Continuing Professional Education

# Exempt Organizations

## Technical Instruction Program for FY 1997

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Midstates Region
Western Region
Southeast Region
Los Angeles
Dallas
Brooklyn
Baltimore

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This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

# PREFACE

This is the twentieth edition of the Exempt Organizations Continuing Professional Education (CPE) Program. As in previous years, the topics have been selected because of their relevance in light of recent developments or because we think a review of the subject would be beneficial.

The text consists of two parts. Part I contains 19 essays on technical topics and Part II, Current Developments, recaps the technical developments since June 1995, including a discussion on Taxpayer Bill of Rights 2. The Cumulative Index, at the end of the book, has been updated to include references to this year's material, including a listing of current revenue procedures.

The material in this book is for educational use only. The general counsel memoranda and private letter rulings are cited for illustrative purposes and cannot be used or cited as precedent.

We view our CPE program as an important tool for maintaining the highest possible level of currency and technical competence among our EO specialists, and I believe you will find this year's curriculum useful in carrying out your EO responsibilities.

Marcus S. Owens
Director, Exempt Organizations Division

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# PART I

## EXEMPT ORGANIZATIONS TECHNICAL TOPICS

### A. UPDATE ON STATE INSTITUTIONS - INSTRUMENTALITIES

by
Joseph O'Malley and Marvin Friedlander

1. Introduction

Organizations such as state colleges, fire departments, libraries, school districts, hospital districts, soil and water conservation districts, port authorities, and Indian related entities, are some examples of organizations that may be created by, controlled by, or closely affiliated with governments. Many of these organizations file applications for exemption. For the purposes of this article, these government affiliated organizations will be referred to as instrumentalities.

IRM 7664.31(2) has been revised so exemption applications filed by instrumentalities are now being processed by the Key District Offices. Only those applications submitted by instrumentalities where an adverse determination is contemplated are referred to Headquarters.

Specific information on handling instrumentality exemption applications can be found in IRM 7751-34(12), Exempt Organizations Handbook, the 1990 CPE text under the heading of Instrumentalities, and the 1996 CPE text under the heading of State Institutions-Instrumentalities. Basically, if an instrumentality is a separately organized entity, not an integral part of a state or municipal government, and does not possess a disqualifying regulatory or enforcement power, we can recognize it as exempt from federal income tax under IRC 501(a) as an organization described in IRC 501(c)(3).

There have been a few recent developments dealing with instrumentalities that require the referenced materials to be updated. That is the purpose of this article. We are also updating IRM 7751-34(12).

2. Recent Developments

A. Power of Taxation - The 1996 CPE article stated that Headquarters was considering several cases involving the power of taxation, including how to distinguish a power to merely recommend a tax rate from the power to levy, assess or impose taxes, and that additional guidance would be provided in this area.

At issue is whether there is a difference between a power to recommend or certify a tax rate and a power to levy, assess, or impose a tax in terms of the latter powers being disqualifying for purposes of being considered an organization with purposes limited to those within IRC 501(c)(3). Rev. Rul. 74-15, 1974-1 C.B. 126, held that it is okay to certify or determine a tax rate. We have concluded that there is no distinction between the power to recommend or certify a tax rate, the power to determine a tax rate, and the power to levy, assess, or impose a tax, but that the regulatory or enforcement power lies with the power to collect. Thus, if an organization has the power to collect the tax, it will be disqualified from being recognized as exempt.

B. Rev. Proc. 95-48, 1995-47 I.R.B. 13 - One of the requirements for an organization that is recognized as exempt from federal income tax is the requirement to file an annual information return on Form 990, Return of Organization Exempt From Income Tax. Rev. Proc. 95-48, published in November, 1995, relieves most instrumentalities of that filing requirement. This revenue procedure supplements Rev. Proc. 83-23, 1983-1 C.B. 687, and specifies two additional classes of organizations that are not required to file the annual information return. These two classes are (1) governmental units, and (2) affiliates of governmental units that are exempt from federal income tax under IRC 501(a).

The majority of cases under this revenue procedure will involve "affiliates of governmental units." For most of these organizations to be treated as an "affiliate of a governmental unit" and be excepted from filing the annual information return on Form 990, the following two requirements must be satisfied:

First, the organization must be controlled by a governmental unit. This means that a governmental unit (or a public official acting in his official capacity) must appoint the majority of the members of the organization's governing body. A governing body elected by the public also satisfies this requirement. For purposes of this control test, a governmental unit is a state, a possession of the United States, or a political subdivision of one of them; the

United States; the District of Columbia; or a federally recognized Indian tribal government. Indirect control also satisfies this requirement. Thus, an organization controlled by an organization that is itself a qualifying "affiliate of a governmental unit" under the revenue procedure also qualifies.

Second, the organization must satisfy two of the five affiliation factors listed in the revenue procedure indicating actual oversight of its financial affairs and activities by the governmental unit.

At the time it files its application for recognition of exemption under IRC 501(a), an organization may request a determination that it meets the requirements to be excepted from filing Form 990.

An organization that has been recognized as exempt under IRC 501(a) may (but is not required to) request a ruling or determination that it meets the requirements to be excepted from filing Form 990. Requests to be excepted from filing Form 990 that are processed by Headquarters require a $200.00 user fee. Requests to be excepted from filing Form 990 that are processed by the Key District Offices currently require no fee. See Rev. Proc. 96-8, 1996-1 I.R.B. 187 (or its successor).

3. Closing Remarks

The materials on instrumentalities referred to in this update contain adequate information for handling most instrumentality exemption applications. As stated previously, except for cases where an adverse determination is contemplated, these exemption applications are now being processed by the Key District Offices. For those adverse cases referred to Headquarters that present unique issues, further guidance will be developed as needed.

## B. PUBLICITY AND DISCLOSURE OF FORM 990

by
John Roman Faron and David Flavin

### 1. Introduction - Who Must File

With some exceptions, exempt organizations, private foundations, and IRC 4947 trusts must file annual returns. IRC 6033(a) provides that, in general,

> ***...every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe....***

Generally, for years beginning after December 31, 1969, organizations exempt from tax under IRC 501(a) (other than organizations described in IRC 401(a) or 501(d)), that are not specifically excepted from filing are required by Regs. 1.6033-2 (a)(2) to file an annual return on Form 990, Return of Organization Exempt From Income Tax. Any non-exempt charitable trust described in IRC 4947(a)(1) which is not treated as a private foundation and meets the gross receipts threshold is also required to file Form 990.

For years beginning after December 31, 1972, organizations that have private foundation status under IRC 509(a) are required by Regs. 1.6033-2(a)(2) to file an annual return on Form 990-PF, Return of Private Foundation (for prior years, such organizations filed Form 990). Nonexempt charitable trusts described in IRC 4947(a)(1) that are treated as private foundations must also file Form 990-PF. IRC 6033(d)(2) requires an annual return on Form 990-PF by private foundations that are not exempt from tax under IRC 501(a).

IRC 6033(a)(2)(B) provides for discretionary exceptions from filing information returns where the Secretary "determines such filing is not necessary to the efficient administration of the internal revenue laws." Regs. 1.6033-2(g)(6) of the Income Tax Regulations delegates authority to the Commissioner to excuse organizations from the filing requirement. Regs. 1.6033-2(g)(1) provides a list of organizations that are not required to file annual returns either because they are excepted by statute or because the Commissioner has exercised the authority delegated by the regulations.

Rev. Proc. 83-23, 1983-1 C.B. 687, also contains a list of those organizations exempt under IRC 501(a) that are not required to file an annual information return. Rev. Proc. 83-23 has been supplemented by Rev. Proc. 86-23, 1986-1 C.B. 564, which establishes an additional class of organizations, affiliated with a church or convention of churches and exempt under IRC 501(c)(3), which are not required to file an annual return, Rev. Proc. 94-17, 1994-1 C.B. 457, which relieves certain foreign organizations (other than private foundations) from the requirement to file an annual return and Rev. Proc. 95-48, 1995-47 I.R.B. 13, which specifies two additional classes of organizations, governmental units and affiliates of governmental units, that are not required to file annual information returns on Form 990.

2. IRC 6103 - Confidentiality and Disclosure of Returns and Return Information

IRC 6103 provides that returns and return information are confidential information and, unless otherwise specifically authorized by the Code, may not be disclosed. IRC 6103(b)(1) defines the term "return" to mean "any tax or information return...filed with the Secretary by, on behalf of, or with respect to any person, and any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed."

IRC 6103(b)(2) defines the term "return information" to include

> ***...a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax with-held, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or the offense....***

The annual returns required to be filed by exempt organizations clearly fit within the definition of a "return" under IRC 6103(b)(1) and the information required to be provided on those annual returns constitutes "return information" as defined in IRC 6103(b)(2).

As a result, in the absence of disclosure authorization under a specific section of the Code, tax returns and tax return information of organizations exempt from tax under IRC 501 are confidential. The specific exception to the non-disclosure rule of IRC 6103 for returns required to be filed and return information required to be furnished by organizations exempt from tax under IRC 501(a) is provided by IRC 6104.

3. IRC 6104 - Publicity of Information Required From Certain Exempt Organizations and Certain Trusts

IRC 6104 authorizes the public disclosure of information furnished on annual returns filed under IRC 6033. Public disclosure is required to be made by the Internal Revenue Service, under IRC 6104(b), by private foundations, under IRC 6104(d), and, under 6104(e), by organizations described in subsections (c) or (d) of IRC 501, that are not private foundations.

The intent of Congress in allowing for the public inspection of exempt organization information was to enable the public to scrutinize the activities of these organizations and trusts. Congress intended that these organizations and trusts be subject to a certain degree of public accountability in view of their privileged tax status and because the public has a right to know for what purposes their contributions are being or will be used.

Publicity of exempt organization information is discussed in several parts of the Internal Revenue Manual. IRM 1272, Disclosure of Official Information Handbook, discusses the provisions of law governing disclosure of tax information. IRM 1272-900, Exempt Organization Information, provides rules and procedures for disclosing material under IRC 6104, as does Chapter 49(00) of IRM 7751, Exempt Organizations Handbook. IRM 7(16)00, Publicity and Limitations of EP/EO Material, provides specific procedures for disclosing Exempt Organization information. IRM 7(10)90 discusses penalty procedures with regard to filing and publicity of exempt organization returns.

A. Public Disclosure Under IRC 6104(b) - Inspection of Annual Information Returns

For returns filed after December 31, 1969, IRC 6104(b) provides, in part, that "...[t]he information required to be furnished by sections 6033, 6034 and 6058, together with the names and addresses of such organizations and trusts, shall be made available to the public at such times and in such places as the Secretary may prescribe." Prior to January 1, 1970, only information furnished on Part II of Forms 990-A, filed pursuant to IRC 6033(b) by certain exempt organizations, and on Forms 1041-A, filed pursuant to IRC 6034 by trusts

claiming charitable, etc., deductions under IRC 642(c), was required to be made available for public inspection. This information is still available upon request to the extent that it has not been destroyed in accordance with the Service's records retention schedule.

IRM 1272-900 lists the following documents which are to be made available for public inspection in accordance with IRC 6104(b):

(1) Form 990, Return of Organization Exempt from Income Tax, Form 990-EZ, Short Form Return of Organization Exempt From Income Tax, and attachments which are required to be filed with the Service, except for the names and addresses of contributors. The amounts of contributions and bequests are also disclosed unless such amounts could reasonably be expected to identify any contributor.

(2) Form 990-PF, Return of Private Foundation (under Section 501(c)(3)), or Section 4947(a)(1) Trust Treated as a Private Foundation and attachments required to be filed.

(3) Form 1041-A, U.S. Information Return -- Trust Accumulation of Charitable Amounts.

(4) Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code, filed by foundations. (Note: Forms 4720 filed by individuals are not subject to the disclosure provisions of IRC 6104.)

(5) Form 5578, Annual Certification of Racial Nondiscrimination for a Private School Exempt from Federal Income Tax.

(6) Form 5768, Election/Revocation of Election by an Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation.

IRM 1272-900 lists the following documents which are not to be disclosed except as provided by IRC 6103:

(1) Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code, filed after 12-31-76, by individuals. (Note: Forms 4720 filed by foundations are subject to disclosure under IRC 6104.)

(2) Form 990-C, Farmer's Cooperative Association Income Tax Return.

(3) Form 990-T, Exempt Organization Business Income Tax Return.

(4) Form 5227, Split-Interest Trust Information Return.

Under Regs. 1.6033-2(a)(2)(ii) the information generally required to be furnished by an exempt organization and, therefore, the information which is subject to public inspection is:

(1) Gross income for the year (other than contributions, gifts, grants, and similar amounts received);

(2) Dues and assessments from members and affiliates for the year;

(3) Expenses incurred within the year;

(4) Disbursements made within the year for the purposes for which it is exempt;

(5) A balance sheet showing its assets, liabilities, and net worth as of the beginning and end of such year.

(6) The total of the contributions, gifts, grants and similar amounts received by it during the taxable year, and the names and addresses of all persons who contributed, bequeathed, or devised $5,000 or more (in money or other property) during the taxable year. In the case of a private foundation, the names and addresses of all persons who became substantial contributors (as defined in IRC 507(d)(2)) during the taxable year shall be furnished. In addition, for its first taxable year beginning after December 31, 1969, each private foundation was required to furnish the names and addresses of all persons who became substantial contributors before such taxable year.

(7) The names and addresses of all officers, directors, or trustees (or any person having responsibilities or powers similar to those of officers, directors, or trustees) of the organization, and, in the case of a private foundation, all persons who are foundation managers, within the meaning of IRC 4946(b)(1). Organizations described in IRC 501(c)(3) must also attach a schedule showing the names and addresses of the five employees (if any) who received the greatest amount of annual compensation in excess of $30,000; the total number of other employees who received annual compensation in excess of $30,000; the names and addresses of the five independent contractors (if any) who performed personal services of a professional nature for the organization (such as attorneys, accountants, and doctors, whether such services are performed by such persons in their individual capacity or as employees of a professional service corporation) and who received the greatest amount of compensation in excess of $30,000 from the organization for the year for the performance of such services; and the total number of other such independent contractors who received in excess of $30,000 for the year for the performance of such services.

(8) A schedule showing the compensation and other payments made during the organization's annual accounting period (or during the calendar year ending within such period) that are includible in the gross income of each individual whose name is required to be listed.

(9) In the case of a private foundation liable for tax imposed under Chapter 42, such information as is required by Form 4720.

(10) Its lobbying expenditures, grass roots expenditures, exempt purpose expenditures, lobbying nontaxable amount, and grass roots nontaxable amount for the taxable year and for prior taxable years that are base years (within the meaning of Regs. 1.501(h)-3(c)(7)).

Under IRC 6033(e)(1)(A)(i) and Rev. Proc. 95-35, 1995-32 I.R.B. 51, social welfare organizations described in IRC 501(c)(4) (other than veterans organizations), agricultural and horticultural organizations described in IRC 501(c)(5), and organizations described in IRC 501(c)(6) are required to include on their annual returns information setting forth the total expenditures of the organization to which IRC 162(e)(1) applies and the total amount of the dues or similar amounts paid to the organization to which such expenditures are allocable. IRC 162(e)(1) applies to amounts paid or incurred in connection with (1) influencing legislation, (2) participating in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, (3) any attempt to influence the general public with respect to elections, legislative matters, or referendum, or (4) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official. Since this information is part of the organization's return it would be subject to public inspection under IRC 6104(b). Under IRC 6033(e)(1)(A)(ii), the above organizations are required to provide notice to their dues paying members which contains a reasonable estimate of the portion of the member's dues to which the organization's lobbying and political expenditures are allocable. Since the notice required to be provided under IRC 6033(e)(1)(A)(ii) is not required to be filed as part of the return, that information would not be subject to public inspection.

Certain information normally contained on Form 990, or on attachments thereto, is, by statute or regulation, not disclosable under IRC 6104. IRC 6104(b) exempts the names and addresses of contributors to an organization other than a private foundation from public inspection. Regs. 301.6104(b)-1(b)(3) also mandates that the names, addresses, and amounts of contributions or bequests to a foreign organization described in IRC 4948(b)by persons who are not citizens of the United States are not to be made available for public inspection under section 6104(b).

Under Regs. 301.6104(b)-1(b)(2) the amounts of contributions and bequests to an organization are to be made available for public inspection unless the disclosure of such information can reasonably be expected to identify any contributor. However, the amounts of contributions and bequests to a private foundation, as well as the identities of the contributors and bequeathers, are always to be made available for public inspection. The exemption from public inspection provided by Regs. 301.6104(a)-5 for trade secrets, patents, processes, styles of work, or apparatuses appearing on an application for tax exemption, has no counterpart in Regs. 301.6104(b), and such information, to the extent it appears on an annual return, is available for public inspection.

Under Regs. 301.6104(b)-1(c) information furnished on an exempt organization's annual return is to be made available for public inspection at the IRS National Office and at the office of any district director. Requests for information must be in writing. Oral requests will not be honored. Form 4506-A can be used to request a copy or to inspect an exempt organization return. The request should be sent to the District Director (Attention: Disclosure Office) of the district in which the person making the request wishes to inspect the return. If the person making the request wants to inspect the return at the National Office, the request should be sent to the Commissioner of Internal Revenue, Attention: Freedom of Information Reading Room, 1111 Constitution Avenue, NW, Washington, D.C. 20224.

The written request must include the following information:

(1) The name and address of the organization (city and state);

(2) The type of return;

(3) The year(s) involved.

Under Regs. 301.6104(b)-1(d)(2) a person making a proper request for information will be notified by the Service when the material will be available for inspection. Information will be made available for inspection at reasonable and proper times, and under conditions that will not interfere with its use by the Service and will not exclude other persons from inspecting it. In addition, the Commissioner, Director of the Service Center, or District Director may limit the number of returns to be made available to any person for inspection on a given date. Inspection will be allowed only in the presence of an Internal Revenue officer or employee and only during the regular hours of business of the Internal Revenue Service office.

The Assistant Commissioner (Examination) (CP:EX), has overall responsibility for disclosure of tax information through the Office of Disclosure. That office would normally handle most disclosures of exempt organization tax information under IRC 6103 and 6104. Chapter 700, Reading Room Operations, of IRM 1272 outlines the procedures for disclosing IRC 6104 information. It also discusses the responsibilities different offices - Taxpayer Service, Employee Plans and Exempt Organizations, Public Affairs - have with respect to IRC 6104 disclosure. Because the Office of Disclosure has primary responsibility for disclosing tax information, any IRC 6104 disclosure problem not clearly covered under IRC 6104, the regulations, or IRM 1272 should be referred to that office.

B. Public Disclosure Under IRC 6104(d) - Private Foundations

IRC 6104(d) requires that Form 990-PF be made available by foundation managers for inspection at the principal office of the foundation during regular business hours by any citizen on request made within 180 days after the date of publication of its availability. A "notice of availability" of the annual return must be published not later than the date required for filing the annual return, in a newspaper having general circulation in the county in which the principal office of the foundation is located. The term "newspaper having general circulation" in section 6104(d) includes any newspaper or journal which is permitted to publish statements in satisfaction of State statutory requirements relating to transfers of title to real estate or other similar legal notices. The notice must state that the annual return is available at the principal office of the foundation for inspection during regular business hours by any citizen who requests it within 180 days after the date of such publication. It must also show the address of the foundation's principal office, the name of its principal manager, and, since January 1, 1985, the telephone number of the foundation's principal office.

IRC 6033(c)(2) provides that a copy of the notice required by IRC 6104(d), together with proof of publication, be filed by the foundation with the annual Form 990-PF. A copy of the notice as published, and a statement signed by a foundation manager stating that the notice was published, setting forth the date of publication and the publication in which it appeared, is sufficient proof.

In addition to making the returns publicly available, under Regs. 1.6033-3(c)(1) the foundation manager must furnish a copy of the annual return and Form 4720, if any, to the Attorney General of (a) each state which the foundation is required to list on its return pursuant to Regs. 1.6033-2(a)(2)(iv), (b) the state in which the principal office of the foundation is located, and (c) the state in which the foundation was incorporated or created. Additionally, the foundation manager must also furnish copies to the Attorney General or appropriate state

officer (within the meaning of IRC 6104(c)(2)) of any state who requests them. Copies to the state officials must be mailed at the same time the returns are sent to the Service.

For tax years beginning after December 31, 1980, IRC 4947(a)(1) trusts treated as private foundations are also subject to the public inspection and notice provisions of IRC 6104(d).

C. Public Disclosure Under IRC 6104(e) - Organizations Exempt Under IRC 501 (c) and (d) Other Than Private Foundations

Section 10702 of the Omnibus Budget Reconciliation Act of 1987, P.L. 100-203, 12/22/87, added IRC 6104(e), which requires all exempt organizations except for private foundations, which are covered by IRC 6104(d), to make a copy of their annual Form 990 available for public inspection. The organization must make its return available during the three year period beginning on the filing date of the return. The filing date for this purpose is the last day prescribed for filing the return including any extension of time granted.

The requirements for the content of the required disclosure and the method of inspection are set forth in Notice 88-120, 1988-2 C.B. 454. The organization must make available an exact copy of the original Form 990 and all schedules and attachments filed with the Internal Revenue Service, except for the names and addresses of contributors to the organization. The required disclosure includes, for example, Schedule A of Form 990, containing supplementary information on section 501(c)(3) organizations, the compensation of specific individuals required in Part VI of Form 990 and Parts I and II of Schedule A, and any attachments and amendments. The required disclosure does not include Form 990-T, Exempt Organization Business Income Tax Return, relating to unrelated business income tax, or Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations, relating to taxes on political organizations.

A copy of the annual information return must be made available for public inspection at the organization's principal office. If the organization regularly maintains one or more regional or district offices having three or more full time employees serving as management staff (or part-time employees whose total number of paid hours per week is at least 120), a copy of the return must also be made available at each regional or district office. If the organization does not maintain a permanent office and receives a request to inspect its annual returns, it must provide the person making the request an opportunity to inspect the material at a reasonable location of the organization's choice. At the organization's option, it may mail the information to the requester in lieu of an inspection.

Generally, the required information should be available during the normal business hours of the organization's office on the day of the request for inspection. In exceptional circumstances where an organization has no office, or where the office has limited hours during certain times of the year, the required information should be made available within a reasonable amount of time (normally not more than 2 weeks) and at a reasonable time of day.

An organization is not required to provide or distribute a photocopy of its annual returns, but must have on hand a copy available for inspection. The organization may have an employee present in the room during the inspection, but must allow the person making inspection to take notes freely during the inspection or, if the requester prefers, must allow the requester to photocopy the document on the requester's own photocopying equipment within reasonable constraints of time and place. If the organization does not object to making a photocopy, the organization may charge up to the per page copying charge stated in section 601.702(f)(5)(iv)(B) of the Internal Revenue Service's Statement of Procedural Rules, as well as postage if the copy is mailed.

Individuals who request inspection of an information return at the organization's office and are denied access to the return or any of the information required to be disclosed, should bring this to the attention of the appropriate key district director. The requester should provide, in writing, the name of the person who refused to provide the information and the date on which the refusal occurred. The key district office should attempt to get the organization to comply with the requirements of IRC 6104(e) before imposing the penalties for failure to comply.

4. Penalties for Failure to Make Returns Public

IRC 6652(c)(1)(C) provides that the person who fails to meet the requirements of IRC 6104(d) or (e)(1) relating to public inspection of Forms 990 and 990-PF, must pay a penalty of $10 per day as long as the failure continues. The maximum penalty on all persons for failures with respect to any one return shall not exceed $5,000. No penalty will be imposed if the failure is due to reasonable cause.

A willful failure to permit public inspection of annual returns will result in an additional penalty of $1,000 per return under the provisions of IRC 6685. For taxable years beginning after December 31, 1986, IRC 6685 applies to the annual returns of all exempt organizations. For taxable years beginning before January 1, 1987, IRC 6685 applied only to annual returns of private foundations. If more than one person has a duty, all persons who fail to comply are jointly and severally liable for the penalties. More information on penalties can be found in IRM 7(10)92.2.

5. Current Developments

The Taxpayer Bill Of Rights 2, P.L. 104-168, 110 Stat. 1452, signed by the President on July 30, 1996, adds additional filing and public disclosure rules.

The Act extends the present-law IRC 501(c)(3) private inurement prohibition to nonprofit organizations described in IRC 501(c)(4) and provides for certain intermediate sanctions that could be imposed when nonprofit organizations described in IRC 501(c)(3) ot 501(c)(4) engage in transactions, termed "excess benefit transactions", with certain insiders, called "disqualified persons", that result in private inurement. The Act amends IRC 6033 (b) to require tax exempt organizations described in IRC 501(c)(3) and 501(c)(4) to disclose on their Form 990 the amount of the taxes paid by the organization, or any disqualified person with respect to the organization, during the taxable year as a result of an "excess benefit transaction" and such additional information as the Secretary may prescribe regarding excess benefit transactions and regarding disqualified persons. In addition, exempt organizations described in IRC 501(c)(3) will be required to disclose on their Form 990 any other excise tax penalties paid during the year under present-law sections 4911 (excess lobbying expenditures), 4912 (disqualifying lobbying expenditures), or 4955 (political expenditures), including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved.

The Act also provides that, unless relief is granted, a tax-exempt organization that is subject to the public inspection rules of present-law section 6104(e)(1) will be required to supply copies of their annual return without charge, other than a reasonable fee for reproduction and mailing costs, for any of the organization's three most recent taxable years. In addition, the penalty imposed under IRC 6685 on tax-exempt organizations that willfully fail to allow public inspection of their annual returns (or applications for exemption) is increased.

## C. TAX-EXEMPT HEALTH CARE ORGANIZATIONS COMMUNITY BOARD AND CONFLICTS OF INTEREST POLICY

by
Lawrence M. Brauer and Charles F. Kaiser

1. Overview

A. Introduction

Tax-exempt health care organizations that engage in business dealings with members of their boards run a serious risk of violating the inurement prohibition and private benefit restriction of IRC 501(c)(3). Service experience has shown the potential for abuse to be especially acute when affiliated physicians comprise a substantial part of the board of a health care organization when that health care organization is part of an integrated delivery system (IDS) that purchased for-profit entities controlled by those physicians. To ensure that those organizations would operate for public, rather than private interests, the Service developed the "20 percent safe harbor" guideline. This guideline allowed the Service to recognize health care organizations that were part of an integrated delivery system (IDS) as exempt under IRC 501(c)(3) if physicians affiliated with the organization comprised no more than 20 percent of its board of trustees. (Throughout this article the term "trustee" includes members of a board of directors.)

Failure to meet the 20 percent safe harbor does not preclude exemption. In lieu of the safe harbor, an organization may show other facts and circumstances that balance the roles of physicians or other interested parties to insure the organization operates for exclusively public purposes. In general, a health care organization should show that its board broadly represents the community and that the majority of its members are independent of the organization; that the board has adopted and operates under a conflicts of interest policy; and that all components of the organization conduct periodic activity reviews to ensure the organization operates in a charitable manner.

Collectively, the facts and circumstances are referred to as the "Community Board and Conflicts of Interest Policy." This article describes the particular elements needed to make a successful showing that a health care organization operates according to the policy. It supplements articles on IDS's and health care in the 1994, 1995, and 1996 CPE texts.

B. Background

IRC 501(c)(3) provides exemption for organizations organized and operated exclusively for charitable purposes, where no part of the net earnings inures to the benefit of any private shareholder or individual. An organization cannot be organized or operated exclusively for charitable purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of IRC 501(c)(3), an organization must establish that it is not organized or operated for the benefit of private interests. Reg. 1.501(c)(3)-1(d)(1)(ii).

Promotion of health is considered a charitable purpose in the general law of charity. Thus, a health care organization may qualify as organized and operated in furtherance of charitable purposes if it is operated to benefit the community as a whole rather than private individuals or interests. Rev. Rul. 69-545, 1969-2 C.B. 117, establishes a community benefit standard that focuses on a number of factors to determine whether a hospital operates to benefit the community as a whole rather than private interests. In this revenue ruling, control of a tax-exempt hospital by a board of trustees composed of "independent civic leaders" was a significant fact.

The application of the community benefit standard of Rev. Rul. 69-545, supra, to exempt hospitals and other exempt health care organizations was sustained in Eastern Kentucky Welfare Rights Org. v. Simon, 506 F.2d 1278 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26 (1975), and in Sound Health Association, 71 T.C. 158 (1978), acq., 1981-2 C.B. 2.

2. Community Board

A community board is one in which independent persons representative of the community comprise a majority. Practicing physicians affiliated with the hospital, officers, department heads, and other employees of the hospital are not independent due to their close and continuing connection with the hospital. They may serve on the hospital's board of trustees, but cannot comprise a majority. Other persons who may have some business dealings with the hospital are usually included in the majority. Nevertheless, the entire board of trustees is subject to the conflicts of interest policy.

3. Conflicts of Interest

The purpose of a conflicts of interest policy is to protect the exempt organization's interest in transactions or arrangements that may also benefit an officer's or director's private interest. The primary benefit of a conflicts of

interest policy is that the board can make decisions in an objective manner without undue influence by persons with a private interest. The presence and enforcement of a conflicts of interest policy can also help assure that an exempt health care organization fulfills its charitable purposes, properly oversees the activities of its directors and principal officers, and pays no more than reasonable compensation to physicians and other highly compensated employees. In this latter regard, see Rev. Rul. 69-383, 1969-2 C.B. 113. Maintaining adequate books and records, as generally required by IRC 6001 and Reg. 1.6100-1(c), helps to ensure that the exempt health care organization operates in accordance with its commitment to the conflicts of interest policy.

4. Application

The Service will generally apply the Community Board and Conflicts of Interest Policy when considering applications for recognition of exemption from hospitals and other health care organizations that are part of a multi-entity hospital system. The Service will also generally apply this Community Board and Conflicts of Interests Policy to requests for private letter rulings from exempt health care organizations that have the 20 percent safe harbor expressly stated in their determination or ruling letters. For an existing exempt health care organization, the Service will consider its historic development and record of significant charitable operations to determine if it requires an independent community board. Where facts and circumstances, such as a long history of substantial community service and the absence of inurement or private benefit, provide assurance that the community benefit standard is satisfied, the community board standard may not be required. On the other hand, the Service will consider whether the 20 percent safe harbor guideline should be applied in situations where an existing exempt health care organization has a record of problems with its charitable operations or a history of inurement or private benefit. In any event, the organization should adopt a substantial conflicts of interest policy.

The Community Board and Conflicts of Interest Policy may provide guidance to examining agents in evaluating the facts of a particular case. For example, if an examining agent is concerned about the existence of excessive private benefit, the required records and periodic reviews may provide a valuable source of information. Agents may also find the Community Board and Conflicts of Interest Policy useful as a guide for considering how an exempt health care organization, in danger of having its exemption revoked, may be rehabilitated. For example, an agent may consider recommending that the organization adopt a more stringent conflicts of interest policy that incorporates a community board standard with a strict quorum requirement.

The Community Board and Conflicts of Interest Policy that follows incorporates facts and circumstances that the Service considers significant for exemption. We are also providing a sample conflicts of interest policy that may be adopted in an organization's bylaws or as a resolution of an organization's board of trustees.

## COMMUNITY BOARD AND CONFLICTS OF INTEREST POLICY

I. Community Board

A majority of the voting members of the board of trustees of a hospital should be comprised of independent community members. This means that practicing physicians affiliated with a hospital, as well as officers, department heads and other employees of the hospital, cannot constitute a majority of the board. In a multi-entity hospital system, the board of a subsidiary non-profit health care organization is considered to be comprised of independent community members if it is controlled by an exempt organization whose board is comprised of a majority of voting members who are independent community members.

II. Conflicts of Interest Policy

One significant fact that will help demonstrate that a tax-exempt health care organization promotes the health of the community as a whole, rather than to benefit private interests, is the organization's adoption of a substantial conflicts of interest policy. All exempt organizations in a hospital system should adopt the conflicts of interest policy. The policy should apply to any transaction or arrangement with an "interested person." An "interested person" is a trustee or director, a principal officer, or a member of a committee with board-delegated powers who has a direct or indirect "financial interest," as defined in Section IV.

An interested person who has a financial interest in one or more organizations within the hospital system will be considered to have a financial interest in all related organizations within the system.

A substantial conflicts of interest policy should include the following provisions:

A. Disclosure by interested persons of financial interests and all material facts relating thereto.

B. Procedures for determining whether the financial interest of the interested person may result in a conflict of interest.

C. Procedures for addressing the conflict of interest after determining that there is a conflict:

1. Requiring that the interested person leave the meeting during the discussion of, and the vote on, the transaction or arrangement that results in the conflict of interest;

2. Appointing, if appropriate, a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement;

3. Determining, by a majority vote of the disinterested trustees present, that the transaction or arrangement is in the organization's best interests and for its own benefit; is fair and reasonable to the organization; and, after exercising due diligence, determining that the organization cannot obtain a more advantageous transaction or arrangement with reasonable efforts under the circumstances; and

4. Taking appropriate disciplinary and corrective action with respect to an interested person who violates the conflicts of interest policy.

D. Procedures for adequate record keeping. The minutes of the board meetings and all committees with board-delegated powers should include:

1. The names of the persons who disclosed financial interests, the nature of the financial interests, and whether the board determined there was a conflict of interest; and

2. The names of all persons present for discussions or votes relating to the transaction or arrangement; the content of these discussions, including any alternatives to the proposed transaction or arrangement; and a record of the vote.

E. Procedures ensuring that the policy is distributed to all trustees, principal officers and members of committees with board-delegated powers. Each such person should sign an annual statement that he or she:

1. Received a copy of the conflicts of interest policy;

2. Has read and understands the policy;

3. Agrees to comply with the policy;

4. Understands that the policy applies to all committees and subcommittees having board-delegated powers; and

5. Understands that the organization is a charitable organization that must engage primarily in activities that accomplish one or more of its tax-exempt purposes to maintain its tax-exempt status.

F. Procedures for applying the policy to a compensation committee should include:

1. Restrictions barring practicing physicians who receive, directly or indirectly, compensation from the organization, for services as employees or as independent contractors, from membership on its compensation committee; and

2. Restrictions precluding a voting member of a compensation committee who has a conflict of interest in the organization from which the member receives compensation, directly or indirectly, from voting on matters pertaining to that member's compensation.

