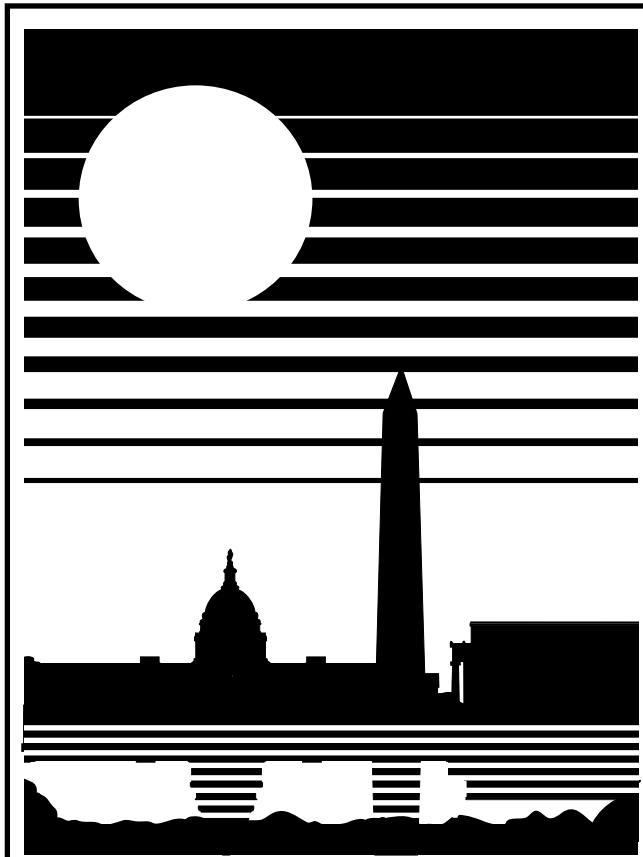


Department
of the
Treasury

Internal
Revenue
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Tax-Exempt Status for Your Organization



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Introduction

This publication discusses the rules and procedures for organizations that seek to obtain recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code (the Code). It explains the procedures you must follow to obtain an appropriate ruling or determination letter recognizing your organization's exemption, as well as certain other information that applies generally to all exempt organizations. To qualify for exemption under the Code, your organization must be organized for one or more of the purposes specifically designated in the Code. Organizations that are exempt under section 501(a) of the Code include those organizations described in section 501(c). Section 501(c) organizations are covered in this publication.

Chapter 1 provides general information about the procedures for obtaining recognition of tax-exempt status.

Chapter 2 contains information about annual filing requirements and other matters that may affect your organization's tax-exempt status.

Chapter 3 contains detailed information on various matters affecting section 501(c)(3)

organizations, including a section on the determination of private foundation status.

Chapter 4 includes separate sections for specific types of organizations described in section 501(c).

Organizations not discussed in this publication. Certain organizations that may qualify for exemption are not discussed in this publication, although they are included in the *Organization Reference Chart* found on page 51 of this publication. These organizations (and the Code sections that apply to them) are as follows:

| | |
|---|------------|
| Corporations organized under Acts of Congress | 501(c)(1) |
| Teachers' retirement fund associations | 501(c)(11) |
| Mutual insurance companies | 501(c)(15) |
| Corporations organized to finance crop operations | 501(c)(16) |
| Employee funded pension trusts (created before June 25, 1959) | 501(c)(18) |
| Withdrawal liability payment fund | 501(c)(22) |
| Veterans organizations (created before 1880) | 501(c)(23) |
| Religious and apostolic associations | 501(d) |
| Cooperative hospital service organizations | 501(e) |
| Cooperative service organizations of operating educational organizations | 501(f) |

Section 501(c)(24) organizations (section 4049 ERISA trusts) are neither discussed in the text nor listed in the *Organization Reference Chart*.

Likewise, farmers' cooperative associations that qualify for exemption under section 521, qualified state tuition programs described in section 529, and pension, profit-sharing, and stock bonus plans described in section 401(a) are not discussed in this publication. If you think your organization falls within one of these categories, contact the Internal Revenue Service for any additional information you need.

Check the Table of Contents at the beginning of this publication to determine whether your organization is described in this publication. If it is, read the chapter (or section) that applies to your type of organization for the specific information you must give when applying for recognition of exemption.

Organization Reference Chart. This chart, located on page 51, enables you to locate at a glance the section of the Code under which your organization might qualify for exemption. It also shows the required application form and, if your organization meets the exemption requirements, the annual return to be filed (if any), and whether or not a contribution to your organization will be deductible by a donor. It also describes each type of qualifying organization and the general nature of its activities.

You may use this chart to determine the Code section that you think applies to your organization. Any correspondence with the IRS (in requesting forms or otherwise) will be greatly expedited if you indicate in your correspondence the appropriate Code section.

1.

Application, Approval, and Appeal Procedures

Introduction

If your organization is one of the organizations described in this publication and is seeking recognition of tax-exempt status from the Internal Revenue Service (IRS), you should follow the procedures described in this chapter and the instructions that accompany the appropriate application forms.

For information on section 501(c)(3) organizations, see chapter 3. If your organization is seeking exemption under one of the other paragraphs of section 501(c), see chapter 4.

Topics

This chapter discusses:

- Application procedures that generally apply to all organizations discussed in this publication, including the application forms
- Rulings and determination letters (approvals/disapprovals)
- Appeal procedures available if an adverse determination letter is proposed
- Group exemption letters

Application Procedures

Oral requests. Oral requests for recognition of exemption will not be considered by the IRS. Your application for tax-exempt status must be in writing using the appropriate forms as discussed below.

Forms Required

Most organizations seeking recognition of exemption from federal income tax must use application forms specifically prescribed by the IRS. Two forms currently prescribed by the IRS are **Form 1023**, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, and **Form 1024**, *Application for Recognition of Exemption Under Section 501(a)*. For information about how to obtain the latest revision, see chapter 5.

Forms 1023 and 1024 contain instructions and checklists to help you provide the information required to process your application. Incomplete applications will not be processed.

Some organizations do not have to use specific application forms. The application your organization must use is specified in the chapter in this publication dealing with your kind of organization. It is also shown in the

Organization Reference Chart on page 51 of this publication.

When no specific application form is prescribed for your organization, application for exemption is by letter to the IRS. Send the application to the appropriate address shown on **Form 8718, User Fee for Exempt Organization Determination Letter Request**. The letter must be signed by an authorized individual such as an officer of the organization or a person authorized by a power of attorney. (See *Power of attorney* on page 4.) Send the power of attorney with the application letter when you file it. The letter should also contain the name and telephone number of the person to contact. The information described below under *Required Inclusions* must be sent with the letter.

User fee. The law now requires the payment of a user fee for determination letter requests such as your application for recognition of tax-exempt status. You should use Form 8718 to figure the amount of your fee and to pay it. Your payment must accompany your request. The IRS will not process a request unless the fee has been paid.

Required Inclusions

Employer identification number. Every exempt organization must have an employer identification number (EIN), whether or not it has any employees.

If your organization does not have an EIN, your application for recognition of exemption should include a completed Form SS-4, *Application for Employer Identification Number*.

Organizing documents. Each application for exemption must be accompanied by a **conformed copy** of your organization's Articles of Incorporation (and the Certificate of Incorporation, if available), Articles of Association, Trust Indenture, Constitution, or other enabling document. If the organization does not have an organizing document, it will not qualify for exempt status.

By-laws. By-laws alone are not organizing documents. However, if your organization has adopted by-laws, include a current copy. The by-laws need not be signed if submitted as an attachment.

If your organization's name has been officially changed by an amendment to your organizing instruments, you should also attach a conformed copy of that amendment to your application.

Conformed copy. A conformed copy is a copy that agrees with the original and all amendments to it. If the original document required a signature, the copy should either be signed by a principal officer or, if not signed, be accompanied by a written declaration signed by an authorized officer of the organization. With either option, the officer must certify that the document is a complete and accurate copy of the original. A certificate of incorporation should be approved and dated by an appropriate state official.

Every attachment should show your organization's name, address, and EIN. It should also state that it is an attachment to your application form and identify the part and line item number that it applies to.

Do not submit original documents because they become part of the IRS file and cannot be returned.

Description of activities. Your application must include a full description of the purposes and the activities of your organization. When describing the activities in which your organization expects to engage, you must include the standards, criteria, procedures, or other means that your organization adopted or planned for carrying out those activities.

To determine the information you need to provide, you should study the chapter (or section) in this publication that applies to your organization. The appropriate chapter will describe the purposes and activities that your organization must pursue, engage in, and include in your application in order to achieve exempt status.

Often your organization's articles of organization (or other organizing instruments) contain descriptions of your organization's purposes and activities.

Financial data. You must include in your application financial statements showing your receipts and expenditures for the current year and the 3 preceding years (or for the number of years your organization was in existence, if less than 4 years). For each accounting period, you must describe the sources of your receipts and the nature of your expenditures. You must also include a balance sheet for the most recent period.

If you have not yet begun operations, or have operated for less than 1 year, a proposed budget for 2 full accounting periods and a current statement of assets and liabilities will be acceptable.

Other information. The IRS may require you to provide additional information necessary to clarify the nature of your organization. Some examples of such additional material are:

- Representative copies of advertising placed,
- Copies of publications, such as magazines,
- Distributed written material used for expressing views on proposed legislation, and
- Copies of leases, contracts, or agreements into which your organization has entered.

Miscellaneous Procedures

For prompt action on your application, be sure to attach all schedules, statements, and other documents required by the application form. If you do not attach them, you may have to resubmit your application or you may otherwise encounter a delay in obtaining recognition of exemption.

Incomplete application. If the application does not contain the required information, it may be returned with a letter of explanation without being considered on its merits. If the completed application is resubmitted within the time period indicated in the letter from the IRS, it will be considered received on the original submission date. In that case, if the original submission was timely, the application will be considered timely filed as discussed in chapter 3, under *Application for Recognition of Exemption*.

Application made under wrong paragraph of section 501(c). Occasionally, an organization may appear to qualify for exemption under a paragraph of section 501(c) that is different from the one for which the organization applied. If the application was made on Form 1024, which applies to more than one paragraph of section 501(c), the organization may be recognized as exempt under any paragraph to which the form applies if the organization has agreed to have its application considered under that paragraph. It must also supply any additional information required for the application under the new paragraph.

Different application form needed. If a different application form is required for your organization, the IRS will so advise your organization and will provide the appropriate application form for your convenience in re-applying under that paragraph, if you wish to do so. Although supporting information previously furnished need not be duplicated, you must provide any necessary additional information required for the application. If your reply is not received within a limited time, your application will be processed only for the paragraph under which you originally applied.

When a specific application form is needed for the paragraph under which your organization qualifies, that form is required before a letter recognizing exemption is issued. This includes cases in which an exemption letter is modified to recognize an organization's exempt status under a paragraph other than the paragraph under which it originally established exemption.

IRS responses. Organizations that submit a complete application will receive an acknowledgment from the IRS. Others will receive a letter requesting more information or returning an incomplete application. Applicants also will be notified if the application is forwarded to the National Office of the IRS for consideration. These letters will be sent out as soon as possible after receipt of the organization's application.

Withdrawal of application. An application may be withdrawn at any time before the issuance of a ruling or determination letter upon the written request of a principal officer or authorized representative of your organization. However, the withdrawal will not prevent the information contained in the application from being used by the IRS in any subsequent examination of your organization's returns. The information forwarded with an application will not be returned to your organization and, generally, when an application is withdrawn, the user fee paid will not be refunded.

Requests for withholding of information from the public. The law requires many exempt organizations to make their application forms and annual information returns available for public inspection. The law also requires the IRS to make available for public inspection, in accordance with section 6104 of the Code and the related regulations, your approved application for recognition of exemption (including any papers submitted in support of the application) and the ruling or determination letter (discussed later, under *Rulings and Determination Letters*).

Any information submitted in the application or in support of it that relates to any trade secret, patent, process, style of work, or apparatus, upon request, may be withheld from

public inspection if the Commissioner determines that the disclosure of such information would adversely affect the organization. Your request must:

- 1) Identify the material to be withheld (the document, page, paragraph, and line) by clearly marking it "**Not Subject To Public Inspection**,"
- 2) Include the reasons for your organization's position that the information is of the type that may be withheld from public inspection, and
- 3) Be filed with the documents in which the material to be withheld is contained.

Where to file. Your application for recognition of tax-exempt status must be filed with the IRS at the address shown on Form 8718.

Your application will be considered by a key District Director who will either issue a favorable determination letter to your organization, issue an adverse determination letter denying the exempt status claimed in the application, or refer the case to the National Office of the IRS for a ruling.



Requests other than applications.

Requests other than applications for recognition of exemption (for example, requests for rulings involving feeder organizations, application of excise taxes to activities of private foundations, taxation of unrelated business income, etc.) should be sent to:

Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: CP:E:EO
P.O. Box 120, Ben Franklin Station
Washington, DC 20044

These requests, like applications for recognition of exemption, must be accompanied by the appropriate user fee.

Referral to the National Office. Key district offices will refer to the National Office any exempt organization issue 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. A key district or Appeals Office may request technical advice on any technical or procedural question that cannot be resolved on the basis of law, regulations, or a clearly applicable revenue ruling or other published precedent. An organization may request that an issue be referred to the National Office for technical advice if it feels that a lack of uniformity exists as to the disposition of the issue or if an issue is so unusual or complex as to warrant consideration by the National Office. If a determination letter is issued based on technical advice from the National Office regarding qualification for exemption or foundation status, no further administrative appeal is available on the issue that was the subject of technical advice.

Power of attorney. If your organization expects to be represented by an agent or attorney, whether in person or by correspondence, you must file a power of attorney with your exemption application specifically authorizing the agent or attorney to represent your organization. Form 2848, *Power of Attorney and*

Declaration of Representative, may be used for this purpose.

Reminder: The law requires payment of a user fee for determination letter requests. Use Form 8718 to figure the amount and pay the fee. Payment must accompany each request.

Rulings and Determination Letters

A ruling or determination letter will be issued to your organization if its application and supporting documents establish that it meets the particular requirements of the section under which it is claiming exemption. However, the IRS will not ordinarily issue rulings or determination letters recognizing exemption if an issue involving the organization's exempt status is pending in litigation or is under consideration within the IRS.

Advance ruling. A ruling or determination letter may be issued in advance of operations if your organization can describe its proposed operations in enough detail to permit a conclusion that it will clearly meet the particular requirements of the section under which it is claiming exemption. A restatement of the organization's purpose or a statement that it will be operated in furtherance of that purpose will not satisfy this requirement. The organization must describe fully the activities in which it expects to engage. This includes standards, procedures, or other means adopted or planned by the organization for carrying out its activities, expected sources of funds, and the nature of its contemplated expenses.

When an organization does not supply the information previously mentioned under *Application Procedures*, or fails to furnish a sufficiently detailed description of its proposed activities to permit a conclusion that it will clearly be exempt, a record of actual operations may be required before a ruling or determination letter is issued.

Adverse determination. If an organization is unable to describe fully its purposes and activities, resulting in a refusal by the IRS to issue a ruling or determination letter, that refusal is considered an adverse determination, which the organization can appeal. See *Appeal Procedures*, later.

Effective Date of Exemption

A ruling or determination letter recognizing exemption is **effective as of the date of formation of an organization** if, during the period before the date of the ruling or determination letter, its purposes and activities were those required by the law. (See *Application for Recognition of Exemption* in chapter 3 for the special rule for organizations applying for recognition of exemption under section 501(c)(3).) Upon obtaining recognition of exemption, the organization may file a claim for a refund of income taxes paid for the period for which its exempt status is recognized.

If an organization is required to alter its activities or substantially amend its charter to qualify, the ruling or determination letter re-

cognizing exemption will be **effective as of the date specified in the letter**. If a non-substantive amendment is made, such as correction of a clerical error in the enabling instrument or the addition of a dissolution clause, exemption will ordinarily be recognized as of the date of formation if the activities of the organization before the ruling or determination are consistent with the exemption requirements.

A ruling or determination letter recognizing exemption may not be relied upon if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization.

Revocation or Modification of Exemption

A ruling or determination letter recognizing exemption may be revoked or modified by:

- 1) A notice to the organization to which the ruling or determination letter originally was issued,
- 2) Enactment of legislation or ratification of a tax treaty,
- 3) A decision of the United States Supreme Court,
- 4) Issuance of temporary or final regulations, or
- 5) Issuance of a revenue ruling, a revenue procedure, or other statement published in the *Internal Revenue Bulletin* or *Cumulative Bulletin*.

When revocation takes effect. If the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented, or, with regard to organizations to which section 503 applies, engaged in a prohibited transaction (such as diverting corpus or income from its exempt purpose), the revocation or modification may be retroactive.

Material change in organization. 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 take effect as of the date of that material change.

Relief from retroactivity. If a ruling or determination letter was issued in error or is no longer in accord with the holding of the IRS, and if section 7805(b) relief is granted, retroactivity of the revocation or modification ordinarily will be limited to a date not earlier than that on which the original ruling or determination letter was modified or revoked. For more information on requesting section 7805(b) relief, see Revenue Procedure 97-4 (or later update).

Foundations. The determination of the effective date is the same for the revocation or modification of foundation status or operating foundation status unless the effective date is expressly covered by statute or regulations.

Written notice. If a key District Director concludes, as a result of examining an information return or considering information from any other source, that a ruling or determination letter should be revoked or modified, the organization will be advised in writing of the proposed action and the reasons for it.

The organization will also be advised of its right to protest the proposed action by re-

questing Appeals Office consideration. The appeal procedures are discussed next.

Appeal Procedures

If an organization applies for tax-exempt status and receives an adverse determination letter, the organization will be advised of its right to protest the determination by requesting Appeals Office consideration. The organization must send its protest to the key District Director within 30 days from the date of the adverse determination letter and must state whether it wishes an Appeals Office conference.

Representation. A principal officer or trustee may represent an organization at any level of appeal within the IRS. Or, the organization may be represented by an attorney, certified public accountant, or individual enrolled to practice before the IRS.

If the organization's representative attends a conference without a principal officer or trustee, the representative must file a proper power of attorney or a tax information authorization before receiving or inspecting confidential information. Form 2848, *Power of Attorney and Declaration of Representative*, or Form 8821, *Tax Information Authorization*, as appropriate (or any other properly written power of attorney or authorization), may be used for this purpose. These forms may be obtained from the IRS. For more information, get Publication 947, *Practice Before the IRS and Power of Attorney*.

Appeals Office Consideration

The protest to the Appeals Office should be filed with the key district office considering the application and contain the following information:

- 1) The organization's name, address, and employer identification number,
- 2) A statement that the organization wants to protest the determination,
- 3) The date and symbols on the determination letter,
- 4) A statement of facts supporting the organization's position in any contested factual issue,
- 5) A statement outlining the law or other authority the organization is relying on, and
- 6) A statement as to whether a conference at the Appeals Office is desired.

The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the protest the following signed declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this protest and in any accompanying schedules and statements and, to the best of my knowledge and belief, it is true, correct, and complete."

Signature.

If the organization's representative submits the protest, a substitute declaration must be included, stating:

- 1) That the representative prepared the protest and accompanying documents, and
- 2) Whether the representative knows personally that the statements of fact contained in the protest and accompanying documents are true and correct.

Be sure the protest contains all of the information requested. Incomplete protests will be returned for completion.

If a conference is requested, it will be held at the Appeals Office, unless the organization requests that the meeting be held at a district office convenient to both parties.

The Appeals Office, after considering the organization's protest as well as information presented in any conference held, will notify the organization of its decision and issue an appropriate determination letter. An adverse decision may be appealed to the courts (discussed later).

Appeals offices must request **technical advice** from the National Office on any exempt organization issue 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. If an organization believes that its case involves such an issue, it should ask the Appeals Office to request technical advice.

Any determination letter issued on the basis of technical advice from the National Office may not be appealed to the Appeals Office for those issues that were the subject of the technical advice.

National Office Consideration

If an application is referred to the National Office for issuance of a ruling and an adverse ruling is issued, the organization will be informed of the basis for the conclusion, its right to file a protest within 30 days, and its right to have a conference at the National Office.

Administrative Remedies

In the case of an application under section 501(c)(3) of the Code, the following actions, called administrative remedies, must be completed by your organization before an unfavorable ruling or determination letter from the IRS can be appealed to the courts:

- 1) The filing of a substantially completed application Form 1023 (described earlier in this chapter) or the filing of a request for a determination of foundation status (see *Private Foundations and Public Charities* in chapter 3);
- 2) In the case of a late-filed application, requesting relief under section 301.9100 of the Regulations regarding applications for extensions of time for making an election or application for relief from tax (see *Application for Recognition of Exemption* in chapter 3);
- 3) The timely submission of all additional information requested to perfect an exemption application or request for determination of private foundation status; and
- 4) Exhaustion of all administrative appeals available within the IRS, including protest of an adverse ruling in National Of-

fice 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, as the case may be.

An organization will not be considered to have exhausted its administrative remedies before the earlier of:

- 1) The completion of the steps just listed and the sending by certified or registered mail of a notice of final determination, or
- 2) The expiration of the **270-day period** in which the IRS has not issued a notice of final determination and the organization has taken, in a timely manner, all reasonable steps to secure a ruling or determination.

270-day period. The 270-day period will be considered by the IRS to begin on the date a substantially completed Form 1023 is sent to the IRS. See *Application Procedures*, earlier, for information needed to complete Form 1023.

If the application does not contain all of the required items, it will not be further processed and may be returned to the applicant for completion. The 270-day period, in this event, will not be considered as starting until the date the application is remailed to the IRS with the requested information, or, if a postmark is not evident, on the date the IRS receives a substantially completed application.

Appeal to Courts

If the IRS issues an unfavorable determination letter or ruling to your organization and you have exhausted all the administrative remedies just discussed, your organization can seek judicial remedies.

For example, if your organization has paid the tax resulting from the unfavorable determination and met all other statutory prerequisites, it can file suit for a refund in a United States district court or the U.S. Court of Federal Claims. Or, if your organization elected not to pay the tax deficiency resulting from the unfavorable determination and met all other statutory prerequisites, it can file suit for a redetermination of the tax deficiencies in the United States Tax Court. For more information on these types of suits, get Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

In certain situations, your organization can file suit for a **declaratory judgment** in the U.S. district court for the District of Columbia, the U.S. Court of Federal Claims, or the U.S. Tax Court. This remedy is available if your organization received an **adverse notice of final determination**, or if the IRS failed to make a timely determination on your initial or continuing qualification or classification as an exempt organization. However, your exempt status claim must be as:

- An organization qualifying under section 501(c)(3),
- An organization to which a deduction for a contribution is allowed under section 170(c)(2),
- An organization other than a private foundation under section 509, or
- A private operating foundation under section 4942(j)(3).

Adverse notice of final determination. The adverse notice of final determination referred to above is a ruling or determination letter sent by certified or registered mail, holding that your organization:

- **Is not** described in section 501(c)(3) or section 170(c)(2) of the Code,
- **Is** a private foundation as defined in section 509(a),
- **Is not** a private operating foundation as defined in section 4942(j)(3), or
- **Is** a public charity described in a part of section 509 or section 170(b)(1)(A) other than the part under which your organization requested classification.

Favorable court rulings - IRS procedure. If a suit results in a final determination that your organization is exempt from tax, the IRS will issue a favorable ruling or determination letter, provided your organization has filed an application for exemption and submitted a statement that the underlying facts and applicable law are the same as in the period considered by the court.

Group Exemption Letter

A group exemption letter is a ruling or determination letter issued to a central organization recognizing on a group basis the exemption under section 501(c) of subordinate organizations on whose behalf the central organization has applied for recognition of exemption.

A **central organization** is an organization that has one or more subordinates under its general supervision or control.

A **subordinate organization** is a chapter, local, post, or unit of a central organization. A central organization may be a subordinate itself, such as a state organization that has subordinate units and is itself affiliated with a national (central) organization.

A subordinate organization may or may not be incorporated, but it must have an organizing document. A subordinate that is organized and operated in a foreign country may not be included in a group exemption letter. A subordinate described in section 501(c)(3) may not be included in a group exemption letter if it is a private foundation described in section 509(a).

If your organization is a subordinate one controlled by a central organization (for example, a church, the Boy Scouts, or a fraternal organization), you should check with the central organization to see if it has been issued a group exemption letter that covers your organization. If it has, you do not have to file a separate application unless your organization no longer wants to be included in the group exemption letter.

If the group exemption letter does not cover your organization, ask your central organization about being included in the next annual group ruling update that it submits to the IRS.

Central Organization Application Procedure

If your organization is a central organization with affiliated subordinates under its control, it may apply for a group exemption letter for its subordinates, provided it has obtained recognition of its own exemption. You should make the application for such subordinates by letter instead of either Form 1023 or 1024. This procedure relieves each of the subordinates covered by a group exemption letter from filing its own application. A central organization obtains its own recognition of exemption by sending its application to the IRS address shown on Form 8718 for the area in which the central organization's principal place of business or principal office is located.

If the central organization has previously obtained recognition of its own exemption, it must indicate its employer identification number, the date of the letter recognizing its exemption, and the IRS office that issued it. It need not forward documents already submitted. However, if it has not already done so, the central organization must submit a copy of any amendment to its governing instruments or internal regulations as well as any information about changes in its character, purposes, or method of operation.

Employer identification number. If the central organization does not have an employer identification number (EIN), it must send a completed Form SS-4 with its exemption application. Each subordinate must have its own EIN even if it has no employees. The central organization must send with the group exemption application a completed Form SS-4 on behalf of each subordinate not having an EIN.

Information required for subordinate organizations. In addition to the information required to obtain recognition of its own exemption, the central organization must submit information for those subordinates to be included in the group exemption letter. The information should be forwarded in a letter signed by a principal officer of the central organization setting forth or including as attachments the following:

- 1) Information verifying that the subordinates:
 - a) Are affiliated with the central organization,
 - b) Are subject to its general supervision or control,
 - c) Are all eligible to qualify for exemption under the same paragraph of section 501(c), though not necessarily the paragraph under which the central organization is exempt,
 - d) Are not private foundations if the application for a group exemption letter involves section 501(c)(3),
 - e) Are all on the same accounting period as the central organization if they are to be included in group returns, and
 - f) Are organizations that have been formed within the 15-month period preceding the date of submission of the group exemption application if they are claiming section 501(c)(3) status and are subject to the requirements of section 508(a)

and wish to be recognized as exempt from their dates of creation (a group exemption letter may be issued covering subordinates, one or more of which have not been organized within the 15-month period preceding the date of submission, if all subordinates are willing to be recognized as exempt only from the date of application),

- 2) A detailed description of the purposes and activities of the subordinates, including the sources of receipts and the nature of expenditures,
- 3) A sample copy of a uniform governing instrument (such as a charter or articles of association) adopted by the subordinates, or, in its absence, copies of representative instruments,
- 4) An affirmation to the effect that, to the best of the officer's knowledge, the purposes and activities of the subordinates are as stated in (2) and (3), above,
- 5) A statement that each subordinate to be included in the group exemption letter has given written authorization to that effect, signed by an authorized officer of the subordinate, to the central organization (see also *New 501(c)(3) organizations that want to be included*, later in this section),
- 6) A list of subordinates to be included in the group exemption letter to which the IRS has issued an outstanding ruling or determination letter relating to exemption,
- 7) If the application for a group exemption letter involves section 501(c)(3) and is subject to the provisions of the Code requiring that it give timely notice that it is not a private foundation (see *Private Foundations* in chapter 3), an affirmation to the effect that, to the best of the officer's knowledge and belief, no subordinate to be included in the group exemption letter is a private foundation as defined in section 509(a),
- 8) For each subordinate that is a school claiming exemption under section 501(c)(3), the information required by Revenue Ruling 71-447 and Revenue Procedure 75-50 (these requirements are fully described in chapter 3, under *Private Schools*; see also Schedule B, Form 1023),
- 9) For any school affiliated with a church, the information to show that the provisions of Revenue Ruling 75-231 have been met, and
- 10) A list of the names, mailing addresses, actual addresses if different, and EINs of subordinates to be included in the group exemption letter. A current directory of subordinates may be furnished instead of the list if it includes the required information and if the subordinates not to be included in the group exemption letter are identified.

New 501(c)(3) organizations that want to be included. A new organization, described in section 501(c)(3), that wants to be included in a group exemption letter, must submit its authorization (as explained in item number 5 above, under *Information required for subordinate organizations*) to the central organiza-

tion before the end of the 15th month after it was formed in order to satisfy the requirement of section 508(a). The central organization must also include this subordinate in its next annual submission of information as discussed below, under *Information Required Annually*.

Keeping the Group Exemption Letter in Force

Continued effectiveness of a group exemption letter is based on the following conditions:

- 1) The continued existence of the central organization,
- 2) The continued qualification of the central organization for exemption under section 501(c),
- 3) The submission by the central organization of the information required annually (described below under *Information Required Annually*), and
- 4) The annual filing of an information return (Form 990, for example) by the central organization if required.

The continued effectiveness of a group exemption letter **as to a particular subordinate** is based on these four conditions, as well as on the continued conformity by the subordinate to the requirements for inclusion in a group exemption letter, the authorization for inclusion, and the annual filing of any required information return for the subordinate.

Information Required Annually

To maintain a group exemption letter, the central organization must submit annually, at least 90 days before the close of its annual accounting period, the following information:

- 1) Information about all changes in the purposes, character, or method of operation of the subordinates included in the group exemption letter.
- 2) A separate list (that includes the names, mailing addresses, actual addresses if different, and EINs of the affected subordinates) for each of the three following categories—
 - a) Subordinates that have changed their names or addresses during the year,
 - b) Subordinates no longer to be included in the group exemption letter because they no longer exist or have disaffiliated or withdrawn their authorization to the central organization, and
 - c) Subordinates to be added to the group exemption letter because they are newly organized or affiliated or because they have recently authorized the central organization to include them.

An annotated directory of subordinates will not be accepted for this purpose. If there were none of the above changes, the central organization must submit a statement to that effect.

- 3) The information required to be submitted by a central organization on behalf of subordinates to be included in the group exemption letter is required for subordinates to be added to the letter. (This information is listed in items 1 through 9, under *Information required for subordinate organizations*. However, if the information upon which the group exemption letter was based applies in all material respects to these subordinates, a statement to this effect may be submitted instead of the information required by items 1 through 4 of that list.)



The organization should send this information to:

Ogden Service Center
Mail Stop 6271
1000 South 1200 West
Ogden, UT 84404-4749



CAUTION *Submitting the required information annually does not relieve the central organization or any of its subordinates of the duty to submit any other information that may be required by a District Director to determine whether the conditions for continued exemption are being met.*

Events Causing Loss of Group Exemption

A group exemption letter no longer has effect, for either a particular subordinate or the group as a whole, when:

- 1) The central organization notifies the IRS that it is going out of existence,
- 2) The central organization notifies the IRS, by its annual submission or otherwise, that any of its subordinates will no longer fulfill the conditions for continued effectiveness, explained earlier, or
- 3) The IRS notifies the central organization or the affected subordinate that the group exemption letter will no longer have effect for some or all of the group because the conditions for continued effectiveness of a group exemption letter have not been fulfilled.

When notice is given under any of these three conditions, the IRS will no longer recognize the exempt status of the affected subordinates until they file separate applications on their own behalf or the central organization files complete supporting information for their reclusion in the group exemption at the time of its annual submission. However, when the notice is given by the IRS and the withdrawal of recognition is based on the failure of the organization to comply with the requirements for recognition of tax-exempt status under the particular subsection of section 501(c), the revocation will ordinarily take effect as of the date of that failure. The notice, however, will be given only after the appeal procedures described earlier in this chapter are completed.

2.

Filing Requirements and Required Disclosures

Introduction

Most exempt organizations (including private foundations) must file various returns and reports at some time during (or following the close of) their accounting period.

Topics

This chapter discusses:

- Annual information returns that must be filed
- The unrelated business income tax return
- Employment tax returns
- A return to report money spent for political activities
- A return to report the sale of certain donated property
- Information to provide to donors
- A report of cash received
- Public inspection of certain documents
- Certain required disclosures and the penalties for not making them

Useful Items

You may want to see:

Publication

- 15 Circular E, Employer's Tax Guide**
- 598 Tax on Unrelated Business Income of Exempt Organizations**

Form (and Instructions)

- 990 Return of Organization Exempt From Income Tax**
- 990-EZ Short Form Return of Organization Exempt From Income Tax**
- 990-PF Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation**
- 990-T Exempt Organization Business Income Tax Return**
- 1120-POL U.S. Income Tax Return for Certain Political Organizations**
- 8300 Report of Cash Payments Over \$10,000 Received in a Trade or Business**

See chapter 5 for information about getting these publications and forms.

Annual Information Returns

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

- 1) A church, an interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church (as defined later under *Religious Organizations* in chapter 3).
- 2) A church-affiliated organization that is exclusively engaged in managing funds or maintaining retirement programs.
- 3) A 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.
- 4) A 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.
- 5) An exclusively religious activity of any religious order.
- 6) A state institution, the income of which is excluded from gross income under section 115.
- 7) A corporation described in section 501(c)(1) (a corporation that is organized under an Act of Congress and is:
 - a) an instrumentality of the United States, and
 - b) exempt from Federal income taxes.)
- 8) A black lung benefit trust described in section 501(c)(21). (Required to file Form 990-BL, *Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons*. See chapter 4 for more information.)
- 9) A stock bonus, pension, or profit-sharing trust that qualifies under section 401.
- 10) A religious or apostolic organization described in section 501(d). (Required to file Form 1065, *U.S. Partnership Return of Income*.)
- 11) A foreign organization described in section 501(a) (other than a private foundation) that normally does not have more than \$25,000 in annual gross receipts from sources within the United States and has no significant activity in the United States. For further information, see Revenue Procedure 94-17, 1994-1 C.B. 579.
- 12) A governmental unit or an affiliate of a governmental unit that meets the requirements of Revenue Procedure 95-48, 1995-2 C.B. 418.
- 13) An exempt organization (other than a private foundation, discussed in chapter 3) having gross receipts in each tax year that normally are not more than \$25,000. (See the instructions for Form 990 for more information about what constitutes annual gross receipts that are normally not more than \$25,000.)

Forms 990 and 990-EZ. Exempt organizations, other than private foundations, must file their annual information return on Form 990, *Return of Organization Exempt From Income Tax*, or Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax*.

Form 990-EZ. This is a shortened version of Form 990. It is designed for use by small exempt organizations and nonexempt charitable trusts.

An organization may file Form 990-EZ, instead of Form 990, if it meets **both** of the following requirements.

- 1) Its gross receipts during the year were less than \$100,000.
- 2) Its total assets (line 25, Column (B) of Form 990-EZ) at the end of the year were less than \$250,000.

If your organization does not meet either of these conditions, you cannot file Form 990-EZ. Instead you must file Form 990.

Group return. A group return on Form 990 may be filed by a central, parent, or like organization for two or more local organizations, none of which is a private foundation. This return is in addition to the central organization's separate annual return, if it must file a return. It cannot be included in the group return. See the instructions for Form 990 for the conditions under which this procedure may be used. In any year that an organization is properly included as a subordinate organization on a group return, it should not file its own Form 990.