III. System of Periodic Reviews

Another significant fact that will help demonstrate that a tax-exempt health care organization promotes the health of the community as a whole, rather than private interests, is that the board of trustees and all committees with board-delegated powers require that, as part of their systems of controls, all tax-exempt organizations within the hospital system conduct periodic reviews of their activities to ensure that the organizations are operating in a manner consistent with accomplishing their charitable purposes and that their operations do not result in private inurement or impermissible benefit to private interests. Issues of special concern are:

A. Whether compensation arrangements and benefits are reasonable and are the result of arm's-length negotiations;

B. Whether acquisitions of physician practices and other provider services result in private inurement or impermissible private benefit;

C. Whether partnership and joint venture arrangements, and arrangements with management service organizations and physician hospital organizations, conform to written policies, are properly recorded, reflect reasonable payments for goods or services, further charitable purposes, and do not result in private inurement or impermissible private benefit; and

D. Whether agreements to provide health care and agreements with other health care providers, employees, and third-party payors serve charitable purposes.

IV. Financial Interest Defined

A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

A. An ownership or investment interest in any entity with which the tax-exempt health care organization has a transaction or arrangement, or

B. A compensation arrangement with the tax-exempt health care organization or with any entity or individual with which the organization has a transaction or arrangement, or

C. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the tax-exempt health care organization is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are substantial in nature.

## SAMPLE CONFLICTS OF INTEREST POLICY

### Article I

### Purpose

The purpose of the conflicts of interest policy is to protect the Corporation's interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Corporation. This policy is intended to supplement but not replace any applicable state laws governing conflicts of interest applicable to nonprofit and charitable corporations.

### Article II

### Definitions

1. Interested Person

Any director, principal officer, or member of a committee with board delegated powers who has a direct or indirect financial interest, as defined below, is an interested person. If a person is an interested person with respect to any entity in the health care system of which the Corporation is a part, he or she is an interested person with respect to all entities in the health care system.

2. Financial Interest

A person has a financial interest if the person has, directly or indirectly, through business, investment or family--

a. an ownership or investment interest in any entity with which the Corporation has a transaction or arrangement, or

b. a compensation arrangement with the Corporation or with any entity or individual with which the Corporation has a transaction or arrangement, or

c. a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Corporation is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are substantial in nature.

## Article III

## Procedures

1. Duty to Disclose

In connection with any actual or possible conflicts of interest, an interested person must disclose the existence and nature of his or her financial interest to the directors and members of committees with board delegated powers considering the proposed transaction or arrangement.

2. Determining Whether a Conflict of Interest Exists

After disclosure of the financial interest, the interested person shall leave the board or committee meeting while the financial interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

3. Procedures for Addressing the Conflict of Interest

   a. The chairperson of the board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.

   b. After exercising due diligence, the board or committee shall determine whether the Corporation can obtain a more advantageous transaction or arrangement with reasonable efforts from a person or entity that would not give rise to a conflict of interest.

   c. If a more advantageous transaction or arrangement is not reasonably attainable under circumstances that would not give rise to a conflict of interest, the board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Corporation's best interest and for its own benefit and whether the transaction is fair and reasonable to the Corporation and shall make its decision as to whether to enter into the transaction or arrangement in conformity with such determination.

4. Violations of the Conflicts of Interest Policy

   a. If the board or committee has reasonable cause to believe that a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

   b. If, after hearing the response of the member and making such further investigation as may be warranted in the circumstances, the board or committee determines that the member has in fact failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

## Article IV

## Records of Proceedings

The minutes of the board and all committee with board-delegated powers shall contain--

a. the names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the board's or committee's decision as to whether a conflict of interest in fact existed.

b. the names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection therewith.

## Article V

## Compensation Committees

a. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member's compensation.

b. Physicians who receive compensation, directly or indirectly, from the Corporation, whether as employees or independent contractors, are precluded from membership on any committee whose jurisdiction includes compensation matters.

## Article VI

## Annual Statements

Each director, principal officer and member of a committee with board delegated powers shall annually sign a statement which affirms that such person--

a. has received a copy of the conflicts of interest policy,

b. has read and understands the policy,

c. has agreed to comply with the policy, and

d. understands that the Corporation is a charitable organization and that in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

## Article VII

## Periodic Reviews

To ensure that the Corporation operates in a manner consistent with its charitable purposes and that it does not engage in activities that could jeopardize its status as an organization exempt from federal income tax, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

a. Whether compensation arrangements and benefits are reasonable and are the result of arm's-length bargaining.

b. Whether acquisitions of physician practices and other provider services result in inurement or impermissible private benefit.

c. Whether partnership and joint venture arrangements and arrangements with management service organizations and physician hospital

organizations conform to written policies, are properly recorded, reflect reasonable payments for goods and services, further the Corporation's charitable purposes and do not result in inurement or impermissible private benefit.

d. Whether agreements to provide health care and agreements with other health care providers, employees, and third party payors further the Corporation's charitable purposes and do not result in inurement or impermissible private benefit.

## Article VIII

## Use of Outside Experts

In conducting the periodic reviews provided for in Article VII, the Corporation may, but need not, use outside advisors. If outside experts are used their use shall not relieve the board of its responsibility for ensuring that periodic reviews are conducted.

## D. DETECTING FRAUD IN CHARITY GAMING

**by**
**James V. Competti and Conrad Rosenberg**

> ***Contrary to popular belief, bingo cannot be categorized as a low-stakes game played by middle-aged and elderly women. It is, rather, a billion-dollar industry whose popularity permeates all aspects of American society, and the abuses of which often go undetected or unremedied.***
>
> ***Despite bingo's popularity as a charity fundraiser and its reputation as a harmless pastime, it has been the object of abuse by a number of sources: Illegal parlors resort to tricks to circumvent the law or openly defy it. Racketeers are thought to control bingo games- legal and illegal- in a number of urban areas. Skimming and other scams are practiced by both organized groups and shady independent operators. Some bingo players have devised elaborate cheating schemes.***

Gambling in America. Final Report of the Commission on the Review of the National Policy Toward Gambling. Washington: 1976; at pages 160 and 164. Although the report was written over 20 years ago, its observations and conclusions are still essentially valid, if not possibly even a bit understated in light of the recent growth of the gambling business in the United States.

### 1. Introduction

The subject of exempt organizations conducting gaming activities, ostensibly to raise funds for charitable uses, has been the focus of a significant amount of interest. The April 1992 Pennsylvania Crime Commission Report entitled, Racketeering and Organized Crime in the Bingo Industry, at page iv, explains why, in its view, bingo may attract a criminal element:

> ***Promoters have infiltrated this industry and have very little to fear from law enforcement because of their low profile and because of the benign way in which society views Bingo. However, the significant amount of monies which these scams, frauds and diversions of revenue produce, represent a multi-million dollar loss to legitimate charities with very little risk of the perpetrators being prosecuted. In a very real sense, fraudulent charitable Bingo is the perfect white-collar crime.***

The purpose of this article is to educate exempt organizations examiners about abuses that have been uncovered in some gaming programs and inform them of audit techniques to detect possible diversion of funds from the charity

by the professional operator. This article will also assist examiners in accomplishing the EP/EO Examination Quality Case Standard of adequately considering and developing issues of possible fraud when examining organizations conducting gaming activities. Lastly, this updates articles on gaming activities in the 1985, 1987, 1990, and 1996 CPE Texts.

2. Factor that Causes Embezzlement in Charity Gaming

A. Inadequate Oversight by the Charity

(1) General

> ***Members of these organizations know little about how to operate a Bingo game. Therefore they rely on the operator at the facility. This reliance eventually becomes essential to the organization continuing their games at the facility. Within a short period of time the organization finds that it has, in effect, given the Bingo hall operator/facility the organization's license to operate their Bingo game.***
>
> ***We find that the organizations knowingly allowed nonbonafide members to manage the intimate details of their organization's Bingo financial affairs. We are convinced often times that these organizations merely "turned their head" and allowed nonbonafide members to take advantage of the organization's apparent good name and reputation because it was an easy way to make money without any responsible supervision whatsoever.***
>
> ***The charitable organization is given every opportunity to raise funds through Virginia and local statutes. Yet a low percentage of their actual gross income goes to the charity. One of the main reasons this happens is that the true charitable organization who entrusts its name to an operator is charged exorbitant expense to run their Bingo operation, and then the operator takes advantage of their position and actually steals from the charity.***

Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va., on September 30, 1992, December 16, 1993, at Sections 4-4, 7-3, and 4-3.

(2) Discussion

An article in the Dayton Daily News dated April 26, 1992, discussed problems with professional bingo operators. The article was headlined "Big Bucks, Big Business. No One Really Knows Where the Bingo Cash Goes." An investigative reporter had interviewed several sources and the story was the same: people outside the charities are controlling this megabucks cash business.

In the article, one minister described signing management contracts with a professional operator. The professional operator ran the bingo game in exchange for a percentage of the gross receipts. Another minister said he allowed operators to obtain bingo licenses in his church's name in exchange for $100 per week.

The following are examples of the typical relationship between the professional operator and the charity. With control over the bookkeeping, money-counting, record-keeping, and an assortment of other duties such as bank deposits and the hiring and firing of workers, the professional operator may create a situation conducive to the diversion of funds.

Pennsylvania Bingo Law requires that bona fide members of nonprofit associations operate bingo games. However, according to the April 1992 Pennsylvania Crime Commission Report entitled, Racketeering and Organized Crime in the Bingo Industry, at pages 6 and 34, the investigation revealed that after the legalization of bingo, professional operators ran bingo games on a commercial scale using charities as "fronts." In exchange the "sponsoring" charity received either a percentage of the profits or a flat fee. The promoter utilized an established formula when distributing the bingo proceeds to the charitable organizations. Regardless of how much money was taken in from the bingo games, the charitable organizations received a specific amount based on the formula. Officers of the charities that sponsor bingo games related that they trusted the individuals that ran the bingo games. No one from the charities ever challenged the operators regarding financial matters, primarily because bingo was their biggest source of revenue, and they could not afford losing these revenues. Testimony clearly demonstrated that the promoter controlled virtually every facet of the bingo operations.

Ohio Revised Code Chapter 2915 also requires that nonprofit associations be the operators of bingo games. However, an IRS Special Agent's affidavit filed on February 9, 1996 with the United States District Court for the Southern District of Ohio provides another example of problems when the promoter controls the entire operation. During the period 1988 through 1990, a promoter and his associates operated seven bingo halls in the Cincinnati and Dayton areas ostensibly for and on behalf of certain tax-exempt organizations. In addition to the bingo games, pull-tab tickets were available for sale at these halls. The associates of the promoter worked as office manager, floor manager, and floor workers at each hall. The promoter and these associates obtained the required pull-tab ticket supplies, sold the pull-tab tickets, and operated the bingo games at the halls. The office manager's duties at each hall were to count the nightly proceeds, to pay the workers, to remove the cash to be given to the promoter, and then report the remaining proceeds to the tax-exempt organizations. The currency given to the promoter from nightly pull-tab and bingo sales

was not reported on the nightly work papers given to the exempt organization. The promoter received approximately one-half of the proceeds from the nightly instant lottery ticket and bingo game sales from each of the seven halls.

Based upon the Special Agent's examination of the records and interviews of the promoter's associates, the above affidavit described that the operator skimmed approximately the following total amounts of cash from the proceeds for the seven bingo halls: $1,546,346 for the year 1990; $1,017,848 for the year 1989; and $703,382 for the year 1988.

(3) Audit Procedures to Determine Adequate Oversight by the Charity

Conduct a detailed interview with the officers of the organization to determine its corporate structure and history. The interview should also discuss whether and, if so, how the Board monitors the bingo game to ensure that all funds are collected from the bingo operator and workers.

The examiner should determine if the bingo operation has a system of internal controls to safeguard adequately the revenue generated from the game. The internal control system should be structured so that various parts of the bingo activity are handled by different members of the charity, each of whom serves as a check on the others. The following is an example of various positions and responsibilities when an internal control system is functioning properly. This example is not a mandatory internal control system; it is merely illustrative.

1. The bingo operator has control over the execution of the game and records the transactions of the game on the daily sheet.

2. The cash controller independently counts the cash receipts and compares the cash on-hand to the inventory/paid out reports.

3. The inventory controller reviews the daily sheets received from the operator to determine the inventory usage and profit achieved.

4. The check writer is responsible for making all payments related to the bingo game and for ensuring that all deposits stated on the daily sheet actually appear on the bank statement.

5. The Board of Directors or Trustees reviews and compares the bingo reports or daily sheets with the previous reports for consistency. The board should monitor the bingo game to ensure the internal controls, as described above, are functioning properly.

## 3. Ways Funds are Embezzled in Charity Gaming

### A. Pull-tab Embezzlement Schemes

#### (1) General

"Pull-tabs" are defined as the gaming pieces used in a game of chance which are made completely of paper or paper products with concealed numbers or symbols that must be exposed by the player to determine wins or losses.

Pull-tabs are known in various jurisdictions as charitable gaming tickets, break-opens, hard cards, banded tickets, jar tickets, pickle cards, Lucky Seven cards, Nevada Club tickets, instant bingo tickets, and other such names and include the tickets used with tip boards, seal cards and club special games. See North American Gaming Regulators Association, Standards on Pull-tabs, October 12, 1991, at page 1. See also Julius M. Israel Lodge of B'nai Brith No. 2113, 1995 RIA TCM 95,439 for distinction between bingo and "instant bingo" (pull-tabs).

At most bingo games, the majority of profits is generated through the sale of pull-tabs. There are approximately ten major manufacturers of pull-tab tickets in the United States. Each state has numerous suppliers who obtain the pull-tabs from the manufacturer and sell the tickets to the local charities conducting the gaming activity. Suppliers provide pull-tab tickets to the charities in the form of packaged boxes known as "deals." Each deal of pull-tabs sold by the charities to players is supposed to generate a specified net profit as indicated by the manufacturer. For example, charities may purchase a pull-tab game called "Form 860" or "C-Note." Each box contains 2400 tickets that sell for $1.00 each. The box's winning tickets pay out a total of $1,992. This results in a net proceeds of $408 (2,400 tickets at $1.00 less $1,992) for each box of tickets sold.

#### (2) Discussion

Recent IRS examinations in the State of Ohio revealed skimming of the pull-tab receipts by the bingo operator. During the examinations, individuals have admitted during interviews with IRS agents to skimming cash from the nightly proceeds. In some instances, the amount skimmed was as much as $250,000 annually on $500,000 of profits. The IRS also found that some bingo game operators are buying their pull-tab supplies with cash. When this happens, the supply company does not provide an invoice to the charity, and the profits from the pull-tabs are easily skimmed by the operator.

The December 16, 1993 report entitled Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va. on September 30, 1992, at Section 6-5, documented similar pull-tab embezzlement schemes:

> ***This investigation has also revealed that boxes of instant bingo [pull-tabs] can be purchased in cash either from local suppliers or from out of state suppliers where supply records would not necessarily document the purchase. The many boxes that are purchased in this manner can easily be sold at a bingo game where the entire profit of each box (anywhere from $160 to $650) could be skimmed or embezzled with absolutely no trace that the sale had occurred.***

For the ten charitable organizations noted in the above report compiled by the Special Grand Jury in Henrico County, Virginia, nearly a million dollars was shown to be missing from the pull-tab operations. (The report does not specify the duration of time involved.)

(3) Audit Procedures for Examination of Pull-tab Operations

The examiner should review the inventory of pull-tab supplies by comparing boxes of pull-tabs in the inventory to the supplier invoices described in the books and records. Where an organization's records do not reflect all pull-tab purchases, secure information from pull-tab manufacturers and suppliers to aid in reconstructing purchases. State laws generally require manufacturers and suppliers to have internal control procedures that enable them to track pull-tab deals by serial number. For those pull-tab deals that are not reflected in the organization's supplier invoices, the examiner could contact the manufacturer to identify the supplier of pull-tabs purchased for cash by describing the serial number and form number of the applicable boxes. Once the supplier is identified, the agent should interview the supplier's salesperson to determine the frequency of currency purchases by the organization. This will help in verifying that the supplier provided copies of all the organization's pull-tab purchases when requested by the Service.

The examiner should analyze the pull-tab income to determine if there was any unreported profit. Gaming regulators have reconstructed pull-tab operations and determined that for every dollar spent on pull-tab supplies, between ten to thirteen dollars in pull-tab profits is generated. If the examiner determines that the pull-tab operation consistently reports ten dollars or less of pull-tab profits for every dollar spent on pull-tab supplies, the gaming operation may be consistently under-reporting profits from the pull-tab operation.

In cases where the examiner suspects that the organization is under-reporting pull-tab profits, he or she should consider completing the following analysis.

- Construct a schedule of the type of pull-tabs and the guaranteed profit for each deal purchased by the organization. Catalogues listing pull-tab profits for various deals may be obtained from suppliers.

- Compare the total amount of pull-tab profits for all deals purchased by the organization for the year to the pull-tab profits described per the general ledger.

- Reconcile and obtain detailed documentation for any differences.

B. Bingo Embezzlement Schemes

(1) General

"Bingo" means a game of chance played for prizes with cards containing five rows of five squares bearing numbers, except for the center square which is a free space. Traditional bingo also requires that the letters "B - I - N - G - O" appear in order over each column and that no more than 75 numbers may be used. The holder of a card ("player") covers such numbers when objects similarly numbered are randomly drawn. The game is won by the first person covering a previously designated arrangement of numbers on such cards. A game of bingo begins with the first number called and ends when an individual covers the previously designated arrangement, declares bingo and the winning card is verified. Beano as it is played in Massachusetts, is the same as bingo. See North American Gaming Regulators Association, Standards on Bingo, October 22, 1992, at page 2.

(2) Discussion

> ***Skimming, the practice of underreporting income [receipts] from games and pocketing the difference, is thought to be the biggest problem regulatory agencies and law enforcement officials have with bingo. Skimmed money is tax free: Federal, State, and local governments do not receive their share of taxes from that income.***
>
> ***Most bingo scams are simple. Not all of the games are reported to the regulatory authority, and the bingo operator merely pockets the money from the unreported ones. Skimming is even easier if the floor workers are involved. For example, after a collector turns over the money picked up from the tables, the counter (who tabulates each game's income) records a figure lower than the amount collected and keeps the difference.***

Gambling in America. Final Report of the Commission on the Review of the National Policy Toward Gambling. Washington: 1976; at page 160.

Illegitimately run bingo games derive much of their unreported income by underreporting the attendance and the number of bingo packages sold. An IRS Special Agent's affidavit filed on February 8, 1992 with the United States District Court of Western Kentucky provides an example of this type of bingo embezzlement scheme. The affidavit describes a professional operator who failed to report the actual number of players attending each bingo session on quarterly reports filed with the local authorities, sometimes reporting less than half the actual players. Former workers stated that the charity's bingo game averaged 650 players per session during the week, and 1,000 players per session on weekends. The records for the charity reflected an average of 350 players per session. If, for argument's sake, we assume in this case that the average spent for bingo packages by players attending the game was $15, the professional operator had the opportunity to skim between $4,500 to $9,750 each night by underreporting the attendance.

According to the 1976 Commission on the Review of the National Policy Toward Gambling, "...to avoid paying out large jackpots advertised to lure players, some operators hire a player who works from a card recorded earlier with the announcer. The announcer calls the numbers from that card to insure that the "plant" wins the jackpot, which remains with the house."

The above IRS Special Agent's report also describes a variation on this scheme. As a promotion for a charity bingo operation, the promoter announced that the organization would give away a new pickup truck. On the night of the drawing, the promoter's neighbor won the truck. The winner later bragged that the truck game was fixed, that the promoter slipped him the winning key. The promoter retained actual possession of the truck. The phony winner received a kickback from the promoter.

### (3) Audit Procedures for Examination of Bingo Operations

The examiner should review the information reported periodically on the application for a gaming license filed with the gaming regulators. The amounts reported from the game under examination should be compared with games similar in size within its respective county. If the game under examination reports significantly less revenue and a smaller profit margin when compared to similar operations in its locality, that could indicate "skimming" or private purposes being served. Information on gaming regulators may be obtained from

the EO Gaming Focus Group or the North American Gaming Regulators Association, which were discussed in the 1996 CPE text, at page 92.

With approval from his or her supervisor, the agent can gain much insight into the gaming activity by monitoring the bingo game while it is in operation. The examiner should determine the type of packages and or specials purchased by the bingo players at the beginning of a bingo occasion. The cash received at the door from the bingo players should be compared to the door receipts reported previously by the bingo operation. While the on site observation does not establish or disprove the accuracy of reported receipts, it may help the examiner determine the appropriate scope of the audit.

The examiner should reconcile the bingo operations' gross receipts reported on the Form 990 to the gross receipts reported on the summary of the daily bingo sheets. Trace the gross income from the bingo occasions to the bank deposit slip for each occasion. The bingo operation should be closely scrutinized if currency deposits are not made soon after each bingo occasion.

Lastly, the examiner should analyze the gross receipts from the bingo occasion to determine the potential for unreported revenue. The daily sheet for each bingo occasion usually reflects the bingo gross receipts from package sales, prizes paid, and the number of players in attendance. The average spent per player is computed by dividing the bingo gross receipts by the number of players in attendance. The average spent per player should be compared to the prices for bingo packages sold during the bingo occasion.

4. Additional Ways Funds are Diverted in Charity Gaming

A. Diverting Charity Gaming Profits by Use of Management, Supply & Real Estate Companies

(1) General

According to the April 1992 Pennsylvania Crime Commission Report entitled Racketeering and Organized Crime in the Bingo Industry, at pages 7 and 16, gaming operations employed related management, supply, and real estate companies to oversee and run the bingo games. These companies were determined to receive unreasonable compensation for their services rendered:

> ***Organized crime obtained an interest in the bingo operations through the use of management companies which are employed by the charity or Indian tribes to oversee and run the bingo games. These management companies control the entire bingo operation,***

> ***including record-keeping and accounting. Once organized crime controls the bingo operation, they siphon the proceeds using several methods, such as skimming the profits before they are dispersed (sic) to the charity or Indian tribes and rigging the jackpot games.***
>
> ***Organized crime also receives the profits from bingo halls through the use of companies which provide supplies and equipment to the halls. By requiring bingo operations to purchase supplies from their businesses, organized crime can charge inflated prices for merchandise or equipment. The halls can also be billed for non-existent supplies.***
>
> ***A sub-lease is also utilized as a means of diverting money from a charity. The commercial operators become the landlords to the charities, and siphon off the profits of the bingo game from the charitable associations. Rents charged for the halls are in excess of the fair market value of the properties, thus obtaining for themselves the great bulk of the profits of the bingo games from the charitable associations and giving the landlord corporations a direct pecuniary interest in the profitability of the Bingo games.***

The December 16, 1993 report entitled Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va. on September 30, 1992, at Section 10-1, also provided an example of sub-leases and unreasonable compensation:

> ***Our investigation reveals that the same practice is prevalent in Henrico County. Four Bingo permittees sponsored eight games per week for years prior to October, 1992, resulting in a weekly rental from Bingo alone of $8,200.00, and an annual rent of $426,400.00. Given the current assessed value of the property is $490,700.00, the question arises whether the rental charged was in excess of a fair market rental for the property.***

(2) Audit Procedures for Reviewing Management, Real Estate, & Supply Companies

Bingo and pull-tab operations may consist of more than one established legal entity. Related entities should be identified as early as possible in the examination. The examiner should ascertain that any management, real estate, supply, or equipment companies are receiving reasonable and true compensation as would ordinarily be paid for like services by like enterprises under like circumstances, as described in Reg. 1.162-7(b)(3).

The examiner should review any management, supply, or rental agreements from the bingo operation. He or she should closely scrutinize any of the above agreements where the charity pays for its management, rental, supplies, or equipment based on its gross sales or net profits from the bingo or pull-tab operation.

The following factors in a management or operating agreement may indicate private benefit or inurement:

1. The contract is lengthy in duration.

2. The contract provides severe penalties if the exempt organization terminates the agreement.

3. The gaming operator was not selected through open bidding, or the organization lacks documentation to support such a claim.

B. Diverting Charity Gaming Profits by Use of Grantee Agreements or by Creating Fraudulent Charities

(1) General

For charitable organizations whose primary purpose is to raise funds from the operation of bingo and pay the proceeds to other charities, the examiner should review any large grants or contributions to other charities. The grantee may be required to make kickbacks to the for-profit fund-raising companies owned and operated by persons who are related to officers of the grantor. Contributions may also be linked to the grantee's participation in supply or service agreements with the grantor officer's for-profit companies. (For the effects of the "feeder organization" provision, section 502 of the Internal Revenue Code, see 1983 CPE at page 83.)

For example, in one recent examination, the bingo operator offered an educational organization a million dollar grant. The educational organization was instructed that it would receive only 50% of the funds, and the remaining funds were to be distributed back to the bingo operator in monthly installments.

(2) Discussion

Recent IRS examinations revealed that some organizations obtaining gaming permits were nothing more than a subterfuge to support the personal living expenses of the family members that controlled the charity. A review of

the general fund of these charities revealed the following transactions that indicated inurement or private benefit:

1. Salaries and loans provided to family members with no substantiation of services being performed.

2. The purchase of vehicles and boats for officers with no substantiation of business purposes.

3. Equipment purchases for a sole proprietorship operated by family members.

(3) Audit Procedures

Review in detail the transactions within the general fund of the charity for expenditures that indicate inurement or private benefit. A discussion of inurement or private benefit for organizations conducting gaming activities is provided in the 1996 CPE text, at page 101.

Determine if the section 501(c)(3) organization operating gaming activities conducts a charitable program commensurate in scope with its financial resources. The charity may fail to operate a real and substantial charitable program. See the discussion in the 1996 CPE text, at page 100.

Review minutes of meetings of the governing board, committees and other groups to determine whether the officers of the charity approved the grant. Grants should be closely scrutinized if large contributions are not approved by officers of the charity and do not appear to further the charity's mission statement.

Compare the date the grants are made by the grantor and the date of any management and supply agreements signed by the grantee. This may provide evidence that the contributions may be linked to the grantee's participation in supply or service agreements with the grantor officer's related companies.

C. Diverting Charity Gaming Profits by Payment of Money to Volunteer Bingo Workers

(1) General

In many states allowing gaming activities, the bingo workers must volunteer their services. The worker may not be paid, or compensated in any manner, directly or indirectly. Recent IRS examinations have revealed that although

persons working the bingo game were referred to as "volunteers," they were actually paid for their work and were legally employees of the bingo operator.

(2) Discussion

The IRS Special Agent's affidavit filed on February 9, 1996 with the United States District Court for the Southern District of Ohio described an example of the diversion of bingo receipts to pay bingo workers in violation of State law. As previously noted, one of the office manager's duties at each hall was to pay the workers with the funds skimmed from the bingo receipts. See Section 2A(2) of this article.

The December 16, 1993 report entitled Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va. on September 30, 1992, at Section 6-8, also provided an example of payment of money to "volunteer" bingo workers:

> ***Clear evidence and testimony has revealed that the "volunteer" workers are paid $30.00 per Bingo event "under the table." Bingo members and family members of the landlord have been paid $40.00 to $50.00 per Bingo event. Payment is usually put under an ashtray or under a cigar box close to the caller's stand and available for the workers to pickup at intermission. Also, sometimes "volunteers" have been paid by not returning their "$30.00 bank" handed to each floor worker at the beginning of the games which they use to make change for sales on the floor. These payments mean that the charity organization is duped out of anywhere from $120.00 to $160.00 per bingo event.***

(3) Audit Procedures

Talk to current and, if possible, former workers. If the organization will not divulge the names of former workers, consideration should be given to issuing a summons for such information. Regarding summons procedures, see IRM 7(10)22.2(1).

The payment of workers in violation of State law may cause exemption or unrelated business income tax issues, excise and employment tax issues. The effect of illegal gaming activities on exempt status is discussed in the 1996 CPE text, at page 99. The unrelated business income tax issues for gaming activities are also discussed in the 1996 CPE text, at page 93. Lastly, Federal excise taxes on wagering are discussed in the 1996 CPE text, at page 105 and Topic E, Excise Tax and Occupational Tax on Wagering, of this text.

5. Conclusion

Since the federal and state governments have cut back on the amount of money they contribute to charitable programs, some organizations have focused more intensely on fundraising options such as charity gaming. Proper control of the bingo games by the officers of the charitable organizations is essential if the charities are to realize their appropriate profit. The officers of the charity should monitor their games as closely as possible to keep instances of embezzlement to a minimum. Instead of just assuming that the volunteers are doing an adequate job, the officers should determine how much money is being realized from the gaming activity. A detailed system of internal controls should be established to safeguard the revenues from the games. Charities and purported charities that lend their names indiscriminately to unscrupulous bingo operators usually have little or no control over their own bingo operations, and may be mere fronts (witting or unwitting) for tax dodges, criminal activities, and scams.

# E. EXCISE TAX AND OCCUPATIONAL TAX ON WAGERING

by
Glenn Cunningham and Conrad Rosenberg

## 1. Introduction

The purpose of this topic is to discuss excise taxes on wagering activities common to tax-exempt organizations such as bingo, pull-tabs, raffles, wheels, casino nights. This topic does not discuss gambling activities such as bookmaking.

Organizations that are exempt from income tax under section 501 or 521 of the Internal Revenue Code are **not** categorically exempt from the excise tax on wagering or the occupational tax. (See sections 7 & 8 below.) Federal wagering tax laws apply to both authorized and unauthorized gaming activities conducted by exempt organizations. The facts and circumstances of the types of wagering conducted, as well as the benefits derived therefrom, may have a bearing on whether the wagers are subject to the taxes.

Internal Revenue Code Sections 4401 and 4411 impose excise taxes on the gaming industry. Section 4401 figures the tax on the wagers themselves while its companion occupational tax under Section 4411 is figured by two rates of tax.

Form 730, Tax on Wagering, and Form 11-C, Special Tax Return and Application for Registry - Wagering, are used for reporting wagering taxes to the Internal Revenue Service. Effective January 1, 1997, Forms 11-C and 730 processing will be centralized at Cincinnati Service Center.

## 2. Disclosure of Wagering Tax Information

Section 4424 of the Code provides that no Treasury Department official or employee may disclose, except in connection with the administration or enforcement of internal revenue taxes, any document or record supplied by a taxpayer in connection with such taxes or any information obtained through any such documents or records. Further, certain documents related to the wagering taxes and information obtained through such documents may not be used against the taxpayer in any criminal proceeding except in connection with the administration or enforcement of internal revenue taxes.

Congress enacted section 4424 of the Code with the intent of removing any constitutional impediment to the enforcement of the wagering taxes. Therefore, a taxpayer who complies with the wagering tax statutes is no longer confronted by substantial hazards of self-incrimination.

Thus no disclosure in any manner to any person of the documents or records described above should be made without first consulting the district disclosure office.

3. Excise Tax on Wagering

IRC 4401(a)(1) imposes a 0.25 percent tax on the amount of any wager authorized under the law of the state in which accepted.

IRC 4401(a)(2) imposes a 2 percent tax on the amount of any wager not described in IRC 4401(a)(2) (i.e., those not authorized by state law).

4. Imposition of Tax

IRC 4404 provides that the tax applies to wagers:

- Accepted in the United States, or
- Placed by a person who is in the United States with a U.S. citizen or resident, or in a wagering pool conducted by a U.S. citizen or resident.

Further, Reg. 44.4404-1(a) states that all wagers made within the United States are taxable regardless of the citizenship or place of residence of the parties to the wager. Thus, the tax applies to wagers placed within the United States, even though the person for whom or on whose behalf the wagers are received is located in a foreign country and is not a citizen or resident of the United States. Likewise, a wager accepted outside the United States by a citizen or resident of the United States is taxable if the person making such wager is within the United States at the time the wager is made.

5. Who is Liable for the Tax, and When

IRC 4401(c) and Reg. 44.4401-2 describe persons who are liable for the tax on wagers as those who

(1) engage in the business of **accepting** wagers;

(2) conduct any wagering pool or lottery; or

(3) **receive** wagers for, or on behalf of, another person.

There is a difference between a person who "accepts" a wager and a person who "receives" a wager. The courts have ruled that an "acceptor of a wager" generally designates the "principal" who is liable for both the tax on wagers and the special tax. "Receiver" designates an "agent" who is liable only for the special tax. See United States v. Pepe, 198 F. Supp. 226 (D. Del. 1961).

Therefore, a principal is a person who is in the business of accepting wagers for his or her own account. This is the person who is at risk for the profit or loss depending on the outcome of the event or contest to which the wager was accepted. The employee-agent is the paid employee of the principal who accepts wagers for the principal.

The excise tax on wagers attaches when a person who operates a lottery for profit accepts a wager or contribution. See Reg. 44.4401-3.

6. Computation of Tax

The tax applies to (1) wagers on sports events or contests placed with a person engaged in the business of accepting such wagers, (2) wagers placed in a wagering pool that involves a sports event or contest, if the pool is conducted for profit, and (3) wagers placed in a lottery conducted for profit. See section 7. below.

Reg. 44.4401-1(b)(2) provides that the tax base on wagers is the gross amount of wagers accepted. Form 730 figures the tax on the wagers themselves. The amount of the wager is the amount risked by the bettor including any fee or charge incident to placing the wager. It is not the amount that the bettor stands to win.

7. Taxable Wagers

IRC 4421 and Reg. 44.4421-1(a) provide that a wager is a bet:

(1) made on sports events or contests with a person in the business of accepting wagers,

(2) placed in a wagering pool on a sports event or contest, if such pool is conducted for profit, and

(3) placed in a lottery conducted for profit.

The excise taxes apply to all race and sports book establishments whether they are authorized or unauthorized.

Where a wagering pool or lottery is operated with the expectation of a profit in the form of increased sales, attendance, or other indirect benefits, the event is staged for profit. See Reg. 44.4421-1(c)(4).

Reg. 44.4421-1(c(1) defines wagering pool. A wagering pool conducted for profit includes any method or scheme for the distribution of prizes to one or more winning bettors based on the outcome of a sports event (see Reg. 44.4421-1(c)(2)), a contest, or a combination or series of such events or contests, if the wagering pool is managed and conducted for the purpose of making a profit.

Reg. 44.4421-1(c)(3) provides that a contest includes any type of competition involving speed, skill, endurance, popularity, politics, strength, appearance, etc., such as a general or primary election, the outcome of a nomination convention, a dance marathon, a log rolling, wood-chopping, weight-lifting, corn-husking, beauty contest, etc.

Reg. 44.4421-1(b)(1) provides the term lottery includes the numbers game, policy, and similar types of wagering. In general, a lottery conducted for profit includes any scheme or method for the distribution of prizes among persons who have paid or promised a consideration for a chance to win such prizes, usually determined by the numbers or symbols on tickets as drawn from a lottery wheel or other receptacle, or by the outcome of an event. **The operation of a punch board or a similar gaming device for profit is also considered to be the operation of a lottery.**

Rev. Rul. 57-258, 1957-1 C.B. 418, holds that a pull-tab game is essentially nothing more than a type of punchboard game that falls within the meaning of the term "lottery" as used in section 4421(2) of the Code and, as such, is subject to the wagering taxes imposed by section 4401 and 4411.

Most legal wagering conducted by non-profit organizations relates to lotteries. "Pull-tab" or "instant" games meet the definition of taxable wagers placed in a lottery. See Rev. Rul. 57-258, supra.

Section 4421(2)(A) of the Code provides that the term lottery does not include games where the wagers are placed, the winners are determined, and the prizes are distributed in the presence of all persons placing wagers in the game. Reg.

44.4421-1(b)(2)(i) provides for example, no tax would be payable with respect to wagers made in a bingo or keno game since such game is usually conducted under circumstances in which the wagers are placed, the winners are determined, and the distribution of prizes is made in the presence of all persons participating in the game. For the same reason, no tax would apply in the case of card games, dice games, or games involving wheels of chance, such as roulette wheels, and gambling wheels of a type used at carnivals and public fairs. Bingo and gambling wheels and perhaps keno are common gaming activities conducted by tax-exempt organizations. Although bingo operations are exempt from excise taxes, bingo must be analyzed to determine if it is played in the traditional manner as described in Reg. 44.4421-1(b)(2)(i).

Reg. 44.4421-1(b)(2)(ii) states that a lottery, for these purposes, is not a drawing conducted by an organization exempt from tax under section 501, if no part of the net proceeds derived from such drawing inures to the benefit of any private shareholder or individual. The term "lottery" does not include any wagering conducted by an exempt organization if no part of the net proceeds derived from the activity inures to the benefit of any private individual or shareholder. See Rev. Rul. 57-241, 1957-1 C.B. 419. See also P.L.R. 8806001 (May 18, 1987); G.C.M. 39740 (May 31, 1988).

Whether inurement exists may depend on the section of the Code under which a particular organization is exempt. Where participation in the revenue raising activity of gambling was limited to members of a social or fraternal organization, inurement was not established since the financial resources were merely shifted between members of the group. Rochester Liederkranz v. United States, 450 F.2d 152 (2d Cir. 1972).

The general rule is that an organization exempt under IRC 501(a) will not be subject to the wagering taxes if no part of the pull-tab net proceeds inures to the private shareholder or individual. However, where inurement to a private shareholder or individual exists with regard to any net income from a pull-tab game conducted for profit, the exemption from the wagering taxes provided by section 4421(2)(B) would not be applicable. An organization may use the proceeds to further its exempt purpose without inurement occurring. For example, a volunteer fire department may use wagering proceeds to purchase equipment, but a social club's use of non-member wagering proceeds to subsidize member activities constitutes inurement for purposes of the wagering tax provisions.

Knights of Columbus Council No. 3660 v. United States, 783 F.2d 69 (7th Cir. 1986), concerned an exempt fraternal organization which sold lottery tickets to the general public and held weekly drawings. The court noted that the Council used proceeds from the drawings to defray club operating expenses and to subsidize membership activities, recreational and social functions. Further, the court found that inurement was present because the income from its public ticket sales was used for the general operation of the organization. Without the income, Council members would have had to pay higher membership dues or see the quality and quantity of membership benefits and services substantially reduced. The court concluded that the taxpayer is liable for the wagering taxes imposed by section 4401 and 4411 of the Code with respect to public ticket sales.

Technical Advice Memorandum 9529004 describes a section 501(c)(19) organization that conducts pull-tab drawings for profit. The pull-tabs are sold to anyone who attends its public bingo games, whether member or not. A portion of the net proceeds is used to pay the operating expense of the organization and, thus, indirectly inures to the members. The TAM concluded that the taxpayer is liable for the wagering taxes imposed by section 4401 and 4411 of the Code with respect to sales of pull-tabs even though the sales were made by uncompensated volunteer members.

Technical Advice Memorandum 9509001 found that a drawing conducted by a 501(c)(3) public charity is not a taxable lottery if no part of the net proceeds inures to the benefit of any private shareholder or individual. The organization is a non-stock, non-dues membership corporation. There was no private inurement resulting from the organization's pull-tab operation. The TAM concluded that the taxpayer is not liable for the wagering taxes imposed by section 4401 and 4411 of the Code with respect to amounts wagered on pull-tab games. See section 44.4421-1(b)(2)(ii) of the Wagering Tax Regulations and Rev. Rul. 74-425, 1974-2 C.B. 373.

Although TAM's cannot be cited as authority, the rationale and discussion contained therein can be used.

The U.S. Tax Court Memorandum Opinion 1995-439, Julius M. Israel Lodge of B'nai B'rith No.2113, v. Commissioner filed September 14, 1995, stated that Federal law dictates when and how to tax regardless of State classification. The Tax Court held that "instant bingo" does not satisfy the requirements of IRC 513(f) and the proceeds from instant bingo activities are subject to the unrelated trade or business income tax under IRC 511(a). Therefore, instant bingo is a type of pull-tab game. Rev. Rul. 57-258, supra, holds that a pull-tab game is

essentially nothing more than a type of punchboard game that falls within the meaning of the term "lottery" as used in section 4421(2) of the Code and, as such, is subject to the wagering taxes imposed by section 4401 and 4411. However, pursuant to Rev. Rul. 54-240, 1954-1 C.B. 254, otherwise taxable punchboard type games conducted by an exempt organization may come within the meaning of a "drawing" as that term is used in section 4421(2). As such, drawings are exempt from the wagering taxes provided no part of the net proceeds derived from such operation inures to the benefit of any private shareholder or individual of the exempt organization.

8. Exemptions and Exclusions From Tax

A. IRC 4402 and Reg. 44.4402-1 provide three exemptions to the taxes on wagering:

(1) Parimutuel Wagering Enterprises Licensed Under Any State Law

If an exempt organization derives income from operating parimutuel wagering on horse racing conducted in conjunction with a fair or exposition, the wagers are not subject to excise tax

(2) Coin-operated Devices

Regulation 44.4402-1(b)(1) provides that these devices include:

> so-called "slot" machines that operate by means of the insertion of a coin, token, or similar object and that, by application of the element of chance, may deliver, or entitle the person playing or operating the machine to receive cash, premiums, merchandise, or tokens; and machines that are similar to slot machines described above and are operated without the insertion of a coin, token, or similar object.
>
> Regulation 44.4402-1(2) provides as examples of wagering machines some pinball type machines that have the features and characteristics of a gaming device; so called crane/claw/digger devices; and a coin-operated machine that displays a poker hand or delivers a ticket with a poker hand symbolized on it that entitles the player to a prize if the poker hand displayed by the machine or symbolized on the ticket constitutes a winning hand.

The IRS has not published a decision as to whether pull-tab dispensing machines and electronically simulated pull-tab games devices are wagering machines within the meaning of Regulation 44.4402-1(b). Therefore, technical

advice should be requested where pull-tab dispensing machines or electronically simulated pull-tab games devices are encountered during examinations.

(3) <u>Sweepstakes, Wagering Pools, or Lotteries Conducted By a State Agency</u>

B. <u>Drawings Conducted by Exempt Organizations</u>

For purposes of IRC 4421(2)(B), any drawing conducted by an organization exempt from income tax under IRC 501 and 521, is not subject to wagering excise and occupational taxes if no part of the net proceeds inures to the benefit of any private interest. If the drawing is conducted by someone other than the organization, the exemption does not apply.

Rev. Rul. 69-21, 1969-1 C.B. 290, concludes that a "drawing" that is "conducted by" an organization exempt under IRC 501 must, in fact, be operated by such organization to be excluded from wagering taxes. The term "drawing" as it relates to wagering taxes refers to the physical drawing of a ticket, or its equivalent thereof, such as the use of a wheel or a similar device whereby the winner is conclusively determined by a number, letter, legend, or symbol without reference to any other event, the happening of which is beyond the control of the operator. The ruling held that there is a basic distinction between mere sponsorship of a drawing and actual conduct thereof. In general, "conduct" denotes supervision and control, as distinguished from lending the name of an organization to the activity or endorsing it.

Presumably, this would also be true for IRC 527 organizations.

Consider the case of a tax exempt organization that arranges with a carnival operator to conduct a carnival under the tax-exempt organization’s auspices. The entire operation is managed and controlled by the carnival operator, including the sale of raffle tickets on an automobile. Under the financial agreement between the two parties, the carnival operator receives a percentage of the amount of raffle ticket sales. The question of whether or not net proceeds are inuring to the benefit of private individuals must be determined not only by the amount of the commissions paid, but by all other factors bearing upon the relationship of the parties to each other. Where there are joint ventures with non-exempt organizations or individuals, the exclusion from the wagering tax is thus defeated not only because the operation is not "conducted by" an exempt organization but also because it follows from the nature of the enterprise that some part of the net proceeds inures to the benefit of the non-exempt organization or individuals involved and the second requirement for exclusion is not met.

C. Social Bets

During the baseball world series, a group of employees in an office each contribute $5 for a chance to win the entire proceeds contributed to the pool. The winner is the person holding the ticket for the inning in which the highest number of runs is scored. This is a social or friendly type of operation because it is not conducted for profit.

A social or friendly bet is not a wager as defined in IRC 4421 and Reg. 44.4421-1(a). However, according to Reg. 44.4421-1(c)(4), a wagering pool or lottery may be conducted for profit even though direct profit will not inure from the operation. If it is operated with expectation of a profit in the form of increased sales or attendance or other indirect benefits, the wagering pool or lottery is conducted for profit for wagering tax purposes.

D. Games When All Are Present

Bingo, for example is customarily played one game at a time and meets the exception to the lottery provisions because the winners are determined and the prizes or other property are awarded in the presence of all persons placing wagers in the game. But bingo must be analyzed to see if it is played in the traditional manner to insure that it is not a lottery for the purposes of excise tax (see section 7. above).

9. Returns, Payments, and Records

Reg. 44.6011(a)-1 requires that Form 730 be used to compute and pay the excise tax under IRC 4401.

Rev. Rul. 77-51, 1977-1 C.B. 346, holds that in view of the enactment of section 4420 of the Code, the delinquency and fraud penalties imposed by sections 6651 and 6653 may be assessed and collected for failure to file wagering Forms 730 and 11-C and pay the required taxes. Congress enacted section 4424 of the Code with the intent of removing any constitutional impediment to the enforcement of the wagering taxes.

Every person required to pay the tax on wagers imposed by section 4401 of the Code shall file Form 730 each month. A return shall be made for each month whether or not liability has been incurred for that month. If the taxpayer ceases operations which make him liable for the tax, the last return shall be marked "Final Return". See Reg. 44.6011(a)-(1)(a).

10. Return and Record Requirements

Tax assessments are generally based on a return filed by a taxpayer upon which he or she has determined the liability. Every person required to pay the tax on wagers must keep adequate records.

IRC 4403 provides that each person liable for the wagering tax shall keep a daily record showing the gross amount of all wagers on which he is so liable, in addition to all other records required pursuant to section 6001(a).

Section 44.4403-1 of the Excise Tax Regulations provides that every person liable for tax under section 4401 shall keep such records as will clearly show as to each day's operations:

(1) The gross amount of all wagers accepted;

(2) The gross amount of each class or type of wager accepted on each separate event, contest, or other wagering medium.

For example, bingo and pull-tab gross wagers should be shown separately.

11. Applicability of Federal and State Laws

IRC 4422 and Reg. 44.4422-1 provide that paying the wagering tax does not protect a person from prosecution for violation of any Federal or state law.

12. Inspection of Books

Section 4423 of the Code provides that notwithstanding section 7605(b), the books of account of any person liable for taxes on wagering may be examined and inspected as frequently as may be needful to the enforcement of taxes on wagering.

13. Record Retention Period

Section 44.6001-1 of the Excise Tax Regulations provides additional provisions relating to general records, records of agent or employee, record of claimants, place for keeping records, and period for retaining records. Rev. Rul. 72-554, 1972-2 C.B. 630, holds that certain documents prepared and used by gambling establishments constitute records within the meaning of section 6001 of the Code and the regulations and must be retained so long as they may become material to the administration of any tax law.

Excise Tax Regulation 44.6001-1(e) provides that all records required by these regulations shall at all times be available for inspection by internal revenue officers. Further, that the records required by section 44.4403-1 and general records required by this section shall be maintained for a period of at least three years from the date the tax became due; records required of agent or employee shall be maintained for a period of at least three years from the date the wager was received; and records required of claimants shall be maintained for a period of at least three years from the date any credit is taken or refund is claimed.

When any person liable for the wagering tax imposed by IRC 4401 or who is engaged in receiving for or on behalf of another person (at any place other than a registered place of business of such other person) wagers of a type subject to the tax imposed by IRC 4401, has failed to maintain sufficient records as required by Regulations 44.4403-1 and 44.6001, a notice on Letter 911 (DO) (Notice of Inadequate Records to Wagering Taxpayers) or Letter 912 (DO)(Notice of Inadequate Records to Agents or Employers of Wagering Taxpayers) may be issued. See IRM 4791. The factors in IRM 4271.21:(4)(b) should be applied in reaching a decision to send a notice of inadequate records.

14. Credit or Refund

If a person overpays the tax imposed under section 4401, IRC 6416 and the regulations thereunder, provide that he or she may either file a claim for refund on Form 8849, Claim for Refund of Excise Taxes, or take credit for such overpayment against the tax due on subsequent monthly return.

A complete statement of the facts involving the overpayment shall be attached either to the claim or to the return on which the credit is claimed. See Excise Tax Regulation 44.6419-1.

15. Occupational Tax

The occupational tax is a companion to the excise tax on wagering.

IRC 4901 and Reg. 44.4901-1(a) hold that persons who plan to engage in the business of **accepting** wagers; conducting any wagering pool or lottery; or **receive** wagers for, or on behalf of, another person are liable for the tax on wagers.

Form 11-C is used by the person who accepts the wagers subject to excise tax to pay the annual occupational tax under IRC 4411. Form 11-C is also used

by each individual who accepts wagers for another person to register under IRC 4412 and pay the annual occupational tax. Reg. 44.4412-1 provides that registration is made by filing Form 11-C. After the form is filed and the tax is paid, the Service issues the taxpayer a special tax stamp as evidence of registration and payment. See Reg. 44.4901-1.

16. Rate and Imposition of Tax

IRC 4411(a) imposes an occupational tax of $500 per year on each person liable for the tax under IRC 4401 on wagers, or upon the person engaged in receiving wagers for or on behalf of any person so liable.

IRC 4411(b) reduces the occupational tax to $50 where liability for the tax under IRC 4401 is determined under IRC 4401(a)(1) (i.e., state authorized wagers) and for persons who are engaged in accepting wagers only for or on behalf of persons so liable.

The occupational tax shall be paid at the time fixed for filing the returns. See section 20. below regarding when returns must be filed and the tax paid. See Reg. 44.6151-1.

17. Partnership Liability

IRC 4902 and Reg. 44.4902-1 provide that only one occupational tax stamp is required of persons in a copartnership.

18. Change of Address

Where there is a change of business or residence address, IRC 4905 and Reg. 44.4905-2 requires the filing of a "Supplemental Return" on Form 11-C.

19. Application of State Laws

IRC 4906 provides that paying the wagering tax does not protect a person from prosecution for violation of any state law. For provisions relating to the applicability of Federal and state laws, see IRC 4422 and Reg. 44.4422.

20. Registration and Penalties

IRC 4901 and Reg. 44.4901-1(a) requires that the occupational tax must be paid before anyone engages in any wagering activities. Registration is accomplished by filing a return, with remittance in full, on Form 11-C.

Form 11-C is filed by a principal or an employee agent. The principal or employee agent must have an EIN (employer identification number); a social security number cannot be used. The Form 11-C requires an EIN.

Section 4901 of the Code provides that for purposes of the occupational tax imposed by section 4411, the tax year begins July 1. In the case of a person commencing any trade or business on which the tax applies, the individual shall pay a proportionate part of the annual tax from the first day of the month in which the liability for the tax commences. Section 44.4901-1(b)(2) of the regulations defines "commencing business" as a person's initial acceptance of a wager subject to the tax imposed by section 4401. Thereafter, the person must pay the full tax by July 1 of each year. Persons in business for only a portion of a month are liable for tax for the full month, i.e. a person first becoming subject to the special tax on, for example, the 20th day of a month, is liable for tax the entire month.

Taxpayers who accept wagers only a few months of the year (wagers are accepted only on a seasonal basis) are still engaged in the business of accepting wagers all year. They may not reduce the tax imposed by section 4411 of the Code and must pay the full occupational tax by July 1 of each year. See Rev. Rul. 81-258, 1981-2 C.B. 216.

Rev. Rul. 77-933, 1977-2 C.B. 382, holds that employees hired before the end of a taxable year to replace employees who had been engaged in receiving wagers on behalf of another person, and who had paid the occupational tax imposed by section 4411 of the Code for the entire taxable year, are also subject to the tax in that taxable year. However, new employees would be liable only for the proportionate part of the tax computed from the first day of the month during which they began receiving wagers to the following June 30th. For example, if D had commenced receiving wagers on A's behalf on April 15, D would have been liable for a special tax of $125 (based on 1/4 of a year) rather than the full $500. In addition, there is no refund available of the occupational tax paid by employees who leave the employ of the person accepting wagers on behalf of another person.

Rev. Rul. 77-51, supra, holds that in view of the enactment of section 4424 of the Code, the delinquency and fraud penalties imposed by sections 6651 and 6653 may be assessed and collected for failure to file wagering Forms 730 and 11-C and pay the required taxes. Congress enacted section 4424 of the Code with the intent of removing any constitutional impediment to the enforcement of the wagering taxes.

### 21. Examination Techniques

An examination of the wagering tax and determination of gaming gross income or unrelated trade or business income tax should be done simultaneously, since the figures used in both examinations, such as gross wagers, are the same. If no records are kept by the taxpayer as to wagering activity or amounts wagered, it will be necessary to reconstruct daily wager play.

Information that would be helpful in reconstructing an average wager daily amount include copies of any available records from local law enforcement officials or gaming regulators. This information may be useful in determining an average daily wager which can be projected between periods that the taxpayer appeared to be in the wagering business.

The Form 11-C should be secured for the period covered by the Forms 730.

Computer generated alphabetical listings for Forms 11-C and Forms 730 are produced in March of each year for the prior calendar year. The listing may be used to determine whether organizations engaged in wagering have filed Forms 11-C and 730.

For a more complete discussion of examination techniques in cases involving gaming activities, see IRM 4700, Excise Tax Procedure, and IRM 4235, Techniques Handbook for In-Depth Examinations.

For a discussion of examination techniques where fraud is suspected, see Topic D. Detecting Fraud in Charity Gaming of this text.

### 22. Jeopardy Assessment

Where the collection of excise taxes is in jeopardy, appropriate jeopardy assessment action may be taken. The statutory authority for jeopardy assessments in excise tax cases is IRC 6862.

### 23. Summary

Organizations that are exempt from income tax under section 501 or 521 of the Internal Revenue Code are **not** categorically exempt from the excise tax on wagering or the occupational tax. Federal wagering tax laws apply to both authorized and unauthorized gaming activities conducted by exempt organizations.

Most legal wagering conducted by non-profit organizations relates to lotteries. "Pull-tab" or "instant" games meet the definition of taxable wagers placed in a lottery. Bingo games are specifically excluded from the tax. The term "lottery" does not include any wagering conducted by an exempt organization if no part of the net proceeds derived from the activity inures to the benefit of any individual.

Certain gaming activities which are "conducted by" organizations exempt under IRC 501 are not subject to wagering excise and occupational taxes, pursuant to IRC 4421(2)(B).

The facts and circumstances of the types of wagering conducted, as well as the benefits derived therefrom, may have a bearing on whether the wagers are subject to the taxes.

Publication 510, <u>Excise Taxes for 1996</u> includes a general discussion of the wagering taxes.

# F. IRC 7602 EXAMINATION OF BOOKS AND WITNESSES

by
Glenn Cunningham and Robert Gardiner

## 1. Introduction

Congress has given the Internal Revenue Service broad powers to compel the production of information it requires to ascertain tax liability or to collect tax. Section 7602 of the Internal Revenue Code permits the Service, for any statutorily authorized purpose, to:

(1) examine any books, papers, records or other data;

(2) summon a taxpayer or any other person, requiring the person to appear, to produce books and records, and to give testimony under oath; and

(3) take testimony under oath.

## 2. Delegation Order No. 4 (Rev.21)

Delegation Order No. 4, Authority to Issue Summonses, to Administer Oaths and Certify, and to Perform Other Functions, authorizes district Employee Plans and Exempt Organization Internal Revenue Agents, Tax Law Specialists, and Tax Auditors to issue summonses, except summonses to third parties, which must be approved by a case manager, group manager, or a supervisory official above the level of group manager; to serve summonses; to examine books, papers, records or other data; to take testimony under oath, and to set the time and place of examination. In addition, these officers and employees are designated to administer oaths and affirmations and to certify to such papers as may be necessary under the internal revenue laws and regulations except that the authority to certify shall not be construed as applying to those papers or documents the certification of which is authorized by separate order or directive.

Delegation Order No. 4 includes limitations which are applicable to student trainees and aides.

Section 7622(a) of the Code provides that every officer or employee of the Treasury Department designated by the Secretary to administer oaths and certify is authorized to administer such oaths or affirmations and to certify to such papers as may be necessary under the internal revenue laws or regulations made thereunder.

3. Examine Any Books, Papers, Records or Other Data and Take Testimony Under Oath

Section 7602 authorizes the Secretary to examine any books, papers, records, or other data which may be relevant or material (emphasis added) and take such testimony of the person concerned, under oath, as may be relevant (emphasis added) to:

(1) determine if a return is correct;

(2) make a return where there is none;

(3) determine tax liability of any person for any internal revenue tax;

(4) determine the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax;

(5) collect taxes; or

(6) inquire into any offense connected with the administration or enforcement of the internal revenue laws.

IRC 7602 provides the authority to interview the taxpayer, principal officers, third parties, and lower level employees. The principal officer or taxpayer's representative should always be informed before interviews of lower level employees begin.

The right to interview a third party is a strong power and should not be abused or used frivolously.

The specialist can summons anyone pertinent to the case for testimony and an interview.

Administering an oath to a taxpayer is an underutilized tool for an agent. The oath is very effective when interviewing third parties, subordinate employees, etc. Also, if a taxpayer has previously given inaccurate or misleading testimony, the same questions should be asked again under oath. The oath should not always be used at the start of an interview. It should be used at the first sign of a misstatement.

Misstatements under oath are significant in fraud cases since they may show willfulness and intent as well as prior knowledge.

Every agent should know how to administer an oath.

When the oath is administered, the person taking it should be asked to stand and raise his or her right hand. The oath should be given as follows:

> ***"Do you solemnly swear (affirm) under the penalties of perjury that the testimony you are about to give in this matter is true and correct to the best of your knowledge and belief so help you God?"***

As noted, the term "affirm" may be substituted. The phrase "so help you God" may be omitted. The witness should respond by saying "I do." See IRM 4022.41(3). However, a witness cannot be forced to give testimony under oath. Where a witness refuses to take the oath, a memorandum should be prepared to document the fact that the witness refused to take the oath.

4. Authority to Summons

A summons may be used to compel testimony, and/or the production of books, papers, records, or other data that may be relevant or material to any of the purposes listed in section 3, above.

A summons may be issued for a dual purpose, i.e., to investigate both the summonee and unknown taxpayers. A dual-purpose summons directs the summonee to surrender information concerning both the summonee and taxpayers whose identities are currently unknown to the Service. Tiffany Fine Arts, Inc. v. United States, 469 U.S. 310, 315-16 (1985) provides an example of such a summons. There the Service issued several summonses to a taxpayer, a holding company, and its tax-shelter promoting subsidiaries. The summonses ordered the holding company to surrender its own financial statements and the names and addresses of all persons who had acquired from the taxpayer licenses to distribute medical devices.

The John Doe procedures of IRC 7609(f) do not apply as long as all the summoned information is relevant to the investigation of the taxpayer-summonee. The Service must, however, comply with the John Doe procedures of IRC 7609(f) if the information sought is relevant only to the investigation of the unnamed taxpayers.

5. Special Procedures for Third-Party Summonses

Special procedures contained in IRC 7609(a) and (b) apply anytime an examiner issues a third-party summons to a third-party recordkeeper. These procedures require the examiner to notify the taxpayers that a third-party recordkeeper summons has been issued and inform them of their right to intervene in any court proceeding brought to enforce the summons. These procedures apply only when the summonee is a third-party recordkeeper.

A third-party recordkeeper is specifically defined in IRC 7609(a)(3). Also included in this group are recordkeepers that extend credit by credit cards or similar devices, such as telephone companies and gambling casinos that extend credit or cashing privileges through credit cards. See United States v. New York Telephone Co., 644 F.2d 953 (2d Cir. 1981).

A thorough discussion of third-party summons may be found in the **Continuing Professional Education Exempt Organizations Technical Instruction Program for 1993 at G. Summons and Enforcement**, page 104.

6. No Administrative Summons When There is Justice Department Referral

A. Limitation of Authority

No summons may be issued or enforced by the Service when a Justice Department referral is in effect with respect to the taxpayer. See IRC 7602(c).

B. Justice Department Referral In Effect

A Justice Department referral is in effect when (1) the Service recommends a grand jury investigation or a criminal prosecution of the taxpayer; or (2) the Attorney General, Deputy Attorney General, or Assistant Attorney General makes a written request to the Service for the taxpayer's return or other return information relating to the taxpayer. See IRM 4022.3(2). A referral is no longer in effect when the Attorney General notifies the Service that (1) it will not prosecute the taxpayer; (2) it will not authorize a grand jury investigation; (3) it will discontinue a grand jury investigation; or (4) there has been a final

disposition in a criminal tax proceeding against the taxpayer. In the case of a referral initiated by the Attorney General, the referral ends when the Attorney General notifies the Service, in writing, that the taxpayer will not be prosecuted. IRM 4022.3(2). See IRC 7602(c)(2)(B).

C. Taxable Years, etc., Treated Separately

Each taxable period (or, in the case of excise taxes, each taxable event) must be treated separately. As a result, the Service may issue a summons for one taxable year even if a Department of Justice referral is in effect with respect to the taxpayer for another taxable year.

7. Purpose May Include Inquiry Into Offenses

The Secretary may examine, summon, and take testimony for the purpose of inquiring into any offense connected with the administration or enforcement of the internal revenue laws.

8. Summary

District Employee Plans and Exempt Organization Internal Revenue Agents, Tax Law Specialists, and Tax Auditors have authority to perform all duties conferred upon such officers under all laws and regulations administered by the Internal Revenue Service, including the authority to investigate, and to require and receive information, as to all matters relating to such laws and regulations.

A thorough discussion of the power to summon, its limitations, summons enforcement, and the procedures involved in issuing a summons may be found in the **Continuing Professional Education Exempt Organizations Technical Instruction Program for 1993** at **G. Summons and Enforcement**, page 100.

## G. UPDATES ON DISCLOSURE AND SUBSTANTIATION RULES

by
**Michael Seto and Dave Jones**

### 1. Introduction

The Omnibus Budget Reconciliation Act of 1993 contains two provisions that significantly affect charities and their contributors. These two provisions are IRC 6115, relating to disclosure of certain information to contributors and IRC 170(f)(8), relating to substantiation of certain information by contributors.

These two provisions were discussed in the 1995 CPE, Substantiation and Disclosure Rules of OBRA '93, at pp. 129-138. That article was written just after the statute was enacted. The Service has since issued proposed regulations, 1.170A-13(f) and 1.6115-1, to implement IRC 6115 and IRC 170(f)(8).

The purpose of this article is to discuss the disclosure and the substantiation rules as interpreted by the proposed regulations. The article will highlight the circumstances where disclosure and substantiation statements are required; the elements necessary to the statements; safe harbors that have been created to ensure greater compliance; and how the rules work in certain special situations.

### 2. Disclosure of Quid Pro Quo Contributions

IRC 6115 provides that charities, for contributions made on or after January 1, 1994, must provide timely written disclosure statements to contributors who make payments described as "quid pro quo" contributions in excess of $75. IRC 170(f)(8)(A) provides that for contributions made on or after January 1, 1994, no deduction will be allowed under IRC 170 for a contribution of $250 or more (whether in cash or property) unless the contributor has a contemporaneous written acknowledgment from the charity substantiating the contribution.

These are two different requirements, and although at times they may overlap (a "quid-pro-quo contribution" of $250 or more), each must be satisfied. For example, in certain circumstances, charities may be able to meet both requirements with the same written document. Nevertheless, they must be careful to provide the written statement in a "timely" manner satisfying the more stringent requirement of the disclosure rules if the statement is to meet the requirements of both sections.

A. Quid Pro Quo Contribution Defined

A "quid pro quo contribution" is defined as a payment made partly as a contribution and partly as payment for goods or services provided to the contributor. A charity provides goods or services in consideration for a contributor's payment if, at the time that contributor make the payment, he or she receives or expects to receive goods or services in exchange for that payment. Goods or services include those provided in a year other than the year in which a contributor made the payment.

> Illustration: On December 20, 1995, a contributor provides the Washington Opera, a section 501(c)(3) organization, $100 in consideration for a concert ticket with a fair market value of $60. The concert is to take place Jan. 20, 1996.
>
> The Washington Opera must furnish that contributor a timely disclosure statement indicating among other things that the value of the ticket is $60.
>
> The contributor may claim the $40 as a charitable deduction on his or her 1995 tax return.

Note that the $75 threshold is determined on the $100 payment, not on the amount of the actual deductible portion (i.e., $40) of said payment.

For purposes of the $75 threshold, separate payments of $75 or less made at different times of the year for separate fundraising events are not aggregated. To prevent circumvention of the disclosure requirement in situations such as the writing of multiple checks by a contributor in the same transaction, the Service is authorized to develop anti-abuse rules. No such rules have been prescribed.

B. Contribution Defined

Whether or not the portion of a payment in excess of the fair market value of the goods or services received is a contribution depends on the intent of the donor. The Service applies a two-part test, which was adopted in United States v. American Bar Endowment, 477 U.S. 105 (1986): first, a payment to a charity is deductible only to the extent the payment exceeds the fair market value of any goods or services the contributor received; and, second, the excess payment is made with the intent to make a gift. See also Rev. Rul. 67-246, 1967-2 C.B. 104.

The first condition is satisfied by evidence that the payment exceeds the fair market value of the goods or services received. The second condition is satisfied where the surrounding facts and circumstances of a particular payment indicates such intent. In most situations, the intent is apparent.

> Illustration 1: WXYZ, public television station, informs A that she may receive a compact disc of classical music, with a fair market value of $15, for a contribution of $50. That compact disc can be purchased for $15 at music stores in the community. A sends the $50 contribution and accepts the compact disc. Since the contribution exceeds the fair market value of the compact disc and A was informed of this before she made the $50 payment, A has made a charitable contribution of $35 to WXYZ.

> Illustration 2: The facts are the same as in Illustration 1 except that WXYZ only asks for a $15 contribution. Notwithstanding the fact that A may think she is making a charitable contribution of $15 to WXYZ, no part of the payment is deductible. Since the payment approximates the established purchase price of identical compact discs sold at music stores, the $15 payment is not a contribution; it is the purchase price of the disc.

### C. Written Disclosure Statement

A charity, in connection with the solicitation or receipt of a quid pro quo contribution in excess of $75, must provide to the contributor a written disclosure statement. See IRC 6115(a).

#### (1) Content

The required written disclosure statement must accomplish the following: first, inform the contributor that the part of the payment 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 above the value of goods or services provided by the charity; second, provide the contributor with good faith estimates of the value of the goods or services furnished to the contributor. For an in-depth discussion of good faith estimates and fair market value, read Section 4 of this article.

> Illustration: On May 1, 1996, X contributes $150 to the Houston Symphony, a section 501(c)(3) organization, and receives in return one concert ticket with a fair market value of $50. The information in the disclosure statement should include the following:

(A) A statement that the amount of the contribution the donor may deduct for Federal income tax purposes is limited to the excess of the money contributed over the value of the goods provided by the Houston Symphony in exchange for the contribution;

(B) A description of the quid pro quo goods (a concert ticket);

(C) the fair market value of the ticket ($50).

Also, the information in the disclosure statement must be made in a manner that is reasonably likely to come to the attention of the contributor. Since there is no specific format, whether a disclosure statement satisfies this requirement depends upon the facts and circumstances of a particular situation.

(2) Time of Disclosure

Charities must furnish the disclosure statements in a timely manner - with either the solicitation of the quid pro quo contribution or the receipt of the quid pro quo contribution. If the disclosure statements are furnished in connection with a particular solicitation, it is not necessary for charities to provide additional statements when contributions are actually received. The timing, however, is critical.

(3) Situations Where Disclosure Statements are Not Required

In the following three circumstances, disclosure statements are not required.

First, when goods or services given to contributors by an organization described in IRC 170(c) have an insubstantial or de minimis value. See Proposed Reg. 1.6115-1(b). These goods or services can be treated as having no value for purposes of disclosure pursuant to IRC 6115. The standards for insubstantial or de minimis value are prescribed in Rev. Rul. 90-12, 1990-1 C.B. 471, as amplified by Rev. Proc. 92-49, 1992-1 C.B. 987, and modified by Rev. Proc. 92-102, 1992-2 C.B. 580; Rev. Proc. 93-49, 1993-2 C.B. 581; Rev. Proc. 94-72, 1994-2 C.B. 811; Rev. Proc. 95-53, 1995-52 I.R.B. 22. Since the dollar amount that the Service considers insubstantial or de minimis is adjusted annually, check any updates or modification to Rev. Proc. 90-12 and Rev. Proc. 92-49. Also, read Section 5 of this article for additional discussion.