Schedule A. Organizations, other than private foundations, that are described in section 501(c)(3) and that are otherwise required to file Form 990 must also complete Schedule A of that form.

Form 990-PF. All private foundations exempt under section 501(c)(3) must file Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*. These organizations are discussed in chapter 3.

Due date. Form 990, 990-EZ, or 990-PF must be filed by the 15th day of the 5th month after the end of your organization's accounting period.

Application for exemption pending. An organization that claims to be exempt under section 501(a) of the Code but has not established its exempt status by the due date for filing an information return should complete and file Form 990 or 990-EZ (or Form 990-PF if it considers itself a private foundation). If the organization's application is pending with the IRS, it must so indicate on Form 990, 990-EZ, or 990-PF (whichever applies) by checking the "application pending" block at the top of page 1 of the return.

For more information on the filing requirements, see the instructions for Forms 990, 990-EZ, and 990-PF.

State reporting requirements. Copies of Form 990, 990-EZ or 990-PF may be used to satisfy state reporting requirements. See the instructions for those forms.

Penalties for failure to file. An exempt organization that fails to file a required return must pay a penalty of \$20 a day for each day the failure continues. The same penalty will apply if the organization does not give all the information required on the return or does not give the correct information.

Maximum penalty. The maximum penalty for any one return is the smaller of \$10,000 or 5% of the organization's gross receipts for the year.

Organization with gross receipts over \$1 million. For an organization that has gross receipts of over \$1 million for the year, the penalty is \$100 a day up to a maximum of \$50,000.

Managers. If the organization is subject to this penalty, the IRS may specify a date by which the return or correct information must be supplied by the organization. Failure to comply with this demand will result in a penalty imposed upon the manager of the organization, or upon any other person responsible for filing a correct return. The penalty is \$10 a day for each day that a return is not filed after the period given for filing. The maximum penalty imposed on all persons with respect to any one return is \$5,000.

Exception for reasonable cause. No penalty will be imposed if reasonable cause for failure to file timely can be shown.

Unrelated Business Income Tax Return

Form 990-T. Even though an organization is recognized as tax exempt, it still may be liable for tax on its unrelated business income. Unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption. An exempt organization that has \$1,000 or more gross income from an unrelated business must file Form 990-T, *Exempt Organization Business Income Tax Return*.

The obligation to file Form 990-T is in addition to the obligation to file the annual information return, Form 990, 990-EZ or 990-PF.

Estimated tax. Exempt organizations must make quarterly payments of estimated tax on unrelated business income. An organization must make estimated tax payments if it expects its tax for the year to be \$500 or more.

For additional information see Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

Employment Tax Returns

Every employer, including an organization exempt from federal income tax, who pays wages to employees is responsible for withholding, depositing, paying, and reporting federal income tax, social security and Medicare (FICA) taxes, and federal unemployment tax (FUTA), unless that employer is specifically excepted by law from those requirements or if the taxes clearly do not apply.

For more information, get a copy of Publication 15, Circular E, *Employer's Tax Guide*, which summarizes the responsibilities of an employer, Publication 15-A, *Employer's Supplemental Tax Guide*, and Form 941, *Employer's Quarterly Federal Tax Return*.

Penalty. If any person required to collect, truthfully account for, and pay over any of these taxes willfully fails to satisfy any of these requirements or willfully tries in any way to evade or defeat any of them, that person will be subject to a penalty. The penalty, often called the "100% penalty," is equal to the tax evaded, not collected, or not accounted for and paid over. The term **person** includes:

- An officer or employee of a corporation, or
- A member or employee of a partnership.

Exception. The penalty is not imposed on any unpaid volunteer director or member of a board of trustees of an exempt organization if the unpaid volunteer serves solely in an honorary capacity, does not participate in the day-to-day or financial operations of the organization, and does not have actual knowledge of the failure on which the penalty is imposed.

This exception does not apply if it results in no one being liable for the penalty.

FICA and FUTA tax exceptions. Payments for services performed by a minister of a church or a member of a religious order are not subject to FICA or FUTA taxes.

FUTA tax exception. Payments for services performed by an employee of a religious, charitable, educational, or other organization described in section 501(c)(3) that are generally subject to FICA taxes if the payments are \$100 or more for the year, are not subject to FUTA taxes.

FICA tax exemption election. Churches and qualified church-controlled organizations can elect exemption from employer FICA taxes by filing **Form 8274, Certification by Churches and Qualified Church-Controlled Organizations Electing Exemption from Employer Social Security and Medicare Taxes**.

To elect exemption, Form 8274 must be filed before the first date on which a quarterly employment tax return would otherwise be due from the electing organization. The organization may make the election only if it is opposed for religious reasons to the payment of FICA taxes.

The election applies to payments for services of current and future employees other than services performed in an unrelated trade or business.

Revoking the election. The election can be revoked by the IRS if the organization fails to file Form W-2, *Wage and Tax Statement*, for 2 years and fails to furnish the information upon request by the IRS. Such revocation will apply retroactively to the beginning of the 2-year period.

Definitions. For purposes of this election, the term **church** means a church, a convention or association of churches, or an elementary or secondary school that is controlled, operated, or principally supported by a church or by a convention or association of churches.

The term **qualified church-controlled organization** means any church-controlled section 501(c)(3) tax-exempt organization, other than an organization that both:

- 1) Offers goods, services, or facilities for sale, other than on an incidental basis,

to the general public at other than a nominal charge that is substantially less than the cost of providing such goods, services, or facilities, **and**

- 2) Normally receives more than 25% of its support from the sum of governmental sources and receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in activities that are not unrelated trades or businesses.

Effect on employees. If a church or qualified church-controlled organization has made an election, payment for services performed for that church or organization, other than in an unrelated trade or business, will not be subject to FICA taxes. However, the employee, unless otherwise exempt, will be subject to self-employment tax on the income. The tax applies to income of \$108.28 or more for the tax year from that church or organization, and no deductions for trade or business expenses are allowed against this "self-employment" income.

Schedule SE (Form 1040), *Self-Employment Tax*, should be attached to the employee's income tax return.

Return for Political Activity

Form 1120-POL. An organization exempt under section 501(c) of the Code must file Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*, for any year in which it:

- 1) Expends any amount 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 those individuals or electors are selected, nominated, elected, or appointed), and

- 2) Has net investment income.

Due date. Form 1120-POL is due by the 15th day of the 3rd month after the end of the exempt organization's tax year. However, Form 1120-POL is **not required** of an exempt organization that makes expenditures for political purposes if either the amount of the expenditures or the organization's net investment income is not more than \$100 for the tax year. For more information about filing Form 1120-POL, refer to the instructions accompanying the form.

Separate fund. If the political activities, described in (1), above, are carried out by a separate segregated fund, which is treated as a separate organization from the exempt organization maintaining the fund, the exempt organization is not liable for a tax on the expenditures.



Section 501(c)(3) organizations are precluded from, and suffer loss of exemption for, engaging in any political campaign on behalf of, or in opposition to, any candidate for public office.

Donee Information Return

Dispositions of donated property. If an organization receives a contribution of **charitable deduction property** and sells, exchanges, or otherwise disposes of the property within 2 years after its receipt, the organization must file **Form 8282, Donee Information Return (Sale, Exchange, or Other Disposition of Donated Property)**. It must be filed within 125 days after the disposition. A copy of Form 8282 is to be given to the donor. Penalties apply if the organization does not file the return.

Charitable deduction property. This is any property (other than money or **publicly traded securities**) for which the organization signed, as donee, an **appraisal summary**.

Publicly traded securities. These are securities for which market quotations for the contribution date are readily available on an established securities market.

Appraisal summary. The donor must get a qualified appraisal for contributions of property (other than money or publicly traded securities), the claimed value of which is more than \$5,000. The donee organization is not a qualified appraiser for the purpose of making a qualified appraisal. For more information, get Publication 561, *Determining the Value of Donated Property*.

Form 8283. The donor must attach Form 8283, *Noncash Charitable Contributions*, to the return on which the deduction is shown. The donee must sign Part IV of Section B, Form 8283. The person who signs for the donee must be an official authorized to sign the donee's tax or information returns, or a person specifically authorized to sign by that official. The signature does not represent concurrence in the appraised value of the contributed property. It represents receipt of the property described on Form 8283 on the date specified on the form. The signature also indicates knowledge of the information reporting requirements on dispositions, as previously discussed. A copy of Form 8283 must be given to the donee.

Information Provided to Donors

A charitable organization must give a donor a disclosure statement for a quid pro quo contribution over \$75. A donor cannot deduct a charitable contribution of \$250 or more unless the donor has a written acknowledgement from the charitable organization.

In certain circumstances, an organization may be able to meet both of these requirements with the same written document.

Disclosure of Quid Pro Quo Contributions

A charitable organization must provide a written **disclosure statement** to donors of a quid pro quo contribution over \$75.

Quid pro quo contribution. This is a payment a donor makes to a charity partly as a contribution and partly for goods or services. For example, if a donor gives a charity \$100 and receives a concert ticket valued at \$40, the donor has made a quid pro quo contribution. In this example, the charitable contribution part of the payment is \$60. Even though the deductible part of the payment is not more than \$75, a disclosure statement must be filed because the donor's payment (quid pro quo contribution) is more than \$75.

Disclosure statement. The required written disclosure statement must:

- 1) Inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of any money (and the value of any property other than money) contributed by the donor over the fair market value of goods or services provided by the charity, and
- 2) Provide the donor with a **good faith estimate** of the fair market value of the goods or services that the donor received.

The charity must furnish the statement in connection with either the solicitation or the receipt of the quid pro quo contribution. If the disclosure statement is furnished in connection with a particular solicitation, it is not necessary for the organization to provide another statement when it actually receives the contribution.

No disclosure statement is required if **any** of the following are true.

- 1) The goods or services given to a donor have "insubstantial value" as described in Revenue Procedure 90-12, in Cumulative Bulletin 1990-1, and Revenue Procedure 92-49, in Cumulative Bulletin 1992-1.
- 2) There is no donative element involved in a particular transaction with a charity (for example, there is generally no donative element involved in a visitor's purchase from a museum gift shop).
- 3) There is only an intangible religious benefit provided to the donor. The intangible religious benefit must be provided to the donor by an organization organized exclusively for religious purposes, and must be of a type that generally is not sold in a commercial transaction outside the donative context. For example, a donor who for a payment is granted admission to a religious ceremony for which there is no admission charge is provided an intangible religious benefit. A donor is not provided intangible religious benefits for payments made for tuition for education leading to a recognized degree, travel services, or consumer goods.
- 4) The donor makes a payment of \$75 or less per year and receives only annual membership benefits that consist of:
 - a) Any rights or privileges (other than the right to purchase tickets for college athletic events) that the taxpayer can exercise often during the membership period, such as free or discounted admissions or parking or preferred access to goods or services, or

- b) Admission to events that are open only to members and the cost per person of which is within the limits for low cost articles described in Revenue Procedure 90-12 (as adjusted for inflation).

Good faith estimate of fair market value. An organization may use any reasonable method to estimate the fair market value (FMV) of goods or services it provided to a donor, as long as it applies the method in good faith.

The organization may estimate the FMV of goods or services that generally are not commercially available by using the FMV of similar or comparable goods or services. Goods or services may be similar or comparable even if they do not have the unique qualities of the goods or services being valued.

Example 1. A charity provides a one-hour tennis lesson with a tennis professional for the first \$500 payment it receives. The tennis professional provides one-hour lessons on a commercial basis for \$100. A good faith estimate of the lesson's FMV is \$100.

Example 2. For a payment of \$50,000, a museum allows a donor to hold a private event in a room of the museum. A good faith estimate of the FMV of the right to hold the event in the museum can be made by using the cost of renting a hotel ballroom with a capacity, amenities, and atmosphere comparable to the museum room, even though the hotel ballroom lacks the unique art displayed in the museum room. If the hotel ballroom rents for \$2,500, a good faith estimate of the FMV of the right to hold the event in the museum is \$2,500.

Example 3. For a payment of \$1,000, a charity provides an evening tour of a museum conducted by a well-known artist. The artist does not provide tours on a commercial basis. Tours of the museum normally are free to the public. A good faith estimate of the FMV of the evening museum tour is \$0 even though it is conducted by the artist.

Penalty for failure to disclose. A penalty is imposed on a charity that does not make the required disclosure of a quid pro quo contribution of more than \$75. The penalty is \$10 per contribution, not to exceed \$5,000 per fund-raising event or mailing. The charity can avoid the penalty if it can show that the failure was due to reasonable cause.

Acknowledgement of Charitable Contributions Over \$250

A donor can deduct a charitable contribution of \$250 or more only if the donor has a written acknowledgement from the charitable organization. The donor must get the acknowledgement by the earlier of:

- 1) The date the donor files the original return for the year the contribution is made, or
- 2) The due date, including extensions, for filing the return.

The donor is responsible for requesting and obtaining the written acknowledgement from the donee.

Quid pro quo contribution. If the donee provides goods or services to the donor in exchange for the contribution (a quid pro quo contribution), the acknowledgement must include a good faith estimate of the value of the goods or services. See *Disclosure of Quid Pro Quo Contributions*, earlier.

Form of acknowledgement. Although there is no prescribed format for the written acknowledgement, it must provide enough information to substantiate the amount of the contribution. For more information, get IRS Publication 1771, *Charitable Contributions – Substantiation and Disclosure Requirements*.

Report of Cash Received

An exempt organization that receives, in the course of its activities, more than \$10,000 cash in one transaction (or 2 or more related transactions) that is not a charitable contribution, must report the transaction to the IRS on **Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business**.

Public Inspection of Exemption Applications and Annual Returns

The following rules do not apply to private foundations. Section 6104(d) describes the public inspection rules for private foundations.

Annual return. An exempt organization must make available for inspection, upon request, a copy of its return (Form 990 or 990-EZ) for the 3-year period starting with the filing date. The organization need not disclose the names of its contributors.

Exemption application. An exempt organization must also make available for public inspection its application for tax-exempt status (generally, Form 1023 or Form 1024). It must also make available a copy of any papers submitted in support of the application (with certain exceptions) and any letter or other document issued by the IRS with respect to the application. This applies for applications submitted on or after July 16, 1987, or before that date if the organization had a copy of the application on July 15, 1987.

Place and time. The annual returns and exemption applications must be made available at the organization's principal office during regular business hours. If the organization has one or more regional or district offices with three or more employees, the annual return and exemption application must be available for inspection at these offices.

Furnishing of copies. An exempt organization must provide a copy of its three most recent annual returns and exemption application to any individual who requests one in person or in writing. If the individual made the request in person, the copy must be provided immediately. If the individual made the re-

quest in writing, the copy must be provided within 30 days. The organization can charge only a reasonable fee for copying and mailing.

The organization does not have to provide copies of these documents if, under regulations:

- 1) It has made the documents widely available, or
- 2) The Secretary of the Treasury has found, upon the organization's request, that the request for documents is part of a harassment campaign and that compliance with the request is not in the public interest.

This requirement to provide copies applies to requests made on or after the 60th day after the regulations referred to in section 6104(e)(3) are issued. At the time this publication was being prepared for print, the regulations had not been issued. But organizations may voluntarily furnish copies before then.

Penalty. The penalty for willful failure to allow public inspection of a return or exemption application is \$1,000 for each return or application. For requests made on or after the 60th day after the regulations referred to in section 6104(e)(3) are issued, the penalty increases to \$5,000 and also applies to a willful failure to provide copies.

Required Disclosures

Certain exempt organizations must disclose to the IRS or the public certain information about their activities. Generally, an organization discloses this information by entering it on the appropriate lines of its annual return. In addition, there are disclosure requirements for:

- Solicitation of nondeductible contributions,
- Sales of information or services that are available free from the government, and
- Dues paid to the organization that are not deductible because used for lobbying or political activities.

Solicitation of Nondeductible Contributions

Solicitations for contributions or other payments by certain exempt organizations (including lobbying groups and political action committees) must include a statement that payments to those organizations are not deductible as charitable contributions for federal income tax purposes. The statement must be included in the fund-raising solicitation and be conspicuous and easily recognizable.

Organizations subject to requirements. An organization must follow these disclosure requirements if it is exempt under section 501(c), other than section 501(c)(1), or under section 501(d), unless the organization is eligible to receive tax deductible charitable

contributions under section 170(c). These requirements must be followed by, among others:

- 1) Social welfare organizations (section 501(c)(4)),
- 2) Labor unions (section 501(c)(5)),
- 3) Trade associations (section 501(c)(6)),
- 4) Social clubs (section 501(c)(7)),
- 5) Fraternal organizations (section 501(c)(8) and (10)) (however, fraternal organizations described in section 170(c)(4) must follow these requirements only for solicitations for funds that are to be used for noncharitable purposes not described in section 170(c)(4)),
- 6) Any political organization described in section 527(e), including political campaign committees and political action committees, and
- 7) Any organization not eligible to receive tax-deductible contributions if the organization or a predecessor organization was, at any time during the 5-year period ending on the date of the fund-raising solicitation, an organization of the type to which this disclosure requirement applies.

Fund-raising solicitation. This disclosure requirement applies to a fund-raising solicitation if all of the following are true.

- 1) The organization soliciting the funds normally has gross receipts over \$100,000 per year.
- 2) The solicitation is part of a coordinated fund-raising campaign that is soliciting more than 10 persons during the year.
- 3) The solicitation is made in written form, by television or radio, or by telephone.

Penalties. Failure by an organization to make the required statement will result in a penalty of \$1,000 for each day the failure occurred, up to a maximum penalty of \$10,000 for a calendar year. No penalty will be imposed if it is shown that the failure was due to reasonable cause. If the failure was due to intentional disregard of the requirements, the penalty may be higher and is not subject to a maximum amount.

Sales of Information or Services Available Free From Government

Certain organizations that sell to individuals information or routine services that could be readily obtained free (or for a nominal fee) from the federal government must include a statement that the information or service can be so obtained. The statement must be made in a conspicuous and easily recognized format when the organization makes an offer or solicitation to sell the information or service. Organizations affected are those exempt under section 501(c) or (d) and political organizations defined in section 527(e).

Penalty. A penalty is provided for failure to comply with this requirement if the failure is due to intentional disregard of the requirement. The penalty is the greater of \$1,000 for each day the failure occurred, or 50% of the

total cost of all solicitations that were made by the organization the same day that it fails to meet the requirement.

Dues Used for Lobbying or Political Activities

Certain exempt organizations must notify anyone paying dues to the organization whether any part of the dues is not deductible because it is related to lobbying or political activities.

An organization must provide the notice if it is exempt from tax under section 501(a) and is one of the following:

- 1) A social welfare organization described in section 501(c)(4) that is not a veterans organization,
- 2) An agricultural or horticultural organization described in section 501(c)(5), or
- 3) A business league, chamber of commerce, real estate board, or other organization described in section 501(c)(6).

However, an organization described in (1), (2), or (3) does not have to provide the notice if it establishes that substantially all the dues paid to it are not deductible anyway or if certain other conditions are met. For more information, see Revenue Procedure 95-35 in Internal Revenue Cumulative Bulletin 1995-2.

If the organization does not provide the required notice, it may have to pay a tax that is reported on Form 990-T. But the tax does not apply to any amount on which the section 527 tax has been paid on Form 1120-POL. See *Return for Political Activity*, earlier.

For more information about nondeductible dues, see *Deduction not allowed for dues used for political or legislative activities* on page 41.

Miscellaneous Rules

Organizational changes and exempt status. If your exempt organization **changes its legal structure**, such as from a trust to a corporation, you must file a new exemption application to establish that the new legal entity qualifies for exemption. If your organization becomes **inactive** for a period of time but does not cease being an entity under the laws of the state in which it was formed, its exemption will not be terminated. However, unless you are covered by one of the filing exceptions, you will have to continue to file an annual information return during the period of inactivity. If your organization has been **liquidated, dissolved, terminated, or substantially contracted**, you should file your annual return of information by the 15th day of the 5th month after the change and follow the applicable instructions to the form.

If your organization amends its articles of organization or its internal regulations (by-laws), you should send a conformed copy of these changes to the appropriate key District Director. (An organization that is covered by a group exemption letter should send two copies of these changes.) If you did not give the IRS a copy of the amendments previously, you may include it when you file Form 990 (or 990-EZ or Form 990-PF), if that return is required.

Change in accounting period. The procedures that an organization must follow to change its accounting period differ for an individual organization and for a central organization that seeks a group change for its subordinate organizations.

Individual organizations that wish to change annual accounting periods generally need only file an information return for the short period indicating that a change is being made. However, if the organization has changed its accounting period within the previous 10 years, it must file Form 1128, *Application to Adopt, Change, or Retain a Tax Year*. Form 1128 is attached to the short period return. See Revenue Procedure 85-58.

Central organizations may obtain approval for a group change in annual accounting period for their subordinate organizations on a group basis only by filing Form 1128 with the Ogden Service Center. The address is given on page 7 under *Information Required Annually*. For more information, see Revenue Procedure 76-10, as modified by Revenue Procedure 79-3.

Form 1128 must be filed by the 15th day of the 5th month following the close of the short period.

3.

Section 501(c)(3) Organizations

Introduction

An organization may qualify for exemption from federal income tax if it is organized and operated exclusively for one or more of the following purposes:

Charitable,
Religious,
Educational,
Scientific,
Literary,
Testing for public safety,

Fostering national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment; however, see *Amateur Athletic Organizations*, later in this chapter), or

The prevention of cruelty to children or animals.

To qualify, the organization must be a corporation, community chest, fund, or foundation. A trust is a fund or foundation and will qualify. However, an individual or a partnership will not qualify.

Examples. Qualifying organizations include:

Nonprofit old age homes,
Parent-teacher associations,

Charitable hospitals or other charitable organizations,
Alumni associations,
Schools,
Chapters of the Red Cross or Salvation Army,
Boys' clubs, and
Churches.

Child care organizations. The term "educational purposes" includes the providing of care of children away from their homes if substantially all the care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public.

Instrumentalities. A state or municipal instrumentality may qualify under section 501(c)(3) if it is organized as a separate entity from the governmental unit that created it and if it otherwise meets the organizational and operational tests of section 501(c)(3). Examples of a qualifying instrumentality might include state schools, universities, or hospitals. However, if an organization is an integral part of the local government or possesses governmental powers, it does not qualify for exemption. A state or municipality itself does not qualify for exemption.

Topics

This chapter discusses:

- Contributions to 501(c)(3) organizations
- Applications for recognition of exemption
- Educational organizations and certain other 501(c)(3) organizations
- Private foundations and public charities
- Lobbying expenditures

Useful Items

You may want to see:

Publications

- 1391** Deductibility of Payments Made to Charities Conducting Fund-Raising Events
- 578** Tax Information for Private Foundations and Foundation Managers

Forms (and Instructions)

- 1023** Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code
- 8718** User Fee for Exempt Organization Determination Letter Request

See chapter 5 for information about getting these publications and forms.

Contributions

Contributions to domestic organizations described in this chapter, except organizations testing for public safety, are deductible as charitable contributions on the donor's federal income tax return.

Fund-raising events. If the donor receives something of value in return for the contribution, a common occurrence with fund-raising efforts, part or all of the contribution may not be deductible. This may apply to fund-raising activities such as charity balls, bazaars, banquets, auctions, concerts, athletic events, and solicitations for membership

or contributions when merchandise or benefits are given in return for payment of a specified minimum contribution.

If the donor receives or expects to receive goods or services in return for a contribution to your organization, the donor cannot deduct any part of the contribution unless the donor intends to, and does, make a payment greater than the fair market value of the goods or services. If a deduction is allowed, the donor can deduct only the part of the contribution, if any, that is more than the fair market value of the goods or services received. You should determine in advance the fair market value of any goods or services to be given to contributors and tell them when you publicize the fund-raising event or solicit their contributions how much is deductible and how much is for the goods or services. See *Disclosure of Quid Pro Quo Contributions* in chapter 2.

This topic is discussed in more detail in Publication 1391, *Deductibility of Payments Made to Charities Conducting Fund-Raising Events*. You can ask the IRS to send you a copy. See chapter 5.

Exemption application not filed. Donors may not deduct any charitable contribution to an organization that is required to apply for recognition of exemption but has not done so.

Separate fund—contributions to which are deductible. An organization that is exempt from federal income tax other than as an organization described in section 501(c)(3) may, if it desires, establish a fund, separate and apart from its other funds, exclusively for religious, charitable, scientific, literary, or educational purposes, fostering national or international amateur sports competition, or for the prevention of cruelty to children or animals.

If the fund is organized and operated exclusively for these purposes, it may qualify for exemption as an organization described in section 501(c)(3), and contributions made to it will be deductible as provided by section 170. A fund with these characteristics must be organized in such a manner as to prohibit the use of its funds upon dissolution, or otherwise, for the general purposes of the organization creating it.

Application for Recognition of Exemption

This discussion describes certain information to be provided upon application for recognition of exemption by all organizations created for any of the purposes described earlier in this chapter. For example, the application must include a conformed copy of the organization's articles of incorporation, as discussed under *Articles of Organization* later in this chapter. See the organization headings that follow for specific information your organization may need to provide.

Form 1023. Your organization must file its application for recognition of exemption on Form 1023. See chapter 1 and the instructions accompanying Form 1023 for the procedures to follow in applying. Some organizations are not required to file Form 1023. These are discussed later in this section.

Form 1023 and accompanying statements must show that all of the following are true.

- 1) The organization is organized exclusively for, and will be operated exclusively for, one or more of the purposes (charitable, religious, etc.) specified in the introduction to this chapter.
- 2) No part of the organization's net earnings will inure to the benefit of private shareholders or individuals. You must establish that your organization will not be organized or operated for the benefit of private interests, such as the creator or the creator's family, shareholders of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests.
- 3) 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. See *Political activity*, next, and *Lobbying Expenditures*, near the end of this chapter.

Political activity. If any of the activities (whether or not substantial) of your organization consist of participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for public office, your organization will not qualify for tax-exempt status under section 501(c)(3). Such participation or intervention includes the publishing or distributing of statements.

Whether your organization is participating or intervening, directly or indirectly, in any political campaign on behalf of (or in opposition to) any candidate for public office depends upon all of the facts and circumstances of each case. Certain voter education activities or public forums conducted in a non-partisan manner may not be prohibited political activity under section 501(c)(3), while other so-called voter education activities may be prohibited.

 If your organization is uncertain as to the effect of its voter education activities, you should request a letter ruling from the Internal Revenue Service. Send the request to:

Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: CP:E:EO
P.O. Box 120, Ben Franklin Station
Washington, DC 20044

Effective date of exemption. Most organizations described in this chapter that were organized after October 9, 1969, will not be treated as tax exempt unless they apply for recognition of exemption by filing Form 1023. These organizations will not be treated as tax exempt for any period before they file Form 1023, unless they file the form within 15 months from the end of the month in which they were organized. If the organization files the application within this 15-month period, the organization's exemption will be recognized retroactively to the date it was organized. Otherwise, exemption will be recognized only for the period after the IRS receives the application. The date of receipt is the date of

the U.S. postmark on the cover in which an exemption application is mailed or, if no postmark appears on the cover, the date the application is stamped as received by the IRS.

Private delivery service. If a private delivery service designated by the IRS, rather than the U.S. Postal Service, is used to deliver the application, the date of receipt is the date recorded or marked by the private delivery service. At the time this publication was printed, the following private delivery services had been designated by the IRS:

- Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service
- DHL Worldwide Express (DHL): DHL "Same Day" Service and DHL USA Overnight
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2Day
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and UPS 2nd Day Air A.M.

Amendments to enabling instrument required. If an organization is required to alter its activities or to make **substantive amendments** to its enabling instrument, the ruling or determination letter recognizing its exempt status will be effective as of the date the changes are made. If only a **nonsubstantive amendment** is made, exempt status will be effective as of the date it was organized, if the application was filed within the 15-month period, or the date the application was filed.

Extensions of time for filing. There are two ways organizations seeking exemption can receive an extension of time for filing Form 1023.

- 1) **Automatic 12-month extension.** Organizations will receive an automatic 12-month extension if they file an application for recognition of exemption with the IRS within 12 months of the original deadline. To get this extension, an organization must add the following statement at the top of its application: "Filed Pursuant to Section 301.9100-2T."
- 2) **Discretionary extensions.** An organization that fails to file a Form 1023 within the extended 12-month period will be granted an extension to file if it submits evidence to establish that:
 - a) It acted reasonably and in good faith, and
 - b) Granting a discretionary extension will not prejudice the interests of the government.

How to show reasonable action and good faith. An organization acted reasonably and showed good faith if at least one of the following is true.

- 1) The organization filed its application before the IRS discovered its failure to file.
- 2) The organization inadvertently failed to file because of events beyond its control.
- 3) The organization exercised reasonable diligence but was not aware of the filing requirement. To determine whether the organization exercised reasonable dili-

gence, it is necessary to take into account the complexity of filing and the organization's experience in these matters.

- 4) The organization reasonably relied upon the written advice of the IRS.
- 5) The organization relied upon the advice of a qualified tax professional who failed to file or advise the organization to file Form 1023. An organization cannot rely on the advice of a tax professional if it knows or should know that he or she is not competent to render advice on filing exemption applications or is not aware of all the relevant facts.

Not acting reasonably and in good faith. An organization has not acted reasonably and in good faith if it chose not to file after being informed of the requirement to file and the consequences of failure to do so. Furthermore, an organization has not acted reasonably and in good faith if it used hindsight to request an extension of time to file. That is, if after the original deadline to file passes, filing an application becomes advantageous to an organization, the IRS will not ordinarily grant an extension. To qualify for an extension in this situation, the organization must prove that its decision to file did not involve hindsight.

Prejudicing the interest of the government. Prejudice to the interest of the government results if granting an extension of time to file to an organization results in a lower total tax liability for the years to which the filing applies than would have been the case if the organization had filed on time. Before granting an extension, the IRS may require the organization requesting it to submit a statement from an independent auditor certifying that no prejudice will result if the extension is granted.

Procedure for requesting extension. To request a discretionary extension, an organization must submit (to the IRS address shown on Form 8718) the following:

- A statement showing the date Form 1023 should have been filed and the date it was actually filed.
- An affidavit describing in detail the events that led to the failure to apply and to the discovery of that failure. If the organization relied on a tax professional's advice, the affidavit must describe the engagement and responsibilities of the professional and the extent to which the organization relied on him or her.
- All documents relevant to the election application.
- A dated declaration, signed by an individual authorized to act for the organization, that includes the following statement: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented herein are true, correct, and complete." The individual who signs for the organization must have personal knowledge of the facts and circumstances at issue.
- A detailed affidavit from individuals having knowledge or information about the events that led to the failure to make the application and to the discovery of that failure. These individuals include accountants or attorneys knowledgeable in tax matters who advised the organization concerning the application. Any affidavit

from a tax professional must describe the engagement and responsibilities of the professional as well as the advice that the professional provided to the organization. The affidavit must also include the name, current address, and taxpayer identification number of the individual making the affidavit (the affiant). The affiant must also forward with the affidavit a dated and signed declaration that states: "Under the penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented herein are true, correct, and complete."

More information. For more information about these procedures, see sections 301.9100-1T, 2T, and 3T of the regulations.

Notification from IRS. Organizations filing Form 1023 and satisfying all requirements of section 501(c)(3) will be notified of their exempt status in writing.

Organizations Not Required To File Form 1023

Some organizations are not required to file Form 1023.

These include:

- Churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group.
- Any organization (other than a private foundation) normally having annual gross receipts of not more than \$5,000 (see *Gross receipts test*, later).

These organizations are exempt automatically if they meet the requirements of section 501(c)(3).

Filing Form 1023 to establish exemption. If the organization wants to establish its exemption with the IRS and receive a ruling or determination letter recognizing its exempt status, it should file Form 1023. By establishing its exemption, potential contributors are assured by the IRS that contributions will be deductible. A subordinate organization covered by a group exemption letter does not have to submit a Form 1023 for itself.

Private foundations. See *Private Foundations and Public Charities*, later in this chapter, for more information about the additional notice required from an organization in order for it not to be presumed to be a private foundation and for the additional information required from a private foundation claiming to be an operating foundation.

Gross receipts test. For purposes of the gross receipts test, an organization normally does not have more than \$5,000 annually in gross receipts if:

- 1) During its first tax year the organization received gross receipts of \$7,500 or less,
- 2) During its first 2 years the organization had a total of \$12,000 or less in gross receipts, and
- 3) In the case of an organization that has been in existence for at least 3 years, the total gross receipts received by the organization during the immediately preceding 2 years, plus the current year, are \$15,000 or less.

An organization with gross receipts more than the amounts in the gross receipts test, unless otherwise exempt from filing Form 1023, must file a Form 1023 within 90 days after the end of the period in which the amounts are exceeded. For example, an organization's gross receipts for its first tax year were less than \$7,500, but at the end of its second tax year its gross receipts for the 2-year period were more than \$12,000. The organization must file Form 1023 within 90 days after the end of its second tax year.

If the organization had existed for at least 3 tax years and had met the gross receipts test for all prior tax years but fails to meet the requirement for the current tax year, its tax-exempt status for the prior years will not be lost even if Form 1023 is not filed within 90 days after the close of the current tax year. However, the organization will not be treated as a section 501(c)(3) organization for the period beginning with the current tax year and ending with the filing of Form 1023.

Example. An organization is organized and operated exclusively for charitable purposes and is not a private foundation. It was incorporated on January 1, 1993, and files returns on a calendar year basis. It did not file a Form 1023. The organization's gross receipts during the years 1993 through 1996 were as follows:

| | |
|------------|---------|
| 1993 | \$3,600 |
| 1994 | 2,900 |
| 1995 | 400 |
| 1996 | 12,600 |

The organization's total gross receipts for 1993, 1994, and 1995 were \$6,900. Therefore, it did not have to file Form 1023 and is exempt for those years. However, for 1994, 1995, and 1996 the total gross receipts were \$15,900. Therefore, the organization must file Form 1023 within 90 days after the end of its 1996 tax year. If it does not file within this time period, it will not be exempt under section 501(c)(3) for the period beginning with tax year 1996 and ending when the Form 1023 is received by the IRS. The organization, however, will not lose its exempt status for the tax years ending before January 1, 1996.

The IRS will consider applying the Commissioner's discretionary authority to extend the time for filing Form 1023. See the procedures for this extension discussed earlier.

Articles of Organization

Your organization must include a conformed copy of its articles of organization with the application for recognition of exemption. This may be its trust instrument, corporate charter, articles of association, or any other written instrument by which it is created.

Organizational Test

The articles of organization **must** limit the organization's purposes to one or more of those described at the beginning of this chapter and **must not** expressly empower it to engage, other than as an insubstantial part of its activities, in activities that do not further one or more of those purposes. These conditions for exemption are referred to as the **organizational test**.

Section 501(c)(3) is the provision of law that grants exemption to the organizations

described in this chapter. Therefore, the organizational test may be met if the purposes stated in the articles of organization are limited in some way by reference to section 501(c)(3).