Illustration: In its 1995 fundraising campaign, the March of Dimes provides a bookmark bearing its logo to any contributor donating $75. The cost of each bookmark is 25¢. Each bookmark is considered de

> minimis or a low cost article pursuant to IRC 513(h)(2) because the cost is well below the $6.60 limitation stated in Rev. Proc. 94-72. Also, the $25 payment rule is satisfied because the $75 contribution is more than the $33 limitation stated in Rev. Proc. 94-72. Thus, the March of Dimes may treat the bookmark as having no substantial value and, thus, need not issue a disclosure statement to the contributors.

Second, there is no donative or gift element in a particular transaction. A typical museum gift shop sale is an example of a transaction without a donative element; it is not a quid pro quo contribution.

Third, where there is only an intangible religious benefit provided to contributors. Intangible religious benefits are benefits provided to contributors by an organization organized exclusively for religious purposes and are not generally sold in commercial transactions. Payments for intangible religious benefits are not quid pro quo contributions. See IRC 6115(b). An example of an intangible religious benefit is admission to a religious ceremony. The exception also includes de minimis tangible benefits, such as wine or wafer, provided in connection with a religious ceremony. The intangible religious benefit exception, however, does not apply to such items as payments for tuition for education leading to a recognized degree or for travel services or consumer goods.

D. Failure To Provide Disclosure Statements

IRC 6714(a) provides that a penalty is imposed on organizations that do not meet the disclosure requirement of IRC 6115. This provision also provides that a penalty of $10 per contribution, not to exceed $5,000 per fundraising event or mailing, be imposed on organizations that failed to make the required disclosure in connection with a quid pro quo contribution of more than $75.

Charities may avoid such penalties if they can show that the failure was due to reasonable cause. See IRC 6174(b). Reasonable cause is dependent upon the facts and circumstances of a particular case.

3. Substantiation of Charitable Contributions

IRC 170(f)(8)(A) provides that beginning January 1, 1994, no deduction will be allowed under IRC 170 for a contribution of $250 or more whether in cash or property unless the contributor has a contemporaneous written acknowledgment from the charity. A one year transitional rule, for calendar year filers, allowed contributors to take a deduction where they made a good faith attempt to contact the charities by October 15, 1995, to obtain written substantiation.

If they could not obtain the written substantiation but have documented a good faith attempt to obtain it, they can take a deduction for contributions made. See IRS News Release 95-25 (March 22, 1995). This transitional rule applied to the 1994 tax year, and no further relief has been granted.

A. Written Substantiation

A contributor must have a written statement substantiating the amount of the donation from the donee charity in order to take a deduction. The contributor cannot rely upon cancelled checks alone to substantiate the contribution. It is the responsibility of the contributor to obtain the written statement.

Under IRC 170(f)(8)(D), charities need not substantiate donations if, in accordance with Treasury regulations, they report directly to the Service the information required to be provided in the written statements. There are no regulations at present establishing such reporting procedure, nor will there be any in the foreseeable future. Hence, charities may not report to the Service on behalf of contributors the information in the written statements. In practice, since good donor relations are in charities' interest, most, if not all, charities will provide contributors written statements with the proper information.

(1) Content

The written statement must include sufficient information to substantiate the amounts of deductible contribution. Thus, it should have the following information. First, if the contribution is in cash, the amount must be in the written statement. If the contribution is in property, the written statement must have a description of the property, but need not value the property. See IRC 170(f)(8)(B)(i) and Proposed Reg. 1.170A-13(f)(2). Second, if the charity provided any goods or services in consideration, in whole or in part, for the contribution, the written statement must provide a description and the good faith estimate of the fair market value of the goods or services. See IRC 170(f)(8)(B)(ii), (iii) and Proposed Reg. 1.170A-13(f)(2)(ii), (iii). Finally, if the contributor received nothing in return for the contribution, the written statement must say so. The information does not have to include contributors' social security or tax identification numbers.

If goods or services consist entirely of intangible religious benefits, the written statements should indicate this. The written statements need not describe or provide estimates of the value of these benefits. See IRC 170(f)(8)(B)(iii) and Proposed Reg. 1.170A-13(f)(2)(iv).

(2) Format

There is no prescribed form for the written statement. Letters, postcards, or computer-generated forms are acceptable.

B. Contemporaneous

The written statement must be contemporaneous. IRC 170(f)(8)(C) provides that written statements must be received by a contributor no later than the date the contributor actually files his or her return for the tax year in which the contribution was made. If the return is filed after the due date or extended due date, the written statements must be obtained by the extended due date. See Proposed Reg. 1.170A-13(f)(3).

C. Separate and Aggregate Contributions

Charities may provide separate written statements for each contribution of $250 or more received from a contributor, or provide periodic written statements substantiating contributions of $250 or more. Separate payments received from a contributor at different times are regarded as independent contributions and are not aggregated for the purpose of applying the $250 threshold.

To prevent the circumvention of the substantiation rule in situations such as the writing of multiple checks in an amount below $250 on the same date, the Service is authorized to establish anti-abuse rules. No such rules have been prescribed.

D. Substantiation of Contributions Made By Payroll Deductions

If contributions are made through withholding of wages, the contributions deducted from each paycheck are regarded as separate payments to be substantiated. Reg. 1.170-13(f)(11)(ii). Substantiation of payroll deductions may be done by the following: first, a pay stub, Form W-2, or other documents furnished by the employer that show the amount withheld by the employer for payment to the charity and, second, a pledge card or other document prepared by or at the direction of the charity that includes a statement to the effect that the charity did not provide goods or services in whole or part in consideration for the contribution. See Reg. 1.170-13(f)(11).

E. Substantiation of Contributions Made Through Intermediary Organizations

Frequently, intermediary organizations such as the United Way, Combined Federal Campaign receive contributions and distribute them to one or more charities. Reg. 1.170A-13(f)(12) provides that these intermediary organizations are treated, for purposes of the substantiation rules, as the recipients of the contributions. Therefore, they should provide written statements to contributors.

Intermediary organizations are not treated as the recipients of the contributions if the actual recipient/charities provide goods and services to contributors. They structure the transaction to avoid taking the goods or services into account in determining the amount of the charitable deduction to which contributors are entitled. See Reg. 1.170A-13(f)(12).

F. Substantiation of Out-of-Pocket Expenses

A contributor who incurs expenses while rendering services and qualifies for a charitable deduction is treated as having obtained contemporaneous written acknowledgment for these expenses if:

1. The contributor has records that substantiate the amount of the expenses; and

2. By the appropriate date, obtains from the charitable organization:

   a. a description of the services provided;

   b. the date on which the services were provided;

   c. a statement of whether or not the recipient charity provided any goods or services for performance of the services; if the recipient charity provided such goods and services,

      i. a description and good faith estimate of the value of those goods or services;

      ii. if the recipient charity provided intangible religious benefits, a statement to that effect. See Proposed Reg. 1.170A-13(f)(10)(ii).

G. Substantiation of Matched Payment

If a contributor's payment is matched, in whole or in part, by another contributor and the contributor receives goods or services in consideration for

the payment and some or all of the matching payment, the goods and services will be treated as provided in consideration for the contributor's payment and not in consideration for the matching payment.

H. False Substantiation

Charities that knowingly provide false written substantiation to contributors may be subject to penalties under IRC 6701, aiding and abetting an understatement of tax liabilities. Whether a charity knowingly provided false substantiation depends upon the facts and circumstances of the particular situation.

4. Good Faith Estimate and Fair Market Value

Perhaps the most daunting aspect of the disclosure rule under IRC 6115 and the substantiation rule under IRC 170(f)(8) is the requirement in both provisions to provide contributors with good faith estimates of the goods or services given as an inducement to make contributions. See IRC 6115(a)(2) and IRC 170(f)(8)(B)(iii).

A. Definition of Good Faith Estimate

One basic issue is the definition of a good faith estimate. Proposed Regs. 1.6115-1(a)(1) and 1.170A-13(f)(7) provide that a good faith estimate is the donee charity's estimate of the fair market value of the goods or services. Neither of the proposed regulations requires any particular method of estimating fair market value. Consequently, charities may use any reasonable methodology as long as it is used in good faith. See Proposed Reg. 1.6115-1(a)(1) and 1.170A-13(f)(7).

B. Estimating Fair Market Value

There are many methods that can be used to estimate the fair market value of a particular item or property. One is the market-comparable method. For example, if a real estate agent wants to estimate the value of a house, she examines the sale price of similar houses with similar features in the same neighborhood. Although an identical house may not be available, the agent estimates the value by looking at similar or comparable houses.

Charities may use the market comparable method to estimate the goods or services provided to contributors as long as they do so in good faith.

### (1) Goods or Services That Are Not Commercially Available

A charity may provide goods or services that are not commercially available. In this case, estimates can be based on goods or services that are commercially available even though the commercially available goods or services do not have the unique qualities of the goods or services being valued. See Proposed Reg. 1.6115-1(a)(2).

> Illustration: a museum allows contributor A to hold an event in one of its galleries in return for a contribution of $50,000. No other private events are held in the museum. In the community where it is located, there are four hotels with ballrooms with the same capacity as the gallery in the museum. Two of the four hotels, Y and Z, have ballrooms offering amenities and atmosphere comparable to the gallery in the museum, although the two hotels lack the unique art displayed on the walls of the museum. Because the capacity, amenities and atmosphere of the ballrooms of the two hotels are market-comparable to the room in the museum, a good faith estimate of the fair market value of the benefits received by contributor A may be determined by reference to the cost of renting the ballroom in either of the two hotels. The cost of renting the ballrooms in Y or Z is $5,000. Hence, the rental value of the gallery in the museum is $5,000.

An axiom of tax law is that the fair market value of property is what a willing buyer will pay a willing seller. Fair market value is not what it costs the charity to purchase a particular item. A common error many charities make when estimating the fair market value of benefits is to value items given to it at $0. If a charity is given books, which it turns around and gives as premiums, a good faith estimate of the fair market value of the books can be determined by looking at market-comparable book prices. The value should not be $0.

### (2) Certain Goods or Services Treated As Having No Measurable Value

Newsletters or other publications that are not of commercial quality are treated as though they do not have measurable value as long as their primary purpose is to inform members about the activities of the charity and are not available to the public through subscriptions or newsstands. See Rev. Proc. 90-12, 1990-1 C.B. 471. Generally, publications that contain articles written for compensation and that accept advertising are considered commercial quality publications and have measurable fair market value. Professional journals, whether or not their articles are written for compensation, or whether or not advertising is accepted, are considered commercial quality publications.

> Illustration 1: A museum sends a newsletter to patrons who made $250 contributions. The primary purpose of the newsletter is to inform patrons about forthcoming art exhibits and lectures. It contains no commercial advertisements or articles; it is only available to patrons who made such contributions. The newsletter is treated as having no measurable fair market value for substantiation and disclosure purposes.

> Illustration 2: Assume the same facts as Illustration 1, except that the newsletter also contains high quality photographs of art works and articles and reviews written by experts, critics, historians and collectors of art works. Announcements of art openings held in commercial art galleries are also included in the newsletters; the museum charges a fee to include such announcements. The newsletter is printed on quality paper and in a magazine format, and published quarterly. The newsletter is sold to the general public in the museum's gift shop as well as book stores and museum gift shops throughout the country for $60. The cost of producing the newsletter is $20. Under the facts and circumstances, the newsletter is a commercial quality publication and is also not a de minimis or low cost article. Consequently, the newsletter cannot be treated as having no measurable market value. The value is $60.

Celebrity presence is another item that is treated as having no fair market value. Often celebrities will lend their presence to enhance the fundraising of a charity they support. The mere presence of celebrities need not be valued because, generally, it cannot be valued independently. See Proposed Reg. 1.6115-1(a)(3).

> Illustration: A charity provides a contributor of $1,000 with a dinner for two followed by an evening tour of a museum. An artist, whose most recent works are on display at this museum, conducts the tour. Typically, tours at this museum are free. Because museum tours are free, the celebrity presence is treated as having no value and the charity need not value the tour. The museum, however, must provide a good faith estimate of the fair market value of the dinner for two.

In contrast, another charity provides a one-hour tennis lesson with a tennis professional in return for the first payment of $500 it receives. The tennis professional normally provides one-hour lessons for $100. Because the services of the tennis professional have a market and can be valued, the charity must provide to the contributor a good faith estimate ($100) of the fair market value of the one-hour lessons.

5. Safe Harbors from the Requirements of the Disclosure and Substantiation Rules

Many charities, in their fundraising activities, provide benefits to contributors in appreciation of their contributions or to potential contributors as enticements to make contributions. These charities are required to disclose to contributors the value of benefits for purposes of the disclosure and substantiation rules. Nevertheless, there are several situations where charities need not disclose so long as they conform to any of the following safe harbors.

The first safe harbor involves the use of token items such as bookmarks, calendars, key chains, mugs, tee shirts and other such items that bear the charities' names or logos. See Rev. Proc. 90-12, 1990-1 C.B. 471; see also Proposed Regs. 1.170A-13(8)(i)(A) and 1.6115-1(b). The use of these items must be in the context of a legitimate fundraising campaign. The token items are exchanged for a contribution of $25 or more (adjusted for inflation) and such items are low cost articles within the meaning of IRC 513(h)(2). For 1996, this safe harbor applies where the value of a contribution must be $33.50 or more and the value of low cost articles is $6.70 or less. See Rev. Proc. 95-53, 1995-52 I.R.B. 22 (the dollar amount that the Service considers insubstantial or de minimis is adjusted annually; check any updates or modification). If these conditions are met, the fair market value of token items can be treated as having no substantial value and can be disregarded for charitable deduction purposes.

> Illustration: A charity, an inner city nonprofit health clinic, in its 1996 fundraising campaign, sends its supporters a small calendar bearing its logo in return for a contribution of $250. The cost of production and distribution of the calendar is $1.50 per supporter. Since the cost of the calendar is below $6.70, the calendar is considered a low cost article. Also, the $25 payment rule is satisfied because the $250 contribution is more than the $33.50 limitation stated in Rev. Proc. 95-53. Thus, the health clinic can inform the contributor that the calendar has no substantial value and that the full amount of the contribution is deductible in the substantiation statements.

The second safe harbor involves charities mailing or otherwise distributing free, low-cost, unordered items to patrons. The items will be treated as not having market value. See Rev. Proc. 92-49, 1992-1 C.B. 987. For this safe harbor to apply, items received must not have been distributed at patrons' requests or with the express consent of patrons and must be low cost articles within the meaning of IRC 513(h)(2). In 1996, the amount of low cost articles is $6.70 or less. See Rev. Proc. 95-53, 1995-52 I.R.B. 22.

> Illustration: As part of a fund raising campaign, on June 1, 1995, a charity mails each potential contributor a packet of 20 return address labels containing his or her name along with a solicitation letter requesting a donation of $250. The packet has not been distributed at potential contributors' requests or with their consent. The solicitation states that the potential contributor may keep the packet whether or not he or she makes a contribution. The cost of producing each packet is 75¢. Since the cost of each packet is well below the $6.70 limitation stated in Rev. Proc. 95-53, the packet is considered a low cost article. Thus, the charity may inform the contributor that the labels have no substantial value and that the full amount of the contribution is deductible in the substantiation statements.

The third safe harbor is where the fair market value of a benefit received in return for a contribution is not more than 2% of the contribution or $50, whichever is less. See Rev. Proc. 90-12, 1990-1 C.B. 471. The $50 is indexed for inflation, and in 1996, that amount is $67. See Rev. Proc. 95-53, 1995-52 I.R.B. 22.

> Illustration: A section 501(c)(3) university, in 1996, gives its contributors a framed print of the university campus with a fair market value of $40 in return for contributions of $1000. The university may inform its contributors that the print has no substantial value and that the full amount of the contribution is deductible.

The fourth safe harbor involves membership package benefits. Charities, such as museums, libraries, zoos, and arboretums, typically use membership packages to build a following and base of support. The benefits of a typical membership package may include free parking, gift shop discounts, an admission discount, etc. Charitable organizations which offer basic membership packages at $75 or less and include some or all of the following benefits can treat such membership benefits as having insubstantial value and, hence, need not value them. See Proposed Regs. 1.170A-13(f)(8)(i)(B) and 1.6115-1(b). The membership benefits are:

a) Any right or privilege, other than rights to seating at collegiate athletic events, the contributor can exercise frequently during the membership period. Examples of such rights and privileges include free or discounted admission to organizations' facilities or events, free or discounted parking, preferred access to goods or services, and discounts on purchases of goods or services; and

b) Admission to events during the membership period open only to members if the cost per person for the event, excluding any allocable overhead, is within the limits for low cost articles. For 1996, the limit for low cost articles is $6.70. See Rev. Proc. 95-53, 1995-52 I.R.B. 22.

Illustration: A performing arts center offers a basic membership package for $75. The benefits offered include the right to purchase tickets one week before they go on sale to the general public, free parking in its garage during evening and weekend performances, and a 10% discount at its gift shop. For $150, the performing arts center offers a preferred membership package which includes all the benefits of the $75 package plus a poster sold at its gift shop for $20. The basic membership and the preferred membership are each valid for twelve months. There are approximately 50 productions at the performing arts center during the twelve month period. The center's gift shop is open for several hours during the week and during performances. The performing arts center may disregard the value of the basic membership package benefits for purposes of the disclosure statement. Preferred members must receive a disclosure statement indicating that a reasonable estimate of the fair market value of their membership benefit is $20, the fair market value of the poster. This estimate also should be included in the preferred members' substantiation statements.

This safe harbor can only apply to frequently available benefits. The following illustration is meant to draw the distinction between frequently available benefits and those that cannot be exercised frequently.

Illustration: A community theater group performs four different plays each summer. Each play is performed twice. In return for a membership fee of $60, the theater offers a membership package that consists of free admission to any of its performances. Non-members may purchase tickets for $15 each on a performance-by-performance basis. If a contributor makes a gift of $350 and receives such membership package in return, the theater must provide a reasonable fair market estimate of the benefit, i.e., the value of the performances. Because the benefit provided admission is to a limited number of performances, it could not be frequently exercised and, therefore, does not meet the requirements of the safe harbor.

6. Special Situations

Where a charity provides to a contributing corporation's employees benefits that are same as those described in any of the above safe harbors, such benefits can be treated as insubstantial and need not be valued. See Proposed Reg. 1.170A-13(f)(9). Where the benefits given employees are other than those described in any of the safe harbors, the substantiation and disclosure statements have to be provided.

7. Conclusion

The final and proposed regulations and the revenue procedures are designed to improve compliance with and facilitate enforcement of IRC 170(f)(8) and IRC 6115. They will also relieve exempt organizations from complying with the disclosure and substantiation rules in certain circumstances. It is anticipated that the proposed regulations will be finalized without substantial changes.

## H. EDUCATION, PROPAGANDA, AND THE METHODOLOGY TEST

by
Ward L. Thomas and Robert Fontenrose

> ***What is truth?***
> ***Pontius Pilate (John 18:38)***

### 1. Introduction

The Internal Revenue Code has exempted organizations operated exclusively for "educational" purposes since the inception of the federal income tax (and has allowed deductions for contributions to such organizations for nearly as long). Also, common law regards public trusts to advance education as charitable.

What is an "educational" organization? Neither the Service nor the courts have had much trouble recognizing the educational nature of traditional schools, colleges, and universities. However, it is far less clear under what circumstances an organization is educational if it advocates a particular view as a substantial activity. The Service view is that an organization's mere dissemination of words or a viewpoint to the public does not necessarily benefit the public sufficiently to warrant the organization's tax exemption under IRC 501(c)(3).

This article will discuss the administrative history of the "educational" exemption as it pertains to advocacy organizations, the current "methodology" test, and its relationship to other provisions under IRC 501(c)(3).

### 2. Evolution of the Methodology Test

Developing a satisfactory standard to determine whether an organization has an educational purpose vexed the Service for years. There arose differing tests in distinguishing permissible education from impermissible "propaganda." First came an "ends" test (is the organization's ultimate purpose to achieve a goal other than education of the individual or public?) with a "controversial" gloss (is the subject matter controversial?) The Service later focused on a "means" or "methodology" test (does the organization employ educational methods to achieve its desired result?)

A. Reg. 45

A Treasury regulation promulgated in 1919 provided as follows:

> ***Educational corporations may include an association whose sole purpose is the instruction of the public . . . . But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute.***

Reg. 45, Art. 517.

The regulation overruled two Solicitor's Memoranda published by the Bureau of Internal Revenue in 1918 (S. 400 and S. 455) that recognized exemption of organizations whose sole purpose was to educate the public sentiment in favor of a doctrine or change in the law. A 1920 Memorandum of the Solicitor of Internal Revenue explained Reg. 45 as follows:

> ***The prime purpose of education is to benefit the individual . . . . Propaganda is that which propagates the tenets or principles of a particular doctrine by zealous dissemination . . . . propaganda in the popular sense is disseminated not primarily to benefit the individual at whom it is directed, but accomplish the purpose or purposes of the person instigating it . . . . I believe that it was Congress' intention, when providing for the deduction of contributions to educational corporations, not to benefit and assist the aims of one class against another, not to encourage the dissemination of ideas in support of one doctrine as opposed to another, to the profit of one class and to the detriment perhaps of another, but to foster education in its true and broadest sense, thereby advancing the interest of all, over the objection of none.***

S. 1362, 2 C.B. 152, 154.

B. Early Cases and Subsequent Developments

It is difficult to discern a uniform approach in the early court cases with regard to the "controversial" or "ends" tests of Reg. 45. Some of the leading cases are discussed below. (Because "advocacy" organizations typically seek change that requires implementation by government, the early law on "educational" purposes is intertwined with that of action organizations, although the statutory bans on substantial legislative activity and on political campaign intervention did not appear until 1934 and 1954, respectively. For a review of the following authorities from the perspective of the development of the law on lobbying restrictions, see "Lobbying Issues" in this year's CPE text.)

Slee v. Commissioner, 42 F.2d 184 (2d Cir. 1930), held that the American Birth Control League was not educational. The organization disseminated information on the relationship of national and world problems to uncontrolled procreation, sought to repeal anti-contraception laws through direct lobbying, and operated a clinic to advise women on how to prevent conception. Judge Learned Hand's opinion reasoned that the purpose to change the law would have been permissible if ancillary to the purpose of conducting the clinic, but the purpose to change the law was regarded as an end in itself under the circumstances, and was not considered an exempt purpose. However, the Second Circuit did not assert the "controversial propaganda" regulation as a ground of denial, as the Board of Tax Appeals had done (15 B.T.A. 710, 715 (1929)). Judge Hand reasoned as follows:

> ***Political agitation as such is outside the statute, however innocent the aim, though it adds nothing to dub it "propaganda," a polemical word used to decry the publicity of the other side.***

42 F.2d at 185.

Weyl v. Commissioner, 18 B.T.A. 1092 (1930), held not educational the League for Industrial Democracy, whose purpose was to promote a new social order based on production for use rather than production for profit, and which conducted research, published the views of its members (who differed on the method to best bring about the desired social order), and held lectures and debates. The court reasoned that the organization did not educate in the sense of presenting both sides of the matter, but only advocated its side, and that it was not Congressional intent to exempt organizations that advocate drastic political and economic change. The Second Circuit reversed (48 F.2d 811 (1931)), finding the activities educational in that they were of interest and informative to students of political economy, and finding that the organization had "no legislative program hovering over its activities."

Leubuscher v. Commissioner, 54 F.2d 998 (2d Cir. 1932), involved two organizations. One had the following purposes:

> ***teaching, expounding, and propagating the ideas of Henry George . . . especially what are popularly known as the single tax on land values and international free trade.***

54 F.2d at 999.

The other was the Manhattan Single Tax Club, founded by Henry George, which had a purpose to advocate the abolition of taxes on industry and replacement with a single tax upon land. The court held that the former organization

was educational, reasoning that its purpose was to teach rather than to lobby. But the court also held that the latter organization was not exclusively educational, reasoning that to advocate is not an educational purpose, and that the organization's purpose was not to educate but to effect change. The Board of Tax Appeals had held the former organization also not exempt, on the ground that it had a purpose to effect legislation, though the Board also stated that the controversial nature of the single tax theory did not render the teaching of it non-educational. 21 B.T.A. 1022 (1930). Thus, the Second Circuit reversed as to the former organization.

Cochran v. Commissioner, 30 B.T.A. 1115 (1934), held not educational the World League Against Alcoholism, formed by organizations (some of which favored prohibition and some of which opposed it) from various countries to gather, research, and disseminate information about alcoholism. Its purpose expressed in its constitution was to attain the total suppression throughout the world of alcoholism, through education and legislation, although the reference to "legislation" was later dropped and the organization never had a legislative program. The organization distributed literature both supporting and opposing prohibition, and did not promote particular methods for eliminating alcoholism. The court reasoned that the organization disseminated information that was highly controversial in nature and was like an agent to its members, serving their prohibition or anti-prohibition causes. The Fourth Circuit reversed, reasoning that the elimination of alcoholism (as opposed to alcohol) was not a controversial cause, that the organization disseminated information on both sides of the prohibition issue, and that the controversial views of the members did not detract from the organization's educational nature:

> ***If a public library has on its shelf books of a highly controversial character, it is none the less educational if it is not operated and maintained for the purpose of giving only one side of a question.***

78 F.2d 176, 179 (4th Cir. 1935).

See also Seasongood v. Commissioner, 227 F.2d 907 (6th Cir. 1955).

As previously mentioned, Congress passed the restriction against substantial legislative activities in 1934. The original bill would also have prohibited substantial "participation in partisan politics," but such language was later struck. H.R. Rep. No. 1385, 73d Cong., 2d Sess. 3-4, 17 (1934), 1939-1(Pt. 2) C.B. 629. Some commentators inferred from this action that Congress did not object to the exemption of organizations that advocated a position on controversial or "political" issues (in the broad sense of affecting government policy, as opposed to the narrow sense of supporting or opposing the campaigns of

candidates). However, the Service did not eliminate the "controversial or partisan propaganda" test from its educational regulation when the regulations were subsequently amended in 1935.

In 1938, Treasury amended the educational regulation by adding, in part, the following language:

> ***An organization formed, or availed of, to disseminate controversial or partisan propaganda is not an educational organization within the meaning of the Act. However, the publication of books or the giving of lectures advocating a cause of a controversial nature shall not of itself be sufficient to deny an organization the exemption, if carrying on propaganda, or otherwise attempting, to influence legislation forms no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial and educational nature.***

Reg. 101, Art. 101(6)-1.

As of 1954, the Service regarded the law as establishing that an organization could have as its ultimate objective the creation of public sentiment favorable to one side of a controversial issue and still secure exemption, provided that its methods were educational and that it did not attempt to influence legislation to a substantial degree. See <u>Hearings Before the Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations</u>, H.R. Res. 217, 83d Cong., 2d Sess., pt. 1, 433 (1954) (testimony of Norman A. Sugarman, Assistant Commissioner of Internal Revenue). The Service regarded the caselaw as favoring a methodology test.

C. <u>1959 Regulations</u>

The regulations under the 1954 Code (finalized in 1959) basically adopted a methodology test (referred to below as the educational regulation or "full and fair" test) for determining whether an organization was educational, by including the following statement which remains in the regulation today:

> ***An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.***

Reg. 1.501(c)(3)-1(d)(3)(i).

Applying the educational regulation, Rev. Rul. 68-263, 1968-1 C.B. 256, held not educational an organization that, as a substantial activity, distributed publications that sought to discredit particular institutions and individuals on the basis of unsupported opinions and incomplete information about their affiliations and activities. The organization had a purpose to alert the American citizenry to the dangers of an extreme political doctrine, and distributed materials that included many allegations that certain individuals and institutions were of questionable national loyalty. Such charges were primarily developed by the use of disparaging terms, insinuations, innuendoes, and the suggested implications to be drawn from incomplete facts. For instance, the organization based many of its conclusions on incomplete listings of an individual's organizational affiliations without stating the extent or the nature of the affiliations or attempting to present a full and fair exposition of the pertinent facts about those organizations.

Rev. Rul. 78-305, 1978-2 C.B. 172, provided a useful example of an organization that satisfied the methodology test. It held educational an organization formed to educate the public about homosexuality in order to foster an understanding and tolerance of homosexuals and their problems. The organization collected factual information relating to the role of homosexual men and women in society and disseminated this information to the public. The organization presented seminars, forums, and discussion groups open to the public. Materials distributed to the public included copies of surveys, summaries of opinion polls, scholarly statements, publications of government agencies, and policy resolutions adopted by educational, medical, scientific, and religious organizations. The organization accumulated factual information through the use of opinion polls and independently compiled statistical data from research groups and clinical organizations. All materials disseminated by the organization contained a full documentation of the facts relied upon to support conclusions contained therein.

In National Association for the Legal Support of Alternative Schools v. Commissioner, 71 T.C. 118 (1978), acq., 1981-2 C.B. 2, the organization at issue, which was held to be educational under IRC 501(c)(3), collected and disseminated copies of briefs in legal actions involving alternative schools, and published a newsletter that encouraged individuals with views different from the organization's to submit them for publication. The Service argued that the organization advocated the advantages of alternative schools over public schools without presenting a sufficiently full and fair exposition of pertinent facts. The court reasoned that the dissemination of the briefs filed by the opposing parties

was an appropriate method of presenting a full and fair exposition of facts, and that the newsletter's invitation for supporting views allowed the audience to consider opposing views and form their own opinion on the subject.

D. Big Mama

Big Mama Rag, Inc. v. United States, 631 F.2d 1030 (D.C. Cir. 1980), held unconstitutional the educational regulation. The landmark case generated a great deal of controversy and is extensively discussed in 1981 CPE at 66.

The case involved an organization that published a newspaper dealing with issues of concern to women. The editors printed anything that would advance the cause of the women's movement and refused to publish material they considered damaging to the cause. The organization also devoted a considerable minority of its time to promoting women's rights through workshops, seminars, lectures, a weekly radio program, and a free library.

The lower court upheld denial of exemption under IRC 501(c)(3) for failure to meet the educational tests of Reg. 1.501(c)(3)-1(d)(3)(i) and Rev. Rul. 67-4. 494 F.Supp. 473 (D.D.C. 1979). The government argued that the one-sided editorial policy precluded a full and fair exposition of pertinent facts; that many articles presented unsupported opinion, innuendo, and inflammatory, disparaging language; and that the organization's advocacy of revolution rather than reform was not useful to the community. The organization argued that the newspaper as a whole met the full and fair test; that the full and fair test does not require presentation of opposing points of view, as religious organizations need not make the case for atheism; and that the full and fair test unconstitutionally regulated the content of speech in violation of the First Amendment and was so vague as to allow discriminatory enforcement (in this case, against the organization for its support of lesbianism). The District Court held that the organization failed to meet the "full and fair" test, reasoning that the organization need not present views inimical to its philosophy, but must be sufficiently dispassionate as to provide its readers with the factual basis from which they may draw independent conclusions (unlike organizations that further an exempt purpose other than educational); and that the full and fair test did not impermissibly regulate speech, was sufficiently clear to allow objective enforcement, and did not appear discriminatorily applied under the facts, since the Service had approved an organization promoting understanding of homosexuality in Rev. Rul. 78-305. However, the court rejected the argument that the subject matter was not "useful to the community," finding such a standard too subjective to pass constitutional muster.

The D.C. Circuit reversed, holding that the educational regulation, particularly the full and fair test, was excessively vague in violation of the First Amendment, both in describing who is subject to the test and in articulating its substantive requirements. The court reasoned that the Service defined "advocates a particular position" as synonymous with "controversial" (citing the IRM), and found the "controversial" standard overly subjective. With respect to the "full and fair" test, the court considered the phrase "sufficient . . . to permit an individual or the public to form an independent opinion or conclusion" especially vague, considered it futile to try to distinguish between fact and unsupported opinion, considered the Service's preoccupation with facts misplaced since they can be distorted, and also considered it futile to try to distinguish between appeals to the mind as opposed to the emotions, a test suggested by the government as embodied in the regulation. The court agreed with the lower court insofar as the latter had observed that the regulation does not compel an educational organization to present views inimical to its philosophy. The Circuit Court did indicate that exemption need not be accorded to every organization claiming to be educational, but only that they must be evaluated with criteria capable of neutral application.

E. National Alliance

In National Alliance v. United States, 710 F.2d 868 (D.C. Cir. 1983), the court upheld the Service's denial of exemption to an organization that published a monthly newsletter and membership bulletin, organized lectures and meetings, issued occasional leaflets, and distributed books, all for the stated purpose of arousing in white Americans of European ancestry "an understanding of and a pride in their racial and cultural heritage and an awareness of the present dangers to that heritage." The newsletter's general theme was that "non-whites" are inferior to white Americans of European ancestry, and that Jews control the media and thus cause government policy to be harmful to the interests of white Americans of European ancestry. The lower court, following Big Mama, upheld the organization's exemption as educational, because of the invalidity of the regulation. 81-1 U.S.T.C. ¶ 9464, 48 A.F.T.R.2d ¶ 81-5029 (D.D.C. 1981). The government set forth in its briefs the four-prong "methodology" test (later published in Rev. Proc. 86-43) as its test to determine whether the organization's activities were educational. The court rejected the methodology test, finding its criteria as vague as the regulation, and even more susceptible of selective enforcement since they were not published.

The D.C. Circuit reversed, holding that the organization's materials could not qualify as educational within any reasonable interpretation of the term, and therefore did not decide the question whether the methodology criteria cured

the vagueness problem in the educational regulation. The court reasoned that although the organization cited certain purported facts in support of its views (e.g., crimes committed by blacks), there was no reasoned link between the facts cited and the conclusions asserted by the organization, and that the organization's views required more than mere assertion and repetition, since the truth of such views was not readily demonstrable. The court distinguished Big Mama on the ground that the vague test set forth in the regulations posed a real risk of arbitrary enforcement, in that the organization's activities in Big Mama could have been found educational within some reasonable interpretation of the term. Although the court avoided the question of constitutionality of the methodology test, it did state that the test tends "toward ensuring that the educational exemption be restricted to material which substantially helps a reader or listener in a learning process," and therefore reduces the vagueness found in Big Mama. The court also cited the government's argument that it need not, and cannot, devise an educational standard free from all subjectivity, and that judicial review protects against discriminatory enforcement.

F. Rev. Proc. 86-43

Rev. Proc. 86-43, 1986-2 C.B. 729, remains the Service's official administrative pronouncement on the subject of the methodology test. The Rev. Proc. indicates that it is the Service's policy to maintain a position of disinterested neutrality with respect to the beliefs advocated by an organization, and that it is the method used by the organization in advocating its position, rather than the position itself, which determines whether the organization has educational purposes. The Service stated that publication of the test represented no change either to existing procedures or to the substantive position of the Service. The method used by the organization to develop and present its views will not be considered educational if it fails to provide a factual foundation for the viewpoint being advocated, or if it fails to provide a development from the relevant facts that would materially aid a listener or reader in a learning process. The presence of any of the following factors in the presentations made by an organization is indicative that the method used by the organization to advocate its viewpoints is not educational:

1. The presentation of viewpoints unsupported by facts is a significant portion of the organization's communications.

2. The facts that purport to support the viewpoints are distorted.

3. The organization's presentations make substantial use of inflammatory and disparaging terms and express conclusions more on the basis of strong emotional feelings than of objective evaluations.

4. The approach used in the organization's presentations is not aimed at developing an understanding on the part of the intended audience or readership because it does not consider their background or training in the subject matter.

The Service indicated, however, that an organization's advocacy may be educational in exceptional circumstances even if one of more of the factors are present, and that all the facts and circumstances must be considered.

G. Nationalist Movement

In The Nationalist Movement v. Commissioner, 102 T.C. 558 (1994), affirmed per curiam, 37 F.3d 216 (5th Cir. 1994), cert. denied, 131 L.Ed.2d 136 (1995), the Tax Court upheld the Service's denial of 501(c)(3) exemption to an organization on the ground of failure to operate exclusively for charitable or educational purposes.

The organization, largely through the efforts of its founder, engaged in a variety of activities, including providing "social services" (phone counseling); litigating, mainly as a party plaintiff purportedly to advance First Amendment rights; appearing in radio and television talk shows (often before hostile audiences) and debates; holding conventions, speeches, rallies, and parades; conducting classes and training, including physical and weapons training of members; and publishing a monthly newsletter that reported on rallies, speeches, litigation, and other events, answered questions about the organization, and provided editorial commentary. The organization allocated its staff time as follows:

25% social service
20% legal (First Amendment)
20% TV, broadcasting
10% administration
10% publishing
5% forums, speeches
5% classes, training
5% miscellaneous

A disproportionately large share of the organization's expenditures was devoted to the newsletter and social service activities.

The organization's membership application stated as follows:

> ***I apply for membership in The Nationalist Movement vowing freedom as the highest virtue, America as the superlative nation, Christianity as the consummate religion, social justice as the noblest pursuit, English as the premier language, the White race as the supreme civilizer, work as the foremost standard and communism as the paramount foe.***

The organization was generally critical of blacks, Jews, homosexuals, Communists, and other minorities of various kinds, advocated a "pro-majority" philosophy to counteract minority "tyranny" in the form of special privileges for minority groups such as affirmative action, and advocated voluntary emigration or repatriation of foreigners and minorities, who were considered "unassimilable" and "incompatible". For instance, a fundraising letter described incidents of perceived injustice carried out by minorities against whites (including the beating of a high school student, demands for the ouster of white school officials and other white workers, and the tearing down of the American flag) and included a petition directed to "public officials" to "keep gangs of minorities from replacing government by the people." One newsletter included a list of "common sense" standards for Supreme Court Justices, including "No odd or foreign name," "No beard," "Christian and Protestant," and "Anti-ERA and anti-busing." Another contained a list of people who should be excluded from U.S. citizenship, including "Non-Americans: Boat people, wetbacks and aliens who are incompatible with American nationality and character, such as Nicaraguan refugees and Refusnik immigrants." Another newsletter queried,

> ***What is 'Black History' Month anyhow? No such thing. Nary a wheel, building or useful tool ever emanated from non-white Africa. Africanization aims to set up a tyranny of minorities over Americans.***

The organization encouraged its supporters to help the poor, sick, and elderly, and included Christian observances in its public activities.

With respect to educational purposes, the court held that Rev. Proc. 86-43 was not unconstitutionally vague or overbroad, on its face or as applied. The court stated that Rev. Proc. 86-43 does not by its terms require organizations to present and rebut opposing views, and that it is doubtful whether such a requirement would be appropriate even apart from Constitutional considerations; thus, the Service need not evaluate how accurately or completely an organization presents opposing views.

The court found that the newsletter activity was substantial, reasoning that it was an important source of support and means of communicating with members and was available to the general public. In applying the Rev. Proc.

86-43 criteria and finding the newsletter non-educational, the court found that a significant portion of it was devoted to presenting viewpoints unsupported by facts, such as the standards for Supreme Court Justices, the groups of people who should be excluded from U.S. citizenship, and the statement regarding Black History Month.

The court could not determine whether the newsletter failed the distortion standard since the government had not pointed to specific distorted or erroneous facts in its brief. However, the court did find one obvious distortion of fact: an article stated that the Anti-Defamation League "recently called for Nationalists to be prosecuted and even killed for pamphleteering and exercising free speech," but later indicated that the "killed" reference was an extrapolation from the quoted phrases "must be stopped" and "pay the price." The court noted that such a patent distortion is less serious than one not apparent on its face.

The court found prevalent use of inflammatory terms, such as references to "queers" and "perverts," and in use of the terms "invasion" and "invaders" to describe a protest march in Forsyth County, Georgia by "black-power" participants, with those opposing the march characterized as "patriots" and "martyrs."

The court also found that the organization did not consider its audience's youthful background. The average age of members was in the low twenties, newsletter articles discussed activities of students and skinheads, and the organization sought to recruit youth. The newsletter included many references to events and public leaders in the 1960s, of which the audience may have had limited knowledge.

The Tax Court also held that the organization failed to provide sufficient detail of the social service work (phone counseling) and litigation (mostly involving the organization as party plaintiff) to establish that such activities accomplished exempt purposes. On appeal, the Fifth Circuit did not reach the issue whether the methodology test is constitutional, since it determined that the organization's non-advocacy activities (phone counseling and litigation) were substantial non-exempt activities.

3. <u>Relationship of Methodology Test to Other Exemption Issues</u>

A. <u>Lobbying</u>

Rev. Proc. 86-43 implies that the fact that advocacy is educational does not mean that it is not lobbying. IRC 501(c)(3) prohibits as a substantial activity

the attempting to influence legislation, by carrying on propaganda **or otherwise**. However, the relationship between education and lobbying under IRC 501(c)(3) is complicated, partly by IRC 501(h) and 4911. An important question is under what circumstances an organization's advocacy may satisfy the methodology test and still constitute lobbying.

(1) Advocacy of Objective vs. Nonpartisan Analysis

The 1959 regulations include a definition of an action organization that incorporates both an "ends" test and a "means" test:

An organization is an "action" organization if it has the following two characteristics:

> ***(a) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and***
>
> ***(b) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public.***

Reg. 1.501(c)(3)-1(c)(3)(iv).

Rev. Rul. 62-71, 1962-1 C.B. 85, provided an example of such an action organization. The organization's purpose was to support an educational program for the stimulation of interest in the study of economics, particularly with reference to the single tax theory of taxation. The organization conducted research (primarily concerned with securing information for determining the effect of the various methods of real estate taxation on the rise and fall of land values); moderated discussion groups; disseminated publications at nominal prices; and maintained a lecture service for schools and other organizations that studied social and economic problems. The organization's announced policy was to promote its philosophy by educational methods as well as by the encouragement of political action. Most of the publications and a substantial part of the other activities dealt with the theory advocated, which could be put into effect only by legislative action.

Rev. Rul. 64-195, 1964-2 C.B. 138, involved an organization held to engage in nonpartisan analysis (rather than advocacy), in connection with court reform which was the subject of an upcoming state referendum. The organization was a 501(c)(3) educational organization that promoted the study of law. The analyses explained contemplated changes in (1) the number of such courts,

territory of each; (2) judges: number, pay, removal, duties; (3) clerks: number, pay, removal, duties; (4) jurisdiction of courts, court clerks and magistrates; and (5) rules of practice and procedure for courts and magistrates. The organization did not participate in any way in the presentation of suggested bills to the state legislature and did not campaign to persuade the people to vote for the constitutional amendment. Its activity in connection with court reform was limited to the study, research, and assembly of materials and the presentation of an objective analysis to those interested in court reform including those who opposed it as well as those who favored it, and to the general public.

Other Code and regulatory provisions distinguish between advocacy and nonpartisan analysis. With respect to activities of private foundations, IRC 4945(e), enacted in 1969, defines as a taxable expenditure an amount paid for any attempt to influence legislation through an attempt to affect the opinion of any segment of the general public, other than through making available the results of "nonpartisan analysis, study, or research."

Reg. 53.4945-2(d)(1)(ii), promulgated in 1972, provides as follows:

> ***For purposes of IRC 4945(e), "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of Reg. 1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. On the other hand, the mere presentation of unsupported opinion does not qualify as "nonpartisan analysis, study, or research."***

Reg. 53.4945-2(d)(1)(vii) contains a dozen examples regarding "nonpartisan analysis." Although the examples are too voluminous to discuss in detail here, they illustrate that analyses that present information merely on one side of a controversy rather than discussing the pros and cons do not constitute nonpartisan analysis, because they do not allow the audience to form an independent opinion or conclusion.

It should be noted that the nonpartisan analysis exception applies only where the organization makes the results available to the public in a proper manner, and the communication does not "directly" encourage the recipient to take action, within the meaning of Reg. 56.4911-2(b)(2)(iii)(A) through (C).

A question arises as to the relationship of the educational regulation (Reg. 1.501(c)(3)-1(d)(3)(i)) to the action organization regulation (Reg. 1.501(c)(3)-1(c)(3)(iv)), and to others that deal with the distinction between advocacy and nonpartisan analysis. As discussed above, the regulations under IRC 4945 equate nonpartisan analysis with satisfaction of the methodology test under IRC 501(c)(3). However, those regulations also indicate that nonpartisan analysis must discuss the pros and cons of both sides of an issue, whereas the D.C. District Court in Big Mama and the Tax Court in Nationalist Movement (unlike Alternative Schools) indicated that such discussion is not required under the methodology test.

The court in Haswell v. United States, 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), discussed the meaning of "nonpartisan analysis" under action organization Reg. 1.501(c)(3)-1(c)(3)(iv). At issue was the National Association of Railroad Passengers, an organization formed by an individual concerned by the discontinuance of passenger trains. The organization advocated the preservation of passenger service. The court noted by analogy the definition under IRC 4945(e) and regulations thereunder which make clear that projects designed to present information on one side of a legislative controversy, or that fail to report available information that would tend to dispute conclusions that are advocated, are partisan, and stated that nonpartisan analysis, study, or research requires a fair exposition of both sides of an issue. The court also noted that the term "nonpartisan" relates to issues rather than organized political parties. The court concluded that the organization's materials were partisan and prepared in a manner that would present most forcefully its position rather than being full and fair objective expositions that would enable the audience to reach an independent conclusion.

Some observers have concluded that the Service might be justified in applying a stricter "full and fair" standard for purposes of nonpartisan analysis than for purposes of the educational methodology test.

(2) Advocacy of Legislation vs. Discussion of Broad Problems

The test of lobbying under Reg. 1.501(c)(3)-1(c)(3)(ii) is whether the organization advocates the adoption or rejection of legislation, or whether the organization contacts (or urges the public to contact) legislators for the purpose of proposing, supporting, or opposing legislation. IRC 4945 provides some interpretive guidance.

According to the Senate Report, IRC 4945(d)(1) and (e), which contain a definition of lobbying, were intended essentially to retain the 501(c)(3) definition of lobbying except for the "substantiality" test. S. Rep. No. 552, 91st Cong., 1st Sess. 48 (1969). Reg. 53.4945-2(d)(4) provides that examinations and discussions of broad social, economic, and similar problems are not lobbying, even if the problems are of the type with which government would be expected to deal ultimately. The regulation states that lobbying does not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, but only where such discussion does not address itself to the merits of a specific legislative proposal, and only where such discussion does not directly encourage recipients to take action with respect to legislation.

As mentioned above, the 4945 regulations contain the "nonpartisan analysis" exception to lobbying under Reg. 53.4945-2(d)(1)(ii). The "nonpartisan analysis" exception goes further than the "discussion of broad problems" exception and allows a position to be taken on a specific pending legislative proposal. See Examples (5) and (8) under Reg. 53.4945-2(d)(1)(vii), which involve nonpartisan analysis in which a position is taken with respect to pending legislative proposals.

However, G.C.M. 36127 (Jan. 2, 1975) concluded that an expression of opinion or position by an organization for or against specific proposed or pending legislation, even if educational, would be an attempt to influence legislation under IRC 501(c)(3), notwithstanding the 4945 regulations. The G.C.M. drew a distinction between specific legislative proposals or programs, on the one hand, and general classes of legislative solutions to policy problems, which arise from nonpartisan analysis and are not timed to coincide with specific legislative proposals, on the other.

Under the reasoning of the G.C.M., advocacy favoring or opposing specific legislative proposals would be regarded as lobbying under Reg. 1.501(c)(3)-1(c)(3)(ii), even if presented in conjunction with nonpartisan analysis. Courts have held that time spent in formulating, discussing, and agreeing upon an organization's positions with respect to advocating or opposing legislative measures is properly considered a part of the organization's program for influencing legislation. See Kuper v. Commissioner, 332 F.2d 562 (3d Cir. 1964), cert. denied, 379 U.S. 920 (1964); League of Women Voters v. United States, 180 F.Supp. 379 (Ct.Cl. 1960). Thus, time spent on formulating advocacy positions would apparently also be considered as devoted to influencing legislation.

(3) IRC 501(h) and 4911

The above discussion applies to 501(c)(3) organizations that do not have a 501(h) election in effect; the analysis is somewhat different for organizations with a 501(h) election, which are subject to the lobbying rules under IRC 4911.

The lobbying definitions under IRC 4911 contain exceptions practically identical to those in IRC 4945 for nonpartisan analysis (IRC 4911(d)(2)(A) and Reg. 56.4911-2(c)(1)) and for discussion of broad problems (Reg. 56.4911-2(c)(2)). Furthermore, these exceptions expressly apply in determining whether an organization that has made the 501(h) election has engaged in lobbying for 501(c)(3) purposes, whereas they are not controlling for 501(c)(3) lobbying purposes with respect to organizations without a 501(h) election. Therefore, G.C.M. 36127 cannot be applied to an organization with a 501(h) election; the nonpartisan analysis exception is an absolute exception to lobbying.

The enactment of IRC 501(h) and 4911 was not intended to change the lobbying rules under IRC 501(c)(3) for non-electing organizations. See IRC 501(h)(7). Thus, the relationship of the methodology test to the lobbying rules depends on whether the organization has made a 501(h) election.

Some commentators have questioned the viability of action organization Reg. 1.501(c)(3)-1(c)(3)(iv) for organizations with a 501(h) election in effect, given the purpose of IRC 501(h) to provide a more precise definition of lobbying and of the permissible amounts of lobbying. However, the regulations under IRC 501(h) indicate that Reg. 1.501(c)(3)-1(c)(3)(iv) is not affected by a 501(h) election. See Regs. 1.501(c)(3)-1(c)(3)(ii) and 1.501(h)-1(a)(4).

B. Political Intervention

IRC 501(c)(3) contains an absolute bar to political intervention; Rev. Proc. 86-43 makes clear that nothing vitiates that bar. Under Rev. Proc. 86-43, the publication of statements on behalf of or in opposition to a candidate is prohibited, regardless whether educational. For a fuller discussion, see 1993 CPE at 411-415. However, the Service has condoned certain "voter education" activities (such as the truly impartial publication of the voting records of all legislators) under certain circumstances. See 1993 CPE at 419-427.

C. Other Exempt Purposes

The methodology test determines only whether advocacy is educational. If advocacy serves another exempt purpose, then the test is not controlling. See,

e.g., Rev. Rul. 68-306 (religious publication furthered religious purposes). The regulations expressly state that a charitable organization may advocate its views on controversial issues:

> ***The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under IRC 501(c)(3) so long as it is not an "action" organization.***

Reg. 1.501(c)(3)-1(d)(2). However, non-educational advocacy must be reasonably related to the accomplishment of the exempt purpose. See Rev. Rul. 80-278, 1980-2 C.B. 175. Further, if an organization is "charitable" only in that it advances education, then the methodology test is controlling on the issue of whether its advocacy of particular viewpoints furthers charitable purposes.

Cases involving organizations that claim a religious purpose are particularly sensitive matters. Such advocacy generally falls into two categories--(1) religious proselytizing (i.e., seeking converts to the religion), and (2) advocating a political, social, or other secular cause based on religious principles. Advocacy of the first type (and entailing none of the second) is clearly permissible. Advocacy of the second type could raise questions whether the advocacy is conducted exclusively for religious purposes, requiring a careful examination of the facts and circumstances, through taxpayers have won several cases in such situations. See Girard Trust Co. v. Commissioner, 122 F.2d 108 (3rd.Cir. 1941); Lord's Day Alliance of Pennsylvania v. United States, 65 F.Supp. 62 (E.D.Pa. 1946). Even if the advocacy is conducted exclusively for religious purposes, it may still run afoul of the action organization regulations under IRC 501(c)(3), which contain no exceptions for religious organizations. See, e.g., Christian Echoes National Ministry, Inc. v. United States, 470 F. 2d 849, 854 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973). However, particularly in the case of churches with many activities, the advocacy may prove to be insubstantial.

In cases where advocacy activities purportedly in furtherance of an exempt purpose other than education (e.g., promoting secular causes based on religious beliefs, defending human rights, preventing cruelty to animals) do not appear to satisfy the methodology test, coordination with the Exempt Organizations Division in Headquarters may be appropriate.

D. Activities Illegal or Contrary to Public Policy

If an organization advocates engaging in criminal or other activities contrary to public policy, then it may run afoul of the prohibition against such activity by 501(c)(3) organizations. See. e.g., Rev. Rul. 75-384, 1975-2 C.B. 204; 1994 CPE at 155.

Cases in which educational methodology problems arise may involve organizations whose membership criteria discriminate on the basis of race, religion, or similar criteria. Where such is the case, violation of clearly established public policy may be considered as an alternative ground for denial or revocation. The lower court in National Alliance rejected the government's argument that the organization, by advocating violence against blacks and Jews, violated the common law prohibition against charities engaging in activities that are illegal or contrary to public policy; the court considered this prohibition applicable only to racial discrimination by schools. The issue was not presented to the D.C. Circuit on appeal. However, the Service may raise the argument in appropriate cases.

E. Inurement and Private Benefit

Non-educational purposes and private benefit are not entirely distinct concepts; activities that do not further an exempt purpose may further the private interests of the founders. In some cases, an advocacy organization appears to be carrying on a personal vendetta of its founder against one or more individuals or organizations. The court in Save the Free Enterprise System, Inc. v. Commissioner, T.C.M. 1981-388, relied on inurement and private benefit to the founder as the ground for denial rather than the non-educational nature of the advocacy. See also Puritan Church-The Church of America v. Commissioner, T.C.M. 1951-151; G.C.M. 36323 (June 26, 1975). The Tax Court in Nationalist Movement, however, rejected the Service's argument that the organization privately benefitted its founder by providing him a forum to express his personal agenda and promote his career in politics, reasoning that the founder did not engage much in retaliatory personal attacks, financially benefit from the organization, or appear to have current ambitions for public office (although he had campaigned for office a decade earlier).

Where advocacy qualifies as educational, benefit to the founder arising from the advocacy itself may be incidental to achievement of the educational purpose in most cases, although all the facts and circumstances must be considered.

F. Commerciality

Even if the content of an organization's publications or programming is educational, the organization may still be denied exemption if conducted like a commercial business. See, e.g., Rev. Rul. 77-4, 1977-1 C.B. 141; 1988 CPE at 62.

G. Promotion of the Arts

The Service has long held that promotion of the arts is educational. See, e.g., Rev. Rul. 64-175, 1964-1(Pt. 1) C.B. 185. Although the proposition has never been tested in court, it might be concluded that the methodology test does not apply to an organization that promotes literature, film, or other arts, even if the art contains messages or "advocates" particular views, so long as the art is portrayed as fictional (rather than as documentary or nonfictional).

4. Value Neutrality and Constitutional Concerns

As discussed above, the D.C. Circuit in Big Mama found the educational regulation unconstitutionally vague, in violation of the First Amendment. However, the Tax Court's holding in Nationalist Movement and the D.C. Circuit's dicta in National Alliance indicate that the regulation, as amplified by the methodology test, is not unconstitutionally vague.

Aside from First Amendment concerns, where the Service denies exemption to an organization for failure to meet the methodology test, the organization may claim that it is being treated differently than similar organizations, in violation of its Constitutional rights to due process under the Fifth Amendment and equal protection. The Service is susceptible to this charge in any action that it takes with any taxpayer. However, the charges may arise more frequently in cases involving educational advocacy organizations (and religious organizations), because of the awareness of such organizations that they are engaged in activities protected by the First Amendment, which prohibits federal law from abridging the freedom of speech. Advocacy organizations have sometimes charged that the Service is discriminating against them due to dislike of their viewpoints or positions rather than due to their methodology of presentations.

Such arguments were raised in Nationalist Movement. The Tax Court indicated that although it takes a restrained and cautious approach to allegations of administrative inconsistency, it also does not take such allegations lightly. The court concluded that the organization had not proven unequal treatment as a factual matter.

Thus, cases involving application of the methodology test are particularly sensitive. It is important for the tax law specialist to try to be as objective as possible in applying the test. As the National Alliance court put it, "the government must shun being the arbiter of 'truth'" (although the government, unfortunately, cannot entirely avoid this role to the extent that it must determine whether communications are supported by undistorted facts). Each case should be well-developed and carefully considered before a denial or revocation is issued, and coordination with Headquarters may be appropriate.

# I. PUBLIC CHARITY STATUS ON THE RAZOR'S EDGE

IRC 509(a)(3) AND THE COMPLEXITIES OF THE
OPERATED IN CONNECTION WITH INTEGRAL
PART TEST, AND MISCELLANEOUS
IRC 509(a)(3) ISSUES

**by**
**Ron Shoemaker and Bill Brockner**

***The Internal Revenue Service has drafted fantastically intricate and detailed regulations to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while avoiding the imposition of taxes.***

From a court opinion as to whether an organization was "operated in connection with." Windsor Foundation v. United States, 77 U.S.T.C. 9709 (E.D. Va., 1977).

## 1. Introduction

The primary advantage for the over 32,000 IRC 501(c)(3) or IRC 4947(a)(1) organizations that qualify as "supporting organizations" described under IRC 509(a)(3) is the avoidance of the private foundation rules and taxes under Chapter 42 of the Code. While supporting organizations take several forms, the central focus of this article is on the "operated in connection with" variety that requires application of the "integral part test" and related sub-tests. The crucial elements of the integral part test will be discussed independently and in context with real and hypothetical cases. Finally, the article addresses a number of miscellaneous but important IRC 509(a)(3) issues. A Subject Directory follows the article.

## 2. General

IRC 509(a)(3) was enacted as a part of the Tax Reform Act of 1969. The theory behind the provision, as explained in the 1982 EO CPE Text on the subject, Exclusion From Private Foundation Status Under IRC 509(a)(3), page 24, is "that the public charity's control or involvement with the supporting organization will render unlikely the potential for manipulation to private ends present in a private foundation." It is this element of a supported organization's oversight or accountability that legally allows the supporting organization (often sailing on the razor's edge between public charity and private foundation status) to navigate away from the shoals of Chapter 42 of the Code.

Under the statute, a supporting organization may be one of three different varieties. The relationship that exists where a supporting organization is "operated supervised or controlled by" a public charity is much like the relationship between a parent corporation and its wholly-owned subsidiary. See Reg. 1.509(a)-4(g). The relationship between a supporting organization and the public charity it supports is, in some ways, similar to the relationship between brother-sister corporations. See Reg. 1.509(a)-4(h). The third variety of supporting organization comes under the rubric "operated in connection with". See Reg. 1.509(a)-4(i). The "integral part test" is a key element to qualification under the "operated in connection with" relationship. For a broader discussion of IRC 509(a)(3), see the 1982 EO CPE Text, page 23, and the 1993 EO CPE Text, p. 232.

GCM 36186, March 10, 1975, explains the problem in drafting the regulations with respect to the "operated in connection with" relationship to comply with the purpose behind the Tax Reform Act of 1969. An extract follows:

> ***The Regulations endeavor to restrict the application of this language exclusively to the types of strongly integrated relationships described in the legislative history. See S. Rep. 91-552, 91st Cong., 1st Sess. 57 (1969); H. Rep. 91-413, 91st Cong., 1st Sess. (Part 1) 41 and (Part 2) 6 (1969). Thus, the Regulations require that the supporting organization be responsive to and significantly involved in the operations of the publicly supported charity. Treas. Reg. section 1.509(a)-4(f)(4). In order to do this, the supporting organization must satisfy the "responsiveness test" and the "integral part test" of Treas. Reg. section 1.509(a)-4(i)(2) and (3) respectively.***

3. The "Operated in Connection With" Responsiveness Test and Other IRC 509(a)(3) Requirements

The relationship required of a supporting organization wishing to come under the "operated in connection with" language of IRC 509(A)(3)(B) as defined in Reg. 1.509(a)-4(i) is: (1) responsiveness to the needs of a publicly supported organization; as well as (2) an integral or significant involvement in the operations of the public charity. The regulations define a "responsiveness test" and a "integral part test."

Reg. 1.509(a)-4(i)(2) describes two separate and distinct avenues for achieving responsiveness to the supported organization. The first avenue is where the officers or directors of the supporting organization are elected by or are in common with those officers or directors of the public charity, or there is a close working relationship between the officers and directors of the two entities. Reg.

1.509(a)-4(i)(2)(ii). The second avenue, the one most frequently utilized by trusts, is under Reg. 1.509(a)-4(i)(2)(iii). It provides:

> ***(a) The supporting organization is a charitable trust under State law;***
> ***(b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and***
> ***(c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.***

While the responsiveness test is obviously a crucial element to qualification under "operated in connection with," most applications seen in Headquarters reveal few problems under this test. More often problems arise in complying with the "integral part test." However, before discussing this key test, other general IRC 509(a)(3) requirements deserve mention in passing.

The Regulations impose organizational and operational tests applicable to all three varieties of supporting organizations. Reg. 1.509(a)-4(b). To some extent, qualification under the organizational and operational tests is more difficult for the supporting organization seeking to qualify as "operated in connection with" IRC 509(a)(3). Under Reg. 1.509(a)-4(c), the supporting organization's governing instrument must contain appropriate language concerning the organization's purposes. Additionally, under Reg. 1.509(a)-4(d), the governing instrument, to meet the organizational test, must "specify" the publicly supported charities. Under the operational test set forth in Reg. 1.509(a)-4(e), the supporting charity must engage in activities that support or benefit the specified publicly supported organizations. Usually such activity takes the form of grants to the specified publicly supported charity. However, the activity of the supporting organization may take other forms as described in the Regulations. See also 4B(1) and 6A below. There is a further discussion of the requirements of the organizational test under 6B.

Also applicable to all three varieties under IRC 509(a)(3)(C), a supporting organization must not be controlled directly or indirectly by one or more disqualified persons (as defined in IRC 4946) other than foundation managers or other than one or more of the supported public charities. See also the discussion under 5 below.

## 4. The Integral Part Test

### A. A Common Example

A common example of an organization seeking exemption under IRC 509(a)(3) as a supporting organization, purportedly qualifying under the "operated in connection with" relationship, is an inter vivos or testamentary trust that is funded as a purely charitable trust at some time after the death of the settlor of the trust. In some cases, the trust becomes entirely charitable shortly after the settlor's death and in other cases the trust is not entirely charitable until the expiration of intervening life interests of the settlor's heirs or other beneficiaries who receive an income interest in the trust. After the trust becomes wholly charitable, the trust is commonly managed by a trust department of a bank having no interest in the trust other than as a fiduciary. The charitable beneficiary is one or more public charities specifically named in the Trust document. This type of trust is relatively uncomplicated in form. The main issue is whether there is a sufficient connection between the trust and the named charitable beneficiaries to qualify it as a supporting organization by virtue of the "operated in connection with" relationship; the second subsection of the "integral part test" is usually the key element in meeting such relationship.

### B. The Regulations - Alternative Tests

#### (1) General

The key to qualifying as a supporting organization under the "operated in connection with" relationship is being able to meet the requirements of the "integral part test" set forth in Reg. 1.509(a)-4(i)(3). There are two alternative ways in which the integral part test may be met by a supporting organization. The first is described in Reg. 1.509(a)-4(i)(3)(ii) as follows:

> ***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, such organizations, and, but for the involvement of the supporting organization, would not normally be engaged in by the publicly supported organizations themselves.***

Most IRC 509(a)(3) aspirants in exemption applications processed in Headquarters do not attempt to meet this subsection of the Regulations in order to satisfy the integral part test. Most entities seeking IRC 509(a)(3) status under the "operated in connection with" relationship are trusts or other organizations

having only a purpose to make grants to or for the use of the supported organization. Making grants to the supported organization does not generally constitute the kind of activity described in Reg. 1.509(a)-4(i)(3)(ii) since this integral part test contemplates more ongoing supportive program activity. See GCM 36523, December 18, 1975; GCM 36379, August 15, 1975. However, under GCM 38417, June 20, 1980, grant making would meet the requirement of the Regulation under consideration by virtue of the particular facts of that GCM. This is not inconsistent with the general rule. In GCM 38417, the supporting organization was making grants directly to a class of charitable beneficiaries that were also receiving grants from the supported organization, a community trust, a special type of IRC 509(a)(1)/170(b)(1)(A)(vi) public charity described in Reg. 1.170A-9(e)(11). Grant making is generally the means by which community trusts carry out their charitable purposes.

The second subsection, the alternative method, for qualifying under the "integral part test" is found in Reg. 1.509(a)-4(i)(3)(iii)(a) through (d). Under Reg. 1.509(a)-4(i)(3)(iii)(a), there is a three part test. First, the supporting organization must make payments of "substantially all" of its income to or for the use of one or more publicly supported organizations. Second, the amount of support received by the publicly supported organization(s) must represent a sufficient amount or part of the organization's(s') total support to ensure "attentiveness" to the operations of the supporting organization. Third, "a substantial amount" of the total support of the supporting organization must go to the publicly supported organization(s) that meet the "attentiveness" requirement described in the preceding sentence.

Each of the requirements of the Regulation suggests a certain portion of the income/support of the supporting organization must be paid out by the supporting organization. The Regulation does not define the specific numerical amount of the payout required. Similarly, the Regulation suggests that a certain portion of the support of the recipient public charity's total support must be received from the supporting organization to ensure its attentiveness. While the Regulation does not provide any numerical parameters for determining the income/support amounts, numerical amounts have been defined by revenue ruling and GCM. Each of these separate requirements is examined in turn, and, in detail as follows:

(2) <u>Subtest One- Substantially All of the Supporting Organization's Income</u>

a. <u>General</u>

Rev. Rul. 76-208, 1976-1 C.B. 161, defines the substantially all requirement to mean that the supporting organization must distribute 85 percent or more of its income to one or more publicly supported charities. For purposes of Reg. 1.509(a)-4(i)(3)(iii)(a), Rev. Rul. 76-208 holds that 85 percent is the appropriate definition of "substantially all" by virtue of the definition of "substantially all" under Reg. 53.4942(b)-1(c). The underlying GCM, GCM 36186, notes a number of other Code and Regulation sources where "substantially all" is defined as 85 percent but focuses on the IRC 4942 regulations since IRC 509 and Chapter 42 were both promulgated under the Tax Reform Act of 1969. GCM 36186 stated that "it appears logical to give the term substantially all a consistent meaning throughout the provisions of the Tax Reform Act of 1969 which relate to private foundations." The trust which was the subject of Rev. Rul. 76-208 failed to qualify under the integral part test because it accumulated 25 percent of its income yearly and thus failed to distribute 85 percent.

GCM 36523, December 18, 1975, addresses Rev. Rul. 76-208 and GCM 36186 on the 85 percent income payout requirement. The facts of GCM 36523 indicate that a supporting organization was paying out its income in most years to benefit a specifically named charity named in its trust document. In some years, income was accumulated and paid to the charity in a subsequent year. GCM 36523 distinguished the facts of GCM 36186 and found that accumulations of income in some years may be acceptable if the accumulations are not extended and if the accumulations are ultimately paid to the supported charity. Other favorable factors are that the accumulations were for a specific purpose and at the request of the publicly supported charity. GCM 36186 was distinguished on its facts, in part, from the holding of GCM 36523 because the accumulation of income by the trust described in GCM 36186 would never be paid to the named charitable income beneficiary according to the conclusion reached in GCM 36523.

G.C.M. 36523 goes even further and suggests that a facts and circumstances test may be appropriate in some cases. It states:

> ***Thus, we believe that all the facts and circumstances must be considered in determining whether a supporting organization satisfies the 'substantially all' requirement. Where, as in ... (G.C.M. 36186) ... there is a permanent accumulation of income, or where there is an accumulation for an extended period without***

> ***apparent purpose, the 'substantially all' requirement will not be met. Where, as in the instant case, however, there are only relatively minor delays and arguable reasons for these delays, we think it proper to consider the 'substantially all' test as having been met.***

Is there a conflict between GCM 36523 and GCM 36186 (Rev. Rul. 76-208) on the "substantially all" requirement? The G.C.M. states that it is distinguished from the earlier G.C.M. 36186 on the facts, and perhaps this is the way to view the differences to the extent that differences exist.