The requirement that your organization's purposes and powers must be limited by the articles of organization is **not satisfied** if the limit is contained only in the bylaws or other rules or regulations. Moreover, the organizational test is **not satisfied** by statements of your organization's officers that you intend to operate only for exempt purposes. Also, the test is not satisfied by the fact that your actual operations are for exempt purposes.

In interpreting an organization's articles, the law of the state where the organization was created is controlling. If an organization contends that the terms of its articles have a different meaning under state law than their generally accepted meaning, such meaning must be established by a clear and convincing reference to relevant court decisions, opinions of the state attorney general, or other appropriate state authorities.

The following are **examples** illustrating the organizational test.

Example 1. Articles of organization state that an organization is formed exclusively for literary and scientific purposes within the meaning of section 501(c)(3) of the Internal Revenue Code. These articles appropriately limit the organization's purposes. The organization meets the organizational test.

Example 2. An organization, by the terms of its articles, is formed to engage in research without any further description or limitation. The organization will not be properly limited as to its purposes since all research is not scientific. The organization does not meet the organizational test.

Example 3. An organization's articles state that its purpose is to receive contributions and pay them over to organizations that are described in section 501(c)(3) and exempt from taxation under section 501(a). The organization meets the organizational test.

Example 4. If a stated purpose in the articles is the conduct of a school of adult education and its manner of operation is described in detail, such a purpose will be satisfactorily limited.

Example 5. If the articles state the organization is formed for charitable purposes, without any further description, such language ordinarily will be sufficient since the term charitable has a generally accepted legal meaning. On the other hand, if the purposes are stated to be charitable, philanthropic, and benevolent, the organizational requirement will **not** be met since the terms philanthropic and benevolent have no generally accepted legal meaning and, therefore, the stated purposes may, under the laws of the state, permit activities that are broader than those intended by the exemption law.

Example 6. If the articles state an organization is formed to promote American ideals, or to foster the best interests of the people, or to further the common welfare and well-being of the community, without any limitation or provision restricting such purposes to accomplishment only in a charitable manner, the purposes will **not** be sufficiently limited. Such purposes are vague and may be accomplished other than in an exempt manner.

Example 7. A stated purpose to operate a hospital does not meet the organizational test since it is not necessarily charitable. A hospital may or may not be exempt depending on the manner in which it is operated.

Example 8. An organization that is expressly empowered by its articles to carry on social activities will **not** be sufficiently limited as to its power, even if its articles state that it is organized and will be operated exclusively for charitable purposes.

Dedication and Distribution of Assets

Assets of an organization must be permanently **dedicated** to an exempt purpose. This means that should an organization dissolve, its assets must be **distributed** for an exempt purpose described in this chapter, or to the federal government or to a state or local government for a public purpose. If the assets could be distributed to members or private individuals or for any other purpose, the organizational test is not met.

Dedication. To establish that your organization's assets will be permanently dedicated to an exempt purpose, the articles of organization should contain a provision insuring their distribution for an exempt purpose in the event of dissolution. Although reliance may be placed upon state law to establish permanent dedication of assets for exempt purposes, your organization's application probably can be processed much more rapidly if its articles of organization include a provision insuring permanent dedication of assets for exempt purposes.

Distribution. Revenue Procedure 82-2, 1982-1 C.B. 367, identifies the states and circumstances in which the IRS will not require an express provision for the distribution of assets upon dissolution in the articles of organization. The procedure also provides a sample of an acceptable dissolution provision for organizations required to have one.

If a **named beneficiary** is to be the distributee, it must be one that would qualify and would be exempt within the meaning of section 501(c)(3) at the time the dissolution takes place. Since the named beneficiary at the time of dissolution may not be qualified, may not be in existence, or may be unwilling or unable to accept the assets of the dissolving organization, a provision should be made for distribution of the assets for one or more of the purposes specified in this chapter in the event of any such contingency.

Sample Articles of Organization

The following are examples of a charter (Draft A) and a declaration of trust (Draft B) that contain the required information as to purposes and powers of an organization and disposition of its assets upon dissolution. You should bear in mind that requirements for these instruments may vary under applicable state law.

See page 22 for the special provisions required in a private foundation's governing instrument in order for it to qualify for exemption.

Draft A

Articles of Incorporation of the undersigned, a majority of whom are citizens of the United States, desiring to form a Non-Profit Corporation under the Non-Profit Corporation Law of _____, do hereby certify:

First: The name of the Corporation shall be _____.

Second: The place in this state where the principal office of the Corporation is to be located is the City of _____, _____ County.

Third: Said corporation is organized exclusively for charitable, religious, educational, and scientific purposes, including, for such purposes, the making of distributions to organizations that qualify as exempt organizations under section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code.

Fourth: The names and addresses of the persons who are the initial trustees of the corporation are as follows:

Name _____ Address _____

Fifth: No part of the net earnings of the corporation shall inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons, except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes set forth in Article Third hereof. No substantial part of the activities of the corporation shall be the carrying on of propaganda, or otherwise attempting to influence legislation, and the corporation shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office. Notwithstanding any other provision of these articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or (b) by a corporation, contributions to which are deductible under section 170(c)(2) of the Internal Revenue Code, or the corresponding section of any future federal tax code.

If reference to federal law in articles of incorporation imposes a limitation that is invalid in your state, you may wish to substitute the following for the last sentence of the preceding paragraph: "Notwithstanding any other provision of these articles, this corporation shall not, except to an insubstantial degree, engage in any activities or exercise any powers that are not in furtherance of the purposes of this corporation."

Sixth: Upon the dissolution of the corporation, assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public purpose. Any such assets not so disposed of shall be disposed of by a Court of Competent Jurisdiction of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as said Court shall determine, which are organized and operated exclusively for such purposes.

In witness whereof, we have hereunto subscribed our names this _____ day of _____ 19_____.

Draft B

The _____ Charitable Trust. Declaration of Trust made as of the _____ day of _____, 19_____, by _____, of _____, and _____, of _____, who hereby declare and agree that they have received this day from _____, as Donor, the sum of Ten Dollars (\$10) and that they will hold and manage the same, and any additions to it, in trust, as follows:

First: This trust shall be called "The Charitable Trust."

Second: The trustees may receive and accept property, whether real, personal, or mixed, by way of gift, bequest, or devise, from any person, firm, trust, or corporation, to be held, administered, and disposed of in accordance with and pursuant to the provisions of this Declaration of Trust; but no gift, bequest or devise of any such property shall be received and accepted if it is conditioned or limited in such manner as to require the disposition of the income or its principal to any person or organization other than a "charitable organization" or for other than "charitable purposes" within the meaning of such terms as defined in Article Third of this Declaration of Trust, or as shall in the opinion of the trustees, jeopardize the federal income tax exemption of this trust pursuant to section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code.

Third: A. The principal and income of all property received and accepted by the trustees to be administered under this Declaration of Trust shall be held in trust by them, and the trustees may make payments or distributions from income or principal, or both, to or for the use of such charitable organizations, within the meaning of that term as defined in paragraph C, in such amounts and for such charitable purposes of the trust as the trustees shall from time to time select and determine; and the trustees may make payments or distributions from income or principal, or both, directly for such charitable purposes, within the meaning of that term as defined in paragraph D, in such amounts as the trustees shall from time to time select and determine without making use of any other charitable organization. The trustees may also make payments or distributions of all or any part of the income or principal to states, territories, or possessions of the United States, any political subdivision of any of the foregoing, or to the United States or the District of Columbia but only for charitable purposes within the meaning of that term as defined in paragraph D. Income or principal derived from contributions by corporations shall be distributed by the trustees for use solely within the United States or its possessions. No part of the net earnings of this trust shall inure or be payable to or for the benefit of any private shareholder or individual, and no substantial part of the activities of this trust shall be the carrying on of propaganda, or otherwise attempting, to influence legislation. No part of the activities of this trust shall be the participation in, or intervention in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office.

B. The trust shall continue forever unless the trustees terminate it and distribute all of

the principal and income, which action may be taken by the trustees in their discretion at any time. On such termination, assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public purpose. The donor authorizes and empowers the trustees to form and organize a nonprofit corporation limited to the uses and purposes provided for in this Declaration of Trust, such corporation to be organized under the laws of any state or under the laws of the United States as may be determined by the trustees; such corporation when organized to have power to administer and control the affairs and property and to carry out the uses, objects, and purposes of this trust. Upon the creation and organization of such corporation, the trustees are authorized and empowered to convey, transfer, and deliver to such corporation all the property and assets to which this trust may be or become entitled. The charter, bylaws, and other provisions for the organization and management of such corporation and its affairs and property shall be such as the trustees shall determine, consistent with the provisions of this paragraph.

C. In this Declaration of Trust and in any amendments to it, references to "charitable organizations" or "charitable organization" mean corporations, trusts, funds, foundations, or community chests created or organized in the United States or in any of its possessions, whether under the laws of the United States, any state or territory, the District of Columbia, or any possession of the United States, organized and operated exclusively for charitable purposes, no part of the net earnings of which inures or is payable to or for the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which do not participate in or intervene in (including the publishing or distributing of statements) any political campaign on behalf of or in opposition to any candidate for public office. It is intended that the organization described in this paragraph C shall be entitled to exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code.

D. In this Declaration of Trust and in any amendments to it, the term "charitable purposes" shall be limited to and shall include only religious, charitable, scientific, literary, or educational purposes within the meaning of those terms as used in section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, but only such purposes as also constitute public charitable purposes under the law of trusts of the State of _____.

Fourth: This Declaration of Trust may be amended at any time or times by written instrument or instruments signed and sealed by the trustees, and acknowledged by any of the trustees, provided that no amendment shall authorize the trustees to conduct the affairs of this trust in any manner or for any purpose contrary to the provisions of section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code. An amendment of the provisions of this Article Fourth (or any amend-

ment to it) shall be valid only if and to the extent that such amendment further restricts the trustees' amending power. All instruments amending this Declaration of Trust shall be noted upon or kept attached to the executed original of this Declaration of Trust held by the trustees.

Fifth: Any trustee under this Declaration of Trust may, by written instrument, signed and acknowledged, resign his office. The number of trustees shall be at all times not less than two, and whenever for any reason the number is reduced to one, there shall be, and at any other time there may be, appointed one or more additional trustees. Appointments shall be made by the trustee or trustees for the time in office by written instruments signed and acknowledged. Any succeeding or additional trustee shall, upon his acceptance of the office by written instrument signed and acknowledged, have the same powers, rights and duties, and the same title to the trust estate jointly with the surviving or remaining trustee or trustees as if originally appointed.

None of the trustees shall be required to furnish any bond or surety. None of them shall be responsible or liable for the acts of omissions of any other of the trustees or of any predecessor or of a custodian, agent, depositary or counsel selected with reasonable care.

The one or more trustees, whether original or successor, for the time being in office, shall have full authority to act even though one or more vacancies may exist. A trustee may, by appropriate written instrument, delegate all or any part of his powers to another or others of the trustees for such periods and subject to such conditions as such delegating trustee may determine.

The trustees serving under this Declaration of Trust are authorized to pay to themselves amounts for reasonable expenses incurred and reasonable compensation for services rendered in the administration of this trust, but in no event shall any trustee who has made a contribution to this trust ever receive any compensation thereafter.

Sixth: In extension and not in limitation of the common law and statutory powers of trustees and other powers granted in this Declaration of Trust, the trustees shall have the following discretionary powers:

a) To invest and reinvest the principal and income of the trust in such property, real, personal, or mixed, and in such manner as they shall deem proper, and from time to time to change investments as they shall deem advisable; to invest in or retain any stocks, shares, bonds, notes, obligations, or personal or real property (including without limitation any interests in or obligations of any corporation, association, business trust, investment trust, common trust fund, or investment company) although some or all of the property so acquired or retained is of a kind or size which but for this express authority would not be considered proper and although all of the trust funds are invested in the securities of one company. No principal or income, however, shall be loaned, directly or indirectly, to any trustee or to anyone else, corporate or otherwise, who has at any time made a contribution to this trust, nor to anyone except on the basis of an adequate interest charge and with adequate security.

b) To sell, lease, or exchange any personal, mixed, or real property, at public auction or by private contract, for such consider-

ation and on such terms as to credit or otherwise, and to make such contracts and enter into such undertakings relating to the trust property, as they consider advisable, whether or not such leases or contracts may extend beyond the duration of the trust.

c) To borrow money for such periods, at such rates of interest, and upon such terms as the trustees consider advisable, and as security for such loans to mortgage or pledge any real or personal property with or without power of sale; to acquire or hold any real or personal property, subject to any mortgage or pledge on or of property acquired or held by this trust.

d) To execute and deliver deeds, assignments, transfers, mortgages, pledges, leases, covenants, contracts, promissory notes, releases, and other instruments, sealed or unsealed, incident to any transaction in which they engage.

e) To vote, to give proxies, to participate in the reorganization, merger or consolidation of any concern, or in the sale, lease, disposition, or distribution of its assets; to join with other security holders in acting through a committee, depositary, voting trustees, or otherwise, and in this connection to delegate authority to such committee, depositary, or trustees and to deposit securities with them or transfer securities to them; to pay assessments levied on securities or to exercise subscription rights in respect of securities.

f) To employ a bank or trust company as custodian of any funds or securities and to delegate to it such powers as they deem appropriate; to hold trust property without indication of fiduciary capacity but only in the name of a registered nominee, provided the trust property is at all times identified as such on the books of the trust; to keep any or all of the trust property or funds in any place or places in the United States of America; to employ clerks, accountants, investment counsel, investment agents, and any special services, and to pay the reasonable compensation and expenses of all such services in addition to the compensation of the trustees.

Seventh: The trustees' powers are exercisable solely in the fiduciary capacity consistent with and in furtherance of the charitable purposes of this trust as specified in Article Third and not otherwise.

Eighth: In this Declaration of Trust and in any amendment to it, references to "trustees" mean the one or more trustees, whether original or successor, for the time being in office.

Ninth: Any person may rely on a copy, certified by a notary public, of the executed original of this Declaration of Trust held by the trustees, and of any of the notations on it and writings attached to it, as fully as he might rely on the original documents themselves. Any such person may rely fully on any statements of fact certified by anyone who appears from such original documents or from such certified copy to be a trustee under this Declaration of Trust. No one dealing with the trustees need inquire concerning the validity of anything the trustees purport to do. No one dealing with the trustees need see to the application of anything paid or transferred to or upon the order of the trustees of the trust.

Tenth: This Declaration of Trust is to be governed in all respects by the laws of the State of _____.

Trustee —
Trustee —

Educational Organizations and Private Schools

If your organization wants to obtain recognition of exemption as an educational organization, you must submit complete information as to how your organization carries on or plans to carry on its educational activities, such as by conducting a school, by panels, discussions, lectures, forums, radio and television programs, or through various cultural media such as museums, symphony orchestras, or art exhibits. In each instance, you must explain by whom and where these activities are or will be conducted and the amount of admission fees, if any. You must submit a copy of the pertinent contracts, agreements, publications, programs, etc.

If you are organized to conduct a school, you must submit full information regarding your tuition charges, number of faculty members, number of full-time and part-time students enrolled, courses of study and degrees conferred, together with a copy of your school catalog. See also *Private Schools*, discussed later.

Educational Organizations

The term "educational" relates to:

- 1) The instruction or training of individuals for the purpose of improving or developing their capabilities, or
- 2) The instruction of the public on subjects useful to individuals and beneficial to the community.

Advocacy of a position. Advocacy of a particular position or viewpoint may be educational if there is a sufficiently full and fair exposition of pertinent facts to permit an individual or the public to form an independent opinion or conclusion. The mere presentation of unsupported opinion is not educational.

Method not educational. The method used by an organization to develop and present its views is a factor in determining if an organization qualifies as educational within the meaning of section 501(c)(3). The following factors may indicate that the method is not educational:

- 1) The presentation of viewpoints unsupported by facts is a significant part of the organization's communications.
- 2) The facts that purport to support the viewpoint are distorted.
- 3) The organization's presentations make substantial use of inflammatory and disparaging terms and express conclusions more on the basis of emotion than of objective evaluations.
- 4) The approach used is not aimed at developing an understanding on the part of the audience because it does not consider their background or training.

Exceptional circumstances, however, may exist where an organization's advocacy may be educational even if one or more of the factors listed above are present.

Qualifying organizations. The following types of organizations may qualify as educational:

- 1) An organization, such as a primary or secondary school, a college, or a professional or trade school, that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled student body in attendance at a place where the educational activities are regularly carried on,
- 2) An organization whose activities consist of conducting public discussion groups, forums, panels, lectures, or other similar programs,
- 3) An organization that presents a course of instruction by correspondence or through the use of television or radio,
- 4) A museum, zoo, planetarium, symphony orchestra, or other similar organization, and
- 5) A nonprofit day-care center.

College book stores, restaurants, etc.

These and other on-campus organizations should submit information to show that they are controlled by and operate for the convenience of the faculty and student body or by whom they are controlled and whom they service.

Alumni association. An alumni association should establish that it is organized to promote the welfare of the university with which it is affiliated, is subject to the control of the university as to its policies and destination of funds, and is operated as an integral part of the university or is otherwise organized to promote the welfare of the college or university. If your association does not have these characteristics, it may still be exempt as a social club if it meets the requirements described in chapter 4, under 501(c)(7)—*Social and Recreation Clubs*.

Athletic organization. This type of organization must submit evidence that it is engaged in activities such as directing and controlling interscholastic athletic competitions, conducting tournaments, and prescribing eligibility rules for contestants. If it is not so engaged, your organization may be exempt as a social club described in chapter 4. Raising funds to be used for travel and other activities to interview and persuade prospective students with outstanding athletic ability to attend a particular university does not show an exempt purpose. If your organization is not exempt as an educational organization, see *Amateur Athletic Organizations*, later in this chapter.

Private Schools

Every private school filing an application for recognition of tax-exempt status must supply the IRS (on Schedule B, Form 1023) with the following information:

- 1) The racial composition of the student body, and of the faculty and administrative staff, as of the current academic year. (This information also must be projected, so far as may be feasible, for the next academic year.)
- 2) The amount of scholarship and loan funds, if any, awarded to students enrolled and the racial composition of students who have received the awards.

3) A list of the school's incorporators, founders, board members, and donors of land or buildings, whether individuals or organizations.

- 4) A statement indicating whether any of the organizations described in item (3) above have an objective of maintaining segregated public or private school education at the time the application is filed and, if so, whether any of the individuals described in item (3) are officers or active members of those organizations at the time the application is filed.
- 5) The public school district and county in which the school is located.

How to determine racial composition. The racial composition of the student body, faculty, and administrative staff may be an estimate based on the best information readily available to the school, without requiring student applicants, students, faculty, or administrative staff to submit to the school information that the school otherwise does not require. Nevertheless, a statement of the method by which the racial composition was determined must be supplied. The identity of individual students or members of the faculty and administrative staff should not be included with this information.

A school that is a state or municipal instrumentality (see *Instrumentalities*, near the beginning of this chapter), whether or not it qualifies for exemption under section 501(c)(3), is not considered to be a private school for purposes of the following discussion.

Racially Nondiscriminatory Policy

To qualify as an organization exempt from federal income tax, a private school must 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 and that it does not discriminate against applicants and students on the basis of race, color, or national or ethnic origin. Also, the school must circulate information that clearly states the school's admission policies. A racially nondiscriminatory policy toward students means that the school admits the students of any race to all the rights, privileges, programs, and activities generally accorded or made available to students at that school and that the school does not discriminate on the basis of race in administering its educational policies, admission policies, scholarship and loan programs, and athletic and other school-administered programs.

The IRS considers discrimination on the basis of race to include discrimination on the basis of color or national or ethnic origin.

The existence of a racially discriminatory policy with respect to the **employment of faculty and administrative staff** is indicative of a racially discriminatory policy as to students. Conversely, the absence of racial discrimination in the employment of faculty and administrative staff is indicative of a racially nondiscriminatory policy as to students.

A policy of a school that favors **racial minority groups** with respect to admissions, facilities and programs, and financial assistance is not discrimination on the basis of race when the purpose and effect of this policy is

to promote establishing and maintaining the school's nondiscriminatory policy.

A school that selects students on the basis of **membership in a religious denomination or unit** is not discriminating if membership in the denomination or unit is open to all on a racially nondiscriminatory basis.

Policy statement. The school must include a statement of its racially nondiscriminatory policy in all its brochures and catalogs dealing with student admissions, programs, and scholarships. Also, the school must include a reference to its racially nondiscriminatory policy in other written advertising that it uses to inform prospective students of its programs.

Publicity requirement. The school must make its racially nondiscriminatory policy known to all segments of the general community served by the school. Selective communication of a racially nondiscriminatory policy that a school provides solely to leaders of racial groups will not be considered an effective means of communication to make the policy known to all segments of the community. To satisfy this requirement, the school must use one of the following two methods.

Method one. The school may publish a notice of its racially nondiscriminatory policy in a **newspaper** of general circulation that serves all racial segments of the community. Such publication must be repeated at least once annually during the period of the school's solicitation for students or, in the absence of a solicitation program, during the school's registration period. When more than one community is served by a school, the school may publish the notice in those newspapers that are reasonably likely to be read by all racial segments in the communities that the school serves.

If this method is used, the notice must meet the following printing requirements:

- 1) It must appear in a section of the newspaper likely to be read by prospective students and their families.
- 2) It must occupy at least 3 column inches.
- 3) It must have its title printed in at least 12 point bold face type.
- 4) It must have the remaining text printed in at least 8 point type.

The following is an acceptable example of the notice:

**NOTICE OF
NONDISCRIMINATORY POLICY
AS TO STUDENTS**

The M School admits students of any race, color, national and ethnic origin to all the rights, privileges, programs, and activities generally accorded or made available to students at the school. It does not discriminate on the basis of race, color, national and ethnic origin in administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs.

Method two. The school may use the **broadcast media** to publicize its racially nondiscriminatory policy if this use makes the policy known to all segments of the general community the school serves. If the school uses this method, it must provide documentation showing that the means by which this policy was communicated to all segments of the general community was reasonably expected to be effective. In this case, appropri-

ate documentation would include copies of the tapes or scripts used and records showing that there was an adequate number of announcements. The documentation also would include proof that these announcements were made during hours when they were likely to be communicated to all segments of the general community, that they were long enough to convey the message clearly, and that they were broadcast on radio or television stations likely to be listened to by substantial numbers of members of all racial segments of the general community. Announcements must be made during the period of the school's solicitation for students or, in the absence of a solicitation program, during the school's registration period.

Exceptions. The publicity requirements will not apply in the following situations:

First, if for the preceding 3 years the enrollment of a parochial or other church-related school consists of students at least 75% of whom are members of the sponsoring religious denomination or unit, the school may make known its racially nondiscriminatory policy in whatever newspapers or circulars the religious denomination or unit uses in the communities from which the students are drawn. These newspapers and circulars may be distributed by a particular religious denomination or unit or by an association that represents a number of religious organizations of the same denomination. If, however, the school advertises in newspapers of general circulation in the community or communities from which its students are drawn and the second exception (discussed next) does not apply to the school, then it must comply with either of the publicity requirements explained earlier.

Second, if a school customarily draws a substantial percentage of its students nationwide, worldwide, from a large geographic section or sections of the United States, or from local communities, and if the school follows a racially nondiscriminatory policy as to its students, the school may satisfy the publicity requirement by complying with the instructions explained earlier under *Policy statement*.

The school may demonstrate that it follows a racially nondiscriminatory policy either by showing that it currently enrolls students of racial minority groups in meaningful numbers or, except for local community schools, when minority students are not enrolled in meaningful numbers, that its promotional activities and recruiting efforts in each geographic area were reasonably designed to inform students of all racial segments in the general communities within the area of the availability of the school. The question as to whether a school demonstrates such a policy satisfactorily will be determined on the basis of the facts and circumstances of each case.

The IRS recognizes that the failure by a school drawing its students from local communities to enroll racial minority group students may not necessarily indicate the absence of a racially nondiscriminatory policy when there are relatively few or no such students in these communities. Actual enrollment is, however, a meaningful indication of a racially nondiscriminatory policy in a community in which a public school or schools became subject to a desegregation order of a federal court or are otherwise expressly obligated to implement a desegregation plan under the terms of any written contract or other commitment to which any federal agency was a party.

The IRS encourages schools to satisfy the publicity requirement by using either of the methods described earlier, even though a school considers itself to be within one of the *Exceptions*. The IRS believes that these publicity requirements are the most effective methods to make known a school's racially nondiscriminatory policy. In this regard, it is each school's responsibility to determine whether either of the exceptions apply. Such responsibility will prepare the school, if it is audited by the IRS, to demonstrate that the failure to publish its racially nondiscriminatory policy in accordance with either one of the publicity requirements was justified by one of the exceptions. Also, a school must be prepared to demonstrate that it has publicly disavowed or repudiated any statements purported to have been made on its behalf (after November 6, 1975) that are contrary to its publicity of a racially nondiscriminatory policy as to students, to the extent that the school or its principal official was aware of these statements.

Facilities and programs. A school must be able to show that all of its programs and facilities are operated in a racially nondiscriminatory manner.

Scholarship and loan programs. As a general rule, all scholarship or other comparable benefits obtainable at the school must be offered on a racially nondiscriminatory basis. This must be known throughout the general community being served by the school and should be referred to in its publicity. Financial assistance programs, as well as scholarships and loans made under financial assistance programs, that favor members of one or more racial minority groups and that do not significantly detract from or are designed to promote a school's racially nondiscriminatory policy will not adversely affect the school's exempt status.

Certification. An individual authorized to take official action on behalf of a school that claims to be racially nondiscriminatory as to students must certify **annually**, under penalties of perjury, on Schedule A (Form 990) or Form 5578, *Annual Certification of Racial Nondiscrimination for a Private School Exempt From Federal Income Tax*, whichever applies, that to the best of his or her knowledge and belief the school has satisfied all requirements that apply, as previously explained.

Failure to comply with the guidelines ordinarily will result in the proposed revocation of the exempt status of a school.

 **Recordkeeping requirements.** With certain exceptions, given later, each exempt private school must maintain the following records for a minimum period of 3 years, beginning with the year after the year of compilation or acquisition:

- 1) Records indicating the racial composition of the student body, faculty, and administrative staff for each academic year,
- 2) Records sufficient to document that scholarship and other financial assistance is awarded on a racially nondiscriminatory basis,
- 3) Copies of all materials used by or on behalf of the school to solicit contributions, and
- 4) Copies of all brochures, catalogs, and advertising dealing with student admis-

sions, programs, and scholarships. (Schools advertising nationally or in a large geographic segment or segments of the United States need only maintain a record sufficient to indicate when and in what publications their advertisements were placed.)

The racial composition of the student body, faculty, and administrative staff may be determined in the same manner as that described at the beginning of this section. However, a school may not discontinue maintaining a system of records that reflects the racial composition of its students, faculty, and administrative staff used on November 6, 1975, unless it substitutes a different system that compiles substantially the same information, without advance approval of the IRS.

The IRS does not require that a school release any personally identifiable records or personal information except in accordance with the requirements of the Family Educational Rights and Privacy Act of 1974. Similarly, the IRS does not require a school to keep records prohibited under state or federal law.

Exceptions. The school does not have to independently maintain these records for IRS use if both of the following are true.

- 1) Substantially the same information has been included in a report or reports filed with an agency or agencies of federal, state, or local governments, and this information is current within 1 year.
- 2) The school maintains copies of these reports from which this information is readily obtainable.

If these reports do not include all of the information required, as discussed earlier, records providing such remaining information must be maintained by the school for IRS use.

Failure to maintain records. Failure to maintain or to produce the required records and information, upon proper request, will create a presumption that the organization has failed to comply with these guidelines.

Organizations Providing Insurance

An organization described in section 501(c)(3) or (4) may be exempt from tax only if no substantial part of its activities consist of providing commercial-type insurance.

However, this rule does not apply to state-sponsored organizations described in sections 501(c)(26) or 501(c)(27), which are discussed in chapter 4, or to charitable risk pools, discussed next.

Charitable Risk Pools

A charitable risk pool is treated as organized and operated exclusively for charitable purposes.

A charitable risk pool is an organization that:

- 1) Is organized and operated only to pool insurable risks of its members (not including risks related to medical mal-

practice) and to provide information to its members about loss control and risk management,

- 2) Consists only of members that are section 501(c)(3) organizations exempt from tax under section 501(a),
- 3) Is organized under state law authorizing this type of risk pooling,
- 4) Is exempt from state income tax (or will be after qualifying as a section 501(c)(3) organization),
- 5) Has obtained at least \$1,000,000 in startup capital from nonmember charitable organizations,
- 6) Is controlled by a board of directors elected by its members, and
- 7) Is organized under documents requiring that:
 - a) Each member be a section 501(c)(3) organization exempt from tax under section 501(a),
 - b) Each member that receives a final determination that it no longer qualifies under section 501(c)(3) notify the pool immediately, and
 - c) Each insurance policy issued by the pool provide that it will not cover events occurring after a final determination described in (b).

Other 501(c)(3) Organizations

In addition to the information required for all organizations, as described earlier, you should include any other information described in this section.

Charitable Organizations

If your organization is applying for recognition of exemption as a charitable organization, it must show that it is organized and operated for purposes that are beneficial to the public interest. Some examples of this type of organization are those organized for:

- Relief of the poor, the distressed, or the underprivileged,
- Advancement of religion,
- Advancement of education or science,
- Erection or maintenance of public buildings, monuments, or works,
- Lessening the burdens of government,
- Lessening of neighborhood tensions,
- Elimination of prejudice and discrimination,
- Defense of human and civil rights secured by law, and
- Combating community deterioration and juvenile delinquency.

The rest of this section contains a description of the information to be provided by certain specific organizations. This information is in addition to the "required inclusions" described in chapter 1, and other statements requested on Form 1023. Each of the following organizations must submit the information described.

Charitable organization supporting education. Submit information showing how your organization supports education — for example, contributes to an existing educational institution, endows a professorial chair, contributes toward paying teachers' salaries, or contributes to an educational institution to enable it to carry on research.

Scholarships. If the organization awards or plans to award scholarships, complete Schedule H of Form 1023. Submit the following:

- 1) Criteria used for selecting recipients, including the rules of eligibility,
- 2) How and by whom the recipients are or will be selected,
- 3) If awards are or will be made directly to individuals, whether information is required assuring that the student remains in school,
- 4) If awards are or will be made to recipients of a particular class, for example, children of employees of a particular employer—
 - a) Whether any preference is or will be accorded an applicant by reason of the parent's position, length of employment, or salary,
 - b) Whether as a condition of the award the recipient must upon graduation accept employment with the company, and
 - c) Whether the award will be continued even if the parent's employment ends, and
- 5) A copy of the scholarship application form and any brochures or literature describing the scholarship program.

Hospital. If you are organized to operate a charitable hospital, complete and attach Section I of Schedule C, Form 1023.

If your hospital was transferred to you from proprietary ownership, complete and attach Schedule I of Form 1023. You must attach a list showing:

- 1) The names of the active and courtesy staff members of the proprietary hospital, as well as the names of your medical staff members after the transfer to nonprofit ownership, and
- 2) The names of any doctors who continued to lease office space in the hospital after its transfer to nonprofit ownership and the amount of rent paid. Submit an appraisal showing the fair rental value of the rented space.

Clinic. If you are organized to operate a clinic, attach a statement including:

- 1) A description of the facilities and services,
- 2) To whom the services are offered, such as the public at large or a specific group,
- 3) How charges are determined, such as on a profit basis, to recover costs, or at less than cost,
- 4) By whom administered and controlled,
- 5) Whether any of the professional staff (that is, those who perform or will perform the clinical services) also serve or

- will serve in an administrative capacity, and
- 6) How compensation paid the professional staff is or will be determined.

Home for the aged. If you are organized to operate a home for the aged, complete and attach Schedule F of Form 1023. Explain on Schedule F:

- 1) How charges are or will be determined, such as on a profit basis, to recover costs, or at less than cost, and whether the charges are based on providing service at the lowest feasible cost to the residents,
- 2) Whether all residents are or will be required to pay fees,
- 3) Whether any residents are or will be accepted at lower rates or entirely without pay and, if so, how many, and
- 4) Whether federal mortgage financing has been applied for and if so, the type.

Community nursing bureau. If you provide a nursing register or community nursing bureau, provide information showing that your organization will be operated as a community project and will receive its primary support from public contributions to maintain a nonprofit register of qualified nursing personnel, including graduate nurses, unregistered nursing school graduates, licensed attendants and practical nurses for the benefit of hospitals, health agencies, doctors, and individuals.

Organization providing loans. If you make or will make loans for charitable and educational purposes, submit the following information:

- 1) An explanation of the circumstances under which such loans are or will be made,
- 2) Criteria for selection, including the rules of eligibility,
- 3) How and by whom the recipients are or will be selected,
- 4) Manner of repayment of the loan,
- 5) Security required, if any,
- 6) Interest charged, if any, and when payable, and
- 7) Copies in duplicate of the loan application and any brochures or literature describing the loan program.

Public interest law firms. If your organization was formed to litigate in the public interest (as opposed to providing legal services to the poor), such as in the area of protection of the environment, you should submit the following information:

- 1) How the litigation can reasonably be said to be representative of a broad public interest rather than a private one,
- 2) Whether the organization will accept fees for its services,
- 3) A description of the cases litigated or to be litigated and how they benefit the public generally,
- 4) Whether the policies and program of the organization are the responsibility of a

board or committee representative of the public interest, which is not controlled by employees or persons who litigate on behalf of the organization nor by any organization that is not itself an organization described in this chapter,

- 5) Whether the organization is operated, through sharing of office space or otherwise, in a way to create identification or confusion with a particular private law firm, and
- 6) Whether there is an arrangement to provide, directly or indirectly, a deduction for the cost of litigation that is for the private benefit of the donor.

Acceptance of attorneys' fees. A nonprofit public interest law firm can accept attorneys' fees in public interest cases if the fees are paid directly by its clients and the fees are not more than the actual costs incurred in the case. Once undertaking a representation, the organization cannot withdraw from the case because the litigant is unable to pay the fee.

Firms can accept **fees awarded or approved by a court or an administrative agency** and paid by an opposing party if the firms do not use the likelihood or probability of fee awards as a consideration in the selection of cases. All fee awards must be paid to the organization and not to its individual staff attorneys. Instead, a public interest law firm can reasonably compensate its staff attorneys, but only on a straight salary basis. Private attorneys, whose services are retained by the firm to assist it in particular cases, can be compensated by the firm, but only on a fixed fee or salary basis.

The total amount of all attorneys' fees (court awarded and those received from clients) must not be more than 50% of the total cost of operations of the organization's legal functions, calculated over a 5-year period.

If, in order to carry out its program, an organization violates applicable canons of ethics, disrupts the judicial system, or engages in any illegal action, the organization will jeopardize its exemption.

Religious Organizations

To determine whether an organization meets the religious purposes test of section 501(c)(3), the IRS maintains two basic guidelines:

- 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 belief or creed are not illegal or contrary to clearly defined public policy.

Hence, your group (or organization) may not qualify for treatment as an exempt religious organization for tax purposes if its actions, as contrasted with its beliefs, are contrary to well established and clearly defined public policy. If there is a clear showing that the beliefs (or doctrines) are sincerely held by those professing them, the IRS will not question the religious nature of those beliefs.

Churches. 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, the organ-

ization 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 engaged in carrying out the function of a church.

In determining whether an admittedly religious organization is also a church, the IRS does not accept any and every assertion that the 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.

Integrated auxiliaries. An organization is an integrated auxiliary of a church if all the following are true.

- 1) The organization is described both in sections 501(c)(3) and 509(a)(1), (2), or (3).
- 2) It is affiliated with a church or a convention or association of churches.
- 3) It is internally supported. An organization is internally supported unless both of the following are true.
 - a) It offers admissions, goods, services or facilities for sale, other than on an incidental basis, to the general public (except goods, services, or facilities sold at a nominal charge or for a small part of the cost), and
 - b) It normally gets more than 50% of its support from a combination of governmental sources, public solicitation of contributions, and receipts from the sale of admissions, goods, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses.

Special rule. Men's and women's organizations, seminaries, mission societies, and youth groups that satisfy (1) and (2) above are integrated auxiliaries of a church even if they are not internally supported.

Note. In order for an organization (including a church and religious organization) to qualify for tax exemption, no part of its net earnings may inure to the benefit of any individual.

Although an individual is entitled to a charitable deduction for contributions to a church, the assignment or similar transfer of compensation for personal services to a church generally does not relieve a taxpayer of federal income tax liability on the compensation, regardless of the motivation behind the transfer.

Scientific Organizations

You must show that your organization's research will be carried on in the public interest. Scientific research will be considered to be in the public interest if the results of the research (including any patents, copyrights, processes, or formulas) are made available to the public on a nondiscriminatory basis; if the research is performed for the United States or a state, county, or municipal government; or if the research is carried on for one of the following purposes:

- 1) Aiding in the scientific education of college or university students,
- 2) Obtaining scientific information that is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public,
- 3) Discovering a cure for a disease, or
- 4) Aiding a community or geographical area by attracting new industry to the community or area, or by encouraging the development or retention of an industry in the community or area.

Scientific research, for exemption purposes, does not include activities of a type ordinarily incidental to commercial or industrial operations as, for example, the ordinary inspection or testing of materials or products, or the designing or constructing of equipment, buildings, etc.

If you engage or plan to engage in research, submit the following:

- 1) An explanation of the nature of the research,
- 2) A brief description of research projects completed or presently being engaged in,
- 3) How and by whom research projects are determined and selected,
- 4) Whether you have, or contemplate, contracted or sponsored research and, if so, names of past sponsors or grantors, terms of grants or contracts, together with copies of any executed contracts or grants,
- 5) Disposition made or to be made of the results of your research, including whether preference has been or will be given to any organization or individual either as to results or time of release,
- 6) Who will retain ownership or control of any patents, copyrights, processes or formulas resulting from your research, and
- 7) A copy of publications or other media showing reports of your research activities. Only reports of your research activities or those conducted in your behalf, as distinguished from those of your creators or members conducted in their individual capacities, should be submitted.

Literary Organizations

If your organization is established to operate a book store or engage in publishing activities of any nature (printing, publication, or distribution of your own material or that printed or published by others and distributed by you), explain fully the nature of the operations, including whether sales are or will be made to the general public, the type of literature involved, and how these activities are related to your stated purposes.

Amateur Athletic Organizations

There are two types of amateur athletic organizations that can qualify for tax-exempt status. The first type is an organization that fosters national or international amateur

sports competition but only if none of its activities involve providing athletic facilities or equipment. The second type is a *Qualified amateur sports organization* (discussed below). The difference is that a qualified amateur sports organization may provide athletic facilities and equipment.

Donations to either amateur athletic organization are deductible as charitable contributions on the donor's federal income tax return. However, no deduction is allowed if there is a direct personal benefit to the donor or any other person other than the organization.

Qualified amateur sports organization. An organization will be a qualified amateur sports organization if it is organized and operated—

- 1) Exclusively to foster national or international amateur sports competition, and
- 2) Primarily to conduct national or international competition in sports or to support and develop amateur athletes for that competition.

The organization's membership may be local or regional in nature.

Prevention of Cruelty to Children or Animals

Examples of activities that may qualify this type of organization for exempt status are:

- 1) Preventing children from working in hazardous trades or occupations,
- 2) Promoting high standards of care for laboratory animals, and
- 3) Providing funds to pet owners to have their pets spayed or neutered to prevent overbreeding.

Private Foundations and Public Charities

It is important that you determine if your organization is a private foundation. Most organizations exempt from income tax (as organizations described in section 501(c)(3)) are presumed to be private foundations unless they notify the Internal Revenue Service within a specified period of time that they are not. This notice requirement applies to most section 501(c)(3) organizations regardless of when they were formed.

Private Foundations

Every organization that qualifies for tax exemption as an organization described in section 501(c)(3) is a private foundation unless it falls into one of the categories specifically excluded from the definition of that term (referred to in section 509(a)(1), (2), (3), or (4)). In effect, the definition divides these organizations into two classes namely, **private foundations** and **public charities**. Public charities are discussed later.

Organizations that fall into the excluded categories are generally those that either have broad public support or actively function in a supporting relationship to those organizations. Organizations that test for public safety also are excluded.

Notice to IRS. Even if an organization falls within one of the categories excluded from the definition of private foundation, it will be presumed to be a private foundation, with some exceptions, unless it gives timely notice to the IRS that it is not a private foundation. This notice requirement applies to an organization regardless of when it was organized. The only exceptions to this requirement are those organizations that are excepted from the requirement of filing Form 1023 as discussed earlier under *Organizations Not Required To File Form 1023*.

When to file notice. If an organization has to file the notice, it must do so within 15 months from the end of the month in which it was organized.

If your organization is newly applying for recognition of exemption as an organization described in this chapter (a section 501(c)(3) organization) and you wish to establish that your organization is a public charity rather than a private foundation, you must complete the applicable lines of Part III of your exemption application (Form 1023). An extension of time for filing this application may be granted by the IRS if your request is timely and you demonstrate that additional time is needed. See *Application for Recognition of Exemption*, earlier in this chapter, for more information.

In determining the date on which a corporation is organized for purposes of applying for recognition of section 501(c)(3) status, the IRS looks to the date the corporation came into existence under the law of the state in which it is incorporated. For example, where state law provides that existence of a corporation begins on the date its articles are filed by a certain state official in the appropriate state office, the corporation is considered organized on that date. Later nonsubstantive amendments to the enabling instrument will not change the date of organization, for purposes of the notice requirement.

Notice filed late. An organization that states it is a **private foundation** when it files its application for recognition of exemption after the 15-month period will be treated as a section 501(c)(3) organization and as a private foundation only from the date it files its application.

An organization that states it is a **publicly supported charity** when it files its application for recognition of exemption after the 15-month period cannot be treated as a section 501(c)(3) organization before the date it files the application. Financial support received before that date may not be used for purposes of determining whether the organization is publicly supported. However, an organization that can reasonably be expected to meet the support requirements (discussed later under *Public Charities*) can obtain an advance ruling from the IRS that it is a publicly supported organization.

Excise taxes on private foundations. There is an excise tax on the net investment income of most domestic private foundations. This tax must be reported on Form 990-PF and must be paid annually at the time for filing that return or in quarterly estimated tax payments if the total tax for the year is \$500 or more. In addition, there are several other rules that apply. These include:

- 1) Restrictions on self-dealing between private foundations and their substantial contributors and other disqualified persons,

- 2) Requirements that the foundation annually distribute income for charitable purposes,
- 3) Limits on their holdings in private businesses,
- 4) Provisions that investments must not jeopardize the carrying out of exempt purposes, and
- 5) Provisions to assure that expenditures further exempt purposes.

Violations of these provisions give rise to taxes and penalties against the private foundation and, in some cases, its managers, its substantial contributors, and certain related persons.

Governing instrument. A private foundation cannot be tax exempt nor will contributions to it be deductible as charitable contributions unless its governing instrument contains special provisions in addition to those that apply to all organizations described in section 501(c)(3).

Sample governing instruments. The following samples of governing instrument provisions illustrate the special charter requirements that apply to private foundations. Draft A is a sample of provisions in articles of incorporation; Draft B, a trust indenture.

Draft A

General

- 1) The corporation will distribute its income for each tax year at a time and in a manner as not to become subject to the tax on undistributed income imposed by section 4942 of the Internal Revenue Code, or the corresponding section of any future federal tax code.
- 2) The corporation will not engage in any act of self-dealing as defined in section 4941(d) of the Internal Revenue Code, or the corresponding section of any future federal tax code.
- 3) The corporation will not retain any excess business holdings as defined in section 4943(c) of the Internal Revenue Code, or the corresponding section of any future federal tax code.
- 4) The corporation will not make any investments in a manner as to subject it to tax under section 4944 of the Internal Revenue Code, or the corresponding section of any future federal tax code.
- 5) The corporation will not make any taxable expenditures as defined in section 4945(d) of the Internal Revenue Code, or the corresponding section of any future federal tax code.

Draft B

Any other provisions of this instrument notwithstanding, the trustees shall distribute its income for each tax year at a time and in a manner as not to become subject to the tax on undistributed income imposed by section 4942 of the Internal Revenue Code, or the corresponding section of any future federal tax code.

Any other provisions of this instrument notwithstanding, the trustees will not engage

in any act of self-dealing as defined in section 4941(d) of the Internal Revenue Code, or the corresponding section of any future federal tax code; nor retain any excess business holdings as defined in section 4943(c) of the Internal Revenue Code, or the corresponding section of any future federal tax code; nor make any investments in a manner as to incur tax liability under section 4944 of the Internal Revenue Code, or the corresponding section of any future federal tax code; nor make any taxable expenditures as defined in section 4945 (d) of the Internal Revenue Code, or the corresponding section of any future federal tax code.

Effect of state law. A private foundation's governing instrument will be considered to meet these charter requirements if valid provisions of state law have been enacted that:

- 1) Require it to act or refrain from acting so as not to subject the foundation to the taxes imposed on prohibited transactions, or
- 2) Treat the required provisions as contained in the foundation's governing instrument.

The IRS has published a list of states with this type of law. The list is in Revenue Ruling 75-38 (or later update).

Public Charities

A private foundation is any organization described in section 501(c)(3), unless it falls into one of the categories specifically excluded from the definition of that term in section 509(a), which lists four basic categories of exclusions. These categories are discussed under the "Section 509(a)" headings that follow this introduction.

If your organization falls into one of these categories, it is not a private foundation and you should state this in Part III of your application for recognition of exemption (Form 1023).

If your organization does not fall into one of these categories, it is a private foundation and is subject to the applicable rules and restrictions until it terminates its private foundation status. Some private foundations also qualify as private operating foundations; these are discussed near the end of this chapter.

Generally speaking, a large class of organizations excluded under section 509(a)(1) and all organizations excluded under section 509(a)(2) depend upon a **support test**. This test is used to assure a minimum percentage of broad-based public support in the organization's total support pattern. Thus, in the following discussions, when the **one-third support test** (see *Qualifying As Publicly Supported* later) is referred to, it means the following fraction normally must equal at least one-third:

$$\frac{\text{Qualifying support}}{\text{Total support}}$$

Including items of support in qualifying support (the numerator of the fraction) or excluding items of support from total support (the denominator of the fraction) may decide whether an organization is excluded from the definition of a private foundation, and thus

from the liability for certain excise taxes. So it is very important to classify items of support correctly.

Excise tax on excess benefits. A person who receives a benefit from a section 501(c)(3) or 501(c)(4) organization may have to pay an excise tax. A manager of the organization may also have to pay an excise tax. These taxes are reported on **Form 4720**.

The excise taxes are imposed if all of the following are true.

- 1) The organization provides an **excess benefit** to a **disqualified person**.
- 2) The organization is not a private foundation.
- 3) The organization either:
 - a) Is an exempt organization that (without regard to any excess benefit) would be described in section 501(c)(3) or 501(c)(4), or
 - b) Was an organization described in (a) at any time during the 5-year period ending on the date of the excess benefit transaction.

Excess benefit. An excess benefit is an economic benefit that has more value than the value of the consideration, including services, received by the organization providing the benefit. An economic benefit is not treated as consideration for services unless the organization clearly showed its intent to treat the benefit in that way.

Disqualified person. A disqualified person is any of the following:

- 1) A person who was in a position to exercise substantial influence over the affairs of the organization at any time during the 5-year period ending on the date of the excess benefit transaction,
- 2) A member of the family of an individual described in (1), or
- 3) Certain organizations controlled by persons described in (1) or (2).

More information. For more information, see the instructions to Forms 990 and 4720.

Organizations that are not private foundations. The following kinds of organizations are excluded from the definition of a private foundation.

Section 509(a)(1) Organizations

Section 509(a)(1) organizations include:

- 1) A church or a convention or association of churches,
- 2) An educational organization such as a school or college,
- 3) A hospital or medical research organization operated in conjunction with a hospital,
- 4) Endowment funds operated for the benefit of certain state and municipal colleges and universities,
- 5) A governmental unit, and
- 6) A publicly supported organization.

Church. The characteristics of a church are discussed earlier in this chapter under *Religious Organizations*.

Educational organizations. An educational organization is one whose primary function is to present formal instruction, that normally maintains a regular faculty and curriculum, and that normally has a regularly enrolled body of pupils or students in attendance at the place where it regularly carries on its educational activities. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes federal, state, and other publicly supported schools that otherwise come within the definition. It does not include organizations engaged in both educational and non-educational activities, unless the latter are merely incidental to the educational activities. A recognized university that incidentally operates a museum or sponsors concerts is an educational organization. However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization.

An exempt organization that operates a tutoring service for students on a one-to-one basis in their homes, maintains a small center to test students to determine their need for tutoring, and employs tutors on a part-time basis is not an educational organization for these purposes. Nor is an exempt organization that conducts an internship program by placing college and university students with cooperating government agencies an educational organization.

Hospitals and medical research organizations. A hospital is an organization whose principal purpose or function is to provide hospital or medical care or either medical education or medical research. A rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may qualify as a hospital if its principal purpose or function is providing hospital or medical care. If the accommodations of an organization qualify as being part of an **extended care facility**, that organization may qualify as a hospital if its principal purpose or function is providing hospital or medical care. A **cooperative hospital service organization** that meets the requirements of section 501(e) will qualify as a hospital.

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 a vocation. An organization that mainly provides 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, as an integral part of its medical education or medical research functions.

Medical research organization. A medical research organization must be directly engaged in the continuous active conduct of medical research in conjunction with a hospital, and that activity must be the organization's principal purpose or function.

Publicly supported. A hospital or medical research organization that wants the additional classification of a publicly supported organization (described later in this chapter under *Qualifying As Publicly Supported*) may

specifically request that classification. The organization must establish that it meets the public support requirements of section 170(b)(1)(A)(vi).

Endowment funds. Organizations operated for the benefit of certain state and municipal colleges and universities are endowment funds. They are organized and operated exclusively to:

- 1) Receive, hold, invest in, and administer property for a college or university, and
- 2) Make expenditures to or for the benefit of a college or university.

The college or university must be:

- 1) An agency or instrumentality of a state or political subdivision, or
- 2) Owned or operated by:
 - a) A state or political subdivision, or
 - b) An agency or instrumentality of one or more states or political subdivisions.

The phrase "expenditures to or for the benefit of a college or university" includes expenditures made for any one or more of the normal functions of a college or university. These expenditures include those for:

- 1) Acquiring and maintaining real property comprising part of the campus area,
- 2) Erecting (or participating in erecting) college or university buildings,
- 3) Acquiring and maintaining equipment and furnishings used for, or in conjunction with, normal functions of colleges and universities,
- 4) Libraries,
- 5) Scholarships, and
- 6) Student loans.

The organization must normally receive a substantial part of its support from the United States or any state or political subdivision, or from direct or indirect contributions from the general public, or from a combination of these sources.

Support. Support does not include income received in the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for exemption.

In determining the amount of support received by an organization for a contribution of property when the value of the contribution by the donor is subject to reduction for certain ordinary income and capital gain property, the fair market value of the property is taken into account. For more information, see the discussion of *Support* on page 25.

Indirect contribution. An example of an indirect contribution from the public is the receipt by the organization of its share of the proceeds of an annual collection campaign of a community chest, community fund, or united fund.

Governmental units. A governmental unit includes a state, a possession of the United States, or a political subdivision of either of the foregoing, or the United States or the District of Columbia.

Publicly supported organizations. An organization is a publicly supported organization if it is one that normally receives a substantial part of its support from a governmental unit or from the general public.

Types of organizations that generally qualify are:

- Museums of history, art, or science,
- Libraries,
- Community centers to promote the arts,
- Organizations providing facilities for the support of an opera, symphony orchestra, ballet, or repertory drama, or for some other direct service to the general public, and
- Organizations such as the American Red Cross or the United Way.

Qualifying As Publicly Supported

An organization will qualify as publicly supported if it passes the **one-third support test**. If it fails that test, it may qualify under the **facts and circumstances test**.

One-third support test. An organization will qualify as publicly supported if it **normally** receives at least one-third of its total support from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources. For a definition of support, see *Support*, later.

Definition of "normally" for one-third support test. An organization will be considered as normally meeting the one-third support test for its current tax year and the next tax year if, for the 4 tax years immediately before the current tax year, the organization meets the one-third support test on an aggregate basis. See also *Special computation period for new organizations*, later in this discussion.

Facts and circumstances test. The facts and circumstances test is for organizations failing to meet the one-third support test. If your organization fails to meet the one-third support test, it may still be treated as a publicly supported organization if it normally receives a substantial part of its support from governmental units, from direct or indirect contributions from the general public, or from a combination of these sources. To qualify, an organization must meet the **ten-percent-of-support requirement** and the **attraction of public support requirement**. These requirements establish, under all the facts and circumstances, that an organization normally receives a substantial part of its support from governmental units or from direct or indirect contributions from the general public. The organization also must be in the nature of a publicly supported organization, taking into account five different factors. See *Additional requirements (the five public support factors)*, on page 24.

Ten-percent-of-support requirement. The percentage of support normally received by an organization from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources must be "substantial." An organization will not be treated as normally receiving a substantial amount of governmental or public support unless the total amount of governmental and public support normally received is at least 10% of the total support normally received by that organiza-

tion. For a definition of support, see *Support*, later.

Attraction of public support requirement. An organization must be organized and operated in a manner to attract new and additional public or governmental support on a continuous basis. An organization will meet this requirement if it maintains a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved, or if it carries on activities designed to attract support from governmental units or other charitable organizations described in section 509(a)(1). In determining whether an organization maintains a continuous and bona fide program for solicitation of funds from the general public or community, consideration will be given to whether the scope of its fund raising activities is reasonable in light of its charitable activities. Consideration also will be given to the fact that an organization may, in its early years of existence, limit the scope of its solicitation to persons who would be most likely to provide seed money sufficient to enable it to begin its charitable activities and expand its solicitation program.

Definition of "normally" for facts and circumstances test. An organization will normally meet the requirements of the facts and circumstances test for its current tax year and the next tax year if, for the 4 tax years immediately before the current tax year, the organization meets the ten-percent-of-support and the attraction of public support requirements on an aggregate basis and satisfies a sufficient combination of the factors discussed later. The combination of factors that an organization normally must meet does not have to be the same for each 4-year period as long as a sufficient combination of factors exists to show compliance. See also *Special computation period for new organizations*, later in this discussion.

Special rule. The fact that an organization has normally met the one-third support test requirements for a current tax year, but is unable normally to meet the requirements for a later tax year, will not in itself prevent the organization from meeting the requirements of the facts and circumstances test for the later tax year.

Example. X organization meets the one-third support test in its 1996 tax year on the basis of support received during 1992, 1993, 1994, and 1995. It therefore normally meets the requirements for both 1996 and 1997. For the 1997 tax year, X is unable to meet the one-third support test on the basis of support received during 1993, 1994, 1995, and 1996. If X can meet the facts and circumstances test on the basis of those years, X will normally meet the requirements for 1998 (the tax year immediately after 1997). However, if on the basis of both 4-year periods (1993 through 1996 and 1994 through 1997), X fails to meet both the one-third and the facts and circumstances tests, X will not be a publicly supported organization for 1998.

However, X will not be disqualified as a publicly supported organization for the 1997 tax year, because it normally met the one-third support test requirements on the basis of the tax years 1992 through 1995 unless the provisions governing the *Exception for material changes in sources of support* (discussed later) become applicable.

Additional requirements (the five public support factors). In addition to the two requirements of the facts and circumstances test, the following **five public support factors** will be considered in determining whether an organization is publicly supported. However, an organization generally does not have to satisfy all of the factors. The factors relevant to each case and the weight accorded to any one of them may differ depending upon the nature and purpose of the organization and the length of time it has existed. The combination of factors that an organization normally must meet does not have to be the same for each 4-year period as long as a sufficient combination of factors exists to show that the organization is publicly supported.

1) Percentage of financial support factor. When an organization normally receives at least 10% but less than one-third of its total support from public or governmental sources, the percentage of support received from those sources will be considered in determining whether the organization is publicly supported. As the percentage of support from public or governmental sources increases, the burden of establishing the publicly supported nature of the organization through other factors decreases; while the lower the percentage, the greater the burden.

If the percentage of the organization's support from the general public or governmental sources is low because it receives a high percentage of its total support from investment income on its endowment funds, the organization will be treated as complying with this factor if the endowment fund was originally contributed by a governmental unit or by the general public. However, if the endowment funds were originally contributed by a few individuals or members of their families, this fact will increase the burden on the organization of establishing compliance with other factors. Facts pertinent to years before the 4 tax years immediately before the current tax year also may be considered.

2) Sources of support factor. If an organization normally receives at least 10% but less than one-third of its total support from public or governmental sources, the fact that it receives the support from governmental units or directly or indirectly from a representative number of persons, rather than receiving almost all of its support from the members of a single family, will be considered in determining whether the organization is publicly supported. In determining what is a representative number of persons, consideration will be given to the type of organization involved, the length of time it has existed, and whether it limits its activities to a particular community or region or to a special field that can be expected to appeal to a limited number of persons. Facts pertinent to years before the 4 tax years immediately before the current tax year also may be considered.

3) Representative governing body factor. The fact that an organization has a governing body that represents the broad interests of the public rather than the personal or private interest of a limited number of donors will be considered in determining whether the organization is publicly supported.

An organization will meet this requirement if it has a governing body composed of:

- 1) Public officials acting in their public capacities,

- 2) Individuals selected by public officials acting in their public capacities,
- 3) Persons having special knowledge or expertise in the particular field or discipline in which the organization is operating, and
- 4) Community leaders, such as elected or appointed officials, members of the clergy, educators, civic leaders, or other such persons representing a broad cross-section of the views and interests of the community.

In a **membership organization**, the governing body also should include individuals elected by a broadly based membership according to the organization's governing instrument or bylaws.

4) Availability of public facilities or services factor. If an organization generally provides facilities or services directly for the benefit of the general public on a continuing basis, that is evidence that the organization is publicly supported. Examples are:

- A museum that is open to the public,
- A symphony orchestra that gives public performances,
- A conservation organization that provides educational services to the public through the distribution of educational materials, or
- An old age home that provides domiciliary or nursing services for members of the general public.

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

Similarly, the following factors are also evidence that an organization is publicly supported:

- 1) Participating in, or sponsoring of, the programs of the organization by members of the public having special knowledge or expertise, public officials, or civic or community leaders,
- 2) Maintaining a definitive program by the organization to accomplish its charitable work in the community, such as slum clearance or developing employment opportunities, and
- 3) Receiving 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.

5) Additional factors pertinent to membership organizations. The following are additional factors in determining whether a membership organization is publicly supported:

- 1) 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 (taking into account the size of the area and the nature of the organization's activities),
- 2) Whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make

membership available to a broad cross section of the interested public, rather than to restrict membership to a limited number of persons, and

- 3) Whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations.

Exception for material changes in sources of support. If for the current tax year substantial and material changes occur in an organization's sources of support other than changes arising from unusual grants (discussed later under *Unusual grants*), then in applying either the one-third or the facts and circumstances test, the 4-year computation period applicable to that year, either as an immediately following tax year or as a current tax year, will not apply. Instead of using these computation periods, a computation period of 5 years will apply. The 5-year period consists of the current tax year and the 4 tax years immediately before that year.

For example, if substantial and material changes occur in an organization's sources of support for the 1996 tax year, then, even though the organization meets the one-third or the facts and circumstances test using a computation period of tax years 1991–1994 or 1992–1995, the organization will not meet either test unless it meets the test using a computation period of tax years 1992–1996 (substituted period).

Substantial and material change. An example of a substantial and material change is the receipt of an unusually large contribution or bequest that does not qualify as an unusual grant.

Effect on grantor or contributor. If as a result of this substituted period, an organization is not able to meet either the one-third support or the facts and circumstances test for its current tax year, its status with respect to a grantor or contributor will not be affected until notice of change of status is made to the public (such as by publication in the *Internal Revenue Bulletin*). This does not apply, however, if the grantor or contributor was responsible for or was aware of the substantial and material change or acquired knowledge that the IRS had given notice to the organization that it would be deleted from classification as a publicly supported organization.

A grantor or contributor (other than one of the organization's founders, creators, or foundation managers) will not be considered responsible for, or aware of, the substantial and material change, if the grantor or contributor made the grant or contribution relying upon a written statement by the grantee organization that the grant or contribution would not result in the loss of the organization's classification as a publicly supported organization. The statement must be signed by a responsible officer of the grantee organization and must give enough information, including a summary of the pertinent financial data for the 4 preceding years, to assure a reasonably prudent person that the grant or contribution would not result in the loss of the grantee organization's classification as a publicly supported organization. If a reasonable doubt exists as to the effect of the grant or contribution, or, if the grantor or contributor is one of the organization's founders, creators, or

foundation managers, the grantee organization may request a ruling from the key District Director before accepting the grant or contribution for the protection of the grantor or contributor.

If there is no written statement, a grantor or contributor will not be considered responsible for a substantial and material change if the total gifts, grants, or contributions received from that grantor or contributor for a tax year are 25% or less of the total support received by the organization from all sources for the 4 tax years immediately before the tax year. (If the organization has not qualified as "publicly supported" for those 5 years, see *Special computation period for new organizations*, next.) For this purpose, total support does not include support received from that particular grantor or contributor. The grantor or contributor cannot be a person who is in a position of authority, such as a foundation manager, or who obtains a position of authority or the ability to exercise control over the organization because of the grant or contribution.

Special computation period for new organizations. Organizations that have been in existence for at least 1 tax year consisting of at least 8 months, but for fewer than 5 tax years, can substitute the number of tax years they have been in existence before their current tax year to determine whether they meet the one-third support test or the facts and circumstances test, discussed earlier.

First tax year at least 8 months. The initial status determination of a newly created organization whose first tax year is at least 8 months is based on a computation period of either the first tax year or the first and second tax years.

First tax year shorter than 8 months. The initial status determination of a newly created organization whose first tax year is less than 8 months is based on a computation period of either the first and second tax years or the first, second, and third tax years.

5-year advance ruling period. If an organization has received an advance ruling, the computation is based on all the years in the 5-year advance ruling period. Advance rulings are described later, under *Advance rulings to newly created organizations - Initial determination of status*.

However, if the advance ruling period is terminated by the IRS, the computation period will be based on the period described above under *First tax year at least 8 months* and *First tax year shorter than 8 months*, or if the period is greater, the number of years to which the advance ruling applies.

Support. For purposes of publicly supported organizations, the term "support" includes (but is not limited to):

- 1) Gifts, grants, contributions, or membership fees,
- 2) Net income from unrelated business activities, whether or not those activities are carried on regularly as a trade or business,
- 3) Gross investment income,
- 4) Tax revenues levied for the benefit of an organization and either paid to or spent on behalf of the organization, and
- 5) The value of services or facilities furnished by a governmental unit to an organization without charge (except ser-

vices or facilities generally furnished to the public without charge).

Amounts that are not support. The term "support" does not include:

- 1) Any gain on the sale or disposition of a capital asset,
- 2) The value of exemption from any federal, state, or local tax or any similar benefit,
- 3) Any amount received from the exercise or performance by an organization of the purpose or function constituting the basis for its exemption (in general, these amounts include amounts received from any activity the conduct of which is substantially related to the furtherance of the exempt purpose or function, other than through the production of income), or
- 4) Contributions of services for which a deduction is not allowed.

These amounts are excluded from both the numerator and the denominator of the fractions in determining compliance with the one-third support test and ten-percent-of-support requirement. The following discusses an exception to this general rule.

Organizations dependent primarily on gross receipts from related activities. Organizations will not satisfy the one-third support test or the ten-percent-of-support requirement if they receive:

- 1) Almost all support from gross receipts from related activities, and
- 2) An insignificant amount of support from governmental units (without regard to amounts referred to in (3) in the preceding list) and contributions made directly or indirectly by the general public.

Example. X, an organization described in section 501(c)(3), is controlled by Thomas Blue, its president. X received \$500,000 during the 4 tax years immediately before its current tax year under a contract with the Department of Transportation, under which X engaged in research to improve a particular vehicle used primarily by the federal government. During the same period, the only other support received by X was \$5,000 in small contributions primarily from X's employees and business associates. The \$500,000 is support under (1) above. Under these circumstances, X meets the conditions of (1) and (2) above and so does not meet the one-third support test or the ten-percent-of-support requirement.

For the rules that apply to organizations that fail to qualify as section 509(a)(1) publicly supported organizations because of these provisions, see *Section 509(a)(2) Organizations*, later. See also *Gross receipts from a related activity* in the discussion on section 509(a)(2) organizations.

Membership fees. Membership fees are included in the term support if they are paid to provide support for the organization rather than to buy admissions, merchandise, services, or the use of facilities.

Support from a governmental unit. For purposes of the one-third support test and the ten-percent-of-support requirement, the term "support from a governmental unit" includes any amounts received from a governmental unit, including donations or contributions and amounts received on a contract entered into

with a governmental unit for the performance of services, or from a government research grant. However, these amounts are not support from a governmental unit for these purposes if they constitute amounts received from the exercise or performance of the organization's exempt functions.

Any amount paid by a governmental unit to an organization will not be treated as received from the exercise or performance of its exempt function if the purpose of the payment is primarily to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public (regardless of whether part of the expense of providing the service or facility is paid for by the public), rather than to serve the direct and immediate needs of the payor. This includes:

- 1) Amounts paid to maintain library facilities that are open to the public,
- 2) Amounts paid under government programs to nursing homes or homes for the aged to provide health care or domiciliary services to residents of these facilities, and
- 3) Amounts paid to child placement or child guidance organizations under government programs for services rendered to children in the community.

These payments are mainly to enable the recipient organization to provide a service or maintain a facility for the direct benefit of the public, rather than to serve the direct and immediate needs of the payor. Furthermore, any amount received from a governmental unit under circumstances in which the amount would be treated as a grant will generally constitute support from a governmental unit. See the discussion of *Grants* on page 32.

Medicare and Medicaid payments.

Medicare and Medicaid payments are received from contracts entered into with state and federal governmental units. However, payments are made for services already provided to eligible individuals, rather than to encourage or enable an organization to provide services to the public. The individual patient, not a governmental unit, actually controls the ultimate recipient of these payments by selecting the health care organization. As a result, these payments are not considered support from a governmental unit. Medicare and Medicaid payments are gross receipts derived from the exercise or performance of exempt activities and, therefore, are not included in the term "support."

Support from the general public. In determining whether the one-third support test or the ten-percent-of-support requirement is met, include in your computation support from direct or indirect contributions from the general public. This includes contributions from an individual, trust, or corporation but only to the extent that the total contributions from the individual, trust, or corporation, during the 4-year period immediately before the current tax year (or substituted computation period) are not more than 2% of the organization's total support for the same period.

Thus, a contribution by any one individual will be included in full in the denominator of the fraction used in the one-third support test or the ten-percent-of-support requirement. However, the contribution will be included in the numerator only to the extent that it is not more than 2% of the denominator. In applying the 2% limit, all contributions made by a donor

and by any person in a special relationship to the donor (certain *Disqualified persons* discussed on page 34 under *Section 509(a)(3) Organizations*) are considered made by one person. The 2% limit does not apply to support received from governmental units or to contributions from other publicly supported charities, except as provided under *Grants from public charities*, later.

Indirect contributions. The term "indirect contributions from the general public" includes contributions received by the organization from organizations (such as publicly supported organizations) that normally receive a substantial part of their support from direct contributions from the general public, except as provided under *Grants from public charities*, next.

Grants from public charities. Contributions received from a governmental unit or from a publicly supported organization (including a church that meets the requirements for being publicly supported) are not subject to the 2% limit unless the contributions represent amounts either expressly or impliedly earmarked by a donor to the governmental unit or publicly supported organization as being for, or for the benefit of, the particular organization claiming a publicly supported status.

Example 1. M, a national foundation for the encouragement of the musical arts, is a publicly supported organization. George Spruce gives M a donation of \$5,000 without imposing any restrictions or conditions upon the gift. M later makes a \$5,000 grant to X, an organization devoted to giving public performances of chamber music. Since the grant to X is treated as being received from M, it is fully includable in the numerator of X's support fraction for the tax year of receipt.

Example 2. Assume M is the same organization described in example (1). Tom Grove gives M a donation of \$10,000, but requires that M spend the money to support organizations devoted to the advancement of contemporary American music. M has complete discretion as to the organizations of the type described to which it will make a grant. M decides to make grants of \$5,000 each to Y and Z, both being organizations described in section 501(c)(3) and devoted to furthering contemporary American music. Since the grants to Y and Z are treated as having been received from M, Y and Z each may include one of the \$5,000 grants in the numerator of its support fraction. Although the donation to M was conditioned upon the use of the funds for a particular purpose, M was free to select the ultimate recipient.

Example 3. N is a national foundation for the encouragement of art and is a publicly supported organization. Grants to N are permitted to be earmarked for particular purposes. O, which is an art workshop devoted to training young artists and is claiming status as a publicly supported organization, persuades C, a private foundation, to make a grant of \$25,000 to N. C is a disqualified person with respect to O. C makes the grant to N with the understanding that N would be bound to make a grant to O in the sum of \$25,000, in addition to a matching grant of N's funds to O in the sum of \$25,000. Only the \$25,000 received directly from N is considered a grant from N. The other \$25,000 is an indirect contribution from C to O and is to be excluded from the numerator of O's sup-

port fraction to the extent it exceeds the 2% limit.

Unusual grants. In applying the 2% limit to determine whether the one-third support test or the ten-percent-of-support requirement is met, exclude contributions that are considered unusual grants from both the numerator and denominator of the appropriate percent-of-support fraction. Generally, unusual grants are substantial contributions or bequests from disinterested parties if the contributions:

- 1) Are attracted by the publicly supported nature of the organization,
- 2) Are unusual or unexpected in amount, and
- 3) Would adversely affect, because of the size, the status of the organization as normally being publicly supported. (The organization must otherwise meet the support test in that year without benefit of the grant or contribution.)