GCM 36523 also clarifies GCM 36186. GCM 36523 states that the "substantially all" requirement of Reg. 1.509(a)-4(i)(3)(iii)(a) is a prerequisite to all parts of the integral part test under Reg. 1.509(a)-4(i)(3)(iii).

b. The Definition of Income

What is the meaning of the term "income" for purposes of applying the "substantially all" test of the Regulation? Specifically at issue is the treatment of capital gains income of a trust. Under widely accepted accounting principles, capital gains are allocated to trust corpus unless the trust instrument provides to the contrary. For income tax purposes, the capital gains earned by a trust are included in income.

In PLR 9021060, February 28, 1990, the term "income" was held to not include all capital gains income for purposes of the application of the substantially all test of Reg. 1.509(a)-4(i)(3)(iii)(a). The PLR was also cited in the Private Foundation Handbook, IRM 7752-28.7, paragraph 523.33 (9-20-94).

The Service is now revisiting PLR 9021060, and has amended PFHB 523.33(8) (MT, 7752-38, May 10, 1996) in respect to the exclusion for all capital gains for purposes of the substantially all test. The Service believes that long term capital gains may indeed be excluded from income for purposes of the application of the substantially all test, but short-term capital gains must be included. This position is based on Rev. Rul. 76-208. Since the Service turned to Reg. 53.4942(b)-1(c) for the definition of the term "substantially all", it follows that the term "income" is tied to "adjusted net income." Adjusted net income is defined in Reg. 53.4942(a)-2(d) and includes short-term capital gains, but not long-term capital gains. Although many income tax distinctions between long-term and short-term capital gains ended years ago, there is still a great difference in the nature of short-term gains (a regular carried out financial strategy), versus long-term gains (intermittent sales of long held capital assets). IRC 1222 still distinguishes short-term capital gains as gains from sales or

exchanges of capital assets held for not more than a year and long-term capital gains as gains from the sales of exchanges of capital assets held for more than a year. Under certain facts and circumstances, short-term capital gains may be accumulated by the supporting organization if done at the explicit request of the supported organization. See discussion of GCM 36523 in (2)a above. Headquarters is reviewing this matter.

(3) <u>Subtest Two - The Attentiveness Test</u>

a. <u>General Rule</u>

A second test that must be met to qualify under the integral part test of section 1.509(a)-4(i)(3)(iii)(a) is the attentiveness requirement. In the words of the Regulations "... the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to ensure the attentiveness of such organizations to the operations of the supporting organization."

GCM 36379, August 15, 1975, discussed the attentiveness test in terms of a numerical support limitation. The GCM stated that although the regulations do not specify a required percentage of support, it seems unlikely that grants that were less than 10 percent of a beneficiary's support would, in the usual case, be deemed sufficient to ensure attentiveness. The facts of the GCM disclose that the supporting organization was providing support to the supported organizations in amounts that ranged from 2 to 6 percent of the beneficiaries' support. Thus, the GCM found that under a "strict application" of subdivision (a), the trust did not satisfy the "integral part test."

GCM 36379 does not establish a standard set in stone. The GCM does not absolutely rule out qualifying support to the supported organization of less than 10 percent. Secondly, it does not necessarily bless qualifying support to the supported organization where there is an amount that is greater than 10 percent of the supported organization's total support. The GCM goes on to discuss the "facts and circumstances" test under Reg. 1.509(a)-4(i)(3)(iii)(d). The holding in the GCM was that the trust was able to meet the facts and circumstances test of subdivision (d) because of the large size of the gift and the long history with the supported charity.

The numerical test was again applied in GCM 36523, where it was held that providing 2 percent of the supported organization's support was insufficient to meet the 10 percent test of GCM 36379. Thus, the 10 percent numerical test is given further credence in a subsequent GCM. GCM 36523 also found grounds

for the organization discussed therein to meet the attentiveness test under the facts and circumstances test of subdivision (d). Nonetheless, the 10 percent attentiveness test has become the rule of thumb utilized by the Service in testing for "attentiveness" under subsection (iii)(a) of the Regulations.

b. The Meaning of Support

What is the meaning of "support" for purposes of the Regulations? Is the term limited to just gifts, grants and contributions or does it include all revenue? Section 509(d) of the Code takes a broad approach in defining support to include (1) gifts, grants, and contributions, (2) program related revenues, (3) investment income, and (4) government support, among other listed items of revenue. The two GCMs (36379; 36523) discussed above do not define the term "support" or discuss its application. Both GCMs were using "support" as derived from the use of that term in Reg. 1.509(a)-4(i)(3)(iii)(a). The use of the term in the Regulations can be tied to IRC 509(d) of the Code. IRC 509(d) provides that for purposes of this part and Chapter 42, the term "support" is defined to include a number of sources of revenue as mentioned above. Thus, it is a logical conclusion that the term "support" for purposes of the application of the 10 percent test found in GCM 36379 is controlled by the definition of support under IRC 509(d).

c. Continuance of Support

How long must the supporting organization meet the 10 percent attentiveness test applied by GCM 36379? In that GCM, comparisons were made with respect to the grants to four potentially attentive recipient charities for either a two or a three year period. Apparently, in GCM 36523, the support test may have been examined for a number of years with respect to the 10 percent attentiveness requirement, perhaps longer than ten years. On the other hand, GCM 36523 concluded that, in some situations, the "substantially all" test may not have to be met each and every year. Perhaps, the same is true for the 10 percent attentiveness test; that compliance is not required for each and every year in the recent past. What would seem required, based on a general understanding of the purpose of IRC 509(a)(3) and the intent of the Regulations, is that there is some continuous and ongoing relationship between the attentive charities and the supporting organization. Recently, representatives of a nascent organization, in a preliminary discussion with EO division officials, suggested that the supporting organization would have a number of attentive public charities (also nascent) and that the payout of 10 percent (or more) support would vary among and between the several different charities from year to year so that not every supported charity would receive 10 percent support for every

year or even most years. For this structure to provide a basis for 509(a)(3) status, there would have to be, at the least, some history of a continuing and ongoing relationship with the attentive charities. That relationship would not have existed in the described situation.

d. Attentiveness- Alternative Support of A Program

"Attentiveness" can also be achieved by means other than under the 10 percent support test. Reg. 1.509(a)-4(i)(3)(iii)(b) provides that even where the amount of support received by a publicly supported charity does not represent a sufficient part of the supported beneficiary organization's total support, attentiveness may be achieved where it can be demonstrated that in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. This may be the case where the support received is earmarked for a particular program or activity of the supported organization. Reg. 1.509(a)-4(i)(3)(iii)(c) provides two examples, one involving a museum's chamber music series, and the other the endowment of a chair of a university's law school. In GCM 36326, June 30, 1975, the Service addressed another factual situation, involving a special program of a children's home to recruit, screen, and train foster parents, in which attentiveness may be achieved under subsection (iii)(b) of the Regulations.

Achieving attentiveness under Reg. 1.509(a)-4(i)(3)(iii)(b) offers a real tax planning opportunity to organizations that wish to achieve 509(a)(3) status, but would otherwise fail to meet the 10 percent attentiveness requirement. The EO Division has seen a number of cases where the organization was able to secure status as a supporting organization by providing significant support to one particular program of a large organization where 10 percent attentiveness could not be achieved by a direct grant to the organization as a whole because of the very broad public support for the charity. Thus, providing support to just one separate program will allow the supporting entity to qualify under the integral part test. In GCM 36326, Chief Counsel concluded that it may not be necessary to provide 100 percent of the support to the particular program to qualify under subsection (iii)(b) of the Regulations. The GCM suggested that the loss of 50 percent of the necessary support for the program may be sufficient to interrupt the program within the meaning of the Regulations. GCM 36326 emphasized that the crucial factor was whether the activity would be interrupted without the supporting organization's funding.

e. <u>Attentiveness - Alternative All Pertinent Factors Approach</u>

Reg. 1.509(a)-4(i)(3)(iii)(d) offers a catch-all method for achieving attentiveness under the integral part test. That subsection tests attentiveness based on all pertinent factors, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and the supporting organization, amounts received as support, and evidence of actual attentiveness by the beneficiary organization.

In GCM 36379, August 15, 1975, the supporting organization, a trust, made large grants to four public charities. However, because the public charities were large entities widely supported by the public, the grants by the trust represented only 2 to 6 percent of each charity's total support for the year. Thus, the trust failed to achieve attentiveness under the 10 percent test. However, the GCM held that attentiveness was achieved under the all pertinent factors language of subsection (iii)(d) of the Regulations. One of the pertinent factors relied on in reaching this conclusion was the large amount of the grants in absolute terms. The grants to three of the public charities were in the range of $200,000 to $400,000 per year. The GCM concluded that "no matter how large a beneficiary's total budget may be, it will undoubtedly be at least somewhat attentive to a grant of $200,000 to $400,000 per year." Additionally, the G.C.M. goes on to mention other important pertinent factors that led to the finding of attentiveness. One factor was the long history with the public charities where the grants have continued over 20 years. Also, there was some evidence of actual attentiveness by virtue of the distribution each year of an array of reports to the recipient charities, including the supporting trust's form 990.

GCM 36379 does not suggest that all that is required to achieve attentiveness under subsection (iii)(d) of the Regulations is a large grant and the furnishing of annual reports to the supported attentive charity. The Service does not accept the position that there is a safe harbor for achieving attentiveness simply by virtue of a large grant and providing annual reports to the supported charity.

Support for such position is found, in part, in Rev. Rul. 76-32, 1976-1 C.B. 160, which holds that merely providing the reports of the type described in section 1.509(a)-4(i)(3)(iii)(d) of the Regulations to each of the beneficiaries of charitable trust each year, will not alone satisfy the attentiveness requirement of the integral part test. Other factors are also required to find "attentiveness" under the regulations.

Attentiveness was also achieved under the "all pertinent factors" requirement in GCM 36523. The facts indicate that the organization, a trust, was making grants to a zoo, a part of the city government, for the purpose of aiding the zoo in animal acquisition and housing. The GCM held that there was actual attentiveness as well as a number of other factors suggesting qualification under subsection (iii)(d). An important factor was that the zoo was a component part of the city government, and that the trust was only one of two nongovernmental organizations to support the zoo.

(4) Subtest Three- Substantial Amount of Total Support

The third leg of the integral part test under subdivision (iii) of the Regulations is the requirement that "a substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement . . ." GCM 36326 determined that a supporting organization met the substantial amount requirement if any one of three organizations was proven to be "attentive" where the supporting organization was required to pay its net income equally to three named publicly supported organizations. Thus, the GCM suggests that Chief Counsel may entertain the idea of a safe harbor rule when at least 33 1/3 percent of the total support paid to named public charities must be paid to an attentive charity. The support of multiple organizations is discussed in 5A below.

C. Integral Part Test - - Bottom Line Comments

The numerical guidelines set forth in the GCMs described above are helpful in resolving difficult decisions relating to the application of the integral part test. However, one would assume that the numerical tests, while helpful, cannot be relied upon as absolutes. For example, GCM 36523 appears to have retreated considerably on the 85 percent requirement for the substantially all test (subtest one). Yet, this position is the most fundamentally sound of the three numerical tests discussed in the GCMs, and is supported by Rev. Rul. 76-208.

5. Application of The Integral Part Test and Other 509(a)(3) Requirements to Cases

A. PLR 8617119 - An Example of a Conversion

It is not uncommon for a private foundation to convert to a supporting organization under IRC 509(a)(3). There are several reasons why an organiza-

tion may undergo a conversion, but the primary reason is likely to avoid one or more restrictions under Chapter 42.

Private Letter Ruling 8617119, January 31, 1986, is representative of this type of case. Facts and a discussion of this private ruling follows.

**FACTS**

> **M is a nonprofit organization which was established by A and incorporated in the state of P. M is exempt from federal income tax under section 501(c)(3) of the Code and is presently a private foundation as defined in section 509(a).**
>
> **Pursuant to a plan of reorganization adopted by M on July 9, 1985, N was incorporated as a P nonprofit public benefit corporation. N is identical in all material respects to M. On September 17, 1985, the Service determined N to be exempt from federal tax under section 501(c)(3) of the Code and a private foundation under section 509(a).**
>
> **The Board of Directors of M has approved an amendment to its Articles of Incorporation which provides that M is organized and shall be operated in connection with Q, a corporation sole, the legal entity constituting R. R is an exempt section 501(c)(3) religious institution described in section 170(b)(1)(A)(i) of the Code. The amended articles also list as secondary beneficiaries a number of organizations which are section 501(c)(3) public charities within the meaning of section 509(a). Specifically, the amended articles provide that M shall: (i) operate primarily for the benefit of S, a separate fund of R, (ii) distribute substantially all of its net income to its designated beneficiaries, and (iii) distribute at least one-third of such income to S. The amended articles further provide that R shall have the power to enforce its rights thereunder and to compel an accounting.**
>
> **The office of the Attorney General of the State of P has submitted a letter stating that, under P law, all assets of a corporation formed exclusively for charitable purposes are held in trust for such charitable purposes. This letter also makes it clear that under x, R has the power to compel an accounting or otherwise bring action to remedy any breach of a charitable trust by M.**
>
> **The support provided by M to R will be held and administered in S, and used within R exclusively for the benefit of various religious organizations of R's denomination. R will appoint a**

**committee for administration of S, a minority of which will consist of some members of the Board of Directors of M. The total amount of support of M will be approximately 600w dollars annually. M will make grants of approximately one-third of its total support (200w dollars) to S which will represent substantially all of the support received by S. This 200w dollars of support will be derived from M's proposed assets of fourteen percent of the stock of O described below.**

**Pursuant to the reorganization, M will file the amended articles and will make the operational changes necessary to qualify as a support organization under section 509(a)(3) of the Code. Upon final distribution of the residue of C which consists of the total outstanding stock of O, a "business enterprise" within the meaning of section 4943(d)(3) of the Code, M will transfer to N all of M's existing assets, and all of the residue received from C, except for approximately fourteen percent of the O stock. After the reorganization, the combined holdings of N and its disqualified persons in O will not exceed twenty percent of the total outstanding stock of O. The value of this transfer of assets to N from M will be in excess of 25 percent of the fair market value of M's net assets at the beginning of M's taxable year.**

**Each of the Boards of Directors of M and N is composed of nine persons. The composition of both boards is identical. Of the nine members, only two are disqualified persons within the meaning of section 4946 of the Code (other than as foundation managers). These two persons do not have the power to exercise veto power over the actions of M. Further, except for these two persons, who are employees of O, none of the directors are employees of O. Also, the other seven directors do not work for the two disqualified persons. M has submitted a notice to the Service of the intention to terminate its private foundation status in compliance with section 507(b)(1)(B)(ii) of the Code.**

**DISCUSSION**

The distribution of the estate or trust of "C" would have caused the private foundation, M, to hold over 20 percent of the stock of "O", a business enterprise, in violation of IRC 4943(c). M is able to avoid IRC 4943 restrictions and avoid selling O stock within 5 years by converting to a supporting organization under the integral part test of IRC 509(a)(3). N is created as the new private foundation and will carry out the wishes of M's founder. N will also receive a significant amount of O stock but not enough to violate the IRC 4943(c) prohibition. In addition, by virtue of acquiring IRC 509(a)(3) status, M is not

treated as a disqualified person as to N for purposes of attributing M's large ownership in O stock to N. See Reg. 53.4946-1(a)(7).

Further, M is carrying out its founder's wishes by providing a substantial benefit to S, a special program of Q/R. Note, however, that M retains some of its former private foundation character under the amended Articles of Incorporation in that M may distribute up to 2/3 of its income annually to a number of "secondary" public charities.

PLR 8617119 states, among other items, that M is terminating its private foundation status over a sixty month period and is treated as a public charity for that period. Reg. 1.507-2(f)(1). The Ruling holds that M meets the integral part test of the Regulations. The Ruling holds further that M meets the attentiveness requirement under Reg. 1.509(a)-4(i)(3)(iii)(b) by virtue of the support of S, a particular activity of Q/R. In addition, the large size of the annual contributions is sufficient to ensure the attentiveness of Q/R.

Presumably, the support of S, a particular program of Q/R, was designed by M to avoid problems of achieving attentiveness under the 10 percent test of G.C.M. 36379. If Q/R was a large religious institution, even M's large annual contribution would likely fall far short of 10 percent. An interesting point of this PLR is that under state law a corporation is accorded the same right as a trust in enforcing the beneficiary's rights under the law. Thus, in the Ruling, M, a corporation, is ruled to have complied with the responsiveness test of Reg. 1.509(a)-4(i)(2)(iii) because the corporation is treated the same as a charitable trust under state law.

It is possible that the holding of O stock by M as a private foundation would have created a problem also under IRC 4942 if the O stock paid only a small dividend. Even if IRC 4943 was not a problem, a low yield on the O stock, the primary asset of M, could result in the failure to distribute 5 percent of assets as required by IRC 4942 unless appropriate amounts of O stock were sold.

B. Hypothetical Example - The Integral Part Test and the Disqualified Person Control Test

**FACTS**

**A is the retired owner of major corporation, X, and over 10 years ago had established private foundation, W, holding as its primary asset less than 2 percent of X stock. A owns the remaining X stock. A wishes to support an existing private school, Y, for the benefit of the residents of his home town. In addition, A wishes**

**to establish Z supporting organization under IRC 509(a)(3) to assist the operations of the school but also to make grants to other public charities that A wishes to support. Accordingly, the private school, Y, is informed of A's intentions. At the same time, Z is organized and is funded with X stock to serve as a supporting organization to Y and other named public charities in the articles of incorporation. A's daughter, C, is to serve as CEO of Z and she is also a member of the three person board of directors of Z. The other two members of the Board of Directors of Z are persons asserted by A to be unrelated to A or C and independent as to X or private foundation W. However, one of the directors is a part-time employee with a subsidiary corporation of X. Z will support Y with the payment of $250,000 yearly which will be no less than 35 percent of Z's total support for the year paid to the named public charities. The $250,000 annual grant will not equal 10 percent of Y's support due to tuition revenue and grants from other sources. Some of the stock of W in X will be transferred to Z and some of X stock will be transferred by A to Z during A's lifetime. Under A's estate plan, a significant part of X stock will be transferred to Z on the death of A.**

## DISCUSSION

The public and private charities described above must display considerable flexibility in order to carry out A's estate planning and charitable wishes. Since private foundation W remains in existence, the charitable programs that A was supporting through the foundation may continue. The creation of Z was intended to allow A to use the X stock for his charitable purposes without the restrictions imposed by IRC 4942 or 4943. In addition, the makeup of the Z board of directors would give A considerable influence, if not control, over decision making. Further, since 1/3 of Z's support is paid to Y annually, there is flexibility in benefiting other public charities with special grants. The transfer of X stock by W private foundation to Z is intended to constitute a qualifying distribution under IRC 4942. While it is intended that most of the X stock is to be transferred to Z on the death of A, any lifetime transfer of X stock by A to Z will qualify for IRC 170 deductibility. For an individual, the charitable contribution limitation under IRC 170(b)(1)(A) for a cash gift to a public charity is 50 percent of the taxpayer's contribution base for the year in contrast to a 30 percent limitation for a cash gift to a private foundation under IRC 170(b)(1)(B). For contributions of capital gain property (X stock), gifts to public charities are limited to 30 percent of the taxpayer's contribution base under IRC 170(b)(1)(C) in contrast to the 20 percent limitation under IRC 170(b)(1)(D) for gifts to private foundations.

However, there are a number of problems associated with the hypothetical example. The independence of the board of directors is of critical importance to Z's qualification under IRC 509(a)(3).

Particular focus on the composition of the board of directors of Z is mandated by IRC 509(a)(3)(C). It is necessary to determine that the organization is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2). C is a disqualified person by virtue of her family relationship with her father. IRC 4946(d). In addition, the board member that is a part-time employee of X's subsidiary is likely to be treated as a disqualified person or controlled by a disqualified person. In Rev. Rul. 80-207, 1980-2 C.B. 193, the Service held that for purposes of IRC 509(a)(3)(C) an employee of a corporation owned (over 35 percent) by a substantial contributor will be considered a disqualified person. In applying the holding of Rev. Rul. 80-207 to this example, the part-time employee would be treated as a disqualified person. Accordingly, Z would be considered controlled by disqualified persons. See Reg. 1.509(a)-4(j). Compare to the facts in PLR 8617119, extracted in 5A above.

Finally, in the example, the Service would have a problem with the "attentiveness" requirement under the integral part test. As discussed in part 4B(3)e above, the mere payment of a large sum without other supporting factors, will not ensure attentiveness if the grant does not equal 10 percent of Y's total support for the year.

Under the existing facts, Z would be classified as a private foundation.

6. <u>Miscellaneous IRC 509(a)(3) Issues</u>

A. <u>Flow of Support and Foundation Status of the Supported Charity</u>

A charitable organization may avoid private foundation status by qualifying as a publicly supported organization under IRC 509(a)(1)/170(b)(1)(a)(vi) or IRC 509(a)(2). Qualifying under IRC 509(a)(1)/170(b)(1)(A)(vi) requires an examination of the sources of support and the need to meet certain support limitation tests. Reg. 1.170A-9(e)(2) provides a 33 1/3 support test. Even if failing this test, an organization may qualify under a facts and circumstances test. Reg. 1.170A-(e)(3). Under such test the public support received by the organization must be at least 10 percent of its total support. Reg. 1.170A-9(e)(i). To meet the 33 1/3 and 10 percent tests, the public charity may include in its calculation

of public support from any single donor (individual, trust, or corporation) an amount that does not exceed 2 percent of the organization's total support for the year. Reg. 1.170A-9(e)(6)(i). An exception for the 2 percent limitation is made for gifts or grants from government units or public charities described in IRC 170(b)(1)(A)(vi). Reg. 1.170A-9(e)(6)(i). In contrast, all varieties of IRC 509(a)(3) organizations are subject to the 2 percent limitation.

IRC 509(a)(3) organizations are also subject to the operational test described in Reg. 1.509(a)-4(e). Basically, it provides that an IRC 509(a)(3) organization will be operated exclusively to support one or more specified organizations only if it engages in activities that support or benefit the publicly supported organizations. Generally, providing funds to an IRC 509(a)(1)/170(b)(1)(A)(vi) supported organization is the primary charitable activity of the 509(a)(3) supporting organization. Funds distributed to the IRC 170(b)(1)(A)(vi) supported organization would be taken into account for measuring the latter's public charity status. The EO Division has occasionally observed situations where the supporting organization makes grants to organizations that are not the supported organization in an apparent attempt to avoid having the distributions attributed to the supported organization, especially in those situations where the supporting organization is the dominant financial feeder of the IRC 170(b)(1)(A)(vi) organization which is subject to the two percent rule. In some cases, the IRC 509(a)(3) distributions could jeopardize the IRC 170(b)(1)(A)(vi) status of the supported organization and, as a result, like the collapse of a house of cards, would cause the loss of the supporting organization's IRC 509(a)(3) status.

In any case, to satisfy the IRC 509(a)(3) operations test requirement, pursuant to Reg. 1.509(a)-4(e)(1), payments may be made to organizations other than the specified publicly supported organization only under the following circumstances:

> **(1) The payment constitutes a grant to an individual who is a member of a charitable class benefited by the specified publicly supported organization rather than a grant to the organization receiving it [applicable rules are set forth in Reg. 53.4945-4(a)(4)];**
>
> **(2) The payment is made to an organization that is operated, supervised, or controlled by; supervised or controlled in connection with; or operated in connection with the publicly supported organization; or**
>
> **(3) The payment is made to an organization described in IRC 511(a)(3)(B) (colleges and universities that are governmental agencies or instrumentalities).**

See 4B(1) above for discussion of GCM 38417 and IRC 509(a)(3) support of community trusts. See additional discussion in the 1993 EO CPE Text, at p. 245, et. seq.

B. The Scholarship Cases

As discussed earlier in this article, IRC 509(a)(3) organizations must satisfy organizational and operational tests. Reg. 1.509(a)-4(c)(1); Reg. 1.509(a)-4(e)(1). The state of the law has evolved through a line of cases, rulings, and GCMs dealing with scholarships granted to high school students for the purpose of pursuing advanced education. While the focus of this line of authority was on the IRC 509(a)(3) organization test, many of the authorities also dealt with the responsiveness test and the integral part test. This is because most cases (but not all) that addressed the issue fell under the "operated in connection with" relationship.

The Service took a conservative position on the organizational and operational tests in GCM 36043, October 9, 1974. The facts of the GCM involved two different factual cases where trusts were established to provide funds for high school graduates for advanced study at specifically named institutions of higher learning. In each case, a bank was named as trustee. In one of the cases, a scholarship committee from the named college selected the high school student to receive the grant. Both trusts were held in the GCM to have failed the organizational test because neither trust document included language that the trusts were created to support or benefit the publicly supported organization. See Reg. 1.509(a)-4(d)(2). The two trusts described did not have the requisite language in the trust documents. Additionally, the GCM concluded that neither trust satisfied either the responsiveness test or the integral part test.

The holding of Rev. Rul. 75-437, 1975-2 C.B. 218 reached a similar conclusion. The failure under the organizational test is explained by the Rev. Rul. as follows:

> ***The trust in the instant case does not satisfy this requirement of the 'organizational test,' because the trust instrument does not contain the requisite statement of purpose. Since the trust is not 'operated, supervised, or controlled by' or 'supervised or controlled in connection with' the publicly supported schools and governmental units, the fact that the educational purposes of the trust are consistent with those of schools and governmental units is not sufficient to satisfy the organizational test.***

> ***Under section 1.509(a)-4(d)(2) of the regulations, if the supported organization is neither 'operated, supervised, or controlled by' nor 'supervised or controlled in connection with' a publicly supported organization, then the 'specified' publicly supported organization must be designated by name in the supporting organization's articles unless there has been an historic and continuing relationship between the supporting organization and the supported organization and by reason of such relationship there has developed a substantial identity of interests between such organizations.***

Rev. Rul. 75-437 goes on to conclude that the trust satisfies neither the responsiveness test nor the integral part test. GCM 36050, October 9, 1974, is the underlying GCM of Rev. Rul. 75-437.

The Service position addressed in the scholarship cases was challenged by three cases in the Tax Court. In Warren M. Goodspeed Scholarship Fund v. Commissioner, 70 T.C. 515 (1978), a testamentary trust provided scholarships to graduates of the high school in Duxbury, Massachusetts or bona fide residents of Duxbury for the purpose of attending Yale College. The trust was administered by the trustee, a bank. Yale College participated in the selection of the recipients of the scholarship grant. The case centered on the issue of the absence of specific language in the trust document that the trust was for the benefit of or to carry out the purpose of Yale University. The Court held that it was clear from the trust document that the trust was for the benefit of Yale University. The Court stated that the Regulations did not require more specific language. See the 1993 EO CPE Text, p. 243, footnote 8.

A similar result was reached in Nellie Callahan Scholarship Fund v. Commissioner, 73 T.C. 626 (1980). The facts of the case disclose that the graduates of Winterset Community High School were eligible to a scholarship to attend a school located in Iowa. The selection committee for the scholarship consisted of officials of the school board and the principal of the high school. The Callahan case focused, however, not on the organizational test but on the responsiveness test and the integral part test. In this case, the Service argued that the Trust document failed to name the designated beneficiaries of the trust and, thus, failed under Reg. 1.509(a)-4(i)(2)(iii)(b). The Court found, however, that there was no doubt as to the intended beneficiary of the trust, citing Goodspeed as authority. Further, the Court found compliance with the integral part test under Reg. 1.509(a)-4(i)(iii)(b).

In Cockerline Memorial Fund v. Commissioner, 86 T.C. 53 (1986), the responsiveness test and the integral part test were again at issue as well as the organizational test. After finding compliance with the responsiveness and

integral part test, the Court addressed the organizational test. Under the rule provided by Reg. 1.509(a)-4(d)(2)(iv), the Court found a historic and continuing relationship between the supporting organization and the public supported organization.

In light of the outstanding Tax Court cases, the tax law specialist may wish to approach comparable cases judiciously.

### C. Nonexempt Charitable Trusts (NECTs) Under IRC 4947(a)(1) and 509(a)(3)

In recent years, the Service has received multiple requests in batches from NECTs, many of which have never filed an income tax or information return. This activity may often be due to the national rise in mergers and acquisitions of smaller institutions by larger institutions in the banking industry. The new or acquiring financial institution takes inventory, discovers the NECTs, and, after reviewing the filing requirements of charitable and split interest trusts in Rev. Proc. 83-32, 1983-1 C.B. 723, brings the tax delinquents into compliance. Often this may involve closing agreements since there may be late filing penalties and interest charges and Chapter 42 taxes due in the case of NECTs that are private foundations.

Pursuant to Rev. Proc. 72-50, 1972-2 C.B. 830, as superseded in minor part by Rev. Proc. 76-34, 1976-2 C.B. 657, a charitable trust classified as a 4947(a)(1) trust may request a determination from the Internal Revenue Service as to the status of the trust under IRC 509(a)(3) even though the trust has neither obtained nor seeks exemption under IRC 501(c)(3). Exemption per se may not be relevant since IRC 4947(a)(1) trusts are exempted from the notice requirements of IRC 508(a). See Reg. 1.508-1(b)(7)(iv). A determination letter issued by the Service that the requesting IRC 4947(a)(1) trust qualifies under IRC 509(a)(3) will allow such organization to avoid retroactively the imposition of the private foundation rules. See section 5.01 of Rev. Proc. 72-50. However, the delinquent trust could still be subject to late filing penalties and interest charges.

### D. IRC 509(a)(3)'s Supporting IRC(c)(4)'s, (c)(5)'s, and (c)(6)'s --Foundation Status of the Supported Organizations

The last sentence of IRC 509(a) reads as follows:

> ***For purposes of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3).***

This provision had the dubious honor of being placed at least twice in the Gobbledygook column of the defunct Washington Star (D.C.). In essence, it provides that an organization may qualify as an IRC 509(a)(3) organization if it: (1) supports a section 501(c)(4), (5), or (6) that has public support characteristics of a section 509(a)(2) organization; and (2) meets the 509(a)(3) tests. See Reg. 1.509(a)-4(k).

The provision does not provide for a legal conversion of the section 501(c)(4), (5), or (6) supported organization into a section 501(c)(3) and/or section 509(a)(3) organization for classification purposes. This flip/flop interpretation was made in PLRs 8650091, September 22, 1986 and 8933059, May 25, 1989. The E:EO Division is presently revisiting these PLRs.

E. Organizations Supporting Action Organizations Exempt Under IRC 501(c)(4)

Many educational organizations forego IRC 501(c)(3) status and accept IRC 501(c)(4) status because of substantial lobbying expenditures that would exceed the liberal limits allowed under IRC 501(h)/4911 provisions. In addition, such organizations may wish to be regulated under the less restrictive primary activities test of the social welfare exemption provisions in order to occasionally intervene in political campaigns directly or through an IRC 527(f)(3) segregated fund. See Rev. Rul. 81-95, 1981-1 C.B. 332.

The trade-offs for the degree of freedom to engage in legislative advocacy and political campaign activity that would be precluded under IRC 501(c)(3) are the losses of contributions from donors, that would be deductible under IRC 170(c)(2), and private foundation grants that are subject to IRC 4945. Many of these educational action IRC 501(c)(4) organizations create 501(c)(3) organizations that are funded by the same members or contributors of the IRC 501(c)(4)s. These IRC 501(c)(3) entities may have only one purpose and that is to channel funds to pay for the programs of the IRC 501(c)(4) organizations. These 501(c)(3) entities generally claim IRC 509(a)(1)/170(b)(1)(A)(vi) public charity status. They accordingly make the IRC 501(h) lobbying election to fall under the IRC 501(h)/4911 expenditures' tests to cover any distributions to the IRC 501(c)(4) entities that may secondarily pay for legislative activity associated with funded educational projects.

The IRC 501(c)(3) entity and the IRC 501(c)(4) entity may be structured so that there is no interlocking directorate or a situation where there is a majority of the IRC 501(c)(4)'s directors who are also members of the board of directors of the IRC 501(c)(3) entity. However, the reality of the interrelationship reveals that year after year, the IRC 501(c)(3) entity exists only to fund the IRC 501(c)(4)'s programs and does little if anything else except solicit funds (through the IRC 501(c)(4)'s fundraising component) and maintain an investment portfolio.

This coziness between a IRC 501(c)(4) organization and a IRC 501(c)(3) organization may not have been contemplated by Congress. The totality of the tax exemption and deductibility statutory framework provides that: IRC 501(c)(3) prohibits political campaign intervention and imposes limits on legislative activities; IRC 170(c)(2) restricts deductibility to IRC 501(c)(3) organizations and not IRC 501(c)(4) organizations; and IRC 504 requires denial of IRC 501(c)(4) exemption status to section 501(c)(3) organizations that lose exempt status because of excessive lobbying or political campaign intervention. See also discussion of IRC 504 "transfer" rules in Lobbying Issues, part 5, in this EO CPE text. Under the circumstances of the relationships between the organizations described above, there is a question of whether tax deductible contributions should be allowed and IRC 501(c)(3) exemption recognized to an entity that is in effect a mere conduit for a IRC 501(c)(4) that would not be recognized as a IRC 501(c)(3) if the existing IRC 501(c)(4) was legally merged into it. There is also a question of whether such a conduit IRC 501(c)(3) is eligible to make the IRC 501(h) lobbying election.

IRC 501(h)(4)(F) prohibits IRC 509(a)(3) organizations that support IRC 501(c)(4) organizations from making the lobbying election under IRC 501(h).

According to the General Explanation of the Tax Reform Act of 1976 (Blue Book), page 415, footnote 10:

> ***Also organizations which are public charities because they are support organizations (under sec. 509(a)(3)) of certain types of social welfare organizations(sec. 501(c)(4)), labor unions, etc. (sec. 501(c)(5)), or trade associations (sec. 501(c)(6)) are ineligible to make this election.***

The IRC 501(c)(3) organizations described herein claim eligibility to make the lobbying election through IRC 509(a)(1)/170(b)(1)(A)(vi) status. However, they are clearly IRC 509(a)(3) organizations also. Does that fact make them ineligible to make the lobbying election? Congress would have appeared to deny IRC 501(h) accessibility to organizations that support exempt action organiza-

tions. If ineligible to make the election, the IRC 501(c)(3) organizations discussed here would have to apply closer scrutiny in funding programs of the IRC 501(c)(4) organizations to ensure that any lobbying is insubstantial under the vague substantial part test of IRC 501(c)(3).