For a grant (see the description of *Grants* on page 32) that meets the requirements for exclusion, 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 under the terms of the grant may be excluded for that year. However, no item of gross investment income (defined under *Section 509(a)(2) Organizations*, later) may be excluded under this rule. These provisions allow exclusion of unusual grants made during any of the applicable periods previously discussed under *Special computation period for new organizations*, and to periods described in *Advance rulings to newly created organizations - Initial determination of status*, later.

Characteristics of an unusual grant. A grant or contribution will be considered an unusual grant if the above three factors apply and if it has all of the following characteristics. If these factors and characteristics apply, then even without the benefit of an advance ruling, grantors or contributors have assurance that they will not be considered responsible for substantial and material changes in the organization's sources of support.

- 1) The grant or contribution is not made by a person (or related person) who created the organization or was a substantial contributor to the organization before the grant or contribution.
- 2) The grant or contribution is not made by a person (or related person) who is in a position of authority, such as a foundation manager, or who otherwise has the ability to exercise control over the organization. Similarly, the grant or contribution is not made by a person (or related person) who, because of the grant or contribution, obtains a position of authority or the ability to otherwise exercise control over the organization.
- 3) The grant or contribution is in the form of cash, readily marketable securities, or assets that directly further the organization's exempt purposes, such as a gift of a painting to a museum.
- 4) The donee-organization has received either an advance or final ruling or determination letter classifying it as a publicly supported organization and, except for an organization operating under an

advance ruling or determination letter, the organization is actively engaged in a program of activities in furtherance of its exempt purpose.

- 5) No material restrictions or conditions have been imposed by the grantor or contributor upon the organization in connection with the grant or contribution.
- 6) If the grant or contribution is intended for operating expenses, rather than capital items, the terms and amount of the grant or contribution are expressly limited to one year's operating expenses.

Ruling request. Before any grant or contribution is made, a potential grantee organization may request a ruling as to whether the grant or contribution may be excluded. This request may be filed by the grantee organization with the key District Director for its area. The organization must submit all information necessary to make a determination, including information relating to the factors and characteristics listed in the preceding paragraphs. If a favorable ruling is issued, the ruling may be relied upon by the grantor or contributor of the particular contribution in question. The issuance of the ruling will be at the sole discretion of the IRS. The potential grantee organization should follow the procedures set out in Revenue Procedure 97-4 (or later update) to request a ruling.

Grants and contributions that result in substantial and material changes in the organization and that fail to qualify for exclusion will affect the way the support tests are applied. See *Exception for material changes in sources of support*, earlier.

If a ruling is requested, in addition to the characteristics listed earlier under *Characteristics of an unusual grant*, the following factors may be considered by the IRS in determining if the grant or contribution is an unusual grant.

- 1) Whether the contribution was a bequest or a transfer while living. A bequest will be given more favorable consideration than a transfer while living.
- 2) Whether, before the receipt of the contribution, the organization has carried on an active program of public solicitation and exempt activities and has been able to attract a significant amount of public support.
- 3) Whether, before the year of contribution, the organization met the one-third support test or the ten-percent-of-support requirement without benefit of any exclusions of unusual grants.
- 4) Whether the organization may reasonably be expected to attract a significant amount of public support after the contribution. Continued reliance on unusual grants to fund an organization's current operating expenses (as opposed to providing new endowment funds) may be evidence that the organization cannot reasonably be expected to attract future support from the general public.
- 5) Whether the organization has a representative governing body.

Advance rulings to newly created organizations - Initial determination of status. Because they have not been in existence long enough, many newly created organizations cannot meet either the 4-year normally pub-

licly supported provisions or the provisions for newly created organizations to qualify as normally publicly supported. However, a newly created organization may qualify for an advance ruling that it will be treated as an organization described in section 170(b)(1)(A)(vi) during an advance ruling period long enough to enable it to develop an adequate support history on which to base an initial determination as to foundation status.

Generally, the type of newly created organization that would qualify for an advance ruling is one that can show that its organizational structure, proposed programs and activities, and intended method of operation are likely to attract the type of broadly based support from the general public, public charities, and governmental units that is necessary to meet the public support requirements discussed earlier under *Qualifying As Publicly Supported*.

An advance ruling or determination will provide that an organization will be treated as an organization described in section 170(b)(1)(A)(vi) for an advance ruling period of 5 years.

5-year advance ruling period. A newly created organization may request a ruling or determination letter that it will be treated as a section 170(b)(1)(A)(vi) organization for its first 5 tax years. The request must be accompanied by a consent to extend the statute (on Form 872-C) that, in effect, states the organization will be subject to the taxes imposed under section 4940 if it fails to qualify as **not** a private foundation during the 5-year advance ruling period. The organization's first tax year, regardless of length, will count as the first year in the 5-year period. The advance ruling period will end on the last day of the organization's 5th tax year.

Between 30 and 45 days before the end of the advance ruling period, the District Director will contact the organization and request the financial support information necessary to make a final determination of foundation status. In general, this is the information requested in Part IV, A of Form 1023.

Failure to obtain advance ruling. If a newly created organization has not obtained an advance ruling or determination letter, it cannot rely upon the possibility that it will meet the public support requirements discussed earlier. Thus, in order to avoid the risk of being classified as a private foundation, the organization may comply with the rules governing private foundations by paying any applicable private foundation taxes. If the organization later meets the public support requirements for the applicable period, it will be treated as a section 170(b)(1)(A)(vi) organization from its inception and any private foundation tax that was imposed may be refunded.

Reliance period. The newly created organization will be treated as a publicly supported organization for all purposes other than sections 507(d) (relating to total tax benefit resulting from exempt status) and 4940 (relating to tax on net investment income) for the period beginning with its inception and ending 90 days after its advance ruling period expires. The period will be extended until a final determination is made of an organization's status only if the organization submits, within the 90-day period, information needed to determine whether it meets either of the support tests for its advance ruling period (even if the organization fails to

meet either test). However, this reliance period does not apply to the excise tax imposed on net investment income. If it is later determined that the organization was a private foundation from its inception, that excise tax will be due without regard to the advance ruling or determination letter. Consequently, if any amount of the tax is not paid on or before the last date prescribed for payment, the organization is liable for interest on the tax due for years in the advance ruling period. However, since any failure to pay the tax during the period is due to reasonable cause, the penalty imposed for failure to pay the tax will not apply.

If an advance ruling or determination letter is terminated by the IRS before the expiration of the reliance period, the status of grants or contributions with respect to grantors or contributors to the organization will not be affected until notice of change of status of the organization is made to the public (such as by publication in the *Internal Revenue Bulletin*). However, this will not apply if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's loss of classification as a publicly supported organization.

Also, it will not apply if the grantor or contributor knew that the IRS had given notice to the organization that it would be deleted from this classification. Before any grant or contribution is made, **a potential grantee organization may request a ruling** on whether the grant or contribution may be made without loss of classification as a publicly supported organization.

The ruling request may be filed by the grantee organization with the key District Director. The issuance of the ruling will be at the sole discretion of the IRS. The organization must submit all information necessary to make a determination on the support factors previously discussed. If a favorable ruling is issued, the ruling may be relied upon by the grantor or contributor of the particular contribution in question. The grantee organization also may rely on the ruling for excluding unusual grants.

Comprehensive Examples

Example 1. For the years 1992 through 1995, M organization received support of \$600,000 from the following sources.

| | |
|-------------------------|------------------|
| Investment Income | \$300,000 |
| City Y | 40,000 |
| United Way | 40,000 |
| Contributions | 220,000 |
| Total support | <u>\$600,000</u> |

For 1996, on the basis of the above support, M is considered to have normally received more than one-third of its support from a governmental unit 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 | <u>\$40,000</u> |
| Indirect contributions from the general public (United Way) | 40,000 |
| Contributions by various donors (no one having made contributions that total more than \$12,000—2% of total support) | 50,000 |
| Six contributions (each in excess of \$12,000 —2% of total support) 6 × \$12,000 | <u>72,000</u> |
| | <u>\$202,000</u> |

Since M's support from governmental units and from direct and indirect contributions from the general public normally is more than

one-third of M's total support for the applicable period (1992-1995), M meets the one-third support test and satisfies the requirements for classification as a publicly supported organization for 1996 and 1997. (This remains in effect if no substantial and material changes took place in the organization's character, purposes, methods of operation, or sources of support in these years.)

Example 2. N organization was created to maintain public gardens containing plant specimens and displaying works of art. The facilities, 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 many visitors each year. For the 4 tax years immediately before the current tax year, 95% of the organization's total support was received from investment income from its original endowment. N also maintains a membership society that 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 4-year period in question, these fees from the general public constituted the remaining 5% of the organization's total support. Under these circumstances, N does not meet the one-third support test for its current tax year. Furthermore, since only 5% was received from the general public, N does not satisfy the ten-percent-of-support requirement of the facts and circumstances test. For its current tax year, N therefore is not a publicly supported organization. Since N failed to satisfy the ten-percent-of-support requirement, none of the other requirements or factors can be considered in determining whether N qualifies as a publicly supported organization.

Example 3. In 1960, O organization was founded in Y City by the members of a single family to collect, preserve, interpret, and display to the public important works of art. O is governed by a Board of Trustees that originally consisted almost entirely of members of the founding family.

However, since 1975, members of the founding family or persons related to members of the family have annually been less than 20% of the Board of Trustees. The remaining board members are citizens of Y City from a variety of professions and occupations who represent the interests and views of the people of Y City in the activities carried on by the organization rather than the personal or private interests of the founding family.

O solicits contributions from the general public and for each of its 4 most recent tax years has received total contributions (in small sums of less than \$100, none of which is more than 2% of O's total support for the period) of more than \$10,000. These contributions from the general public are 25% of the organization's total support for the 4-year period. For this same period, investment income from several large endowment funds has been 75% of its total support. O spends substantially all of its annual income for its exempt purposes and thus depends upon the funds it annually solicits from the public as well as its investment income to carry out its activities on a normal and continuing basis and to acquire new works of art. For the entire period of its existence, O has been open to the public and more than 300,000 people (from Y City and elsewhere) have visited the

museum in each of its 4 most recent tax years.

Under these circumstances, O does not meet the one-third support test for its current year since it has received only 25% of its total support for the applicable 4-year period from the general public. However, O has met the ten-percent-of-support requirement as well as the attraction of public support requirement and the factors to be considered, under the facts and circumstances test, in determining whether an organization is publicly supported. Therefore, O is classified as a publicly supported organization for its current tax year and the next tax year.

Example 4. In 1970, the P Philharmonic Orchestra was organized in Z City by a local music society and a local women's club to present to the public a wide variety of musical programs intended to foster music appreciation in the community. The orchestra is composed of professional musicians who are paid by the association. Twelve performances, open to the public, are scheduled each year. A small admission charge is made for each of these performances. In addition, several performances are staged annually without charge.

During its 4 most recent tax years, P received separate contributions of \$200,000 each from Amanda Green and Jackie White (not members of a single family) and support of \$120,000 from the Z Community Chest, a public federated fund-raising organization operating in Z City. P depends on these funds to carry out its activities and will continue to depend on contributions of this type to be made in the future. P has also begun a fund-raising campaign in an attempt to expand its activities for the coming years.

P is governed by a Board of Directors composed of five individuals. A faculty member of a local college, the president of a local music society, the head of a local bank, a prominent doctor, and a member of the governing body of the local Chamber of Commerce currently serve on the Board and represent the interests and views of the community in the activities carried on by P.

For P's current tax year, its sources of support are computed on the basis of the 4 immediately preceding years, as follows.

| | |
|---|------------------|
| Contributions | \$520,000 |
| Receipts from performances | <u>100,000</u> |
| Less: | |
| Receipts from performances (excluded, see <i>Support</i>) | 100,000 |
| Total support | <u>\$520,000</u> |
| Z Community Chest (indirect support from the general public) | \$120,000 |
| Two contributions (each over \$10,400—2% of total support) 2 × | |
| \$10,400 | 20,800 |
| Total support from general public | <u>\$140,800</u> |

P's support from the general public, directly and indirectly, does not meet the one-third support test ($\$140,800/\$520,000 = 27\%$ of total support). However, it meets the ten-percent-of-support requirement. P also meets the requirement of the attraction of public support. As a result of satisfying these requirements and the public support factors, P is considered to be a publicly supported organization.

If P were a newly created organization, it could obtain a ruling that it is a publicly supported organization by reason of its purposes, organizational structure, and proposed method of operation. Even if P had initially been founded by the contributions of a few

individuals, this would not, in and of itself, disqualify P from receiving the ruling.

Example 5. Q is a philanthropic organization founded in 1985 by Anne Elm for the purpose of making annual contributions to worthy charities. Anne created Q as a charitable trust by transferring \$500,000 worth of appreciated securities to Q.

Under the trust agreement, Anne and two other family members are the sole trustees and are vested with the right to appoint successor trustees. In each of its 4 most recent tax years, Q received \$15,000 in investment income from its original endowment. Each year Q solicits funds by operating a charity ball at Anne's home. Guests are invited and asked to make contributions of \$100 per couple. During the 4-year period involved, \$15,000 was received from the proceeds of these events. Anne and the family have also made contributions to Q of \$25,000 over the course of the organization's 4 most recent tax years. Q makes disbursements each year of substantially all of its net income to the public charities chosen by the trustees.

For Q's current tax year, Q's sources of support are computed on the basis of the 4 immediately preceding years as follows.

| | |
|--|------------------|
| Investment income | \$60,000 |
| Contributions | <u>40,000</u> |
| Total support | <u>\$100,000</u> |
| Contributions from the general public | \$15,000 |
| One contribution (over \$2,000 — 2% of total support) 1 × \$2,000 | 2,000 |
| Total support from general public | <u>\$17,000</u> |

Q's support from the general public does not meet the one-third support test ($\$17,000/\$100,000 = 17\%$ of total support). Even though it does meet the ten-percent-of-support requirement, its method of solicitation makes it questionable whether Q satisfies the attraction of public support requirement. Because of its method of operating, Q also has a greater burden of establishing its publicly supported nature under the percentage of financial support factor. Based on these facts and on Q's failure to receive favorable consideration under the remaining factors, Q does not qualify as a publicly supported organization.

Community Trusts

Community trusts are often established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area. Often these contributions come initially from a small number of donors. While the community trust generally has a governing body composed of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds that are subject to varying degrees of control by the governing body.

To qualify as a publicly supported organization, a community trust must meet the one-third support test, explained earlier under *Qualifying As Publicly Supported*. If it cannot meet that test, it must be organized and operated so as to attract new and additional public or governmental support on a continuous basis sufficient to meet the facts and circumstances test, also explained earlier. Community trusts are generally able to satisfy the attraction of public support requirement (as contained in the facts and circumstances test) if they seek gifts and bequests from a wide range of potential donors in the community or area served, through banks or trust

companies, through attorneys or other professional persons, or in other appropriate ways that call attention to the community trust as a potential recipient of gifts and bequests made for the benefit of the community or area served. A community trust, however, does not have to engage in periodic, community-wide, fund-raising campaigns directed toward attracting a large number of small contributions in a manner similar to campaigns conducted by a community chest or a united fund.

Separate trusts or funds. Any community trust may be treated as a single entity, rather than as an aggregation of separate funds, in which case all qualifying funds associated with that organization (whether a trust, not-for-profit corporation, unincorporated association, or a combination thereof) will be treated as component parts of the organization.

Single entity. To be treated as a single entity, a community trust must meet all the following requirements.

- 1) The organization must be commonly known as a community trust, fund, foundation, or other similar name conveying the concept of a capital or endowment fund to support charitable activities in the community or area it serves.
- 2) The organization must prepare periodic financial reports treating all of the funds that are held by the community trust, either directly or in component parts, as funds of the organization.
- 3) All funds of the organization must be subject to a common governing instrument (or a master trust or agency agreement) that may be embodied in a single (or several) document(s) containing common language.
- 4) The organization must have a common governing body (or distribution committee) that either directs or, in the case of a fund designated for specified beneficiaries, monitors the distribution of all funds exclusively for charitable purposes. The governing body must have the power in the governing instrument, the instrument of transfer, the resolutions or bylaws of the governing body, a written agreement, or otherwise—
 - a) To modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified organizations if in the sole judgment of the governing body (without the necessity of the approval of any participating trustee, custodian, or agent), the restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served,
 - b) To replace any participating trustee, custodian, or agent for breach of fiduciary duty under state law, and
 - c) To replace any participating trustee, etc., for failure to produce a reasonable return of net income over a reasonable period of time. (The governing body will determine what is "reasonable.")

A community trust can meet the requirement in (4) above even if its exercise of the

powers in (4)(a), (b), or (c) is reviewable by an appropriate state authority.

Component part. To be treated as a component part of a community trust (rather than as a separate trust or a not-for-profit corporation), a trust or fund:

- 1) Must be created by gift, bequest, legacy, devise, or other transfer to a community trust that is treated as a single entity (described above), and
- 2) May not be directly subjected by the transferor to any material restriction or condition with respect to the transferred assets.

Grantors and contributors. Grantors, contributors, or distributors to a community trust may rely on the public charity status, which the organization has claimed in a timely filed notice, on or before the date the IRS informs the public (through such means as publication in the *Internal Revenue Bulletin*) that such reliance has expired. However, if the grantor, contributor, or distributor acquires knowledge that the IRS has notified the community trust that it has failed to establish that it is a public charity, then reliance on the claimed status expires at the time such knowledge is acquired.

Section 509(a)(2) Organizations

Section 509(a)(2) excludes certain types of broadly, publicly supported organizations from private foundation treatment. Generally, an organization described in section 509(a)(2) may also fit the description of a publicly supported organization under section 509(a)(1). There are, however, two basic differences.

- 1) For section 509(a)(2) organizations, the term support includes items of support discussed earlier (under *Support*, in the discussion of *Section 509(a)(1) Organizations*) **and** income from activities directly related to their exempt function. This income is not included in meeting the support test for a publicly supported organization under section 509(a)(1).
- 2) Section 509(a)(2) places a limit on the total gross investment income and unrelated business taxable income (in excess of the unrelated business tax) an organization may have, while section 509(a)(1) does not.

To be excluded from private foundation treatment under section 509(a)(2), an organization must meet two support tests:

- 1) The one-third support test, and
- 2) The not-more-than-one-third support test.

Both these tests are designed to insure that an organization that is excluded from private foundation treatment is responsive to the general public, rather than to the private interests of a limited number of donors or other persons.

One-third support test. The one-third support test will be met if an organization **normally** receives **more than** one-third of its support in each tax year from any combination of:

- 1) Gifts, grants, contributions, or membership fees, and

- 2) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities in an activity that is not an unrelated trade or business, subject to certain limits, discussed below under *Limit on gross receipts*.

For this purpose, the support must be from permitted sources, which include:

- Section 509(a)(1) organizations, described earlier,
- Governmental units, described on page 23 under *Section 509(a)(1) Organizations*, and
- Persons other than *Disqualified persons* (defined on page 34 under *Section 509(a)(3) Organizations*).

Limit on gross receipts. In computing the amount of support received from gross receipts under (2) above, gross receipts from related activities received from any person or from any bureau or similar agency of a governmental unit are includable in any tax year only to the extent the gross receipts are not more than the greater of \$5,000 or 1% of the organization's total support in that year.

Not-more-than-one-third support test. This test will be met if an organization **normally** receives no more than one-third of its support in each tax year from the sum of:

- 1) Gross investment income, and
- 2) The excess (if any) of unrelated business taxable income from unrelated trades or businesses acquired after June 30, 1975 over the tax imposed on that income.

Gross investment income. Gross investment income means the gross amount of income from interest, dividends, payments with respect to securities loans, rents, and royalties, but it does not include any income that would be included in computing tax on unrelated business income from trades or businesses.

Definition of "normally." Both support tests are computed on the basis of the nature of the organization's normal sources of support. An organization will be considered to have normally met both tests for its current tax year and the tax year immediately following, if it meets those tests on the basis of the total support received for the 4 tax years immediately before the current tax year.

Exception for material changes in sources of support. If during the current tax year there are substantial and material changes in an organization's sources of support other than changes arising from unusual grants (discussed later under *Unusual grants*), neither the 4-year computation period for the current year as an immediately following tax year, nor the 4-year computation period for that year as a current tax year applies. Instead, the normal sources of support will be determined on the basis of a 5-year period consisting of the current tax year and the 4 preceding tax years.

For example, if material changes occur in support for the year 1996, then even though the organization meets the requirements of the support tests based on the years 1991–1994 or 1992–1995, it does not meet these tests unless it meets the requirements based on the 5-year computation period of 1992–1996. An example of a substantial and material change is the receipt of an unusually

large contribution that does not qualify as an unusual grant.

Effect on grantor or contributor. If an organization is not able to meet either of the support tests because of a substantial or material change in the sources of support, its status with respect to a grantor or contributor will not be affected until notice of a change in status is made to the public (such as by publication in the *Internal Revenue Bulletin*).

However, this rule does not apply to any grantor or contributor who:

- 1) Was responsible for the substantial or material change,
- 2) Was aware of it, or
- 3) Has acquired knowledge that the IRS gave notice to the organization that it would no longer be classified as a section 509(a)(2) organization.

A grantor or contributor (other than one of the organization's founders, creators, or foundation managers) is not considered responsible for, or aware of, the substantial and material change if the grantor or contributor made the grant or contribution relying upon a written statement by the grantee organization that the grant or contribution would not result in the loss of the organization's classification as an organization that is not a private foundation. The statement must be signed by a responsible officer of the grantee organization and must give enough information, including a summary of the pertinent financial data for the 4 preceding years, to assure a reasonably prudent person that the grant or contribution would not result in the loss of the grantee organization's classification as not a private foundation. If a reasonable doubt exists as to the effect of the grant or contribution, or if the grantor or contributor is one of the organization's founders, creators, or foundation managers, the grantee organization may request a ruling from its key District Director for the protection of the grantor or contributor.

If there is no written statement, a grantor or contributor will not be considered responsible for a substantial and material change if the total gifts, grants, or contributions received from that grantor or contributor for a tax year are 25% or less of the total support received by the organization from all sources for the 4 tax years immediately before the tax year. (If the organization has not qualified as "publicly supported" for those 5 years, see *Special computation period for new organizations*, next.) For this purpose, total support does not include support received from that particular grantor or contributor. The grantor or contributor cannot be a person who is in a position of authority, such as a foundation manager, or who obtains a position of authority or the ability to exercise control over the organization because of the grant or contribution.

Special computation period for new organizations. A newly created organization may need several years to establish its normal sources of support. Organizations generally are allowed a 5-year period to establish that they meet the section 509(a)(2) support test. This is called the advance ruling period. If an organization can reasonably be expected to meet the support test by the end of its advance ruling period, the IRS may issue it an advance ruling or determination letter. See *Advance rulings for newly created*

organizations

, later. This will permit the organization to be treated as a section 509(a)(2) organization for its advance ruling period.

An advance ruling or determination is *not* a ruling that the organization will meet the requirements of section 509(a)(2) during the advance ruling period. An organization that receives an advance ruling or determination letter must, at the expiration of the advance ruling period, establish that it satisfies the section 509(a)(2) support requirements for the years covered by the advance ruling, or the organization will be presumed to be a private foundation under section 508(b).

Unusual grants. An unusual grant may be excluded from the support test computation if it:

- 1) Was attracted by the publicly supported nature of the organization,
- 2) Was unusual or unexpected in amount, and
- 3) Would, because of its size, adversely affect the status of the organization as normally meeting the one-third support test. (The organization must otherwise meet the test in that year without benefit of the grant or contribution.)

Characteristics of an unusual grant. A grant or contribution will be considered an unusual grant if the above 3 factors apply and it has all of the following characteristics. If these factors and characteristics apply, then even without the benefit of an advance ruling, grantors or contributors have assurance that they will not be considered responsible for substantial and material changes in the organization's sources of support.

- 1) The grant or contribution is not made by a person (or related person) who created the organization or was a substantial contributor to the organization before the grant or contribution.
- 2) The grant or contribution is not made by a person (or related person) who is in a position of authority, such as a foundation manager, or who otherwise has the ability to exercise control over the organization. Similarly, the grant or contribution is not made by a person (or related person) who, because of the grant or contribution, obtains a position of authority or the ability to otherwise exercise control over the organization.
- 3) The grant or contribution is in the form of cash, readily marketable securities, or assets that directly further the organization's exempt purposes, such as a gift of a painting to a museum.
- 4) The donee organization has received either an advance or final ruling or determination letter classifying it as a publicly supported organization and, except for an organization operating under an advance ruling or determination letter, the organization is actively engaged in a program of activities in furtherance of its exempt purpose.
- 5) No material restrictions or conditions have been imposed by the grantor or contributor upon the organization in connection with the grant or contribution.
- 6) If the grant or contribution is intended for operating expenses, rather than capital

items, the terms and amount of the grant or contribution are expressly limited to one year's operating expenses.

Ruling request. If there is any doubt that a grant or contribution may be excluded as an unusual grant, the grantee organization may request a ruling, submitting all of the necessary information for making a determination to its key District Director. The IRS has the sole discretion of issuing a ruling, but if a favorable ruling is issued, it may be relied on by the grantor or contributor for purposes of a charitable contributions deduction and by the organization for purposes of the exclusion for unusual grants. The organization should follow the procedures set out in Revenue Procedure 97-4 (or later update).

In addition to the characteristics listed above, the following factors may be considered by the IRS in determining if the grant or contribution is an unusual grant.

- 1) Whether the contribution was a bequest or a transfer while living. A bequest will ordinarily be given more favorable consideration than a transfer while living.
- 2) Whether, before the contribution, the organization carried on an actual program of public solicitation and exempt activities and was able to attract a significant amount of public support.
- 3) Whether the organization met the one-third support test in the past without the benefit of any exclusions of unusual grants.
- 4) Whether the organization may reasonably be expected to attract a significant amount of public support after the contribution. Continued reliance on unusual grants to fund an organization's current operating expenses may be evidence that the organization cannot attract future support from the general public.
- 5) Whether the organization has a representative governing body.

Example 1. In 1992, Y, an organization described in section 501(c)(3), was created by Marshall Pine, the holder of all the common stock in M corporation, Lisa, Marshall's wife, and Edward Forest, Marshall's business associate. Each of the three creators made small cash contributions to Y to enable it to begin operations. The purpose of Y was to sponsor and equip athletic teams composed of underprivileged children of the community. Between 1992 and 1995, Y was able to raise small amounts of contributions through fundraising drives and selling admission to some of the sponsored sporting events.

For its first year of operations, it was determined that Y was excluded from the definition of private foundation under the provisions of section 509(a)(2). Marshall made small contributions to Y from time to time. At all times, the operations of Y were carried out on a small scale, usually being restricted to the sponsorship of two to four baseball teams composed of underprivileged children.

In 1996, M recapitalized and created a first and second class of 6% nonvoting preferred stock, most of which was held by Marshall and Lisa. Marshall then contributed 49% of his common stock in M to Y. Marshall, Lisa, and Edward continued to be active participants in the affairs of Y from its creation through 1996. Marshall's contribution of M's common stock was 90% of Y's total support

for 1996. Although Y could satisfy the one-third support test on the basis of the 4 tax years before 1996, a combination of the facts and circumstances preclude Marshall's contribution of M's common stock in 1996 from being excluded as an unusual grant. Marshall's contribution in 1996 was a substantial and material change in Y's sources of support and on the basis of the 5-year period (1992 to 1996), Y would not be considered as **normally** meeting the one-third support test for the tax years 1996 (the current tax year) and 1997 (the immediately following tax year).

Example 2. M, an organization described in section 501(c)(3), was organized to promote the appreciation of ballet in a particular region of the United States. Its principal activities will consist of erecting a theater for the performance of ballet and the organization and operation of a ballet company. The governing body of M consists of nine prominent unrelated citizens living in the region who have either an expertise in ballet or a strong interest in encouraging appreciation of ballet. To provide sufficient capital for M to begin its activities, X, a private foundation, makes a grant of \$500,000 in cash to M. Although Albert Cedar, the creator of X, is one of the nine members of M's governing body, was one of M's original founders, and continues to lend his prestige to M's activities and fund-raising efforts, Albert does not, directly or indirectly, exercise any control over M. By the close of its first tax year, M also has received a significant amount of support from a number of smaller contributions and pledges from members of the general public. Upon the opening of its first season of ballet performances, M expects to charge admission to the general public. Under these circumstances, the grant by X to M may be excluded as an unusual grant.

Advance rulings for newly created organizations. Newly created organizations generally are allowed an advance ruling period of 5 years.

An organization that is claiming on its Form 1023 (or other section 508(b) notice) to be described under section 509(a)(2) must have operated for at least 1 tax year consisting of at least 8 months before the IRS will make a final determination of its status. However, if an organization can show that it can reasonably be expected to qualify under section 509(a)(2), the IRS will issue an advance ruling or determination letter on the organization's private foundation status. Generally, an advance ruling or determination provides that an organization will be treated as an organization described in section 509(a)(2) for an advance ruling period of 5 years.

A newly created organization may request a ruling or determination that it will be treated as a section 509(a)(2) organization for its first 5 tax years. This request must be filed with a consent to extend the statute (Form 872-C) that in effect states the organization will be subject to private foundation taxes (under section 4940) if it fails to qualify as **not** a private foundation during the 5 year advance ruling period.

In determining whether an organization can meet the support tests, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation will attract the type of broadly based support from the general pub-

lic, public charities, and governmental units that is necessary to meet the tests. The facts that are relevant to this determination and the weight accorded each fact may differ from case to case. A favorable determination will not be made when the facts indicate that an organization is likely to receive less than one-third of its support from permitted sources or to receive more than one-third of its support from gross investment income and unrelated business taxable income.

All pertinent facts and circumstances are taken into account in determining whether the organizational structure, programs or activities, and method of operation of an organization will enable it to meet the tests for its advance ruling period (discussed earlier). Some pertinent factors considered are:

- 1) Whether the organization has or will have a governing body that is composed of persons having special knowledge in the particular field in which the organization is operating or of community leaders, such as elected officials, members of the clergy, and educators, or, in the case of a membership organization, of individuals elected under the organization's governing instrument or bylaws by a broadly based membership.
- 2) Whether a substantial part of the organization's initial funding is to be provided by the general public, by public charities, or by government grants rather than by a limited number of grantors or contributors who are disqualified persons with respect to the organization.
- 3) Whether a substantial proportion of the organization's initial funds are placed, or will remain, in an endowment and whether the investment of those funds is unlikely to result in more than one-third of its total support being received from gross investment income and from unrelated business taxable income in excess of the tax imposed on that income.
- 4) Whether an organization that carries on fund-raising activities has developed a concrete plan for solicitation of funds on a community or area-wide basis.
- 5) Whether an organization that carries on community service activities has a concrete program to carry out its work in the community.
- 6) Whether membership dues for individual (rather than institutional) members of an organization that carries on education or other exempt activities for or on behalf of members have been fixed at rates designed to make membership available to a broad cross section of the public rather than to restrict membership to a limited number of persons.
- 7) Whether an organization that provides goods, services, or facilities is or will be required to make its services, facilities, performances, or products available (regardless of whether a fee is charged) to the general public, public charities, or governmental units rather than to a limited number of persons or organizations.

Reliance period. The reliance period for a ruling or determination letter begins with the inception of the organization and ends 90 days after the advance ruling period. The reliance period will be extended until a final determination is made of the organization's

status only if the organization submits, within the 90-day period, the necessary information to determine whether it meets the requirements for a section 509(a)(2) organization.

However, this reliance period does not apply to the section 4940 excise tax on net investment income. Therefore, if it is later determined that the organization was a private foundation from its inception, the tax on net investment income will be due without regard to the ruling or determination letter.

Grantors or contributors. If a ruling or determination letter is terminated before the expiration of the reliance period, the status of a charitable contribution deduction of a grantor or contributor will not be affected until notice of change of status is made public (such as by publication in the *Internal Revenue Bulletin*).

However, this rule will **not** apply if the grantor or contributor is responsible for, or aware of, the act or failure to act that resulted in the organization's loss of section 509(a)(2) status, or if a grantor or contributor acquires knowledge that the IRS had given notice of the loss of status to the organization.

Failure to obtain advance ruling. See the corresponding discussion under *Failure to obtain advance ruling* on page 27 of the discussion of *Section 509(a)(1) Organizations*.

Gifts, contributions, and grants distinguished from gross receipts. In determining whether an organization normally receives more than one-third of its support from permitted sources, include all gifts, contributions, and grants received from permitted sources in the numerator of the support fraction in each tax year. However, gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities, in an activity that is not an unrelated trade or business, are includable in the numerator of the support fraction in any tax year only to the extent that the amounts received from any person or from any bureau or similar agency of a governmental unit are not more than the greater of \$5,000 or 1% of support.

Gifts and contributions. Any payment of money or transfer of property without adequate consideration is considered a gift or contribution. When payment is made or property is transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing facilities to the donor, the status of the payment or transfer under section 170(c) determines whether and to what extent the payment or transfer is a gift or contribution as distinguished from gross receipts from related activities.

The amount includable in computing support from gifts, grants, or contributions of property or use of property is the fair market or rental value of the property at the date of the gift or contribution.

Example. P is a local agricultural club and is an organization described in section 501(c)(3). It makes awards at its annual fair for outstanding specimens of produce and livestock to encourage interest and proficiency by young people in farming and raising livestock. Most of these awards are cash or other property donated by local businessmen. When the awards are made, the donors are given recognition for their donations by being identified as the donor of the award. The recognition given to donors is merely incidental to the making of the award to worthy youngsters. For these reasons, the donations

are contributions. The amount includable in computing support is equal to the cash contributed or the fair market value of other property on the dates contributed.

Grants. Grants often contain certain terms and conditions imposed by the grantor. Because of the imposition of terms and conditions, the frequent similarity of public purposes of grantor and grantee, and the possibility of benefit to the grantor, amounts received as grants **for** carrying on exempt activities are sometimes difficult to distinguish from amounts received as gross receipts **from** carrying on exempt activities.

In distinguishing the term **gross receipts** from the term **grants**, the term gross receipts means amounts received from an activity that is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor rather than primarily to confer a direct benefit on the general public. In general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as gross receipts by the payee.

For example, a profit-making organization, primarily for its own betterment, contracts with a nonprofit organization for a service from that organization. Any payments received by the nonprofit organization (whether from the profit-making organization or from another nonprofit) for similar services are primarily for the benefit of the payor and are therefore gross receipts, rather than grants.

Research leading to the development of tangible products for the use or benefit of a payor generally will be treated as a service provided to serve the direct and immediate needs of the payor, while basic research or studies carried on in the physical or social sciences generally will be treated as primarily to confer a direct benefit upon the general public.

Medicare and Medicaid payments are gross receipts from the exercise or performance of an exempt function. The individual patient, not a governmental unit, actually controls the ultimate recipient of these payments. Therefore, Medicare and Medicaid receipts for services provided each patient are included as gross receipts to the extent they are not more than the greater of \$5,000 or 1% of the organization's total support for the tax year.

Membership fees distinguished from gross receipts. The fact that a membership organization provides services, admissions, facilities, or merchandise to its members as part of its overall activities will not, in itself, result in the classification of fees received from members as gross receipts subject to the \$5,000 or 1% limit rather than membership fees. However, if an organization uses membership fees as a means of selling admissions, merchandise, services, or the use of facilities to members of the general public who have no common goal or interest (other than the desire to buy the admissions, merchandise, services, or use of facilities), the fees are not membership fees but are gross receipts.