In regard to the threshold issue of IRC 501(c)(3) exempt status, the 1976 Blue Book provides the following on page 411, footnote 7, in commenting about public charities and the legislative activity tests under IRC 501(c)(3), 501(h), and 4911:

> ***This Act deals only with whether an organization is to be treated as violating the lobbying activity limits of the law. The Act does not affect the question of whether an expenditure might cause the organization to lose its charitable status because the expenditure violates the requirement that the organization be organized and operated "exclusively" for charitable, etc. purposes. (The Supreme Court has defined "exclusively" in this context to mean that there is no nonexempt purpose that is "substantial in nature." Better Business Bureau v. U.S., 326 U.S. 279, 283 (1945)). Also, the Act does not deal with the circumstances under which an expenditure might be treated as electioneering, which constitutes another cause for loss of exempt status.***

In the scenario described herein, the IRC 501(c)(3) organization has no other purpose or activity except fund the IRC 501(c)(4) action organization. The IRC 501(c)(4) is receiving indirectly IRC 170(c)(2) tax deductible dollars that it could not receive directly. Is the IRC 501(c)(3) promoting a substantial nonexempt purpose under these circumstances? Or has Congress inadvertantly created a loophole allowing organizations supporting IRC 501(c)(4) action organizations to meet IRC 501(c)(3) qualifications through the "gobbledygook" provision of IRC 509(a)(3)?

Headquarters is reviewing this matter.

F. Review the 1023 - Is the Private Foundation Applicant a Qualified Public Charity?

Tax Law Specialists should review whether a 501(c)(3) applicant may qualify as a supporting organization under IRC 509(a)(3) (or under some other public charity category) even if the organization has checked off Private Foundation status on its 1023. Headquarters occasionally considers private letter ruling and technical advice cases involving challenging chapter 42 issues which would not have been raised if the subject organizations were properly classified as public charities during the application process.

Once an organization is classified as a private foundation, the organization will always be treated as a private foundation, including paying an IRC 4940 tax, unless it terminates its private foundation status under IRC 507(a)(1)(B). In order to terminate private foundation status, the organization must notify the Key District Office. See 1982 and 1989 EO CPE texts at pages 93 and 119 respectively; PLRs 8617119 and 9407029; and Reg. 1.507-2(b)(3). During the 60 month termination period, the organization must still file 990PF returns. These IRC 507 termination requirements may be onerous for the organization. Thus, it is helpful to the organization, and the Service in the long run, if the private foundation/public charity status is correctly determined at the outset.

7. Conclusion

Many IRC 501(c)(3) organizations seek to avoid private foundation status through classification as a supporting organization under IRC 509(a)(3). Achieving IRC 509(a)(3) status is often a matter of tax planning for organizations contemplating conversion or reorganization transactions. A working knowledge of the "operated in connection with" integral part test is crucial to developing the issues related to the determination of IRC 509(a)(3) status. It is also important to keep up with current developments in this evolving area through a review of the important Miscellaneous Issues discussed in this article.

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# J. VIRTUAL MERGERS
# HOSPITAL JOINT OPERATING AGREEMENT AFFILIATIONS

**by**
**Roderick Darling and Marvin Friedlander**

## 1. Introduction

The nonprofit healthcare industry in the United States is in the midst of significant change. A variety of different operational arrangements are being devised to achieve efficiencies and improve particular institutions' financial health. Some of these arrangements, including the "virtual mergers" discussed in this article and "whole hospital joint ventures" of the sort arising between nonprofit and proprietary institutions, reflect substantial changes in the tax exempt entities' operations. Agents examining institutions that have entered into such arrangments should ascertain whether the Service was notified of the change in operations as required by the terms of the standard IRS exemption determination letter and by Rev. Rul. 58-617, 1958-2 C.B. 260. Failure to notify the Service of significant changes in operations could have serious consequences for the exempt institution. Should adverse tax positions be taken by the Service, the presence or absence of notification would be significant for purposes of the effective date of the adverse action.

## 2. Background

For some period of time, formerly independent exempt hospitals have been forming affiliations that are actual mergers, as evidenced by absolute structural and financial control ceded to a centralized "parent" entity, as in the following two situations.

### A. Northwestern Healthcare Network

In an exemption ruling (administrative file is a matter of public record pursuant to IRC 6104) issued to Northwestern Healthcare Network, the centralized entity had the following powers:

1. Appoint and remove the members of the boards of the subordinates.
2. Approve amendments to the Articles or Bylaws of the subordinates.
3. Approve or disapprove withdrawal of subordinates from the system.

4. Monitor and audit the subordinates to assure compliance with its directives.

5. Authority over asset transfers, overall budgets and strategic plans, and capital acquisition strategies of the subordinates.

6. Direct or approve the mergers, acquisitions or affiliations of the subordinates and their affiliates with other entities.

B. PLRs 9609012 and 9623011

In PLRs 9609012 and 9623011 the Office of Assistant Chief Counsel (Financial Institutions and Products) relied on representations that a newly established parent organization would constitute the sole governance authority of a network that included previously unrelated hospital systems and the Service concluded, in part, that services shared among the network's participants were being performed as an integral part of the exempt activities of organizations that are financially and structurally related. These rulings reflect the interaction between virtual mergers and the rules for tax exempt bonds under IRC 141.

3. Joint Operating Agreements

Unlike the absolute financial and structural control affiliations previously described where a centralized authority has power over participating hospitals' boards of directors and assets, regional hospital systems are now affiliating through a joint operating agreement that may be implemented through a partnership or through a non-profit corporation. The hallmark of the joint operating agreement type of affiliation is that participating hospitals retain their separate identities, boards of directors, and a certain amount of autonomy even though considerable management and financial authority is shifted to the governing body of the JOA. For example, authority to make moral or ethical decisions based on religious principles is usually retained by the hospitals. Powers ceded to the governing body of the joint operating agreement and powers reserved by the hospitals may be spelled out in a variety of documents, including a joint operating agreement, a partnership agreement, articles of incorporation, bylaws, a code of regulations, or management contracts. Because a joint operating agreement affiliation is not a true merger, it has come to be called a "virtual merger."

Virtual mergers are intended to unify operations to achieve cost efficiencies necessary to compete successfully in a managed care environment by eliminating duplications, consolidating managerial decisions, and offering third-party payers unified access to cost effective services.

4. What's The Fuss?

When an exempt hospital provides support activities that are not the direct provision of health care, such as management, fiscal, or administrative services, to exempt hospitals for a fee, it is usually subject to unrelated business income tax pursuant to IRC 511. This result is derived from IRC 513(e), which creates an exception to the unrelated trade or business rules for a hospital providing certain services listed in IRC 501(e) (e.g., data processing, billing and collection, or record center) but only if provided to exempt hospitals with facilities for less than 100 inpatients. Thus, ancillary services provided by an exempt organization to other exempt organizations outside the IRC 513(e) exception are an unrelated trade or business. See also BSW Group, Inc. v. Commissioner, 70 T.C. 352 (1978).

If this was the primary purpose of a healthcare organization, the provision of ancillary services for a fee to other exempt hospitals, then it would not be qualified for exemption since it would have a substantial nonexempt purpose. See Better Business Bureau v. United States, 326 U.S. 279, 283 (1945). Also, IRC 502 describes as a feeder organization one that is operated for the primary purpose of carrying on a trade or business for profit. A feeder organization is not qualified for exemption under IRC 501(a) on the grounds that all the profits are payable to exempt organizations. Moreover, where an organization is providing support activities on a centralized basis to hospitals, the exclusive route to exemption is generally provided by IRC 501(e), which provides exemption for certain cooperative hospital service organizations. See HCSC-Laundry v. United States, 450 U.S. 1 (1981).

5. Integral Part Basis For Exemption

Even if an organization does not independently qualify for exemption, it may qualify if it is an integral part of an IRC 501(c)(3) organization, provided it is not a feeder organization within the meaning of IRC 502. An otherwise properly organized and operated organization could derivatively qualify for exemption as an integral part if (1) it performs essential services for an exempt organization and the services, if performed by the exempt organization itself, would not be an unrelated trade or business, and (2) the exempt organization exercises sufficient control and close supervision, based on all the facts and circumstances, to establish the equivalent of a parent and subsidiary relationship. See Rev. Rul. 78-41, 1978-1 C.B. 148 (trust to satisfy malpractice claims against a hospital); Rev. Rul. 75-282, 1975-2 C.B. 201 (organization controlled by a conference of churches to provide member churches with mortgage loans); GCM 39830 (September 10, 1990) (a separately incorporated health maintenance

organization that was controlled by an exempt hospital was not providing essential services or services that would not be an unrelated trade or business if performed by the exempt parent necessary to satisfy the integral part basis for exemption); and GCM 39684 (December 10, 1987) (an organization was not qualified for exemption on the integral part basis where it performed services for an exempt parent organization and its subsidiary organizations as well as organizations that had no relationship to the parent).

If the equivalent of a parent-subsidiary relationship is established, dealings between the parent and the subsidiary that would not otherwise have resulted in unrelated trade or business are considered to be merely a matter of accounting rather than unrelated trade or business activity under IRC 513. See Rev. Rul. 77-72, 1977-1 C.B. 157 (indebtedness owed to a labor union by its wholly owned tax-exempt subsidiary is not acquisition indebtedness within the meaning of IRC 514 since the parent-subsidiary relationship shows the indebtedness to be merely a matter of accounting).

6. Application To Joint Operating Agreements

Joint operating agreements between or among previously independent hospitals and hospital systems usually do not provide the "parent" authority over boards of directors and assets. Therefore, the Service must look for other explicit manifestations of control so dealings between the hospitals (and the parts of the hospital systems that are completely financially integrated) under the agreement are between organizations that are the equivalent of a parent and its subsidiary and thus not unrelated trade or business. If the hospitals establish a "super" parent to implement the joint operating agreement, and the facts and circumstances establish that the equivalent of a parent-subsidiary relationship exists, then the "super" parent will be considered to be an integral part of the subsidiaries. Thus, essential services it provides to the subsidiaries would not constitute unrelated trade or business.

7. Facts and Circumstances

The following facts and circumstances provide the basis for a more flexible control analysis that does not rely strictly on the degree of structural control or on any one factor. Although some factors are more significant than others, the analysis looks to a preponderance of all the facts and circumstances that demonstrates significant control over management and financial decisions which have been ceded by participating entities to a governing body under a joint operating agreement or a "super" parent organization. There may be other

facts and circumstances that have not been listed and they too will be considered if raised by organizations.

A. Delegation of Significant Authority

The following facts and circumstances consider the long range and day-to-day management decisions delegated to the JOA governing body. In addition to specific items such as those set out below, the facts and circumstances also consider frequency of meetings by the JOA governing body and its overall responsibility for operational decisions. For example, if the JOA governing body meets infrequently merely to ratify a participating entity's decision, it does not have authority to exercise significant management authority. Elements of specific management authority include:

(1) Authority to establish budgets. This significant aspect includes responsibility to establish overall budgets, as well as authority to approve major expenditures, debt, contracts, managed care agreements, and capital expenditures. This aspect also considers whether the JOA governing body regularly meets to establish long term and short term budgets and to implement its decisions.

(2) Authority by the JOA governing body to monitor and audit each participating entity's compliance with its directives. This is a significant aspect.

(3) Authority to direct services. This significant aspect considers whether the JOA governing body can direct that health care services be undertaken or not be undertaken by the participating entities. For example, whether the governing body of the JOA can direct a participating hospital to refrain from being a provider of pediatric services.

(4) Authority to enter agreements that bind participating entities, particularly agreements with managed care providers.

(5) Authority to hire and fire personnel.

(6) Authority to grant hospital staff privileges.

(7) Authority to set or approve fees and prices.

(8) Authority to buy assets for and sell assets of participating entities.

(9) Authority to re-allocate income among the participating entities to balance income and expenses to assure financial integration and to achieve mutual objectives.

B. Permanence

Factors that establish a permanent arrangement include whether there are significant penalties or other hindrances to terminating the agreement, and whether there are mechanisms such as direct negotiations and binding arbitration in place to resolve disputes among the parties. The degree to which the JOA is permanent also affects the determination whether the JOA establishes the equivalent of a parent-subsidiary relationship.

C. Veto Power

A veto power is not the same as a power to initiate an action. If the authority ceded to the JOA governing body is merely the power to veto actions taken by participating hospitals, then the facts and circumstances necessary to establish the equivalent of a parent-subsidiary relationship would not be present. Similarly, if actions of the JOA governing body are subject to veto by the participating hospitals, this too would negate a finding that the hospitals function as subordinates of the JOA.

D. Reserved Powers

If participating hospitals retain some authority, this is not necessarily determinative of whether the equivalent of a parent-subsidiary relationship has been established. For example, authority over ethical or moral issues based on religious principles may be reserved by the participating entities. If all of the other surrounding facts and circumstances showed that sufficient authority had otherwise been ceded to the JOA governing body, this type of reservation would not preclude a finding that the equivalent of a parent-subsidiary relationship had been established.

E. Less Than Full Integration

Where there is not full integration among participating hospitals because, for example, a hospital system excludes one or more of its subsidiary hospitals from participating in the joint operating agreement, then services involving the excluded organization would not be covered by the joint operating agreement and may not be excepted from unrelated business income tax.

8. Conclusion

This is a new and evolving area for tax exempt hospitals. Certainly, we will be continuing to look closely at transactions that involve joint operating agreements or other forms of affiliations between exempt hospitals. Private Letter Rulings (PLR) in this area involving unrelated business income tax issues will be available to the public under IRC 6110. They will reflect application of these tax law considerations to specific factual situations.

# K. CHARITABLE REMAINDER TRUSTS: THE INCOME DEFERRAL ABUSE AND OTHER ISSUES

by
Ron Shoemaker and David Jones

## 1. Introduction

The focus of this article is the use of charitable remainder unitrusts to defer income and the circumstances where this creates problems under the IRC 4941 self-dealing rules. Following this material is a discussion of several of the current issues relating to charitable remainder unitrusts.

Under IRC 4947(a)(2) some of the Chapter 42 restrictions, primarily IRC 4941 and IRC 4945, are applicable to split interest charitable trusts, including charitable remainder unitrusts. The Service is aware of a growing practice of using this format for purposes other than those originally intended by Congress.

In making these arrangements, a number of donors and their relatives, who are disqualified persons under IRC 4946, may have violated the self-dealing prohibition of IRC 4941. For example, in Notice 94-78, 1994-2 C.B. 555, the Service addressed the problem of the charitable remainder unitrust format being used as a vehicle to avoid tax resulting from the realization of gain on the sale of appreciated assets. An article in the FY 1996 CPE text, "Self-Dealing and Other Issues Involving Charitable Remainder Trusts" (Topic G at 159), discusses the self-dealing aspect of the problem presented in Notice 94-78.

Another recent tax scheme involves the use of the "net income with makeup" charitable remainder unitrust, the so-called "NIMCRUT." The tax deferral aspects of these trusts have been touted in a number of published tax articles.

## 2. Discussion of the Problem

The standard fixed charitable remainder unitrust under IRC 664(d)(2)(A) requires a minimum fixed percentage payout from the trust annually in an amount that is no less than 5 percent of the net fair market value of the trust assets which are valued no less frequently than annually. The fixed percentage payout may be greater than 5 percent. If the unitrust is unable to generate sufficient income from its investments to pay the required unitrust payout amount, the trustee must dip into trust principal for the necessary funds.

An alternative, the net income limitation under IRC 664(d)(3), allows a trust instrument to provide an annual payout that is the lesser of the amount of trust income for the year or the fixed percentage (of trust assets) payout of 5 percent or more provided for in the trust instrument. Thus, with a net income limitation, if the trust income is not sufficient to pay the fixed percentage payout amount, the trustee is authorized to pay to the noncharitable income beneficiary only the amount that is the trust's income for the year. Under IRC 664(d)(3), a trust's income is defined by state law. The advantage of this provision is that the trustee need not resort to trust principal to fulfill the trust's obligation to the income beneficiary.

The deficit in the income paid to the income beneficiary also may be made up at some future date if the unitrust has a makeup provision pursuant to IRC 664(d)(3)(B). With a makeup provision, if the trust income exceeds the fixed percentage payout amount, the excess may be paid to the income beneficiary to make up a deficiency from prior years. Trusts with both net income limitations and makeup provisions are called NIMCRUTS. The Service has seen NIMCRUTS used to defer income to the beneficiary.

When Congress described IRC 664(d)(3), it stated:

> ***Allowing a charitable remainder unitrust to distribute to the income beneficiary the lesser of the trust income or the stated payout will prevent a trust from having to invade its corpus when the income for the year is below that originally contemplated.***

General Explanation of the Tax Reform Act of 1969, 91st Cong., 1st Sess., at 85. IRC 664(d)(3) was enacted to give trustees breathing room. If, in any year, trust income dropped and the distributions to the noncharitable beneficiaries originally intended by the donor could not be met using trust income, the trustees could temporarily reduce the current payout, or could otherwise adjust the unitrust's portfolio to generate sufficient income for future years.

However, the net income and makeup provisions of IRC 664 are now being used not to gain flexibility in the normal management of the portfolio, but for a tax deferral purpose not contemplated by Congress.

To achieve a maximum deferral for a noncharitable beneficiary, a trust's assets must be manipulated in such a manner so that the net income and makeup provisions can be used to avoid payout in the early years of the trust and to realize income, including the makeup amount, only in later years when the noncharitable income beneficiary may be in a lower tax bracket. This device is called an income deferral NIMCRUT.

The operation of the income deferral NIMCRUT and the tax benefits that may be achieved are illustrated by the following example:

> Individual **A** is a key employee and major stockholder of closely-held corporation **M** which specializes in high technology products. **A** has substantial wealth from his ownership of **M** stock as well as a substantial salary with **M** of $500,000 per year. **A** is 55 years of age and wishes to arrange his income, retirement, and estate planning to avoid taxes to the greatest extent possible.
>
> In year one, **A** executes a NIMCRUT, called **TRUST X**. **TRUST X** will pay the unitrust amount annually to **A** for his life and then to **A**'s wife for her life. The unitrust amount will be the lesser of 8 percent of the annual fair market value of the trust's assets or the income of the trust. If the trust income is greater than 8 percent in any year, the excess income will be used to make up any deficiency in the unitrust amounts for prior years. Income is defined under the governing instrument to include income from the sale of the trust's assets.
>
> **Trust X** is funded with **M** stock which has a zero basis and a current fair market value in year one of $20,000,000. The **M** stock has no history of paying a dividend, and, when **TRUST X** is created, the stock is expected to appreciate significantly in value over the years.
>
> Time passes. **Trust X** realizes no income from the **M** stock during the first 10 years while **A** continues to receive his substantial salary from **M** as a key employee. In year eleven, **A** retires. In year eleven the **M** stock has a fair market value of $34,000,000. By prearrangement and subject to regular consultation, **Trust X** has held the stock off the market. Beginning in year eleven and over the next five years **Trust X**, at **A's** direction, sells all of the **M** stock, 20 percent each year. Beginning in year eleven and for the next five years, **A** receives substantial income from **Trust X** under the makeup provision of IRC 664(d)(3)(B). **A** will continue to receive income from the trust in year 15 and thereafter since **Trust X** has invested a portion of the proceeds from the sale of **M** stock (the portion not distributed to **A**) in other assets.
>
> Assuming that taxes can be avoided under IRC 4941, the tax benefits to **A** are obvious. As is true for donors to all charitable remainder trusts, **A** will receive a current charitable deduction. The deduction will be used to offset his substantial salary generated by his employment with **M**. In addition, **A** is able to benefit from the tax free build-

up of the income from **Trust X** for ten years and has shifted the receipt of that income to years when he will be taxed at a lower rate.

3. NIMCRUTS and the Self-Dealing Provisions

Analytically, the self-dealing issues for both charitable remainder unitrusts used as tax shelters and for the income deferral NIMCRUTS are similar. In both cases, unitrust assets must be managed in a particular way if the desired result is to be achieved. For **Trust X**, the way is to hold the stock of **M** off the market until year eleven in order to defer tax during years one through ten. Whether this is an act of self-dealing depends on whether it can be characterized as "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation", as that phrase is used in IRC 4941(d)(1)(E).

A classic example of the use of foundation assets to benefit a disqualified person may be found in Rev. Rul. 74-600, 1974-2 C.B. 385. Rev. Rul. 74-600 states that the placing of paintings owned by a private foundation in the residence of a substantial contributor/ disqualified person constitutes an act of self-dealing.

As early as 1969, the Joint Committee on Taxation realized that self-dealing could involve something other than a transfer of the asset between the parties. The General Explanation of the Tax Reform Act of 1969 states at p. 31 that:

> A self-dealing transaction may occur even though there has been no transfer of money or property between the foundation and any disqualified person. For example, securities purchases or sales by the foundation to manipulate the prices of the securities to the advantage of the disqualified person constitute a "use by or for the benefit of a disqualified person of the income or assets of a private foundation."

This conclusion was echoed in the regulations. Reg. 53.4941(d)-2(f)(1) provides in part that "the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person."

One point that the regulation makes quite clear is that for a stock manipulation to be considered a "use by or for the benefit of a disqualified person," it must be intentional. In the words of the regulation, it must be "made in an attempt to manipulate" the price of the stock. (Emphasis added)

Although the manipulation must be intentional, the individuals involved need not know that engaging in such manipulation may constitute self-dealing. Reg. 53.4941(a)-1(a)(1) provides that the excise tax shall be imposed on a disqualified person even though he had no knowledge at the time of the act that the act constituted self-dealing. See also G.C.M. 37731 (October 26, 1978).

Also consider the case of a private foundation which receives from an estate as a bequest three secured mortgage notes carrying a rate of interest described as excellent. The obligor under the notes is a partnership that is a disqualified person with respect to the private foundation. The loan was made at an earlier date, but is less than 10 years old. It was not contemplated that the notes would be transferred to the foundation. Reg. 53.4941(d)-2(a)(2) provides that if a private foundation assumes a mortgage that a disqualified person placed on the property within 10 years, the transfer will be considered self-dealing under 4941(d)(1)(B).

An asset manipulation intended to provide an economic benefit (the maximum tax deferral) for a NIMCRUT's income beneficiary, therefore, may be involved in self-dealing where the beneficiary is a disqualified person. In 4941 terms, it may be a use that is for the benefit of a disqualified person.

In the earlier example, **Trust X** may be involved in self-dealing, because the stock of **M** intentionally has been managed in such a way as to obtain a benefit (the maximum tax deferral) for **A**, a disqualified person. The issue then becomes whether it is the kind of benefit that is appropriate for a noncharitable beneficiary under IRC 4947(a)(2).

Charitable remainder unitrusts are unlike tax exempt private foundations in that they partially serve noncharitable interests. To rationally apply IRC 4941 to charitable remainder unitrusts, there has to be some way to draw the distinction between legitimate charitable and noncharitable interests.

For split interest trusts, that method is suggested in Reg. 53.4947-1(c)(2)(i). The regulation provides that the income beneficiaries under the terms of the trust are excepted from self-dealing with respect to unitrust distributions providing that these payments are not made from amounts for which a deduction was allowed. (Emphasis added.) This exception, found at IRC 4947(a)(2)(A), is obviously necessary to preclude the application of the self-dealing rules where a trust makes a payout to the noncharitable income beneficiary. Without such a provision, the charitable remainder trust is not possible.

It also suggests that the remainder interest must be negatively affected in order for a transaction to be characterized self-dealing.

The IRM makes the obvious point that "Payments to private beneficiaries in excess of proper unitrust or annuity amounts are subject to IRC 4941..." IRM 7752:(18)73(2). However, excessive payments made to disqualified persons are not the only form of self-dealing.

Under IRC 4941(d)(1)(B), a loan of foundation assets to a disqualified person is an act of self-dealing. Rev. Rul. 74-600, discussed earlier, illustrated this. If unitrust assets were lent to a disqualified person, the issue then becomes how it affects the remainder interest. Is it a use of the assets that ultimately affects the amount for which a deduction was allowed under Reg. 53.4947-1(c)(2)(i)?

If unitrust assets were paintings and the paintings were placed in the residence of a noncharitable beneficiary/disqualified person, the value of the remainder interest could certainly be affected if the paintings were lost or stolen. For instance, the insurance proceeds could be invested in such a way as to produce a lesser return than might have been the case had the paintings remained in the possession of the unitrust. In that circumstance, the remainderman assumes a risk so that the noncharitable beneficiary/ disqualified person may benefit.

In the unitrust format, the noncharitable beneficiary is only entitled to a stream of income. In the hypothetical, the noncharitable beneficiary/ disqualified person receives something (the use of assets in a situation where he is only entitled to an income stream) that does not fall within the self-dealing exception of Reg. 53.4947-1(c)(2)(i).

Where, in the loaned painting hypothetical, a noncharitable beneficiary/ disqualified person receives a benefit that puts the value of the remainder interest at risk, self-dealing questions arise. If the benefit is not excepted by Reg. 53.4947-1(c)(2)(i), self-dealing in fact occurs.

If both interests are served equally by a particular transaction, there would be no self-dealing. If, for example, a trustee were to sell an appreciated asset when the trustee believed the market was favorable, no self-dealing would occur because one interest would not <u>intentionally</u> be served at the expense of the other.

Clearly, the maximization of the noncharitable beneficiary/disqualified person's tax deferral is not a benefit excepted from the self-dealing rules under

Reg. 53.4947-1(c)(2)(1). The question becomes how holding an asset off the market adversely affects a charitable remainder interest for which a deduction is allowed. Returning to the example at the beginning of the article, suppose that the **M** stock, which funded **Trust X**, did not rise in value as fast as the general market. Suppose that, as is often the case, the products that **M** produced were not technology leaders as was originally thought, but played only a secondary role. By withholding from the market a stock that pays no current dividend, the trustees of **Trust X** were not taking advantage of market conditions that would have benefitted the charitable remaindermen of **Trust X**.

In the end, it does not matter whether a charitable remainderman gains or loses as the result of any particular transaction. The rules of IRC 4941 apply to whatever a transaction produces. As Reg. 53.4941(d)-1(a) puts it: "For purposes of this section [defining self-dealing] it is immaterial whether the transaction results in a benefit or a detriment to the private foundation."

In a general sense, preventing the manipulation of the assets of a charitable remainder trust was precisely the purpose of Congress in enacting the rules relating to split interest charitable remainder trusts as a part of the Tax Reform Act of 1969. The General Explanation of the Tax Reform Act of 1969, supra., at page 84, explained that the fixed percentage payout requirements imposed on charitable remainder trusts "... remove the flexibility of the prior provisions whereby it was possible to favor the income beneficiary over the remainder beneficiary by means of manipulating the trust's investments." The application of IRC 4941 to the split interest remainder trusts gave the Service the tools to address the problem of manipulation by deferral of income.

4. Application to Other Situations

Another issue before the National Office involves a NIMCRUT holding limited partnership interests in a partnership. The facts involve a husband and wife who transferred shares of stock to a newly formed limited family partnership. They each received in exchange therefor, a .5 percent general partnership and a 49.5 percent limited partnership interest. Both husband and wife donated their limited partnership interests to the NIMCRUT.

The stock will then be sold to purchase diversified investment assets. Both husband and wife retained the .5 percent general partnership interest and use their authority as general partners to manage the partnership investments and make distributions. They do not foresee making any income distributions from the partnership to the NIMCRUT until many years in the future after the husband has retired from his current position which pays a significant salary.

Accordingly, the NIMCRUT will receive no income distributions from the partnership for many years and until after the husband's retirement.

The creators of the NIMCRUT are disqualified persons by virtue of being substantial contributors to the trust. IRC 4946(a)(2) and 507(d)(2). In addition, the partnership, as an entity, would also be a disqualified person by virtue of the application of the constructive ownership rules. The income interest of the husband and wife in the NIMCRUT results in the application of the attribution rules.

Treating the partnership as a disqualified person probably makes little difference in the final analysis in asserting that the decision not to distribute income to the NIMCRUT may constitute an act of self-dealing. Clearly, its purpose is to maximize the income deferral.

The missing element, using the preceding analysis, may be the absence of risk to the remainder interest. In a situation such as this, there is no risk that the remainderman assumes if the trustee chooses to accumulate the income inside of the partnership. Quite to the contrary, the value of the remainder interest should increase with the accumulation.

If, on the other hand, one takes the position that self-dealing involves any impact that this transaction has on the remainder interest whether positive or negative, then this transaction involves self-dealing.

5. Charitable Remainder Trusts - Other Issues

As of March 1, 1996, there were over 61,000 charitable remainder trusts on file with the Service under IRC 4947(a)(2). There are a number of issues that have surfaced recently related to such trusts; these issues have no common element or central theme other than the characteristic of involving organizations as charitable remainder trusts. These issues are discussed briefly in the following material.

A. The Settlor's Charitable Pledge

The charitable pledge issue is a self-dealing issue not strictly limited to organizations that are only IRC 4947(a)(2) trusts. However, the issue has been addressed recently in the context of charitable remainder trusts as well as typical private foundations.

PLR 8128072 (April 16, 1981) ruled that a distribution from a private foundation to fulfill the obligation of a disqualified person to pay a legally enforceable charitable pledge constitutes an act of self-dealing under IRC 4941(d)(1)(E). The private foundation was created by corporations which intended to use the private foundation as a conduit to distribute the contributions made by such corporations to and through the private foundation to satisfy certain legally enforceable charitable pledges to exempt organizations which were previously incurred by the creating corporations. The Service ruled that such actions were acts of self-dealing under the authority provided by Reg. 53.4941(d)-2(f)(1).

However, the Service seemed to reach a contrary result in PLR 9233053 (May 22, 1992), where it ruled that the creation of a charitable remainder trust in satisfaction of a previously incurred charitable pledge did not result in an act of self-dealing. In the ruling, the charity that had previously received the pledge received the remainder interest under the charitable remainder trust in the place of the charitable pledge that had reached maturity prior to such exchange. In a letter dated December 14, 1995, the Service advised the subject trust that it could no longer rely on PLR 9233053. That letter has not yet been numbered for publication.

Another charitable pledge case (PLR 9540042 (July 6, 1995)) is also being revisited. PLR 9610032 (December 13, 1995) also advised the subject trust that it could no longer rely on PLR 9540042. PLR 9540042 involved a charitable trust under IRC 4947(a)(1) which was created to distribute funds to charities in order to fulfill the charitable pledges of the corporate creator of the trust and the pledges of related corporate entities.

The authority for the Service position regarding the charitable pledges is found in Reg. 53.4941(d)-2(f)(1). It provides that if a private foundation makes a grant or other payment which satisfies a legal obligation of a disqualified person, that payment or grant will normally constitute an act of self-dealing. There is an exception for certain pledges made on or before April 16, 1973.

On a slightly different topic, G.C.M. 38103 (September 21, 1979) and G.C.M. 39644 (June 26, 1987) discuss permissible substitutions of existing charitable pledges with new charitable pledges or with charitable transfers prior to the maturity date of the original charitable pledge. The key element to the pledge issue discussed in the G.C.M.s is that the terms of the pledge are revised with the consent of the charity prior to the date that the pledge was to mature. Further, such revision of the pledge is made without any economic disadvantage to the charity.

B. Reformation of Charitable Remainder Trust

In PLR 9522021 (March 1, 1995), the Service ruled that reformation of the terms of an existing charitable remainder unitrust would constitute an act of self-dealing. The creator and income beneficiary received an income right for a period that was the greater of his life or a set period of years. The trust document was drafted to include a net income limitation that limits the income to the lesser of trust income or the fixed percentage of the value of trust assets under IRC 664(d)(3)(A). The grantor wished to petition to reform the trust instrument to delete the net income limitation provision. The Service concluded that such reformation by the creator of the trust, a disqualified person, would constitute an act of self-dealing under IRC 4941(d)(1)(E). The Service held that the reforming of the trust in the manner proposed would remove interests in the trust that were previously dedicated to charity and transfer them to the benefit of the disqualified person (income beneficiary).

This issue continues to be debated in estate planning circles. Critics argue that the ability to "flip" (change format from a NIMCRUT to a standard CRUT) is a necessity given modern portfolio management theory. Variations of the "flip" trusts need to be closely scrutinized to make sure they comply with self-dealing rules.

C. Installment Redemption

The Service ruled in PLR 9347035 (August 31, 1993) that the redemption of stock held by a charitable remainder trust by a corporation which was a disqualified person with respect to the trust did not constitute an act of self-dealing, but rather fell under the IRC 4941(d)(2)(F) exception to self-dealing for any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization or reorganization. The unusual aspect of the ruling was that the redemption was made on the installment basis so that the charitable trust received the installment note of the corporation. Thus, in effect, the note constituted a loan from the trust to the corporation, a disqualified person. The loan constitutes an act of self-dealing under IRC 4941(d)(1)(B). PLR 9347035 is being revoked. For a further discussion of this topic, see the material in the FY 1995 CPE article, Private Foundations in the Mid-1990s with an Emphasis on IRC 4941 and IRC 4945 at 263.

# L. TAX-EXEMPT ADVANCE REFUNDING BONDS -- SOME BASICS

by
**Brigitte Finley and Lon B. Smith**

## 1. Introduction

The arbitrage article in the 1996 CPE Book presented a practical application of the arbitrage restrictions to an issue of tax-exempt bonds that financed the construction of a governmental facility (the "1996 Article"). Frequently, however, tax-exempt bonds are issued to refinance facilities. These refinancing bonds, commonly referred to as "refunding bonds," are issued for a variety of reasons, such as the realization of savings in the payment of debt service or the release of the issuer from covenants in the original financing documents. This article will show the reader how to analyze one type of refinancing transaction, an advance refunding.

Like the 1996 Article, this article shows how the rules apply to a specific example. The example presents two simplified issues of advance refunding bonds. Each refunding issue wholly refunds, rather than partially refunds, an outstanding issue of bonds, and the outstanding issue of bonds finances a single purpose, rather than two or more purposes. Although more complex refinancing structures are common, the example raises most of the same questions presented by these complex structures.

Part 2 of this article sets forth the facts of the example. To clearly demonstrate the effects of transferred proceeds, the facts begin with an issue of bonds in 1985, continue with an issue of advance refunding bonds in 1990, and end with another issue of advance refunding bonds in 1993. Some facts have been simplified to make the example more instructional.