On the other hand, to the extent the basic purpose of the payment is to provide support for the organization rather than to buy ad-

missions, merchandise, services, or the use of facilities, the payment is a membership fee.

Bureau defined. The term **any bureau or similar agency of a governmental unit** for determining amounts subject to the \$5,000 or 1% limit, means a specialized operating unit of the executive, judicial, or legislative branch of government in which business is conducted under certain rules and regulations. Since the term bureau refers to a unit functioning at the operating, as distinct from the policy-making, level of government, it normally means a subdivision of a department of government. The term would not usually include those levels of government that are basically policy-making or administrative, such as the office of the Secretary or Assistant Secretary of a department, but would consist of the highest operational level under the policy-making or administrative levels.

Amounts received from a unit functioning at the policy-making or administrative level of government are treated as received from one bureau or similar agency of the unit. Units of a governmental agency above the operating level are combined and considered a separate bureau for this purpose. Thus, an organization that has gross receipts from both a policy-making or administrative unit and an operational unit of a department will be treated as having gross receipts from two bureaus. For this purpose, the Departments of Air Force, Army, and Navy are separate departments and each has its own policy-making, administrative, and operating units.

Example 1. The Bureau for Africa and the Bureau for Latin America are considered separate bureaus. Each is an operating unit under the Administrator of the Agency for International Development, a policy-making official. If an organization had gross receipts from both of these bureaus, the amount of gross receipts from each would be subject to the greater of \$5,000 or the 1% limit.

Example 2. A bureau is an operating unit under the administrative office of the Executive Director. The subdivisions of the bureau are Geographic Areas and Project Development Staff. If an organization had gross receipts from these subdivisions, the total gross receipts from these subdivisions would be considered gross receipts from the same bureau and would be subject to the greater of \$5,000 or the 1% limit.

Grants from public charities. For purposes of the one-third support test, grants received from a section 509(a)(1) organization (public charity) are generally includable in full in computing the numerator of the support fraction for that tax year.

However, if the amount received is considered an indirect contribution from one of the public charity's donors, it will retain its character as a contribution from the donor, and if, for example, the donor is a substantial contributor to the ultimate recipient, the amount is excluded from the numerator of the support fraction. If a public charity makes both an indirect contribution from its donor and an additional grant to the ultimate recipient, the indirect contribution is treated as made first.

An indirect contribution is one that is expressly or impliedly earmarked by the donor as being for, or for the benefit of, a particular recipient rather than for a particular purpose.

Method of accounting. An organization's support is determined solely on the cash receipts and disbursements method of accounting. For example, if a grantor makes a grant to an organization payable over a term of years, the grant will be includable in the support fraction of the grantee organization only when and to the extent amounts payable under the grant are received by the grantee.

Gross receipts from a related activity. When the charitable purpose of an organization described in section 501(c)(3) is accomplished through furnishing facilities for a rental fee or loans to a particular class of persons, such as aged, sick, or needy persons, the support received from those persons will be considered gross receipts from a related exempt activity rather than gross investment income or unrelated business taxable income.

However, if the organization also furnishes facilities or loans to persons who are not members of a particular class and furnishing the facilities or funds does not contribute importantly to accomplishing the organization's exempt purposes, the support received from furnishing the facilities or funds will be considered rents or interest and will be treated as gross investment income or unrelated business taxable income.

Example. X, an organization described in section 501(c)(3), is organized and operated to provide living facilities for needy widows of deceased servicemen. X charges the widows a small rental fee for the use of the facilities. Since X is accomplishing its exempt purpose through the rental of the facilities, the support received from the widows is considered gross receipts from a related exempt activity. However, if X rents part of its facilities to persons having no relationship to X's exempt purpose, the support received from these rentals will be considered gross investment income or unrelated business taxable income.

Section 509(a)(3) Organizations

Section 509(a)(3) excludes from the definition of private foundation those organizations that meet all of the three following requirements.

- 1) The organization must be organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations (which can be either domestic or foreign) as described in section 509(a)(1) or (2). These section 509(a)(1) and 509(a)(2) organizations are commonly called **publicly supported** organizations.
- 2) The organization must be operated, supervised, or controlled by or in connection with one or more of the organizations described in section 509(a)(1) or (2).
- 3) The organization must not be controlled directly or indirectly by disqualified persons (defined later) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Section 509(a)(3) differs from the other provisions of section 509 that describe a publicly supported organization. Instead of describing an organization that conducts a particular kind of activity or that receives financial support from the general public, sec-

tion 509(a)(3) describes organizations that have established certain relationships in support of section 509(a)(1) or (2) organizations. Thus, an organization may qualify as other than a private foundation even though it may be funded by a single donor, family, or corporation. This kind of funding ordinarily would indicate private foundation status, but a section 509(a)(3) organization has limited purposes and activities and gives up a significant degree of independence.

The requirement in (2) above provides that a supporting (section 509(a)(3)) organization have one of three types of relationships with one or more publicly supported (section 509(a)(1) or (2)) organizations. It must be:

- 1) Operated, supervised, or controlled by a publicly supported organization,
- 2) Supervised or controlled in connection with a publicly supported organization, or
- 3) Operated in connection with a publicly supported organization.

More than one type of relationship may exist between a supporting organization and a publicly supported organization. Any relationship, however, must insure that the supporting organization will be responsive to the needs or demands of, and will be an integral part of or maintain a significant involvement in, the operations of one or more publicly supported organizations.

The first two relationships, "operated, supervised, or controlled by" and "supervised or controlled in connection with," are based on an existence of majority control of the governing body of the supporting organization by the publicly supported organization. They have the same rules for meeting the tests under requirement (1) and are discussed as *Category one* in the following discussion. The "operated in connection with" relationship requires that the supporting organization be responsive to and have operational relationships with publicly supported organizations. This third relationship has different rules for meeting the requirement (1) tests and is discussed separately as *Category two*.

Category one. This category includes organizations either "operated, supervised, or controlled by" or "supervised or controlled in connection with" organizations described in section 509(a)(1) or (2).

These kinds of organizations have a governing body that either includes a majority of members elected or appointed by one or more publicly supported organizations or that consists of the same persons that control or manage the publicly supported organizations. If an organization is to qualify under this category, it also must meet an organizational test, an operational test, and not be controlled by disqualified persons. These requirements are covered later in this discussion.

Operated, supervised, or controlled by. Each of these terms, as used for supporting organizations, presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, in which the subsidiary is under the direction of and is accountable or responsible to the parent organization. This relationship is established when a majority of the officers, directors, or trustees of the sup-

porting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

A supporting organization may be operated, supervised, or controlled by one or more publicly supported organizations even though its governing body is not made up of representatives of the specified publicly supported organizations for whose benefit it is operated. This occurs only if it can be demonstrated that the purposes of the publicly supported organizations are carried out by benefiting the specified publicly supported organizations (discussed later under *Specified organizations*).

Supervised or controlled in connection with. The control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organization. In order for an organization to be supervised or controlled in connection with a publicly supported organization, common supervision or control by the persons supervising or controlling both organizations must exist to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organization.

An organization will not be considered supervised or controlled in connection with one or more publicly supported organizations if it merely makes payments (mandatory or discretionary) to the publicly supported organizations. This is true even if the obligation to make payments is legally enforceable and the organization's governing instrument contains provisions requiring the distribution. These arrangements do not provide a sufficient connection between the payor organization and the needs and requirements of the publicly supported organizations to constitute supervision or control in connection with the organizations.

Organizational and operational tests. To qualify as a section 509(a)(3) organization (supporting organization), the organization must be both **organized** and **operated** for the purposes set out in requirement (1) at the beginning of this section. If an organization fails to meet either the organizational or the operational test, it cannot qualify as a supporting organization.

In the case of supporting organizations created before 1970, the organizational and operational tests apply as of January 1, 1970. Therefore, even though the original articles of organization did not limit its purposes to those in requirement (1), and even though it operated before 1970 for some purpose other than those in requirement (1), an organization will satisfy the organizational and operational tests if, on January 1, 1970, and at all times thereafter, it is so constituted as to comply with these tests.

Organizational test. An organization is organized exclusively for one or more of the purposes specified in requirement (1) only if its articles of organization:

- 1) Limit the purposes of the organization to one or more of those purposes,
- 2) Do not expressly empower the organization to engage in activities that are not in furtherance of those purposes,
- 3) "Specify" (as explained later under *Specified organizations*) the publicly

supported organizations on whose behalf the organization is operated, and

- 4) Do not expressly empower the organization to operate to support or benefit any organization other than the ones specified in item (3).

In meeting the organizational test, the organization's purposes as stated in its articles may be as broad as, or more specific than, the purposes set forth in requirement (1) at the beginning of the discussion of *Section 509(a)(3) Organizations*. Therefore, an organization that by the terms of its articles is formed **for the benefit of** one or more specified publicly supported organizations will, if it otherwise meets the other requirements, be considered to have met the organizational test.

For example, articles stating that an organization is formed to perform the publishing functions of a specified university are enough to comply with the organizational test. An organization operated, supervised, or controlled by, or supervised or controlled in connection with, one or more publicly supported organizations to carry out the purposes of those organizations, will be considered to have met these requirements if the purposes set forth in its articles are similar to but no broader than the purposes set forth in the articles of its controlling organizations. If, however, the organization by which it is operated, supervised, or controlled is a publicly supported section 501(c)(4), (5), or (6) organization, the supporting organization will be considered to have met these requirements if its articles require it to carry on charitable, etc., activities within the meaning of section 170(c)(2).

Limits. An organization is not organized exclusively for the purposes specified in requirement (1) if its articles expressly permit it to operate, to support, or to benefit any organization other than the specified publicly supported organizations. It will not meet the organizational test even though the actual operations of the organization have been exclusively for the benefit of the specified publicly supported organizations.

Specified organizations. In order to meet requirement (1), an organization must be organized and operated exclusively to support or benefit one or more specified publicly supported organizations. The manner in which the publicly supported organizations must be specified in the articles will depend on whether the supporting organization is "operated, supervised, or controlled by" or "supervised or controlled in connection with" the organizations or whether it is "operated in connection with" the organizations.

Generally, the articles of the supporting organization must designate each of the specified organizations by name, **unless:**

- 1) The supporting organization is "operated, supervised, or controlled by" or "supervised or controlled in connection with" one or more publicly supported organizations **and** the articles of organization of the supporting organization require that it be operated to support or benefit one or more beneficiary organizations that are designated by class or purpose and include—
 - a) The publicly supported organizations referred to above (without designating the organizations by name), or

- b) Publicly supported organizations that are closely related in purpose or function to those publicly supported organizations, **or**
- 2) An historic and continuing relationship exists between the supporting organization and the publicly supported organizations, and because of this relationship, a substantial identity of interests has developed between the organizations.

If a supporting organization is operated, supervised, or controlled by, or is supervised or controlled in connection with, one or more publicly supported organizations, it will not fail the test of being organized for the benefit of specified organizations solely because its articles:

- 1) Permit the substitution of one publicly supported organization within a designated class for another publicly supported organization either in the same or a different class designated in the articles,
- 2) Permit the supporting organization to operate for the benefit of new or additional publicly supported organizations of the same or a different class designated in the articles, or
- 3) Permit the supporting organization to vary the amount of its support among different publicly supported organizations within the class or classes of organizations designated by the articles.

See also the rules considered under the *Organizational test*, in the later discussion for organizations in *Category two*.

Operational test—permissible beneficiaries. A supporting organization will be regarded as operated exclusively to support one or more specified publicly supported organizations only if it engages solely in activities that support or benefit the specified organizations. These activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization.

For example, a supporting organization may make a payment indirectly through another unrelated organization to a member of a charitable class benefited by a specified publicly supported organization, but only if the payment is a grant to an individual rather than a grant to an organization. Similarly, an organization will be regarded as operated exclusively to support or benefit one or more specified publicly supported organizations if it supports or benefits a section 501(c)(3) organization, other than a private foundation, that is operated, supervised, or controlled directly by or in connection with a publicly supported organization, or an organization that is a publicly owned college or university. However, an organization will not be regarded as one that is operated exclusively to support or benefit a publicly supported organization if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

Operational test—permissible activities. A supporting organization does not have to pay its income to the publicly supported organizations to meet the operational test. It may satisfy the test by using its income

to carry on an independent activity or program that supports or benefits the specified publicly supported organizations. All such support, however, must be limited to permissible beneficiaries described earlier. The supporting organization also may engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business, to raise funds for the publicly supported organizations or for the permissible beneficiaries.

Absence of control by disqualified persons. The third requirement an organization must meet to qualify as a supporting organization requires that the organization not be controlled directly or indirectly by one or more disqualified persons other than foundation managers or one or more publicly supported organizations.

Disqualified persons. For the purposes of the rules discussed in this publication, the following persons are considered disqualified persons:

- 1) All substantial contributors to the foundation.
- 2) All foundation managers of the foundation.
- 3) An owner of more than 20% of—
 - a) The total combined voting power of a corporation that is (during such ownership) a substantial contributor to the foundation,
 - b) The profits interest of a partnership that is (during such ownership) a substantial contributor to the foundation, or
 - c) The beneficial interest of a trust or unincorporated enterprise that is (during such ownership) a substantial contributor to the foundation.
- 4) A member of the family of any of the individuals just listed.
- 5) A corporation of which more than 35% of the total combined voting power is owned by persons just listed.
- 6) A partnership of which more than 35% of the profits interest is owned by persons described in (1), (2), (3), or (4).
- 7) A trust, estate, or unincorporated enterprise of which more than 35% of the beneficial interest is owned by persons described in (1), (2), (3), or (4).

Remember, however, that foundation managers and publicly supported organizations are not disqualified persons for purposes of the third requirement under section 509(a)(3).

If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor, 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, that person is still a disqualified person, rather than a representative of the publicly supported organization.

An organization is considered controlled for this purpose if the disqualified persons, by combining their votes or positions of authority, may require the organization to perform any act that significantly affects its operations or may prevent the organization from performing the act. This includes, but is not limited to, the right of any substantial contrib-

utor or spouse to designate annually the recipients from among the publicly supported organizations of the income from his or her contribution. Except as explained under *Proof of independent control*, next, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of those persons is 50% or more of the total voting power of the organization's governing body, or if one or more of those persons have the right to exercise veto power over the actions of the organization.

Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, the foundation is not considered controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances (including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest) are considered in determining whether a disqualified person does in fact indirectly control an organization.

Proof of independent control. An organization is permitted to establish to the satisfaction of the IRS that disqualified persons, in fact, do not directly or indirectly control it. For example, in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization will not disqualify the organization under section 509(a)(3) if a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.

Category two. This category includes organizations “operated in connection with” one or more organizations described in section 509(a)(1) or (2).

This kind of section 509(a)(3) organization is one that has certain types of operational relationships. If an organization is to qualify as a section 509(a)(3) organization because it is “operated in connection with” one or more publicly supported organizations, it must not be controlled by disqualified persons (as described earlier) and it must meet an organizational test, a responsiveness test, an integral part test, and an operational test.

Organizational test. This test requires that the organization, in its governing instrument:

- 1) Limit its purposes to supporting one or more publicly supported organizations,
- 2) Designate the organizations “operated, supervised, or controlled by,” and
- 3) Not have express powers inconsistent with these purposes.

These tests apply to all supporting organizations.

In the case of an organization that is “operated in connection with” one or more publicly supported organizations, however, the designation requirement under the organizational test can be satisfied using either of the following two methods.

Method one. If an organization is organized and operated to support one or more publicly supported organizations and it is "operated in connection with" that type of organization or organizations, then, its articles of organization must designate the specified organizations by name to satisfy the test. But a supporting organization that has one or more specified organizations designated by name in its articles will not fail the organizational test solely because its articles:

- 1) Permit a publicly supported organization, that is designated by class or purpose rather than by name, to be substituted for the publicly supported organization or organizations designated by name in the articles, but only if the substitution is conditioned upon the occurrence of an event that is beyond the control of the supporting organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the organization or organizations designated in the articles,
- 2) Permit the supporting organization to operate for the benefit of an organization that is not a publicly supported organization, but only if the supporting organization is currently operating for the benefit of a publicly supported organization and the possibility of its operating for the benefit of other than a publicly supported organization is remote, or
- 3) Permit the supporting organization to vary the amount of its support between different designated organizations, as long as it meets the requirements of the integral part test (discussed later) with respect to at least one beneficiary organization.

If the beneficiary organization referred to in (2) is not a publicly supported organization, the supporting organization will not meet the operational test. Therefore, if a supporting organization substituted a beneficiary other than a publicly supported organization and operated in support of that beneficiary, the supporting organization would not be one described in section 509(a)(3).

Method two. If an historic and continuing relationship exists between the supporting organization and the publicly supported organizations, and because of this relationship, a substantial identity of interests has developed between the organizations, then the articles of organization will not have to designate the specified organization by name.

Responsiveness test. An organization will meet this test if it is responsive to the needs or demands of the publicly supported organizations. To meet this test, *either* of the following must be satisfied:

- 1) The publicly supported organizations must elect, appoint, or maintain a close and continuing relationship with the officers, directors, or trustees of the supporting organization (Consequently, 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 and the manner of making them, the selection of recipients, and generally the use of the income or assets of the supporting organization.); **or**

- 2) The supporting organization is a charitable trust under state law, each specified publicly supported organization is a named beneficiary under the trust's governing instrument, and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.

For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, may be taken into account in addition to the factors described earlier to establish compliance with the responsiveness test.

Integral part test. The organization will meet this test if it maintains a significant involvement in the operations of one or more publicly supported organizations and these organizations are in turn dependent upon the supporting organization for the type of support that it provides. To meet this test, *either* of the following must be satisfied (unless transitional rules, discussed later, apply):

- 1) The activities engaged in for, or on behalf of, the publicly supported organizations are activities to perform the functions of or to carry out the purposes of the organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves, **or**
- 2) The supporting organization makes payments of substantially all of its income to, or for the use of, publicly supported organizations, and the amount of support received by one or more of these publicly supported organizations is enough to insure the attentiveness of these organizations to the operations of the supporting organization.

If item (2) is being relied on, a substantial amount of the total support of the supporting organization also must go to those publicly supported organizations that meet the attentiveness requirement with respect to the supporting organization. Except as explained in the next paragraph, the amount of support received by a publicly supported organization must represent a large enough part of the organization's total support to insure such attentiveness. In applying this, if the supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital, or church, the total support of the department or school must be substituted for the total support of the beneficiary organization.

Even when the amount of support received by a publicly supported beneficiary organization does not represent a large enough part of the beneficiary organization's total support, the amount of support received from a supporting organization may be large enough to meet the requirements of item (2) of the integral part test if it can be demonstrated that, in order to avoid the interruption of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. This may occur when either the supporting organization or the beneficiary organization earmarks the support received from the supporting organization for a particular

program or activity, even if the program or activity is not the beneficiary organization's primary program or activity, as long as the program or activity is a substantial one.

All factors, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and supporting organization, and the purpose to which the funds are put, will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is large enough to insure the attentiveness of the organization to the operations of the supporting organization.

Normally, the attentiveness of a beneficiary organization is motivated by the amounts received from the supporting organization. Thus, the more substantial the amount involved, in terms of a percentage of the publicly supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is large enough to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of the supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance.

Imposing this requirement is merely one of the factors in determining whether a supporting organization is complying with the attentiveness test. The absence of this requirement will not preclude an organization from classification as a supporting organization if it complies with the other factors.

However, when none of the beneficiary organizations are dependent upon the supporting organization for a large enough amount of their support, the requirements of item (2) of the integral part test will not be satisfied, even though the beneficiary organizations have enforceable rights against the supporting organization under state law.

If an organization cannot meet the requirements of item (2) of the integral part test for its current tax year solely because the amount received by one or more of the beneficiaries from the supporting organization is no longer large enough, it can still qualify under the integral part test if it can establish that it has met the requirements of item (2) of the integral part test for any 5-year period and that there has been an historic and continuing relationship of support between the organizations between the end of the 5-year period and the tax year in question.

Transitional rule. A charitable trust created before November 20, 1970, will meet the integral part test if for tax years beginning after October 16, 1972, the trustee makes annual written reports to all publicly supported beneficiary organizations giving a description of the trust assets (including a detailed list of the assets and the income produced by them) and if the following five conditions have been met continuously since November 20, 1970.

- 1) All the unexpired interests in the trust are devoted to charitable purposes.
- 2) The trust did not receive any grant, contribution, bequest, or other transfer on or after November 20, 1970.
- 3) The trust is required by its governing instrument to distribute all its net income currently to designated publicly supported beneficiary organizations.

- 4) The trustee does not have discretion to vary either the beneficiaries or the amounts payable to the beneficiaries.
- 5) None of the trustees would be disqualified persons (other than foundation managers) with respect to the trust if the trust were treated as a private foundation.

Operational test. The requirements for meeting the operational test for organizations “operated, supervised, or controlled by” publicly supported organizations (discussed earlier, beginning on page 23, under *Qualifying As Publicly Supported*) have limited applicability to organizations “operated in connection with” one or more publicly supported organizations. This is because the operational requirements of the integral part test, just discussed, generally are more specific than the general rules found for the operational test in the preceding category. However, a supporting organization can fail both the integral part test and the operational test if it conducts activities of its own that do not constitute activities or programs that would, but for the supporting organization, have been conducted by any publicly supported organization named in the supporting organization’s governing instrument. A similar result occurs for such activities or programs that would not have been conducted by an organization with which the supporting organization has established an historic and continuing relationship.

An organization operated in conjunction with a social welfare organization, labor or agricultural organization, business league, chamber of commerce, or other organization described in section 501(c)(4), (5), or (6), may qualify as a supporting organization under section 509(a)(3) and therefore not be classified as a private foundation if both the following conditions are met.

- 1) The supporting organization must meet all the requirements previously specified (the organizational tests, the operational test, and the requirement that it be operated, supervised, or controlled by or in connection with one or more specified organizations, and not be controlled by disqualified persons).
- 2) The section 501(c)(4), (5), or (6) organization would be described in section 509(a)(2) if it was a charitable organization described in section 501(c)(3). This provision allows separate charitable funds of certain noncharitable organizations to be described in section 509(a)(3) if the noncharitable organizations receive their support and otherwise operate in the manner specified by section 509(a)(2).

Special rules of attribution. To determine whether an organization meets the not-more-than-one-third support test in section 509(a)(2), amounts received by the organization from an organization that seeks to be a section 509(a)(3) organization because of its support of the organization are gross investment income (rather than gifts or contributions) to the extent they are gross investment income of the distributing organization. (This rule also applies to amounts received from a charitable trust, corporation, fund, association, or similar organization that is required by its governing instrument or otherwise to distribute, or that normally does

distribute, at least 25% of its adjusted net income to the organization, and whose distribution normally comprises at least 5% of its adjusted net income.) All income that is gross investment income of the distributing organization will be considered distributed first by that organization. If the supporting organization makes distributions to more than one organization, the amount of gross investment income considered distributed will be prorated among the distributees.

Also, treat amounts paid by an organization to provide goods, services, or facilities for the direct benefit of an organization seeking section 509(a)(2) status (rather than for the direct benefit of the general public) in the same manner as amounts received by the latter organization. These amounts will be treated as gross investment income to the extent they are gross investment income of the organization spending the amounts. An organization seeking section 509(a)(2) status must file a separate statement with its annual information return, Form 990, listing all amounts received from supporting organizations.

Relationships created for avoidance purposes. If a relationship between an organization seeking section 509(a)(3) status and an organization seeking section 509(a)(2) status is established or availed of after October 9, 1969, and one of the purposes of establishing or using the relationship is to avoid classification as a private foundation with respect to either organization, then the character and amount of support received by the section 509(a)(3) organization will be attributed to the section 509(a)(2) organization for purposes of determining whether the latter meets the support tests under section 509(a)(2). If this type of relationship is established or used between an organization seeking 509(a)(3) status and two or more organizations seeking 509(a)(2) status, the amount and character of support received by the former organization will be prorated among the latter organizations.

In determining whether a relationship exists between an organization seeking 509(a)(3) status (supporting organization) and one or more organizations seeking 509(a)(2) status (beneficiary organizations) for the purpose of avoiding private foundation status, all pertinent facts and circumstances will be taken into account. The following facts may be used as evidence that such a relationship was *not* established or availed of to avoid classification as a private foundation.

- 1) The supporting organization is operated to support or benefit several specified beneficiary organizations.
- 2) The beneficiary organization has a substantial number of dues-paying members who have an effective voice in the management of both the supporting and the beneficiary organizations.
- 3) The beneficiary organization is composed of several membership organizations, each of which has a substantial number of members, and the membership organizations have an effective voice in the management of the supporting and beneficiary organizations.
- 4) The beneficiary organization receives a substantial amount of support from the general public, public charities, or governmental grants.

- 5) The supporting organization uses its funds to carry on a meaningful program of activities to support or benefit the beneficiary organization and, if the supporting organization were a private foundation, this use would be sufficient to avoid the imposition of the tax on failure to distribute income.
- 6) The operations of the beneficiary and supporting organizations are managed by different persons, and each organization performs a different function.
- 7) The supporting organization is not able to exercise substantial control or influence over the beneficiary organization because the beneficiary organization receives support or holds assets that are disproportionately large in comparison to the support received or assets held by the supporting organization.

Effect on 509(a)(3) organizations. If a beneficiary organization fails to meet either of the support tests of section 509(a)(2) due to these provisions, and the beneficiary organization is one for whose support the organization seeking section 509(a)(3) status is operated, then the supporting organization will not be considered to be operated exclusively to support or benefit one or more section 509(a)(1) or (2) organizations and therefore would not qualify for section 509(a)(3) status.

Classification under section 509(a). If an organization is described in section 509(a)(1), and is also described in either section 509(a)(2) or (3), it will be treated as a section 509(a)(1) organization.

Reliance by grantors and contributors. Once an organization has received a final ruling or determination letter classifying it as an organization described in section 509(a)(1), (2), or (3), the treatment of grants and contributions and the status of grantors and contributors to the organization will generally not be affected by reason of a later revocation by the IRS of the organization’s classification until the date on which notice of change of status is made to the public (generally by publication in the *Internal Revenue Bulletin*) or another applicable date, if any, specified in the public notice. In appropriate cases, however, the treatment of grants and contributions and the status of grantors and contributors to an organization described in section 509(a)(1), (2), or (3) may be affected pending verification of the continued classification of the organization. Notice to this effect will be made in a public announcement by the IRS. In these cases, the effect of grants and contributions made after the date of the announcement will depend on the statutory qualification of the organization as an organization described in section 509(a)(1), (2), or (3).

The preceding paragraph shall not apply if the grantor or contributor:

- 1) *Had knowledge of the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a)(1), (2), or (3), or*
- 2) *Was in part responsible for, or was aware of, the act, the failure to act, or the substantial and material change on the part of*



the organization that gave rise to the revocation.

Section 509(a)(4) Organizations

Section 509(a)(4) excludes from classification as private foundations those organizations that qualify under section 501(c)(3) as organized and operated for the purpose of **testing products for public safety**. Generally, these organizations test consumer products to determine their acceptability for use by the general public.

Private Operating Foundations

Some private foundations qualify as private operating foundations. These are types of private foundations that, although lacking general public support, make **qualifying distributions** directly for the active conduct of their educational, charitable, and religious purposes, as distinct from merely making grants to other organizations for these purposes.

Most of the restrictions and requirements that apply to private foundations also apply to private operating foundations. However, there are advantages to being classified as a private operating foundation. For example, a private operating foundation (as compared to a private foundation) can be the recipient of grants from a private foundation without having to distribute the funds received currently within 1 year, and the funds nevertheless may be treated as qualifying distributions by the donating private foundation; charitable contributions to a private operating foundation qualify for a higher charitable deduction limit on the donor's tax return; and for tax years beginning after 1984, the excise tax on net investment income does not apply to an **exempt operating foundation**.

Private operating foundation means any private foundation that meets the assets test, the support test, or the endowment test, and makes qualifying distributions directly for the active conduct of its activities for which it was organized of substantially all (85% or more) of the lesser of its:

- 1) Adjusted net income, or
- 2) Minimum investment return.

Assets test. A private foundation will meet the assets test if substantially more than half (65% or more) of its assets are:

- 1) Devoted directly to the active conduct of its exempt activity, to a functionally related business, or to a combination of the two,
- 2) 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 substantially all (at least 85%) the assets of which are devoted as provided above, or
- 3) Any combination of (1) and (2).

This test is intended to apply to organizations such as museums and libraries.

Support test. A private foundation will meet the support test if:

- 1) Substantially all (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,
- 2) Not more than 25% of its support (other than gross investment income) is normally received from any one exempt organization, and
- 3) Not more than 50% of its support is normally received from gross investment income.

This test is intended to apply to special-purpose foundations, such as learned societies and associations of libraries.

Endowment test. A foundation will meet the endowment test if it normally makes qualifying distributions directly for the active conduct of its exempt function of at least two-thirds of its minimum investment return.

The **minimum investment return** for any private foundation for any tax year is 5% of the excess of the total fair market value of all assets of the foundation (other than those used directly in the active conduct of its exempt purpose) over the amount of indebtedness incurred to acquire those assets.

In determining whether the amount of qualifying distributions is at least two-thirds of the organization's minimum investment return, the organization is not required to trace the source of the expenditures to determine whether they were derived from investment income or from contributions.

This test is intended to apply to organizations such as research organizations that actively conduct charitable activities but whose personal services are so great in relationship to charitable assets that the cost of those services cannot be met out of small endowments.

Exempt operating foundations. The excise tax on net investment income does not apply to an exempt operating foundation. An exempt operating foundation for the tax year is any private foundation that—

- 1) Is an operating foundation, as described previously,
- 2) Has been publicly supported for at least 10 tax years or was an operating foundation on January 1, 1983, or for its last taxable year ending before January 1, 1983,
- 3) Has a governing body that, at all times during the tax year, is broadly representative of the general public and consists of individuals no more than 25% of whom are disqualified individuals, and
- 4) Does not have any officer, at any time during the tax year, who is a disqualified individual.

The foundation must obtain a ruling letter from the IRS recognizing this special status.

New organization. If you are applying for recognition of exemption as an organization described in section 501(c)(3) and you wish to establish that your organization is a private operating foundation, you should complete Schedule E of your exemption application (Form 1023).

Lobbying Expenditures

In general, if a substantial part of the activities of your organization consists of carrying on propaganda or otherwise **attempting to influence legislation**, your organization's exemption from federal income tax will be denied. However, a public charity (other than a church, an integrated auxiliary of a church or of a convention or association of churches, or a member of an affiliated group of organizations that includes a church, etc.) may avoid this result. Such a charity can elect to replace the substantial part of activities test with a limit defined in terms of expenditures for influencing legislation. Private foundations cannot make this election.

Making the election. Use **Form 5768, Election/Revocation of Election By an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation**, to make the election. The form must be signed and postmarked within the first tax year to which it applies. If the form is used to revoke the election, it must be signed and postmarked before the first day of the tax year to which it applies.

Eligible section 501(c)(3) organizations that have made the election to be subject to the limits on lobbying expenditures must use Part VI-A of Schedule A (Form 990) to figure these limits.

Attempting to influence legislation. Attempting to influence legislation, for this purpose, means:

- 1) Any attempt to influence any legislation through an effort to affect the opinions of the general public or any segment thereof (grass roots lobbying), and
- 2) Any attempt to influence any legislation through communication with any member or employee of a legislative body or with any government official or employee who may participate in the formulation of legislation (direct lobbying).

However, the term "attempting to influence legislation" does **not** include the following activities:

- 1) Making available the results of nonpartisan analysis, study, or research,
- 2) Examining and discussing broad social, economic, and similar problems,
- 3) Providing technical advice or assistance (where the advice would otherwise constitute the influencing of legislation) to a governmental body or to a committee or other subdivision thereof in response to a written request by that body or subdivision,
- 4) Appearing before or communicating with any legislative body about a possible decision of that body that might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to the organization, or
- 5) Communicating with a government official or employee, other than—

- a) A communication with a member or employee of a legislative body (when the communication would otherwise constitute the influencing of legislation), or
- b) A communication with the principal purpose of influencing legislation.

Also excluded are communications between an organization and its bona fide members about legislation or proposed legislation of direct interest to the organization and the members, unless these communications directly encourage the members to attempt to influence legislation or directly encourage the members to urge nonmembers to attempt to influence legislation, as explained earlier.

Lobbying expenditures limits. If a public charitable organization makes the election to be subject to the lobbying expenditures limits rules (instead of the substantial part of activities test), it will not lose its tax-exempt status under section 501(c)(3), unless it normally makes **lobbying expenditures** that are more than 150% of the **lobbying nontaxable amount** for the organization for each tax year or normally makes **grass roots expenditures** that are more than 150% of the **grass roots nontaxable amount** for the organization for each tax year. See *Tax on excess expenditures to influence legislation*, later in this section.

Lobbying expenditures. These are any expenditures that are made for the purpose of attempting to influence legislation, as discussed earlier under *Attempting to influence legislation*.

Grass roots expenditures. This term refers only to those lobbying expenditures that are made to influence legislation by attempting to affect the opinions of the general public or any segment thereof.

Lobbying nontaxable amount. The lobbying nontaxable amount for any organization for any tax year is the lesser of \$1,000,000 or:

- 1) 20% of the **exempt purpose expenditures** if the exempt purpose expenditures are not over \$500,000,
- 2) \$100,000 plus 15% of the excess of the exempt purpose expenditures over \$500,000 if the exempt purpose expenditures are over \$500,000 but not over \$1,000,000,
- 3) \$175,000 plus 10% of the excess of the exempt purpose expenditures over \$1,000,000 if the exempt purpose expenditures are over \$1,000,000 but not over \$1,500,000, or
- 4) \$225,000 plus 5% of the excess of the exempt purpose expenditures over \$1,500,000 if the exempt purpose expenditures are over \$1,500,000.

The term **exempt purpose expenditures** means the total of the amounts paid or incurred (including depreciation and amortization, but not capital expenditures) by an organization for the tax year to accomplish its exempt purposes. In addition, it includes:

- 1) Administrative expenses paid or incurred for the organization's exempt purposes, and
- 2) Amounts paid or incurred for the purpose of influencing legislation, whether or not

the legislation promotes the organization's exempt purposes.

Exempt purpose expenditures **do not include** amounts paid or incurred to or for:

- 1) A separate fund-raising unit of the organization, or
- 2) One or more other organizations, if the amounts are paid or incurred primarily for fund raising.

Grass roots nontaxable amount. The grass roots nontaxable amount for any organization for any tax year is 25% of the lobbying nontaxable amount for the organization for that tax year.

Years for which election is effective. Once an organization elects to come under these provisions, the election will be in effect for all tax years that end after the date of the election and begin before the organization revokes this election.

Note. These elective provisions for lobbying activities by public charities do not apply to a church, an integrated auxiliary of a church or of a convention or association of churches, or a member of an affiliated group of organizations that includes a church, etc., or a private foundation. Moreover, these provisions will not apply to any organization for which an election is not in effect.

Expenditures of affiliated organizations. If two or more section 501(c)(3) organizations are members of an affiliated group of organizations and at least one of these organizations has made the election regarding the treatment of certain lobbying expenditures, then the determination as to whether excess lobbying expenditures have been made and the determination as to whether the expenditure limits, described earlier, have been exceeded by more than 150% will be made as though the affiliated group is one organization.

If the group has excess lobbying expenditures, each organization for which the election is effective for the year will be treated as an organization that has excess lobbying expenditures in an amount that equals the organization's proportionate share of the group's excess lobbying expenditures. Further, if the expenditure limits, described in this section, are exceeded by more than 150%, each organization for which the election is effective for that year will lose its tax-exempt status under section 501(c)(3).

Two organizations will be considered members of an affiliated group of organizations if:

- 1) The governing instrument of one of the organizations requires it to be bound by decisions of the other organization on legislative issues, or
- 2) The governing board of one of the organizations includes persons who—
 - a) Are specifically designated representatives of the other organization or are members of the governing board, officers, or paid executive staff members of the other organization, and
 - b) Have enough voting power to cause or prevent action on legislative issues by the controlled organization by combining their votes.

Tax on excess expenditures to influence legislation. If an election for a tax year is in effect for an organization and that organization exceeds the lobbying expenditures limits, an excise tax of 25% of the excess lobbying expenditures for the tax year will be imposed. Excess lobbying expenditures for a tax year, in this case, means the greater of:

- 1) The amount by which the lobbying expenditures made by the organization during the tax year are more than the lobbying nontaxable amount for the organization for that tax year, or
- 2) The amount by which the grass roots expenditures made by the organization during the tax year are more than the grass roots nontaxable amount for the organization for that tax year.

Eligible organizations that have made the election to be subject to the limits on lobbying expenditures and that owe the tax on excess lobbying expenditures (as computed in Part VI-A of Schedule A (Form 990)) must file Form 4720, *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*, to report and pay the tax.

Organization that no longer qualifies.

An organization that no longer qualifies for exemption under section 501(c)(3) because of substantial lobbying activities will not at any time thereafter be treated as an organization described in section 501(c)(4). This provision, however, does not apply to certain organizations (churches, etc.) that cannot make the election discussed earlier.

Tax on disqualifying lobbying expenditures. The law imposes a tax on certain organizations if they no longer qualify under section 501(c)(3) by reason of having made disqualifying lobbying expenditures. An additional tax may be imposed on the managers of those organizations.

Tax on organization. Organizations that lose their exemption under section 501(c)(3) due to lobbying activities generally will be subject to an excise tax of 5% of the lobbying expenditures. The tax does not apply to private foundations. Also, the tax does not apply to organizations that have elected the lobbying limits of section 501(h) or to churches or church-related organizations that cannot elect these limits. This tax is to be paid by the organization.

Tax on managers. Managers may also be liable for a 5% tax on the lobbying expenditures that result in the disqualification of the organization. For the tax to apply, a manager would have to agree to the expenditures knowing that the expenditures were likely to result in revocation of the organization's exempt status. No tax will be imposed if the manager's agreement is not willful and is due to reasonable cause.

Excise taxes on political expenditures.

The law imposes an excise tax on the political expenditures of section 501(c)(3) organizations. A two-tier tax is imposed on both the organizations and the managers of those organizations.

Taxes on organizations. An initial tax of 10% of certain political expenditures is imposed on a charitable organization. A second tax of 100% of the expenditure is imposed if the political expenditure that resulted in the imposition of the initial (first-tier) tax is not

corrected within a specified period. These taxes must be paid by the organization.

Taxes on managers. An initial tax of 2½% of the amount of certain political expenditures is imposed on a manager of an organization who agrees to such expenditures knowing that they are political expenditures. No tax will be imposed if the manager's agreement was not willful and was due to reasonable cause. A second tax of 50% of the expenditures is imposed on a manager if he or she refuses to agree to a correction of the expenditures that resulted in the imposition of the initial (first-tier) tax. For purposes of these taxes, an organization manager is generally an officer, director, trustee, or any employee having authority or responsibility concerning the organization's political expenditures. These taxes must be paid by the manager of the organization.

Political expenditures. Generally, political expenditures that will trigger these taxes are amounts paid or incurred by a section 501(c)(3) organization in any participation or intervention in any political campaign for or against any candidate for public office. Political expenditures include publication or distribution of statements for these purposes. Political expenditures also include certain expenditures by organizations that are formed primarily to promote the candidacy (or prospective candidacy) of an individual for public office and by organizations that are effectively controlled by a candidate and are used primarily to promote that candidate.

Correction of expenditure. A correction of a political expenditure is the recovery, if possible, of all or part of the expenditure and the establishment of safeguards to prevent future political expenditures.

Status after loss of exemption for lobbying or political activities. As explained earlier, an organization can lose its tax-exempt status under section 501(c)(3) of the Code because of lobbying activities or participation or intervention in a political campaign on behalf of or in opposition to a candidate for public office. If this happens to an organization, it cannot later qualify for exemption under section 501(c)(4) of the Code.

locate at a glance the type of organization discussed in this chapter.

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

If your organization is not organized for profit and will be operated only to promote social welfare, you should file Form 1024 to apply for recognition of exemption from federal income tax under section 501(c)(4). The discussion that follows describes the information you must provide when applying. For application procedures, see chapter 1.

To qualify for exemption under section 501(c)(4), the organization's net earnings must be devoted only to charitable, educational, or recreational purposes. In addition, no part of the organization's net earnings may benefit any private shareholder or individual. If the organization provides an "excess benefit" to certain persons, an excise tax may be imposed. See *Excise tax on excess benefits* under *Public Charities* in chapter 3 for more information about this tax.

Examples. Examples of types of organizations that are considered to be social welfare organizations are civic associations and volunteer fire companies.

Nonprofit operation. You must submit evidence that your organization is organized and will be operated on a nonprofit basis. However, such evidence, including the fact that your organization is organized under a state law relating to nonprofit corporations, will not in itself establish a social welfare purpose.

Social welfare. To establish that your organization is organized exclusively to promote social welfare, you should submit evidence with your application showing that your organization will operate primarily to further (in some way) the common good and general welfare of the people of the community (such as by bringing about civic betterment and social improvements).

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. It therefore does not qualify as a section 501(c)(4) organization. Similarly, an organization formed to represent member-tenants of an apartment complex does not qualify, since its activities benefit the member-tenants and not all tenants in the community. However, an organization formed to promote the legal rights of all tenants in a particular community may qualify under section 501(c)(4) as a social welfare organization.

Political activity. Promoting social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. However, if you submit proof that your organization is organized exclusively to promote social welfare, it may still obtain exemption even if it participates legally in some political activity on behalf of or in opposition to candidates for public office. See the discussion in chapter 2 under *Return for Political Activity*.

Social activity. If social activities will be the primary purpose of your organization, you should not file an application for exemption as a social welfare organization but should file for exemption as a social club described in section 501(c)(7).

Retirement benefit program. An organization established by its members that has as its primary activity providing supplemental retirement benefits to its members or death benefits to their beneficiaries does not qualify as an exempt social welfare organization. It may qualify under another paragraph of section 501(c) depending on all the facts.

However, a nonprofit association that is established, maintained, and funded by a local government to provide the only retirement benefits to a class of employees may qualify as a social welfare organization under section 501(c)(4).

Tax treatment of donations. Donations to volunteer fire companies are deductible on the donor's federal income tax return, but only if made for exclusively public purposes. Contributions to civic leagues or other section 501(c)(4) organizations generally are not deductible as charitable contributions for federal income tax purposes. They may be deductible as trade or business expenses, if ordinary and necessary in the conduct of the taxpayer's business. However, see *Deduction not allowed for dues used for political or legislative activities* on page 41 for more information.

Specific Organizations

The following information should be contained in the application form and accompanying statements of certain types of civic leagues or social welfare organizations.

Volunteer fire companies. If your organization wishes to obtain exemption as a volunteer fire company or similar organization, you should submit evidence that its members are actively engaged in fire fighting and similar disaster assistance, whether it actually owns the fire fighting equipment, and whether it provides any assistance for its members, such as death and medical benefits in case of injury to them.

If your organization does not have an independent social purpose, such as providing recreational facilities for members, it may be exempt under section 501(c)(3). In this event, your organization should file Form 1023.

Homeowners associations. A membership organization formed by a real estate developer to own and maintain common green areas, streets, and sidewalks and to enforce covenants to preserve the appearance of the development should show that it is operated for the benefit of all the residents of the community. The term "community" generally refers to a geographical unit recognizable as a governmental subdivision, unit, or district thereof. Whether a particular association meets the requirement of benefiting a community depends on the facts and circumstances of each case. Even if an area represented by an association is not a community, the association can still qualify for exemption if its activities benefit a community.

The association should submit evidence that areas such as roadways and park land that it owns and maintains are open to the

4.

Other Section 501(c) Organizations

Introduction

This chapter contains specific information for certain organizations described in section 501(c), other than those organizations that are described in section 501(c)(3); the latter organizations are covered in chapter 3 of this publication.

The Table of Contents at the beginning of this publication, as well as the *Organization Reference Chart* on page 51, may help you

general public and not just its own members. It also must show that it does not engage in exterior maintenance of private homes.

A homeowners association that is not exempt under section 501(c)(4) and that is either a condominium management association or a residential real estate management association generally may elect under the provisions of section 528 to receive certain tax benefits that, in effect, permit it to exclude its exempt function income from its gross income.

Other organizations. Other nonprofit organizations that qualify as social welfare organizations include:

- An organization operating an **airport** that is on land owned by a local government, which supervises the airport's operation, and that serves the general public in an area with no other airport,
- A **community association** that works to improve public services, housing and residential parking, publishes a free community newspaper, sponsors a community sports league, holiday programs and meetings, and contracts with a private security service to patrol the community,
- A **community association** devoted to preserving the community's traditions, architecture, and appearance by representing it before the local legislature and administrative agencies in zoning, traffic, and parking matters,
- An organization that tries to encourage **industrial development** and relieve unemployment in an area by making loans to businesses so they will relocate to the area, and
- An organization that holds an annual **festival** of regional customs and traditions.

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

If you are a member of an organization that wants to obtain recognition of exemption from federal income tax as a labor, agricultural, or horticultural organization, you should submit an application on Form 1024. You must indicate in your application for exemption and accompanying statements that your organization will not permit its net earnings to inure to the benefit of any member. In addition, you should follow the procedure for obtaining recognition of exempt status described in chapter 1. Submit any additional information that may be required, as described in this section.

Tax treatment of donations. Contributions to labor, agricultural, and horticultural organizations are not deductible as charitable contributions on the donor's federal income tax return. However, such payments may be deductible as business expenses, provided they are ordinary and necessary in the conduct of the taxpayer's trade or business. For

more information about certain limits affecting the deductibility of these business expenses, see *Deduction not allowed for dues used for political or legislative activities* on page 41.

Labor Organizations

A labor organization is an association of workers, usually in the form of a labor union, council, or committee, that is organized to protect and promote the interests of labor in connection with employment.

To show that your organization has the purpose of a labor organization, you should include in the articles of organization or accompanying statements (submitted with your exemption application) information establishing that the organization is organized to better the conditions of workers, improve the grade of their products, and develop a higher degree of efficiency in their respective occupations. In addition, no net earnings of the organization may inure to the benefit of any member.

Composition of membership. While a labor organization generally is composed of employees or representatives of the employees (in the form of collective bargaining agents) and similar employee groups, evidence that an organization's membership consists mainly of workers does not in itself indicate an exempt purpose. You must show in your application that your organization has the purposes described in the preceding paragraph. These purposes may be accomplished by a single labor organization acting alone or by several organizations acting together through a separate organization.

Benefits to members. The payment by a labor organization of death, sick, accident, and similar benefits to its individual members with funds contributed by its members, if made under a plan to better the conditions of the members, does not preclude exemption as a labor organization. However, an organization does not qualify for exemption as a labor organization if it has no authority to represent members in job-related matters, even if it provides weekly income to its members in the event of a lawful strike by the members' union, in return for an annual payment by the member.

Agricultural and Horticultural Organizations

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

For the purpose of these provisions, **aquatic resources** include only animal or vegetable life, but not mineral resources. The term harvesting, in this case, includes fishing and related pursuits.

Agricultural organizations may be quasi-public in character and are often designed to encourage the development of better agricultural and horticultural products through a system of awards, using income from entry fees, gate receipts, and donations to meet the necessary expenses of upkeep and operation. When the activities are directed toward the improvement of marketing or other business conditions in one or more lines of business, rather than the improvement of production techniques or the betterment of the

conditions of persons engaged in agriculture, the organization must qualify for exemption as a business league, board of trade, or other organization, as discussed next in the section on 501(c)(6) organizations.

The primary purpose of exempt agricultural and horticultural organizations must be to better the conditions of those engaged in agriculture or horticulture, develop more efficiency in agriculture or horticulture, or improve the grade of products.

The following list contains some **examples** of activities that show an agricultural or horticultural purpose:

- 1) Promoting various cooperative agricultural, horticultural, and civic activities among rural residents by a state and county farm and home bureau,
- 2) Exhibiting livestock, farm products, and other characteristic features of agriculture and horticulture,
- 3) Testing soil for members and nonmembers of the farm bureau on a cost basis, the results of the tests and other recommendations being furnished to the community members to educate them in soil treatment,
- 4) Guarding the purity of a specific breed of livestock,
- 5) Encouraging improvements in the production of fish on privately-owned fish farms, and
- 6) Negotiating with processors for the price to be paid to members for their crops.

501(c)(6)— Business Leagues, Etc.

If your association wants to apply for recognition of exemption from federal income tax as a nonprofit business league, chamber of commerce, real estate board, board of trade, or professional football league (whether or not administering a pension fund for football players), it should file Form 1024. For a discussion of the procedure to follow, see chapter 1.

Your organization must indicate in its application form and attached statements that no part of its net earnings will inure to the benefit of any private shareholder or individual and that it is not organized for profit or organized to engage in an activity ordinarily carried on for profit (even if the business is operated on a cooperative basis or produces only sufficient income to be self-sustaining).

In addition, your organization must be primarily engaged in activities or functions that are the basis for its exemption. It must be primarily supported by membership dues and other income from activities substantially related to its exempt purpose.

A business league, in general, is an association of persons having some common business interest, the purpose of which is to promote that common interest and not to engage in a regular business of a kind ordinarily carried on for profit. Trade associations and professional associations are considered business leagues.

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

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

Chambers of commerce and boards of trade usually promote the common economic interests of all the commercial enterprises in a given trade community.

Real estate board. A real estate board consists of members interested in improving the business conditions in the real estate field. It is not organized for profit and no part of the net earnings inures to the benefit of any private shareholder or individual.

General purpose. You must indicate in the material submitted with your application that your organization will be devoted to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. It must be shown that the conditions of a particular trade or the interests of the community will be advanced. Merely indicating the name of the organization or the object of the local statute under which it is created is not enough to demonstrate the required general purpose.

Line of business. This term generally refers either to an entire industry or to all components of an industry within a geographic area. It does not include a group composed of businesses that market a particular brand within an industry.

Common business interest. A common business interest of all members of the organization must be established by the application documents.

Examples of activities that would tend to illustrate a common business interest are:

- 1) Promotion of higher business standards and better business methods and encouragement of uniformity and cooperation by a retail merchants association,
- 2) Education of the public in the use of credit,
- 3) Establishment of uniform casualty rates and compilation of statistical information by an insurance rating bureau operated by casualty insurance companies,
- 4) Establishment and maintenance of the integrity of a local commercial market,
- 5) Operation of a trade publication primarily intended to benefit an entire industry, and
- 6) Encouragement of the use of goods and services of an entire industry (such as a lawyer referral service whose main purpose is to introduce individuals to the use of the legal profession in the hope that they will enter into lawyer-client relationships on a paying basis as a result).

Improvement of business conditions generally must be shown to be the purpose of the organization. This is not established by evidence of particular services that provide a convenience or economy to individual mem-

bers in their businesses, such as advertising that carries the name of members, interest free loans, assigning exclusive franchise areas, operation of a real estate multiple listing system, or operation of a credit reporting agency.

Stock or commodity exchange. A stock or commodity exchange is not a business league, chamber of commerce, real estate board, or board of trade and is not exempt under section 501(c)(6).

Legislative activity. An organization that is exempt under section 501(c)(6) may work for the enactment of laws to advance the common business interests of the organization's members.

Deduction not allowed for dues used for political or legislative activities. A taxpayer cannot deduct the part of dues or other payments to a business league, trade association, labor union, or similar organization that is for any of the following activities:

- 1) Influencing legislation,
- 2) Participating or intervening in a political campaign for, or against, any candidate for public office,
- 3) Trying to influence the general public, or part of the general public, with respect to elections, legislative matters, or referendums (also known as "grassroots lobbying"), or
- 4) Communicating directly with certain executive branch officials to try to influence their official actions or positions.

See *Dues Used for Lobbying or Political Activities under Required Disclosures* in chapter 2 for more information.

Exception for local legislation. Members may deduct dues (or assessments) to an organization that are for expenses of:

- 1) Appearing before, submitting statements to, or sending communications to members of a local council or similar governing body with respect to legislation or proposed legislation of direct interest to the member, or
- 2) Communicating information between the member and the organization with respect to local legislation or proposed legislation of direct interest to the organization or the member.

Legislation or proposed legislation is of direct interest to a taxpayer if it will, or may reasonably be expected to, affect the taxpayer's trade or business.

De minimis exception. In-house expenditures of \$2,000 or less for the year for activities (1)–(4) listed earlier will not prevent a deduction for dues, if the dues meet all other tests to be deductible as a business expense.

Grassroots lobbying. A tax-exempt trade association, labor union, or similar organization is considered to be engaging in grassroots lobbying if it contacts prospective members or calls upon its own members to contact their employees and customers for the purpose of urging such persons to communicate with their elected state or Congressional representatives to support the promotion, defeat, or repeal of legislation that is of direct interest to the organization. Any dues or assessments directly related to such ac-

tivities are not deductible by the taxpayer, since the individuals being contacted, who are not members of the organization, are a segment of the general public.

Appeal procedures. If the IRS determines that dues or other payments made by contributors to a labor union, trade association, or similar organization are not deductible because of the lobbying or political activity of the organization, the appeal procedures discussed in chapter 1 will apply to the organization.

Tax treatment of donations. Contributions to organizations described in this section are not deductible as charitable contributions on the donor's federal income tax return. They may be deductible as trade or business expenses if ordinary and necessary in the conduct of the taxpayer's business.

501(c)(7)— Social and Recreation Clubs

If your club is organized for pleasure, recreation, and other similar nonprofitable purposes and substantially all of its activities are for these purposes, it should file Form 1024 to apply for recognition of exemption from federal income tax.

In applying for recognition of exemption, you should submit the information described in this section. Also see chapter 1 for the procedures to follow.

Typical organizations that should file for recognition of exemption as social clubs include:

- College alumni associations that are not described in chapter 3 under *Alumni association*,
- College fraternities or sororities operating chapter houses for students,
- 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 clubs, and
- Variety clubs.

Discrimination prohibited. Your organization will not be recognized as tax exempt if its charter, bylaws, or other governing instrument, or any written policy statement provides for discrimination against any person on the basis of race, color, or religion.

However, a club that in good faith limits its membership to the members of a particular religion to further the teachings or principles of that religion and not to exclude individuals of a particular race or color will not be considered as discriminating on the basis of religion. Also, the restriction on religious discrimination does not apply to a club that is an auxiliary of a fraternal beneficiary society (discussed later) if that society is described in section 501(c)(8) and exempt from tax under section 501(a) and limits its membership to the members of a particular religion.

Private inurement prohibited. No part of the organization's net earnings may inure to the benefit of any person having a personal and private interest in the activities of the organization. For purposes of this requirement, it is not necessary that net earnings be actually distributed. Even undistributed earnings can benefit members. Examples of this include a decrease in membership dues or an increase in the services the club provides to its members without a corresponding increase in dues or other fees paid for club support. However, fixed fee payments to members who bring new members into the club are not an inurement of the club's net earnings, if the payments are reasonable compensation for performance of a necessary administrative service.

Purposes. To show that your organization possesses the characteristics of a club within the meaning of the exemption law, you should submit evidence with your application that personal contact, commingling, and fellowship exist among members. You must show that members are bound together by a common objective of pleasure, recreation, and other nonprofitable purposes.

Fellowship need not be present between each member and every other member of a club if it is a material part in the life of the organization. A statewide or nationwide organization that is made up of individual members, but is divided into local groups, satisfies this requirement if fellowship is a material part of the life of each local group.

The term **other nonprofitable purposes** means other purposes similar to pleasure and recreation. For example, a club that, in addition to its social activities, has a plan for the payment of sick and death benefits is not operating exclusively for pleasure, recreation, and other nonprofitable purposes.

Limited membership. The membership in a social club must be limited. To show that your organization has a purpose that would characterize it as a club, you should submit evidence with your application that there are limits on admission to membership consistent with the character of the club.

A social club that issues **corporate membership** is dealing with the general public in the form of the corporation's employees. Corporate members of a club are not the kind of members contemplated by the law. Gross receipts from these members would be a factor in determining whether the club qualifies as a social club. See *Gross receipts from nonmembership sources*, later. Bona fide individual memberships paid for by a corporation would not have an effect on the gross receipts source.

The fact that a social club may have an **associate (nonvoting) class of membership** will not be, in and of itself, a cause for nonrecognition of exemption. However, if one membership class pays substantially lower dues and fees than another membership class, although both classes enjoy the same rights and privileges in using the club facilities, there may be an inurement of income to the benefited class, resulting in a denial of the club's exemption.

Support. In general, your club should be supported solely by membership fees, dues, and assessments. However, if otherwise entitled to exemption, your club will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

Business activities. If your club will engage in business, such as selling real estate, timber, or other products or services, it generally will be denied exemption. However, evidence submitted with your application form that your organization will provide meals, refreshments, or services related to its exempt purposes only to its own members or their dependents or guests will not cause denial of exemption.

Facilities open to public. Evidence that your club's facilities will be open to the general public (persons other than members or their dependents or guests) may cause denial of exemption. This does not mean, however, that any dealing with outsiders will automatically deprive a club of exemption.

Gross receipts from nonmembership sources. A section 501(c)(7) organization may 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%, up to 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. If an organization has outside income that is more than these limits, all the facts and circumstances will be taken into account in determining whether the organization qualifies for exempt status.

Gross receipts. Gross receipts, for this purpose, are receipts from the normal and usual (traditionally conducted) activities of the club. These receipts include charges, admissions, membership fees, dues, assessments, investment income, and normal recurring capital gains on investments. Receipts do not include initiation fees and capital contributions. Unusual amounts of income, such as from the sale of a clubhouse or similar facility, are not included in gross receipts or in figuring the percentage limits.

Fraternity foundations. If your organization is a foundation formed for the exclusive purpose of acquiring and leasing a chapter house to a local fraternity chapter or sorority chapter maintained at an educational institution and does not engage in any social activities, it may be a title holding corporation (discussed later under section 501(c)(2) organizations and under section 501(c)(25) organizations) rather than a social club.

Tax treatment of donations. Donations to exempt social and recreation clubs are not deductible as charitable contributions on the donor's federal income tax return.

ies do not provide these benefits but rather devote their earnings to fraternal, religious, charitable, etc., purposes. The procedures to follow in applying for recognition of exemption are described in chapter 1.

If your organization is controlled by a central organization, you should check with your controlling organization to determine whether your unit has been included in a group exemption letter or may be added. If so, your organization need not apply for individual recognition of exemption. For more information see *Group Exemption Letter* in chapter 1 of this publication.

Tax treatment of donations. Donations by an individual to a domestic fraternal beneficiary society or a domestic fraternal society operating under the lodge system are deductible as charitable contributions only if used exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals.

Fraternal Beneficiary Societies (501(c)(8))

A fraternal beneficiary society, order, or association should file an application for recognition of exemption from federal income tax on Form 1024. The application and accompanying statements should establish that the organization:

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

Lodge system. Operating under the lodge system means carrying on activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like.

Payment of benefits. It is not essential that every member be covered by the society's program of sick, accident, or death benefits. An organization can qualify for exemption if most of its members are eligible for benefits, and the benefits are paid from contributions or dues paid by those members.

The benefits must be limited to members and their dependents. If members will have the ability to confer benefits to other than themselves and their dependents, exemption will not be recognized.

Whole-life insurance. Whole-life insurance constitutes a life benefit under section 501(c)(8) even though the policy may contain investment features such as a cash surrender value or a policy loan.

Reinsurance pool. Payments by a fraternal beneficiary society into a state-sponsored reinsurance pool that protects participating insurers against excessive losses on major medical health and accident insurance will not preclude exemption as a fraternal beneficiary society.

501(c)(8) and (10)—Fraternal Beneficiary Societies and Domestic Fraternal Societies

This section describes the information to be provided upon application for recognition of exemption by two types of fraternal societies: beneficiary and domestic. The major distinction is that fraternal beneficiary societies provide for the payment of life, sick, accident, or other benefits to their members or their dependents, while domestic fraternal societ-

Domestic Fraternal Societies (501(c)(10))

A domestic fraternal society, order, or association may file an application for recognition of exemption from federal income tax on Form 1024. The application and accompanying statements should establish that the organization:

- 1) Is a domestic fraternal organization,
- 2) Operates under the lodge system,
- 3) Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and
- 4) Does not provide for the payment of life, sick, accident, or other benefits to its members.

The organization may arrange with insurance companies to provide optional insurance to its members without jeopardizing its exempt status.

501(c)(4), (9), and (17)—Employees' Associations

This section describes the information to be provided upon application for recognition of exemption by the following types of employees' associations:

- 1) **A local association of employees** whose membership is limited to employees of a designated person or persons in a particular municipality, and whose income will be devoted exclusively to charitable, educational, or recreational purposes,
- 2) **A voluntary employees' beneficiary association**, (including federal employees' associations) organized to pay life, sick, accident, and similar benefits to members or their dependents, or designated beneficiaries, if no part of the net earnings of the association inures to the benefit of any private shareholder or individual, and
- 3) **A supplemental unemployment benefit trust** whose primary purpose is providing for payment of supplemental unemployment benefits.

Both the application form to file and the information to provide are discussed later under the section that describes your employee association. Chapter 1 describes the procedures to follow in applying for exemption.

Tax treatment of donations. Donations to these organizations are not deductible as charitable contributions on the donor's federal income tax return.

Local Employees' Associations (501(c)(4))

A local employees' association may apply for recognition of exemption by filing Form 1024. The organization must submit evidence that:

- 1) It is of a purely local character,
- 2) Its membership is limited to employees of a designated person or persons in a particular locality, and
- 3) Its net earnings will be devoted exclusively to charitable, educational, or recreational purposes.

A local association of employees that has established a system of paying retirement and/or death benefits to its members will not qualify for exemption, since the payment of these benefits is not considered as being for charitable, educational, or recreational purposes. Similarly, a local association of employees that is operated primarily as a cooperative buying service for its members in order to obtain discount prices on merchandise, services, and activities does not qualify for exemption.

Voluntary Employees' Beneficiary Associations (501(c)(9))

An application for recognition of exemption as a voluntary employees' beneficiary association must be filed on Form 1024. The material submitted with the application must show that your organization:

- 1) Is a voluntary association of employees,
- 2) Will provide for payment of life, sick, accident, or other benefits to members or their dependents or designated beneficiaries and substantially all of its operations are for this purpose, and
- 3) Will not allow any of its earnings to inure to the benefit of any private individual or shareholder except in the form of scheduled benefit payments.

Notice requirement. An organization will not be considered tax exempt under this section unless the organization gives notice to the IRS that it is applying for recognition of exempt status. The organization gives notice by filing Form 1024. If the notice is not given by 15 months after the end of the month in which the organization was created, the organization will not be exempt for any period before notice is given. The key District Director may grant an extension of time for filing the notice under the same procedures as those described for section 501(c)(3) organizations in chapter 3 under *Application for Recognition of Exemption*.

Membership. Membership of a section 501(c)(9) organization must consist of individuals who are employees and have an employment-related common bond. This common bond may be a common employer (or affiliated employers), coverage under one or more collective bargaining agreements, membership in a labor union, or membership in one or more locals of a national or international labor union.

The membership of an association may include some individuals who are not employees, provided they have an employment-related bond with the employee-members. For example, the owner of a business whose employees are members of the association may be a member. An association will be considered composed of employees if 90% of its total membership on one day of each quarter of its tax year consists of employees.

Employees. Employees include individuals who became entitled to membership because they are or were employees. For example, an individual will qualify as an employee even though the individual is on a leave of absence or has been terminated due to retirement, disability, or layoff.

Generally, membership is **voluntary** if an affirmative act is required on the part of an employee to become a member. Conversely, membership is involuntary if the designation as a member is due to employee status. However, an association will be considered voluntary if employees are required to be members of the organization as a condition of their employment and they do not incur a detriment (such as a payroll deduction) as a result of their membership. An employer has not imposed involuntary membership on the employee if membership is required as the result of a collective bargaining agreement or as an incident of membership in a labor organization.

Payment of benefits. The information submitted with your application must show that your organization will pay life, sick, accident, supplemental unemployment, or other similar benefits. The benefits may be provided directly by your association or indirectly by your association through the payments of premiums to an insurance company (or fees to a medical clinic). Benefits may be in the form of medical, clinical, or hospital services, transportation furnished for medical care, or money payments.

Nondiscrimination requirements. An organization that is part of a plan will not be exempt unless the plan meets certain nondiscrimination requirements. However, if the organization is part of a plan maintained under any collective bargaining agreement between employee organizations and employers, the plan need not meet these requirements for the organization to qualify as tax exempt.

A plan meets the nondiscrimination requirements only if both of the following statements are true.

- 1) Each class of benefits under the plan is provided under a classification of employees that is set forth in the plan and does not discriminate in favor of employees who are highly compensated individuals.
- 2) The benefits provided under each class of benefits do not discriminate in favor of highly compensated individuals.

A life insurance, disability, severance pay, or supplemental unemployment compensation benefit does not discriminate in favor of highly compensated individuals merely because the benefits available bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of employees covered by the plan.

For purposes of determining whether a plan meets the nondiscrimination requirements, the employer may elect to exclude all disability or severance payments payable to individuals who are in pay status as of January 1, 1985. This will not apply to any increase in such payment by any plan amendment adopted after June 22, 1984.

If a plan provides a benefit for which there is a nondiscrimination provision provided under the Internal Revenue Code as a condition of that benefit being excluded from gross in-

come, these nondiscrimination requirements do not apply. The benefit will be considered nondiscriminatory only if it meets the nondiscrimination provision of the applicable Code section. For example, benefits provided under a medical reimbursement plan would meet the nondiscrimination requirements for an association, if the benefits meet the nondiscrimination requirements of Code section 105(h)(3) and (4).

Excluded employees. Certain employees who are not covered by a plan may be excluded from consideration in applying these requirements. These include employees—

- 1) Who have not completed 3 years of service,
- 2) Who have not attained age 21,
- 3) Who are seasonal or less than half-time employees,
- 4) Who are not in the plan and who are included in a unit of employees covered by a collective bargaining agreement if the class of benefits involved was the subject of good faith bargaining, or
- 5) Who are nonresident aliens and who receive no earned income from the employer that is United States source income.

Highly compensated individual. A highly compensated individual is one who:

- 1) Owned 5 percent or more of the employer at any time during the current year or the preceding year,
- 2) Received more than \$80,000 (adjusted for inflation) in compensation from the employer for the preceding year, and
- 3) Was among the top 20% of employees by compensation for the preceding year.

But the employer can choose not to have (3) apply.

Aggregation rules. The employer may choose to treat two or more plans as one plan for purposes of meeting the nondiscrimination requirements. Employees of controlled groups of corporations, trades or businesses under common control, or members of an affiliated service group, are treated as employees of a single employer. Leased employees are treated as employees of the recipient.

One employee. A trust created to provide benefits to one employee will not qualify as a "voluntary employees' beneficiary association" under section 501(c)(9).

Supplemental Unemployment Benefit Trusts (501(c)(17))

A trust or trusts forming part of a written plan (established and maintained by an employer, his or her employees, or both) providing solely for the payment of supplemental unemployment compensation benefits must file the application for recognition of exemption on Form 1024. The trust must be a valid, existing trust under local law and must be evidenced by an executed document. A conformed copy of the plan of which the trust is a part should be attached to the application.

Notice requirement. An organization will not be considered tax exempt under this section unless the organization gives notice to the IRS that it is applying for recognition of exempt status. The organization gives notice by filing Form 1024. If the notice is not given by 15 months after the end of the month in which the organization was created, the organization will not be exempt for any period before such notice is given. The key District Director may grant an extension of time for filing the notice under the same procedures as those described for section 501(c)(3) organizations in chapter 3, under *Application for Recognition of Exemption*.

Types of payments. You must show that the supplemental unemployment compensation benefits will be benefits paid to an employee because of the employee's involuntary separation from employment (whether or not the separation is temporary) resulting directly from a reduction-in-force, discontinuance of a plant or operation, or other similar conditions. In addition, sickness and accident benefits (but not vacation, retirement, or death benefits) may be included in the plan if these are subordinate to the unemployment compensation benefits.

Diversion of funds. It must be impossible under the plan (at any time before the satisfaction of all liabilities with respect to employees under the plan) to use or to divert any of the corpus or income of the trust to any purpose other than the payment of supplemental unemployment compensation benefits (or sickness or accident benefits to the extent just explained).

Discrimination in benefits. Neither the terms of the plan nor the actual payment of benefits may be discriminatory in favor of the company's officers, stockholders, supervisors, or highly paid employees. However, a plan is not discriminatory merely because benefits bear a uniform relationship to compensation or the rate of compensation.

Reestablishing exemption. If your organization is a supplemental unemployment benefit trust and has received a denial of exemption because it engaged in a prohibited transaction, as defined by section 503(b), it may file a claim for exemption in any tax year following the tax year in which the notice of denial was issued. It must file the claim on Form 1024. The organization must include a written declaration that it will not knowingly again engage in a prohibited transaction. An authorized principal officer of your organization must make this declaration under the penalties of perjury.

If your organization has satisfied all requirements as a supplemental unemployment benefit trust described in section 501(c)(17), it will be notified in writing that it has been recognized as exempt. However, the organization will be exempt only for those tax years after the tax year in which the claim for exemption (Form 1024) is filed. Tax year in this case means the established annual accounting period of the organization or the calendar year, if the organization has not established an annual accounting period. For more information about the requirements for reestablishing an exemption previously denied, contact the IRS.

501(c)(12)— Local Benevolent Life Insurance Associations, Mutual Irrigation and Telephone Companies, and Like Organizations

Each of the following organizations may apply for recognition of exemption from federal income tax by filing Form 1024:

- 1) **Benevolent life insurance associations** of a purely local character and like organizations,
- 2) **Mutual ditch or irrigation companies** and like organizations, and
- 3) **Mutual or cooperative telephone companies** and like organizations.

A **like organization** is an organization that performs a service comparable to that performed by any one of the above organizations.

The information to be provided upon application by each of these organizations is described in this section. For information as to the procedures to follow in applying for exemption, see chapter 1.

General requirements. These organizations must use their income solely to cover losses and expenses, with any excess being returned to members or retained for future losses and expenses. They must collect at least 85% of their income from members for the sole purpose of meeting losses and expenses.

Mutual character. These organizations, other than benevolent life insurance associations, must be organized and operated on a mutual or cooperative basis. They are associations of persons and organizations, or both, banded together to provide themselves a mutually desirable service approximately at cost and on a mutual basis. To maintain the mutual characteristic of democratic ownership and control, they must be so organized and operated that their members have the right to choose the management, to receive services substantially at cost, to receive a return of any excess of payments over losses and expenses, and to share in any assets upon dissolution.

The rights and interests of members in the annual savings of the organization must be determined in proportion to their business with the organization. Upon dissolution, gains from the sale of appreciated assets must be distributed to all persons who were members during the period the assets were owned by the organization in proportion to the amount of business done during that period. The by-laws must not provide for forfeiture of a member's rights and interest upon withdrawal or termination.

Membership. Membership of a mutual organization consists of those who join the organization to obtain its services, acquire an interest in its assets, and have a voice in its management. In a stock company, the stock-

holders are members. Membership may include distributors who furnish service to individual consumers. However, it does not include the individual consumers served by the distributor. A mutual service organization may serve nonmembers as long as at least 85% of its gross income is collected from members. However, a mutual life insurance organization may have no policyholders other than its members.

Losses and expenses. In furnishing services substantially at cost, an organization must use its income solely for paying losses and expenses. Any excess income not retained in reasonable reserves for future losses and expenses belongs to members in proportion to their patronage or business done with the organization. If such patronage refunds are retained in reasonable amounts for purposes of expanding facilities, retiring capital indebtedness, acquiring other assets, etc., the organization must maintain records sufficient to reflect the equity of each member in the assets acquired with the funds.

Dividends. Dividends paid to stockholders on stock or the value of a capital equity interest **constitute a distribution of profits and are not an expense** within the term losses and expenses. Therefore, a mutual or cooperative association whose shares carry the right to dividends will not qualify for exemption. However, this prohibition does not apply to the distribution of the unexpended balance of collections or assessments remaining on hand at the end of the year to members as patronage dividends or refunds prorated to each on the basis of their patronage or business done with the organization. Such distribution represents a reduction in the cost of services rendered to the member.

The 85% requirement. All of the organizations discussed in this section must submit evidence with their application that they receive 85% or more of their gross income from their members for the sole purpose of meeting losses and expenses. Nevertheless, certain items of income are excluded from the computation of the 85% requirement if the organization is a mutual or cooperative telephone or electric company.

A mutual or cooperative telephone company will exclude from the computation of the 85% requirement any income received or accrued from:

- 1) A nonmember telephone company for the performance of communication services involving the completion of long distance calls to, from, or between members of the mutual or cooperative telephone company,
- 2) Qualified pole rentals,
- 3) The sale of display listings in a directory furnished to its members, or
- 4) The prepayment of a loan created in 1987, 1988, or 1989, under section 306A, 306B, or 311 of the Rural Electrification Act of 1936.

A mutual or cooperative electric company will exclude from the computation any income received or accrued from qualified pole rentals and from the prepayment of loans described in (4) above. An electric cooperative's sale of excess fuel at cost in the year of purchase is not income for purposes of determining compliance with the 85% requirement.

The term **qualified pole rental** means any rental of a pole (or other structure used to support wires) if the pole (or other structure) is used:

- 1) By the telephone or electric company to support one or more wires that are used by the company in providing telephone or electric services to its members, and
- 2) Pursuant to the rental to support one or more wires (in addition to wires described in (1)) for use in connection with the transmission by wire of electricity or of telephone or other communications.

The term rental, for this purpose, includes any sale of the right to use the pole (or other structure).

The 85% requirement is applied on the basis of **an annual accounting period**. Failure of an organization to meet the requirement in a particular year precludes exemption for that year, but has no effect upon exemption for years in which the 85% requirement is met.

Gain from the **sale or conversion of the organization's property** is not considered an amount received from members in determining whether the organization's income consists of amounts collected from members.

Because the 85% income test is based on gross income, capital losses cannot be used to reduce capital gains for purposes of this test.

Example. The books of an organization reflect the following for the calendar year.

| | |
|---|---------|
| Collections from members | \$2,400 |
| Short-term capital gains | 600 |
| Short-term capital losses | 400 |
| Other income | None |
| Gross income (\$2,400 + \$600 - \$400) .. | 100% |
| Collected from members (\$2,400) | 80% |

Since amounts collected from members do not constitute at least 85% of gross income, the organization is not entitled to exemption from federal income tax for the year.

Voluntary contributions in the nature of gifts are not taken into account for purposes of the 85% computation.

Other tax-exempt income besides gifts is considered as income received from other than members in applying the 85% test.

If the 85% test is not met, your organization, if classifiable under this section, will not qualify for exemption as any other type of organization described in this publication.

Tax treatment of donations. Donations to an organization described in this section are not deductible as charitable contributions on the donor's federal income tax return.

Local Life Insurance Associations

A benevolent life insurance association or an organization seeking recognition of exemption on grounds of similarity to a benevolent life insurance association must submit evidence upon applying for recognition of exemption that it will be of a purely local character, that its excess funds will be refunded to members or retained in reasonable reserves to meet future losses and expenses, and that it meets the 85% income requirement. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15% of its

income is derived, it will not be entitled to exemption.

To establish that your organization is of a **purely local character**, it should show that its activities will be confined to a particular community, place, or district irrespective of political subdivisions. Evidence that the activities of an organization are limited only by the borders of a state or any other political subdivision will not establish that it is purely local in character. A benevolent life insurance association that does not terminate membership when a member moves from the local area in which the association operates will qualify for exemption if it meets the other requirements.

A copy of each type of policy issued by your organization should be included with the application for recognition of exemption.

Organizations similar to local benevolent life insurance companies. These organizations include those that in addition to paying death benefits also provide for the payment of sick, accident, or health benefits. However, an organization that pays only sick, accident, or health benefits, but not life insurance benefits, is not an organization similar to a benevolent life insurance association and should not apply for recognition of exemption as described in this section.

Burial and funeral benefit insurance organization. This type of organization can apply for recognition of exemption as an organization similar to a benevolent life insurance company if it establishes that the benefits are paid in cash and if it is not engaged directly in the manufacture of funeral supplies or the performance of funeral services. An organization that provides its benefits in the form of supplies and service is not a life insurance company. Such an organization may seek recognition of exemption from federal income tax, however, as a mutual insurance company other than life.

Mutual or Cooperative Associations

Mutual ditch or irrigation companies, mutual or cooperative telephone companies, and like organizations need not establish that they are of a purely local character. They may serve noncontiguous areas.

Like organization. This is a term generally restricted to organizations that perform a service comparable to mutual ditch, irrigation, and telephone companies such as mutual water, communications, electric power, or gas companies all of which satisfy the 85% test. Examples are an organization structured for the protection of river banks against erosion whose only income consists of assessments against the property owners concerned, a nonprofit organization providing and maintaining a two-way radio system for its members on a mutual or cooperative basis, or a local light and water company organized to furnish light and water to its members. A cooperative organization providing cable television service to its members may qualify for exemption as a "like" organization if the requirements discussed in this section are met.

Associations operating a bus for their members' convenience, providing and maintaining cooperative housing facilities for the personal benefit of individuals, or furnishing a financing service for purchases made by members of cooperative organizations are not like organizations.

501(c)(13)— Cemetery Companies

If your organization wishes to obtain recognition of exemption from federal income tax as a cemetery company or a corporation chartered solely for the purpose of the disposal of human bodies by burial or cremation, it should file an application on Form 1024. For the procedure to follow, see chapter 1.

A **nonprofit mutual cemetery company** that seeks recognition of exemption should submit evidence with its application that it is owned and operated exclusively for the benefit of its lot owners who hold lots for bona fide burial purposes and not for purposes of resale. A mutual cemetery company that also engages in charitable activities, such as the burial of paupers, will be regarded as operating within this standard. The fact that a mutual cemetery company limits its membership to a particular class of individuals, such as members of a family, will not affect its status as mutual so long as all the other requirements of section 501(c)(13) are met.

If your organization is a nonprofit corporation chartered solely for the purpose of the disposal of human bodies by burial or cremation, you should show that it is not permitted by its charter to engage in any business not necessarily incident to that purpose. The sale of monuments, markers, vaults, and flowers solely for use in the cemetery is permissible if the profits from these sales are used to maintain the cemetery as a whole.

How income may be used. You should show that your organization's earnings are or will be used only in one or more of the following ways:

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

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

Ordinary and necessary expenses in connection with the operation, management, maintenance, and improvement of the cemetery are permitted, as are reasonable fees for the services of a manager.

Buying cemetery property. Payments may be made to amortize debt incurred to buy land, but may not be in the nature of profit distributions. You must show the method used to finance the purchase of the cemetery property and that the purchase price of the land at the time of its sale to the cemetery was not unreasonable.

Except for holders of preferred stock (discussed later), no person may have any interest in the net earnings of a tax-exempt cemetery company or crematorium. Therefore, if property is transferred to the organization in exchange for an interest in the organization's net earnings, the organization will not be exempt so long as that interest remains outstanding.

An equity interest in the organization is an interest in the net earnings of the organiza-

tion. However, an interest in the organization that is not an equity interest may still be an interest in the organization's net earnings. For example, a bond issued by a cemetery company that provides for a fixed rate of interest and also provides for additional interest payments based on the income of the organization is considered an interest in the net earnings of the organization. Similarly, a convertible debt obligation issued after July 7, 1975, is considered an interest in the net earnings of the organization.

A **perpetual care organization**, including, for example, a trust organized to receive, maintain, and administer funds that it receives from a nonprofit tax-exempt cemetery pursuant to state law and contracts, may apply for recognition of exemption on Form 1024, even though it does not own the land used for burial. However, the income from these funds must be devoted exclusively to the perpetual care and maintenance of the nonprofit cemetery as a whole. Also, no part of the net earnings may inure to the benefit of any private shareholder or individual.

In addition, a perpetual care organization not operated for profit, but established as a civic enterprise to maintain and administer funds, the income of which is devoted exclusively to the perpetual care and maintenance of an abandoned cemetery as a whole, may qualify for exemption.

Care of individual plots. When funds are received by a cemetery company for the perpetual care of an individual lot or crypt, a trust is created that is subject to federal income tax. Any trust income that is used or permanently set aside for the care, maintenance, or beautification of a particular family burial lot or mausoleum crypt is not deductible in computing the trust's taxable income.

Common and preferred stock. A cemetery company that issues **common stock** may qualify for exemption only if no dividends may be paid. The payment of dividends must be legally prohibited either by the corporation's charter or by applicable state law.

Generally, a cemetery company or crematorium is not exempt if it issues **preferred stock**. However, it can still be exempt if the preferred stock was issued before November 28, 1978, or was issued after that date under a written plan adopted before that date. The adoption of the plan must be shown by the acts of the responsible officers and appear on the official records of the organization.

The preferred stock issued either before November 28, 1978, or under a plan adopted before that date, must meet all the following requirements.

- 1) The preferred stock entitles the holders to dividends at a fixed rate that is not more than the greater of the legal rate of interest in the state of incorporation or 8% a year on the value of the consideration for which the stock was issued.
- 2) The organization's articles of incorporation require—
 - a) That the preferred stock be retired at par as rapidly as funds become available from operations, and
 - b) That all funds not required for the payment of dividends on or for the retirement of preferred stock be

used by the company for the care and improvement of the cemetery property.

Tax treatment of donations. Donations to exempt cemetery companies, corporations chartered solely for human burial purposes, and perpetual care funds (operated in connection with such exempt organizations) are deductible as charitable contributions on the donor's federal income tax return. However, a donor may not deduct a contribution made for the perpetual care of a particular lot or crypt. Payments made to a cemetery company or corporation as part of the purchase price of a burial lot or crypt, whether irrevocably dedicated to the perpetual care of the cemetery as a whole or earmarked for the care of a particular lot, are also not deductible.

501(c)(14)— Credit Unions and Other Mutual Financial Organizations

If your organization wants to obtain recognition of exemption as a credit union without capital stock, organized and operated under state law for mutual purposes and without profit, it should file an application including the facts, information, and attachments described in this section. In addition, it should follow the procedures described in chapter 1.

Federal credit unions organized and operated in accordance with the Federal Credit Union Act, as amended, are instrumentalities of the United States, and therefore, are exempt under section 501(c)(1). They are included in a group exemption letter issued to the National Credit Union Administration. They are not discussed in this publication.

State chartered credit unions and other mutual financial organizations may file applications for recognition of exemption from federal income tax under section 501(c)(14). The "other mutual financial organizations" must be corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit to provide reserve funds for, and insurance of, shares or deposits in:

- 1) Domestic building and loan associations,
- 2) Cooperative banks (without capital stock) organized and operated for mutual purposes and without profit,
- 3) Mutual savings banks (not having capital stock represented by shares), or
- 4) Mutual savings banks described in section 591(b).

Similar organizations, formed before September 1, 1957, that provide reserve funds for (but not insurance of shares or deposits in) one of the types of savings institutions described in (1), (2), or (3) above may be exempt from tax if 85% or more of the organization's income is from providing reserve funds and from investments. There is no specific restriction against the issuance of capital stock for these organizations.

Building and loan associations, savings and loan associations, mutual savings banks, and cooperative banks, other than those described in this section, are not exempt from tax.

Application form. The Internal Revenue Service does not provide a printed application form for the use of organizations described in this section. Any form of written application is acceptable as long as it shows the information indicated in this section and includes a declaration that it is made under the penalties of perjury. The application must be submitted in duplicate.

State Chartered Credit Unions

Your organization must show on its application that it is formed under a state credit union law, the state and date of incorporation, and that the state credit union law with respect to loans, investments, and dividends, if any, is being complied with.

A form of statement furnished to applicants by the Credit Union National Association is acceptable in meeting the application requirements for credit unions, and may be used instead of the statement form of application just described. Following is a reproduction of that form:

Claim for Exemption from Federal Income Tax _____ (Date)

The undersigned _____ (Complete name) _____ Credit Union, Inc., _____ (Complete address, including street and number) a credit union operating under the credit union law of the State of _____ claims exemption from Federal income tax and supplies the following information relative to its operation:

- 1) Date of incorporation _____.
- 2) It was incorporated under the credit union law of the State of _____, and is being operated under uniform bylaws adopted by said state.
- 3) In making loans the state credit union law requirements including their purposes, security, and rate of interest charged thereon, are complied with.
- 4) Its investments are limited to securities which are legal investments for credit unions under the state credit union law.
- 5) Its dividends on shares, if any, are distributed as prescribed by the state credit union law.

I, the undersigned, a duly authorized officer of the _____ Credit Union, Inc., declare that the above information is a true statement of facts concerning the credit union.

Signature _____ of Officer _____
Title _____

Other Mutual Financial Organizations

Every other organization included in this section must show in its application the state in which the organization is incorporated and the date of incorporation; the character of the organization; the purpose for which it was organized; its actual activities; the sources of its receipts and the disposition thereof; whether

any of its income may be credited to surplus or may inure to the benefit of any private shareholder or individual; whether the law relating to loans, investments, and dividends is being complied with; and, in general, all facts relating to its operations that affect its right to exemption.

The application must include detailed information showing either that the organization provides both reserve funds for and insurance of shares and deposits of its member financial organizations; or that the organization provides reserve funds for shares or deposits of its members and 85% or more of the organization's income is from providing reserve funds and from investments. There should be attached a conformed copy of the articles of incorporation or other document setting forth the permitted powers or activities of the organization; the bylaws or other similar code of regulations; and the latest annual financial statement showing the receipts, disbursements, assets, and liabilities of the organization.

- 3) To provide entertainment, care, and assistance to hospitalized veterans or members of the U.S. Armed Forces,
- 4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors,
- 5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,
- 6) To sponsor or participate in activities of a patriotic nature,
- 7) To provide insurance benefits for its members or dependents of its members or both, or
- 8) To provide social and recreational activities for its members.

Auxiliary unit. An auxiliary unit or society of a veterans organization may apply for recognition of exemption provided that the veterans organization (parent organization) meets the requirements explained earlier in this section. The auxiliary unit or society must also meet all the following additional requirements.

- 1) It is affiliated with, and organized in accordance with, the bylaws and regulations formulated by the parent organization.
- 2) At least 75% of its members are either past or present members of the U.S. Armed Forces, spouses of those members, or related to those members within two degrees of kinship (grandparent, brother, sister, and grandchild represent the most distant allowable relationship).
- 3) All of its members either are members of the parent organization, spouses of a member of the parent organization, or related to a member of such organization within two degrees of kinship.
- 4) No part of its net earnings inure to the benefit of any private shareholder or individual.

Trusts or foundations. Trusts or foundations for a veterans organization also may apply for recognition of exemption provided that the parent organization meets the requirements explained earlier. The trust or foundation must also meet all the following qualifications.

- 1) The trust or foundation is in existence under local law and, if it is organized for charitable purposes, has a dissolution provision similar to charitable organizations. (See *Articles of Organization* in chapter 3 of this publication.)
- 2) The corpus or income cannot be diverted or used other than for—
 - a) The funding of a veterans organization, described in this section,
 - b) Religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals, or
 - c) An insurance set aside.
- 3) The trust income is not unreasonably accumulated and, if the trust or foundation is not an insurance set aside, a substantial portion of the income is in fact distributed to the parent organization or for the purposes described in item (2)(b).

501(c)(19)— Veterans Organizations

A post or organization of past or present members of the Armed Forces of the United States may file Form 1024 to apply for recognition of exemption from federal income tax. You should follow the general procedures outlined in chapter 1. The organization must also meet the qualifications described in this section.

Examples of groups that would qualify for exemption are posts or auxiliaries of the American Legion, Veterans of Foreign Wars, and similar organizations.

To qualify for recognition of exemption, your application should show:

- 1) That the post or organization is organized in the United States or any of its possessions,
- 2) That at least 75% of the members are past or present members of the U.S. Armed Forces and that at least 97.5% of all members of the organization are past or present members of the U.S. Armed Forces, cadets (including only students in college or university ROTC programs or at armed services academies) or spouses, widows, or widowers of any of those listed here, and
- 3) That no part of the net earnings inure to the benefit of any private shareholder or individual.

In addition to these requirements, a veterans organization also must be operated exclusively for one or more of the following purposes:

- 1) To promote the social welfare of the community (that is, to promote in some way the common good and general welfare of the people of the community),
- 2) To assist disabled and needy war veterans and members of the U.S. Armed Forces and their dependents and the widows and orphans of deceased veterans,

- 4) It is organized exclusively for one or more of the purposes listed earlier in this section that are specifically applicable to the parent organization.

Tax treatment of donations. Donations to war veterans organizations are deductible as charitable contributions on the donor's federal income tax return. At least 90% of the organization's membership must consist of war veterans. The term "war veterans" means persons, whether or not present members of the U.S. Armed Forces, who have served in the U.S. Armed Forces during a period of war (including the Korean and Vietnam conflicts).

501(c)(20)— Group Legal Services Plan Organizations

For tax years that began before July 1, 1992, an organization or trust created in the U.S. for the exclusive function of forming a part of a qualified group legal services plan or plans could obtain recognition of exemption from income tax by filing Form 1024. The law that allows the exemption has expired for tax years beginning after June 30, 1992.

501(c)(21)— Black Lung Benefit Trusts

If your organization wishes to obtain recognition of exemption as a black lung benefit trust, it must file its application by letter and include a copy of its trust instrument. The general procedures to follow for obtaining recognition are discussed in chapter 1 of this publication. This section describes the additional (or specific) information to be provided upon application.

Requirements. A black lung benefit trust that is established in writing, created or organized in the United States, and contributed to by any person (except an insurance company) will qualify for tax-exempt status if it meets both of the following requirements.

- 1) Its only purpose is—
 - a) To satisfy in whole or in part the liability of that person (generally, the coal mine operator contributing to the trust) for, or with respect to, claims for compensation arising under federal or state statutes for disability or death due to pneumoconiosis,
 - b) To pay the premiums for insurance that covers only that liability, and
 - c) To pay the administrative and other incidental expenses of that trust (including legal, accounting, actuarial, and trustee expenses) in connection with the operation of the trust and processing of black lung

- claims against such person arising under federal or state statutes.
- 2) No part of its assets may be used for, or diverted to, any purposes other than—
 - a) The purposes described in (1), above,
 - b) Payments into the Black Lung Disability Trust Fund or into the general fund of the U.S. Treasury (other than in satisfaction of any tax or other civil or criminal liability of the person who established or contributed to the trust),
 - c) Investment in public debt securities of the U.S., obligations of a state or local government that are not in default as to principal or interest, or time or demand deposits in a bank or an insured credit union located in the U.S. (These investments are restricted to the extent that the trustee determines that a portion of the assets is not currently needed for the purposes described in (1), above), or
 - d) Accident and health benefits or insurance premiums and other administrative expenses for retired coal miners and their spouses. The amount of assets available for such use is generally limited to 110% of the present value of the liability for black lung benefits.

An annual information return is required of exempt trusts described in section 501(c)(21). Form 990-BL, *Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons*, must be used for this purpose. However, a trust that normally has gross receipts in each tax year of not more than \$25,000 is excepted from this filing requirement.

Excise taxes. If your organization makes any expenditures, payments, or investments other than those described earlier in this section, a tax equal to 10% of the amount of such expenditures is imposed on the trust. If there are any acts of self-dealing between the trust and a disqualified person, a tax equal to 10% of the amount involved is imposed on the disqualified person. Both of these excise taxes are reported on Schedule A (Form 990-BL). See the Form 990-BL instructions for more information on these taxes and what has to be filed, even if the trust is excepted from filing.

Tax treatment of donations. Contributions by a taxpayer (generally, the coal mine operator) to a black lung benefit trust are deductible for federal income tax purposes under section 192 of the Code. The deduction is limited, and any excess contributions are subject to an excise tax of 5%. Form 6069, *Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction*, is used to compute the allowable deduction and any excise tax liability. The form does not have to be filed if there is no excise tax liability. For more information about these contributions, see Form 6069 and its instructions.

501(c)(2)— Title Holding Corporations For Single Parents

If your organization wants to obtain recognition of exemption from federal income tax as a corporation organized to hold title to property, collect income from that property, and turn over the entire amount less expenses to a single parent organization that is exempt from income tax, it should file its application on Form 1024. The information to submit upon application is described in this section. For a discussion of the procedures for obtaining recognition of exemption, see chapter 1.

You must show that your organization is a corporation. If you are in doubt as to whether your organization qualifies as a corporation for this purpose, contact your District Director's office.

A title holding corporation will qualify for exemption only if there is effective ownership and control over it by the distributee exempt organization. For example, the distributee organization may control the title holding corporation by owning its voting stock or possessing the power to select nominees to hold its voting stock.

Corporate charter. The corporate charter that you submit upon application must confine the purposes and powers of your organization to holding title to property, collecting income from the property, and turning the income over to an exempt organization. If the charter authorizes your organization to engage in activities that go beyond these limits, its exemption may not be recognized even if its actual operations are so limited. If your organization's original charter does not limit its powers, you may amend the charter to conform to the required limits and submit evidence with your application that the charter has been so amended.

Payment of income. You must show that your corporation is required to turn over the entire income from the property, less expenses, to one or more exempt organizations.

Actual payment of the income is required. A mere obligation to use the income for the exempt organization's benefit, or the fact that such organization has control over the income does not satisfy this requirement.

Expenses. Expenses may reduce the amount of income required to be turned over to the tax-exempt organization for which your organization holds property. The term "expenses" (for this purpose) includes not only ordinary and necessary expenses paid or incurred, but also reasonable additions to depreciation reserves and other reserves that would be proper for a business corporation holding title to and maintaining property.

In addition, the title holding corporation may retain part of its income each year to apply to debt on property to which it holds title. This transaction is treated as if the income had been turned over to the exempt organization and the latter had used the income to make a contribution to the capital of the title holding corporation that in turn, applied the contribution to the debt.

Waiver of payment of income. Generally, there is no payment of rent when the occupant of property held by your title holding corporation is the exempt organization for which your corporation holds the title. In this situation, the statutory requirement that income be paid over to the exempt organization is satisfied if your corporation turns over whatever income is available.

Application for recognition of exemption. In addition to the information required by Form 1024, the title holding corporation must furnish evidence that the organization for which title is held has obtained recognition of exempt status. If that organization has not been specifically notified in writing by the IRS that it is exempt, the title holding corporation must submit the necessary application and supporting documents to enable the IRS to determine whether the organization for which title is held qualifies for exemption. A copy of a ruling or determination letter issued to the organization for which title is held will be proof that it qualifies for exemption. However, until the organization for which title is held obtains recognition of exempt status or proof is submitted to show that it qualifies, the title holding corporation cannot obtain recognition of exemption.

Tax treatment of donations. Donations to an exempt title holding corporation generally are not deductible as charitable contributions on the donor's federal income tax return.

501(c)(25)— Title Holding Corporations for Multiple Parents

If your organization wants to obtain recognition of exemption from federal income tax as an organization organized for the exclusive purpose of acquiring, holding title to, and collecting income from real property, and turning over the entire amount less expenses to member organizations exempt from income tax, it should file its application on Form 1024. For a discussion of the procedures for obtaining recognition of exemption, see chapter 1.

Who can control the organization. Organizations recognized as exempt under this section may have up to 35 shareholders or beneficiaries, in contrast to title-holding organizations recognized as exempt under IRC 501(c)(2), which may have only 1 controlling parent organization.

Organizational requirements. A 501(c)(25) organization must be either a corporation or a trust. Only one class of stock is permitted in the case of a corporation. In the case of a trust, only one class of beneficial interest is allowed.

Organizations eligible to acquire or hold interests in this type of title-holding organization are qualified pension, profit-sharing, or stock bonus plans, governmental plans, governments and their agencies and instrumentalities, and charitable organizations.

The articles of incorporation or trust instrument must include provisions showing

that the corporation or trust is organized to meet the requirements of the statute, including compliance with the limitations on membership and classes of stock or beneficial interest, and compliance with the income distribution requirements. The organizing document must permit the organization's shareholders or beneficiaries to dismiss the organization's investment advisor, if any, upon a vote of the shareholders or beneficiaries holding a majority interest in the organization.

The organizing document must permit the shareholders or beneficiaries to terminate their interests by at least one of the following methods:

- 1) By selling or exchanging their stock or beneficial interest to any organization described in IRC 501(c)(25)(C), provided that the sale does not cause the number of shareholders or beneficiaries to exceed 35, or
- 2) By having their stock or beneficial interest redeemed by the 501(c)(25) organization upon 90 days notice.

If state law prevents a corporation from including in its articles of incorporation the above provisions, such provisions must instead be included in the bylaws of the corporation.

A 501(c)(25) organization may be organized as a nonstock corporation if its articles of incorporation or bylaws provide members with the same rights as described above.

Subsidiaries. A wholly owned subsidiary will not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit will be treated as belonging to the section 501(c)(25) organization. Subsidiaries should not apply separately for recognition of exemption.

Tax treatment of donations. Donations to an exempt title holding corporation generally are not deductible as charitable contributions on the donor's federal income tax return.

Unrelated Business Income

In general, the receipt of unrelated business income by a section 501(c)(25) organization will subject the organization to loss of exempt status, since the organization cannot be exempt from taxation if it engages in any business other than that of holding title to *real property* and collecting the income from the property. However, exempt status will not be affected by the receipt of debt-financed income that is treated as unrelated business taxable income solely because of section 514.

Under section 514(c)(9), certain shareholders or beneficiaries are not subject to unrelated debt-financed income tax under section 514 on their investments through the organization. These shareholders are generally schools, colleges, universities, or supporting organizations of such educational institutions. Organizations other than these will take into account as gross income from an unrelated trade or business their pro-rata share of income that is treated as unrelated debt-financed income because section 514(c)(9) does not apply. These organizations will also take their pro-rata share of the allowable deductions from unrelated taxable income.

Real property. Real property can include personal property leased in connection with real property, but only if the rent from the personal property is not more than 15% of the total rent for both the real property and the personal property.

Real property acquired after June 10, 1987 cannot include any interest as a tenant in common (or similar interest) or any indirect interest.

501(c)(26)— State-Sponsored High-Risk Health Coverage Organizations

A state-sponsored organization established to provide medical care to high-risk individuals should apply by letter for recognition of exemption from federal income tax under section 501(c)(26).

To qualify for exemption, the organization must be a membership organization established by a state exclusively to provide coverage for medical care on a nonprofit basis to high-risk individuals who are state residents. It may provide coverage either by issuing insurance itself or by entering into an arrangement with a health maintenance organization (HMO).

The state must determine the composition of membership in the organization. No part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

High-risk individuals. These are individuals who, because of a pre-existing medical condition:

- 1) Cannot get medical care coverage for that condition through insurance or an HMO, or
- 2) Can get coverage for that condition only at a rate that is substantially higher than the rate for the same coverage from the state-sponsored organization.

501(c)(27)— State-Sponsored Worker's Compensation Reinsurance Organizations

A state-sponsored worker's compensation reinsurance organization should apply by letter for recognition of exemption from federal income tax under section 501(c)(27).

To qualify for exemption, the organization must meet all the following requirements.

- 1) It was established by a state before June 1, 1996, exclusively to reimburse its members for losses under worker's compensation acts.

- 2) The state requires that the membership consist of all persons who issue insurance covering worker's compensation losses in the state and all persons and government entities who self-insure against those losses.
- 3) It operates as a nonprofit organization by returning surplus income to its members or worker's compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

5.

How To Get More Information



You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library

or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services*. It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access To Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1-800-829-1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1-800-829-4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

Organization Reference Chart

| Section of 1986 Code | Description of organization | General nature of activities | Application Form No. | Annual return required to be filed | Contributions allowable |
|-------------------------|--|--|-------------------------|--|--|
| 501(c)(1) | Corporations Organized Under Act of Congress (including Federal Credit Unions) | Instrumentalities of the United States | No Form | None | Yes, if made for exclusively public purposes |
| 501(c)(2) | Title Holding Corporation For Exempt Organization | Holding title to property of an exempt organization | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(3) | Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition, or Prevention of Cruelty to Children or Animals Organizations | Activities of nature implied by description of class of organization | 1023 | 990 ¹ or 990EZ ⁸ , or 990-PF | Yes, generally |
| 501(c)(4) | Civic Leagues, Social Welfare Organizations, and Local Associations of Employees | Promotion of community welfare; charitable, educational or recreational | 1024 | 990 ¹ or 990EZ ⁸ | No, generally ^{2,3} |
| 501(c)(5) | Labor, Agricultural, and Horticultural Organizations | Educational or instructive, the purpose being to improve conditions of work, and to improve products and efficiency | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(6) | Business Leagues, Chambers of Commerce, Real Estate Boards, Etc. | Improvement of business conditions of one or more lines of business | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(7) | Social and Recreation Clubs | Pleasure, recreation, social activities | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(8) | Fraternal Beneficiary Societies and Associations | Lodge providing for payment of life, sickness, accident, or other benefits to members | 1024 | 990 ¹ or 990EZ ⁸ | Yes, if for certain Sec. 501(c)(3) purposes |
| 501(c)(9) | Voluntary Employees' Beneficiary Associations | Providing for payment of life, sickness, accident, or other benefits to members | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(10) | Domestic Fraternal Societies and Associations | Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members | 1024 | 990 ¹ or 990EZ ⁸ | Yes, if for certain Sec. 501(c)(3) purposes |
| 501(c)(11) | Teachers' Retirement Fund Associations | Teachers' association for payment of retirement benefits | No Form ⁶ | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(12) | Benevolent Life Insurance Associations, Mutual Ditch or Irrigation Companies, Mutual or Cooperative Telephone Companies, Etc. | Activities of a mutually beneficial nature similar to those implied by the description of class of organization | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(13) | Cemetery Companies | Burials and incidental activities | 1024 | 990 ¹ or 990EZ ⁸ | Yes, generally |
| 501(c)(14) | State Chartered Credit Unions, Mutual Reserve Funds | Loans to members | No Form ⁶ | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(15) | Mutual Insurance Companies or Associations | Providing insurance to members substantially at cost | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(16) | Cooperative Organizations to Finance Crop Operations | Financing crop operations in conjunction with activities of a marketing or purchasing association | No Form ⁶ | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(17) | Supplemental Unemployment Benefit Trusts | Provides for payment of supplemental unemployment compensation benefits | 1024 | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(18) | Employee Funded Pension Trust (created before June 25, 1959) | Payment of benefits under a pension plan funded by employees | No Form ⁶ | 990 ¹ or 990EZ ⁸ | No ² |
| 501(c)(19) | Post or Organization of Past or Present Members of the Armed Forces | Activities implied by nature of organization | 1024 | 990 ¹ or 990EZ ⁸ | Yes, generally ⁷ |
| 501(c)(21) | Black Lung Benefit Trusts | Funded by coal mine operators to satisfy their liability for disability or death due to black lung diseases | No Form ⁶ | 990-BL | No ⁴ |
| 501(c)(22) | Withdrawal Liability Payment Fund | To provide funds to meet the liability of employers withdrawing from a multi-employer pension fund | No Form ⁶ | 990 or 990EZ ⁸ | No ⁵ |
| 501(c)(23) | Veterans Organization (created before 1880) | To provide insurance and other benefits to veterans | No Form ⁶ | 990 or 990EZ ⁸ | Yes, generally ⁷ |
| 501(c)(25) | Title Holding Corporations or Trusts with Multiple Parents | Holding title and paying over income from property to 35 or fewer parents or beneficiaries | 1024 | 990 or 990EZ | No |
| 501(c)(26) | State-Sponsored Organization Providing Health Coverage for High-Risk Individuals | Provides health care coverage to high-risk individuals | No Form ⁶ | 990 ¹ or 990EZ ⁸ | No |
| 501(c)(27) | State-Sponsored Workers' Compensation Reinsurance Organization | Reimburses members for losses under workers' compensation acts | No Form ⁶ | 990 ¹ or 990EZ ⁸ | No |
| 501(d) | Religious and Apostolic Associations | Regular business activities. Communal religious community | No Form | 1065 ⁹ | No ² |
| 501(e) | Cooperative Hospital Service Organizations | Performs cooperative services for hospitals | 1023 | 990 ¹ or 990EZ ⁸ | Yes |
| 501(f) | Cooperative Service Organizations of Operating Educational Organizations | Performs collective investment services for educational organizations | 1023 | 990 ¹ or 990EZ ⁸ | Yes |
| 501(k) | Child Care Organization | Provides care for children | 1023 | 990 or 990EZ ⁸ | Yes |
| 501(n) | Charitable Risk Pools | Pools certain insurance risks of 501(c)(3) organizations | 1023 | 990 ¹ or 990EZ ⁸ | Yes |
| 521(a) | Farmers' Cooperative Associations | Cooperative marketing and purchasing for agricultural producers | 1028 | 990-C | No |

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

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

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

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

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

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

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

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

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

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