Part 3 of this article, which sets forth the analysis under the Internal Revenue Code and Income Tax Regulations, focuses on the arbitrage yield restriction rules in § 148(a) and the special advance refunding rules in § 149(d). Although arbitrage rebate is mentioned, the computations for rebate are not included here because no rebatable arbitrage is earned under the facts of the example. The computations for rebate were explained in the 1996 Article.

Before moving to the example itself, a few warnings are in order. First, this article assumes the reader is familiar with the concepts discussed in the introductory guide to arbitrage presented in the 1994 CPE Book and in the 1996 Article. For example, both the concept and computation of yield were described in the previous articles and are not explained here. An understanding of that concept and computation is necessary for an understanding of the concepts in this article. THE READER IS STRONGLY ENCOURAGED TO REVIEW THE 1996 ARTICLE BEFORE READING THIS ARTICLE.

Second, this article is a tool for understanding advance refundings. Although it shows how to analyze one specific example, it is not an attempt to set forth audit guidelines. If an agent follows only the steps in this article during an actual examination, the agent may miss issues in the examination.

Third, the example assumes that all the bond documents, such as the official statement, accurately reflect the underlying facts. Therefore, this article does not explore the circumstances requiring an agent to look beyond the bond documents.

Fourth, the example does not illustrate an abusive transaction. During an actual examination, an agent should be mindful of the anti-abuse rules of the regulations, which can modify the application of other rules in the regulations.

Fifth, this article emphasizes the current statute and the 1993 regulations. Because an issue of refunding bonds refinances another issue of bonds issued at a different time, it is likely that different sets of regulations will apply to the different issues of bonds. Also, an agent must be aware of the transition rules in §§ 1312 through 1318 of the Tax Reform Act of 1986 (the "1986 Act"), which can affect application of the current rules to the various issues of bonds.

Finally, this article only discusses the requirements found in §§ 148 and 149(d). Other requirements are contained in §§ 103 and 141 through 150 and are not addressed here.

## 2. Facts of the Example

### A. Overview

The State of Z ("State") issues an original or "new money" issue of bonds in 1985 (the "1985 Bonds") to finance the construction of several new classroom buildings at University of Z ("University"). The classroom buildings will be used only by students and teachers at University. The 1985 Bonds have 10-year call protection to make the issue more marketable to investors.[1]

Over the next few years, interest rates decline. State wishes to refinance the 1985 Bonds to lock in lower interest rates and lower its debt service payments. Consequently, State issues a second issue of bonds in 1990 (the "1990 Bonds") and deposits a portion of the proceeds into an escrow account (the "1990 Escrow"). The 1990 Escrow will pay

[1] "Ten-year call protection" means that State is contractually unable to redeem the 1985 Bonds within the first 10 years after the 1985 Bonds are issued.

the debt service on the 1985 Bonds until all of the 1985 Bonds can be redeemed. Like the 1985 Bonds, the 1990 Bonds have 10-year call protection to make the issue more marketable to investors.

Interest rates continue to decline, and State wishes to refinance the 1990 Bonds to lock in lower interest rates and lower its debt service payments further. Therefore, State issues a third issue of bonds in 1993 (the "1993 Bonds") and deposits a portion of the proceeds into an escrow account (the "1993 Escrow"). The 1993 Escrow will pay the debt service on the 1990 Bonds until all of the 1990 Bonds can be redeemed.

This article focuses generally on the application of the arbitrage restrictions under § 148 and the advance refunding limitations under § 149(d) to the 1993 Bonds. Remember that the Internal Revenue Code of 1954 and §§ 1.103-13, 1.103-14, and 1.103-15 of the 1979 regulations apply to the 1985 Bonds; the 1986 Code, some of the 1979 regulations, some of the 1989 temporary regulations under § 148, and some of the 1992 regulations under § 148 apply to the 1990 Bonds[2]; and the 1986 Code and the 1993 regulations under § 148 apply to the 1993 Bonds.[3] Also, remember that §§ 1312 through 1318 of the 1986 Act set forth a series of transition rules that apply to post-1986 Act refinancings of pre-1986 Act issues of bonds. Therefore, a complete analysis of the 1993 Bonds requires an understanding of the application of some of the former rules to the 1985 Bonds and the 1990 Bonds. These former rules are discussed where necessary.

B. The 1985 Bonds

On December 15, 1985, State issues the 1985 Bonds[4] to finance the construction of several new classroom buildings at University. University is a state institution that is part of State. It is not a separate corporation and is not an organization described in § 501(c)(3). The classroom buildings will be used only by students and teachers at University.

As shown on the cover page of the official statement, attached as Appendix A, the 1985 Bonds are limited obligations of State payable solely from University's revenues, such as tuition and dormitory fees. The 1985 Bonds have an aggregate stated principal amount of $50,000,000. Each bond in the issue pays a fixed, stated rate of interest semiannually on April 1 and October 1 of each year. Interest is computed using the 30/360 day count convention.

[2] Section 1.148-0(b) of the 1992 regulations contains the effective dates for the 1992 regulations.

[3] Section 1.148-11 of the 1993 regulations contains the effective dates for the 1993 regulations.

[4] All of the bonds that make up the 1985 Bonds are part of the same "issue" within the meaning of § 1.150-1T(c).

The 1985 Bonds are comprised of 10 serial bonds ($15,530,000 total) and one term bond ($34,470,000). The serial bonds mature annually between 1987 and 1996 in the amounts shown in Appendix A. The term bond matures on April 1, 2006, but is subject to mandatory annual sinking fund redemptions. Table 1 shows the mandatory sinking fund redemption schedule:

**TABLE 1**
**1985 Bonds**
**Term Bond Mandatory Redemption Schedule**

| Maturity (April 1) | Principal Amount |
|---|---|
| 1997 | $ 2,270,000.00 |
| 1998 | 2,475,000.00 |
| 1999 | 2,695,000.00 |
| 2000 | 2,940,000.00 |
| 2001 | 3,205,000.00 |
| 2002 | 3,490,000.00 |
| 2003 | 3,805,000.00 |
| 2004 | 4,145,000.00 |
| 2005 | 4,520,000.00 |
| 2006 | 4,925,000.00 |
| | $34,470,000.00 |

The term bond also is subject to optional redemption before maturity on April 1, 1996, or on any later date. This call protection makes the term bond more marketable to investors. In order to call the term bond, State must pay all interest accrued to the applicable redemption date plus the applicable redemption price, expressed as a percentage of the outstanding principal amount redeemed, as follows:

| Redemption Period (Dates Inclusive) | Redemption Price |
|---|---|
| April 1, 1996 through March 31, 1997 | 102% |
| April 1, 1997 through March 31, 1998 | 101 |
| April 1, 1998 and thereafter | 100 |

State uses the proceeds of the 1985 Bonds to pay the costs of constructing the new classroom buildings and the costs of issuing the 1985 Bonds. The costs of issuing the 1985 Bonds include (1) underwriters' discount, (2) a premium for bond insurance,

(3) a premium for a surety bond to fund the debt service reserve fund[5], and (4) legal and other fees. Construction of the classroom buildings is completed as expected on December 1, 1988, the date on which the last of the proceeds from the 1985 Bonds are spent.

C. The 1990 Bonds

Between 1985 and 1990, interest rates decline. State decides to refinance the 1985 Bonds to lock in lower interest rates and lower its debt service payments. On October 15, 1990, State issues the 1990 Bonds[6] to refinance the 1985 Bonds and deposits most of the proceeds of the 1990 Bonds into the 1990 Escrow. The 1990 Escrow is structured to pay the debt service on the 1985 Bonds until all of the 1985 Bonds are redeemed. Because the 1990 Escrow will pay the debt service on the 1985 Bonds, the University revenues formerly pledged for the same purpose are defeased and available to be used for other purposes, such as payment of the 1990 Bonds.[7] This defeasance is permitted by the documents for the 1985 Bonds.

As shown on the cover page of the official statement, attached as Appendix B, the 1990 Bonds are limited obligations of State payable solely from University's revenues. The 1990 Bonds have an aggregate stated principal amount of $50,085,000. Each bond in the issue pays a fixed, stated rate of interest semiannually on April 1 and October 1 of each year. Interest is computed using the 30/360 day count convention. The yield on the 1990 Bonds is 7.111415%.

The 1990 Bonds are comprised of 15 serial bonds ($27,945,000 total) and one term bond ($22,140,000). The serial bonds mature annually between 1991 and 2005 in the amounts shown in Appendix B. The term bond matures on April 1, 2011, but is subject to mandatory annual sinking fund redemptions. Table 2 shows the mandatory sinking fund redemption schedule:

[5] The surety bond is an insurance policy that pays if State is ever required to draw from the debt service reserve fund. Because State purchases a surety bond for this purpose, no cash is deposited into the debt service reserve fund.

[6] All of the bonds that make up the 1990 Bonds are part of the same "issue" within the meaning of § 1.150-1T(c).

[7] Under a defeasance, the lien on the pledged revenues or other properties is released, and the revenues or properties no longer secure the bond issue.

**TABLE 2**
**1990 Bonds**
**Term Bond Mandatory Redemption Schedule**

| Maturity (April 1) | Principal Amount |
|---|---|
| 2006 | $ 3,090,000.00 |
| 2007 | 3,310,000.00 |
| 2008 | 3,545,000.00 |
| 2009 | 3,790,000.00 |
| 2010 | 4,060,000.00 |
| 2011 | 4,345,000.00 |
| | $22,140,000.00 |

The serial bonds maturing in the years 2002 through 2005 and the term bond also are subject to optional redemption before maturity on April 1, 2001, or on any later date. Like the 1985 Bonds, the 1990 Bonds have 10-year call protection to make them more marketable to investors. In order to call these serial bonds or the term bond, State must pay all interest accrued to the applicable redemption date plus the applicable redemption price, expressed as a percentage of the outstanding principal amount redeemed, as follows:

| Redemption Period (Dates Inclusive) | Redemption Price |
|---|---|
| April 1, 2001 through March 31, 2002 | 102% |
| April 1, 2002 through March 31, 2003 | 101 |
| April 1, 2003 and thereafter | 100 |

State uses a portion of the proceeds of the 1990 Bonds to pay the costs of issuing the 1990 Bonds. These costs include (1) underwriters' discount, (2) a premium for bond insurance, (3) a premium for a surety bond to fund the debt service reserve fund, and (4) legal and other fees.

State uses $48,751,100 of the proceeds of the 1990 Bonds to purchase, at par, certain United States Treasury securities-State and Local Government Series ("SLGS") on October 15, 1990. State deposits these SLGS into the 1990 Escrow. State also deposits $80.78 of cash from the proceeds of the 1990 Bonds into the 1990 Escrow. This cash deposit is required because the total receipts from the SLGS are $80.78 less than the total debt service on the 1985 Bonds that will be paid by the 1990 Escrow. The 1990 Escrow is irrevocably pledged to the payment of debt service on the 1985 Bonds.

Over time, the SLGS will earn investment income and then mature. These receipts by the 1990 Escrow, together with the initial cash deposit, will be sufficient to pay the principal of, and interest and premium on, the 1985 Bonds up to and including the first

optional redemption date of the 1985 Bonds on April 1, 1996. The yield on the SLGS in the 1990 Escrow for arbitrage purposes is 7.110979%.[8]

The following tables describe the SLGS State deposits into the 1990 Escrow, the cash flow from the SLGS in the 1990 Escrow, and the debt service on the 1985 Bonds that will be paid from the cash and the SLGS in the 1990 Escrow:

**TABLE 3**
**Description of SLGS in 1990 Escrow**

| Type of SLGS[9] | Maturity Date | First Interest Payment Date | Par Amount | Interest Rate |
|---|---|---|---|---|
| Certificate | 04/01/1991 | 04/01/1991 | $ 1,882,800.00 | 0% |
| Certificate | 10/01/1991 | 10/01/1991 | 243,400.00 | 0% |
| Note | 04/01/1992 | 04/01/1991 | 1,808,300.00 | 6.484% |
| Note | 10/01/1992 | 04/01/1991 | 244,900.00 | 6.665% |
| Note | 04/01/1993 | 04/01/1991 | 1,933,000.00 | 6.785% |
| Note | 10/01/1993 | 04/01/1991 | 255,600.00 | 6.871% |
| Note | 04/01/1994 | 04/01/1991 | 2,069,400.00 | 6.958% |
| Note | 10/01/1994 | 04/01/1991 | 266,900.00 | 7.026% |
| Note | 04/01/1995 | 04/01/1991 | 2,221,200.00 | 7.087% |
| Note | 10/01/1995 | 04/01/1991 | 278,200.00 | 7.130% |
| Note | 04/01/1996 | 04/01/1991 | 37,547,400.00 | 7.181% |
| | | | $48,751,100.00 | |

[8] Note that the yield on the 1990 Escrow is not exactly the same as the yield on the 1990 Bonds. In general, an issuer specifies the yield it will receive on SLGS purchased for a refunding escrow. However, SLGS must be purchased in multiples of $100, and debt service on the prior bonds is not always evenly divisible by $100. Consequently, the yield on the investments in a refunding escrow may not be identical to the yield on the refunding issue.

[9] The United States Department of the Treasury issues three types of SLGS. These types are (1) certificates of indebtedness, which have maturity periods from 30 days up to and including 1 year, (2) notes, which have maturity periods from 1 year and 1 day up to and including 10 years, and (3) bonds, which have maturity periods from 10 years and 1 day up to and including 30 years.

**TABLE 4**
**1990 Escrow Cash Flow**

| Date | Principal at Redemption | Total Interest | Net Escrow Receipts |
|---|---|---|---|
| 04/01/1991 | $ 1,882,800.00 | $ 1,531,643.64 | $ 3,414,443.64 |
| 10/01/1991 | 243,400.00 | 1,659,280.63 | 1,902,680.63 |
| 04/01/1992 | 1,808,300.00 | 1,659,280.63 | 3,467,580.63 |
| 10/01/1992 | 244,900.00 | 1,600,655.54 | 1,845,555.54 |
| 04/01/1993 | 1,933,000.00 | 1,592,494.25 | 3,525,494.25 |
| 10/01/1993 | 255,600.00 | 1,526,917.22 | 1,782,517.22 |
| 04/01/1994 | 2,069,400.00 | 1,518,136.08 | 3,587,536.08 |
| 10/01/1994 | 266,900.00 | 1,446,141.65 | 1,713,041.65 |
| 04/01/1995 | 2,221,200.00 | 1,436,765.45 | 3,657,965.45 |
| 10/01/1995 | 278,200.00 | 1,358,057.23 | 1,636,257.23 |
| 04/01/1996 | 37,547,400.00 | 1,348,139.40 | 38,895,539.40 |
| | $48,751,100.00 | $16,677,511.72 | $65,428,611.72[10] |

**TABLE 5**
**1985 Bond Debt Service Paid With**
**Proceeds of SLGS and Cash in 1990 Escrow**

| Date | Maturing Principal | Interest | Principal Redeemed | Redemption Premium | Total |
|---|---|---|---|---|---|
| 04/01/1991 | $ 1,460,000.00 | $ 1,954,472.50 | $ --- | $ --- | $ 3,414,472.50 |
| 10/01/1991 | --- | 1,902,642.50 | --- | --- | 1,902,642.50 |
| 04/01/1992 | 1,565,000.00 | 1,902,642.50 | --- | --- | 3,467,642.50 |
| 10/01/1992 | --- | 1,845,520.00 | --- | --- | 1,845,520.00 |
| 04/01/1993 | 1,680,000.00 | 1,845,520.00 | --- | --- | 3,525,520.00 |
| 10/01/1993 | --- | 1,782,520.00 | --- | --- | 1,782,520.00 |
| 04/01/1994 | 1,805,000.00 | 1,782,520.00 | --- | --- | 3,587,520.00 |
| 10/01/1994 | --- | 1,713,027.50 | --- | --- | 1,713,027.50 |
| 04/01/1995 | 1,945,000.00 | 1,713,027.50 | --- | --- | 3,658,027.50 |
| 10/01/1995 | --- | 1,636,200.00 | --- | --- | 1,636,200.00 |
| 04/01/1996 | 2,100,000.00 | 1,636,200.00 | 34,470,000.00 | 689,400.00 | 38,895,600.00 |
| | $10,555,000.00 | $19,714,292.50 | $34,470,000.00 | $689,400.00 | $65,428,692.50 |

The proceeds from the 1990 Bonds that are in the 1990 Escrow are used to pay principal of, and interest and redemption premium on, the 1985 Bonds between April 1, 1991, and April 1, 1996.

[10] This amount plus the $80.78 State deposits in the 1990 Escrow equals the $65,428,692.50 total debt service on the 1985 Bonds shown in Table 5.

D. The 1993 Bonds

Interest rates continue to decline, and State decides to refinance the 1990 Bonds to lock in lower interest rates and lower its debt service payments further. On July 1, 1993, State issues the 1993 Bonds[11] to refinance the 1990 Bonds and deposits most of the proceeds of the 1993 Bonds into the 1993 Escrow. The 1993 Escrow is structured to pay the debt service on the 1990 Bonds until all of the 1990 Bonds are redeemed. Because the 1993 Escrow will pay the debt service on the 1990 Bonds, the University revenues formerly pledged for the same purpose are defeased and available to be used for other purposes, such as payment of the 1993 Bonds. This defeasance is permitted by the documents for the 1990 Bonds.

As shown on the cover page of the official statement, attached as Appendix C, the 1993 Bonds are limited obligations of State payable solely from University's revenues. The 1993 Bonds have an aggregate stated principal amount of $54,950,000. Each bond in the issue pays a fixed, stated rate of interest semiannually on April 1 and October 1 of each year. Interest is computed using the 30/360 day count convention.

The 1993 Bonds are comprised of 14 serial bonds ($30,510,000 total) and one term bond ($24,440,000). The serial bonds mature annually between 1994 and 2007 in the amounts shown in Appendix C. The term bond matures on April 1, 2014, but is subject to mandatory annual sinking fund redemptions. Table 6 shows the mandatory sinking fund redemption schedule:

**TABLE 6**
**1993 Bonds**
**Term Bond Mandatory Redemption Schedule**

| Maturity (April 1) | Principal Amount |
|---|---|
| 2008 | $ 3,000,000.00 |
| 2009 | 3,150,000.00 |
| 2010 | 3,310,000.00 |
| 2011 | 3,475,000.00 |
| 2012 | 3,650,000.00 |
| 2013 | 3,830,000.00 |
| 2014 | 4,025,000.00 |
| | $24,440,000.00 |

[11] All of the bonds that make up the 1993 Bonds are part of the same "issue" within the meaning of § 1.150-1T(c).

State receives $54,582,453.45 from the sale of the 1993 Bonds to the public. The price for each bond is as follows:

**TABLE 7**
**1993 Bond Price Schedule**

| Maturity (April 1) | Principal Amount | Interest Rate | Yield | Price |
|---|---|---|---|---|
| 1994 | $ 1,300,000.00 | 2.70% | 2.70% | $ 1,300,000.00 |
| 1995 | 1,770,000.00 | 3.15 | 3.15 | 1,770,000.00 |
| 1996 | 1,825,000.00 | 3.45 | 3.45 | 1,825,000.00 |
| 1997 | 1,885,000.00 | 3.70 | 3.70 | 1,885,000.00 |
| 1998 | 1,955,000.00 | 3.95 | 3.95 | 1,955,000.00 |
| 1999 | 2,035,000.00 | 4.05 | 4.05 | 2,035,000.00 |
| 2000 | 2,115,000.00 | 4.15 | 4.15 | 2,115,000.00 |
| 2001 | 2,205,000.00 | 4.25 | 4.25 | 2,205,000.00 |
| 2002 | 2,300,000.00 | 4.35 | 4.35 | 2,300,000.00 |
| 2003 | 2,400,000.00 | 4.40 | 4.40 | 2,400,000.00 |
| 2004 | 2,505,000.00 | 4.50 | 4.50 | 2,505,000.00 |
| 2005 | 2,615,000.00 | 4.60 | 4.60 | 2,615,000.00 |
| 2006 | 2,735,000.00 | 4.70 | 4.80 | 2,708,935.45 |
| 2007 | 2,865,000.00 | 4.80 | 4.90 | 2,836,350.00 |
| 2014 | 24,440,000.00 | 5.00 | 5.10 | 24,127,168.00 |
| | $54,950,000.00 | | | $54,582,453.45[12] |

State uses a portion of the proceeds of the 1993 Bonds to pay the costs of issuing the 1993 Bonds. These costs include (1) underwriters' discount, (2) a premium for bond insurance, (3) a premium for a surety bond to fund the debt service reserve fund, and (4) legal and other fees. Both the bond insurance and the surety bond are qualified guarantees within the meaning of § 1.148-4(f).

State also uses a portion of the proceeds of the 1993 Bonds to purchase, at par, certain SLGS on July 1, 1993. State deposits these SLGS into the 1993 Escrow. State also deposits $58.09 of cash from the proceeds of the 1993 Bonds into the 1993 Escrow. This cash deposit is required because the total receipts from the SLGS are $58.09 less than the total debt service on the 1990 Bonds that will be paid by the 1993 Escrow. The 1993 Escrow is irrevocably pledged to the payment of debt service on the 1990 Bonds.

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[12] This amount is equal to the par amount of the 1993 Bonds ($54,950,000) minus the discount resulting from the differences between the stated interest rates of, and the yields on, the bonds maturing in 2006, 2007, and 2014 ($367,546.55).

The following table shows the sources and uses of the funds State raises from the sale of the 1993 Bonds:

**TABLE 8**
**1993 Bonds**
**Sources and Uses**

| | |
|---|---|
| Sources of Funds: | |
| Par Amount | $54,950,000.00 |
| Less Discount | 367,546.55 |
| Total Sources | $54,582,453.45 |
| | |
| Uses of Funds: | |
| 1993 Escrow Deposits: | |
| Cash | $ 58.09 |
| SLGS | 53,619,700.00 |
| | 53,619,758.09 |
| Costs of Issuance: | |
| Underwriters' Discount | 522,025.00 |
| Bond Insurance Premium | 262,972.10 |
| Surety Bond Premium | 126,801.90 |
| Legal and Other Fees | 50,896.36 |
| | 962,695.36 |
| | |
| Total Uses | $54,582,453.45 |

Over time, the SLGS will earn investment income and then mature. These receipts by the 1993 Escrow, together with the initial cash deposit, will be sufficient to pay the principal of, and interest and premium on, the 1990 Bonds up to and including the first optional redemption date of the 1990 Bonds on April 1, 2001.

The following tables describe the SLGS State deposits into the 1993 Escrow, the cash flow from the SLGS in the 1993 Escrow, and the debt service on the 1990 Bonds that will be paid from the cash and the SLGS in the 1993 Escrow:

**TABLE 9**
**Description of SLGS in 1993 Escrow**

| Type of SLGS | Maturity Date | First Interest Payment Date | Par Amount | Interest Rate |
|---|---|---|---|---|
| Certificate | 10/01/1993 | 10/01/1993 | $ 1,002,700.00 | 0% |
| Certificate | 04/01/1994 | 04/01/1994 | 1,815,800.00 | 0% |
| Note | 10/01/1994 | 10/01/1993 | 351,000.00 | 3.198% |
| Note | 04/01/1995 | 10/01/1993 | 1,866,700.00 | 3.483% |
| Note | 10/01/1995 | 10/01/1993 | 340,800.00 | 3.686% |
| Note | 04/01/1996 | 10/01/1993 | 1,952,100.00 | 3.852% |
| Note | 10/01/1996 | 10/01/1993 | 332,600.00 | 4.009% |
| Note | 04/01/1997 | 10/01/1993 | 2,049,200.00 | 4.165% |
| Note | 10/01/1997 | 10/01/1993 | 325,500.00 | 4.322% |
| Note | 04/01/1998 | 10/01/1993 | 2,157,500.00 | 4.470% |
| Note | 10/01/1998 | 10/01/1993 | 320,000.00 | 4.608% |
| Note | 04/01/1999 | 10/01/1993 | 2,272,400.00 | 4.718% |
| Note | 10/01/1999 | 10/01/1993 | 315,900.00 | 4.801% |
| Note | 04/01/2000 | 10/01/1993 | 2,398,400.00 | 4.884% |
| Note | 10/01/2000 | 10/01/1993 | 312,000.00 | 4.958% |
| Note | 04/01/2001 | 10/01/1993 | 35,807,100.00 | 5.022% |
| | | | $53,619,700.00 | |

**TABLE 10**
**1993 Escrow Cash Flow**

| Date | Principal at Redemption | Total Interest | Net Escrow Receipts |
|---|---|---|---|
| 10/01/1993 | $ 1,002,700.00 | $ 613,623.29 | $ 1,616,323.29 |
| 04/01/1994 | 1,815,800.00 | 1,220,576.80 | 3,036,376.80 |
| 10/01/1994 | 351,000.00 | 1,220,576.80 | 1,571,576.80 |
| 04/01/1995 | 1,866,700.00 | 1,214,964.31 | 3,081,664.31 |
| 10/01/1995 | 340,800.00 | 1,182,455.71 | 1,523,255.73 |
| 04/01/1996 | 1,952,100.00 | 1,176,174.79 | 3,128,274.79 |
| 10/01/1996 | 332,600.00 | 1,138,577.34 | 1,471,177.34 |
| 04/01/1997 | 2,049,200.00 | 1,131,910.37 | 3,181,110.37 |
| 10/01/1997 | 325,500.00 | 1,089,235.78 | 1,414,735.78 |
| 04/01/1998 | 2,157,500.00 | 1,082,201.72 | 3,239,701.72 |
| 10/01/1998 | 320,000.00 | 1,033,981.59 | 1,353,981.59 |
| 04/01/1999 | 2,272,400.00 | 1,026,608.79 | 3,299,008.79 |
| 10/01/1999 | 315,900.00 | 973,002.87 | 1,288,902.87 |
| 04/01/2000 | 2,398,400.00 | 965,419.69 | 3,363,819.69 |
| 10/01/2000 | 312,000.00 | 906,850.76 | 1,218,850.76 |
| 04/01/2001 | 35,807,100.00 | 899,116.28 | 36,706,216.28 |
| | $53,619,700.00 | $16,875,276.91 | $70,494,976.91[13] |

[13] This amount plus the $58.09 State deposits in the 1993 Escrow equals the $70,495,035 total debt service on the 1990 Bonds shown in Table 11.

**TABLE 11**
**1990 Bond Debt Service Paid With Proceeds of SLGS and Cash in 1993 Escrow**

| Date | Maturing Principal | Interest | Principal Redeemed | Redemption Premium | Total |
|---|---|---|---|---|---|
| 10/01/1993 | $ --- | $ 1,616,346.25 | $ --- | $ --- | $ 1,616,346.25 |
| 04/01/1994 | 1,420,000.00 | 1,616,346.25 | --- | --- | 3,036,346.25 |
| 10/01/1994 | --- | 1,571,616.25 | --- | --- | 1,571,616.25 |
| 04/01/1995 | 1,510,000.00 | 1,571,616.25 | --- | --- | 3,081,616.25 |
| 10/01/1995 | --- | 1,523,296.25 | --- | --- | 1,523,296.25 |
| 04/01/1996 | 1,605,000.00 | 1,523,296.25 | --- | --- | 3,128,296.25 |
| 10/01/1996 | --- | 1,471,133.75 | --- | --- | 1,471,133.75 |
| 04/01/1997 | 1,710,000.00 | 1,471,133.75 | --- | --- | 3,181,133.75 |
| 10/01/1997 | --- | 1,414,703.75 | --- | --- | 1,414,703.75 |
| 04/01/1998 | 1,825,000.00 | 1,414,703.75 | --- | --- | 3,239,703.75 |
| 10/01/1998 | --- | 1,354,022.50 | --- | --- | 1,354,022.50 |
| 04/01/1999 | 1,945,000.00 | 1,354,022.50 | --- | --- | 3,299,022.50 |
| 10/01/1999 | --- | 1,288,865.00 | --- | --- | 1,288,865.00 |
| 04/01/2000 | 2,075,000.00 | 1,288,865.00 | --- | --- | 3,363,865.00 |
| 10/01/2000 | --- | 1,218,833.75 | --- | --- | 1,218,833.75 |
| 04/01/2001 | 2,215,000.00 | 1,218,833.75 | 32,620,000.00 | 652,400.00 | 36,706,233.75 |
| | $14,305,000.00 | $22,917,635.00 | $32,620,000.00 | $652,400.00 | $70,495,035.00 |

The proceeds from the 1993 Bonds that are in the 1993 Escrow are used to pay principal of, and interest and redemption premium on, the 1990 Bonds between October 1, 1993, and April 1, 2001.

Because State purchases a surety bond to fund the debt service reserve fund for the 1993 Bonds, no proceeds of the 1993 Bonds are deposited into this fund.

On the issue date of the 1993 Bonds, State makes an election under § 1.148-9(g) to waive its right to invest the proceeds of the 1993 Bonds in higher yielding investments during the temporary period applicable to those proceeds.

Under the documents for the 1993 Bonds, State establishes a debt service fund into which it makes monthly deposits from University's revenues equal to one-sixth of the next semiannual interest payment plus one-twelfth of the next annual principal payment. Under the documents for the 1993 Bonds, State must deplete this fund at least once each bond year, except for a reasonable carryover amount not to exceed the greater of (1) the earnings on the fund for the immediately preceding bond year or (2) one-twelfth of the principal of, and interest payments on, the 1993 Bonds for the immediately preceding bond year. This debt service fund is a bona fide debt service fund within the meaning of § 1.148-1(b). The amounts in this fund are invested in short-term investments permitted

under documents for the 1993 Bonds until the amounts are needed to pay the next debt service payment on the 1993 Bonds.

3. Analysis of Code and Regulations

A. General

Section 103(a) provides that interest on any state or local bond is excluded from gross income. However, this interest exclusion is limited by § 103(b), which makes § 103(a) inapplicable to any arbitrage bond under § 148 or any bond that does not comply with the applicable requirements of § 149.

Section 148 generally provides that a state or local bond will be an arbitrage bond if either (1) the issuer invests the proceeds of the bonds at a yield that is materially higher than the yield on the bonds ("yield restriction rules") or (2) the issuer fails to rebate the excess earnings on those bond proceeds ("rebate rules"). These arbitrage restrictions apply to all state and local bonds unless the bonds meet one or more of the enumerated exceptions to the yield restriction rules (e.g., temporary period exceptions) or the rebate rules (e.g., 6-month spending exception or small issuer exception).

Section 149 contains other requirements that must be met for a state or local bond to qualify for the interest exclusion under § 103(a). Among the requirements are those found in § 149(d) for "advance refundings."

B. Definition of "Refunding"

In general, a "refunding" is a refinancing of another debt obligation. The precise definition of a "refunding issue" can be found in § 1.150-1(d)(1). Under this definition, a "refunding issue" is an issue of debt obligations the proceeds of which are used to pay principal of, or interest or redemption price on, another issue of bonds. The bonds of a refunding issue are often called the "refunding bonds." The definition also provides that the proceeds of the refunding issue may be used for issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or any similar costs that are properly allocable to that refunding issue.

The "other issue" that has amounts paid by the proceeds of a refunding issue is called the "prior issue" under § 1.150-1(d)(5). The prior issue also is commonly called the "refunded issue," and the bonds of the prior issue that are refinanced are often called the "refunded bonds." Although the regulations use the term "prior issue," § 1.150-1(d)(5) states that a prior issue may be issued before, at the same time as, or after, a refunding issue. Thus, the determination of whether a particular bond issue is a refunding issue

depends on the use of its proceeds rather than the relative issue dates of the refunding and refunded issues.

In addition to the general requirement that the proceeds of the refunding issue must be used to pay the principal of, or interest or redemption price on, the prior issue, § 1.150-1(d)(2)(ii) states that an issue is not a refunding issue to the extent that the obligor of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. In general, the "obligor" of an issue is the actual issuer of the bonds.

State is the actual issuer of the 1985 Bonds, the 1990 Bonds, and the 1993 Bonds. Thus, State is the obligor of each of these issues, even though the debt service on each issue is payable, at some point, solely from University's revenues.

State uses the proceeds of the 1993 Bonds to purchase the SLGS in the 1993 Escrow, and the principal and investment income from these SLGS plus the initial cash deposit in the 1993 Escrow will be used to pay the principal of, and interest and call premium on, the 1990 Bonds. Therefore, the 1993 Bonds are a refunding issue of the 1990 Bonds, and the 1990 Bonds are a prior issue of the 1993 Bonds. Similarly, State uses the proceeds of the 1990 Bonds to purchase the SLGS in the 1990 Escrow, and the principal and investment income from these SLGS plus the initial cash deposit in the 1990 Escrow will be used to pay the principal of, and interest and call premium on, the 1985 Bonds. Therefore, the 1990 Bonds are a refunding issue of the 1985 Bonds, and the 1985 Bonds are a prior issue of the 1990 Bonds. Note that the 1990 Bonds are both a refunding issue and a prior issue.

### C. "Current" and "Advance" Refunding Issues

Every refunding issue is classified as either a current refunding issue or an advance refunding issue. This classification is important because the limitations in § 149(d) discussed below only apply to advance refunding issues. In general, the classification is based on the number of days between the issue date of the refunding issue and the last date the proceeds of the refunding issue will be used to pay debt service on the prior issue.

Under § 149(d)(5) and § 1.150-1(d)(3), a refunding issue issued after 1985 is an "advance refunding issue" if any proceeds of the refunding issue are used more than 90 days after the issue date to pay debt service on the prior issue. For bonds issued before 1986, the time period is 180 days. A current refunding issue is an issue of refunding bonds that is not an advance refunding issue.

State issues the 1990 Bonds on October 15, 1990. State uses a portion of the proceeds of the 1990 Bonds to purchase the SLGS in the 1990 Escrow. These SLGS, together with the initial cash deposit in the 1990 Escrow, will be used to pay debt service on the 1985 Bonds until they are called on April 1, 1996. Because April 1, 1996, is more than 90 days from October 15, 1990, the 1990 Bonds are an advance refunding issue. Under a similar analysis, the 1993 Bonds are also an advance refunding issue.

D. Advance Refunding Limitations Under § 149(d)

i. General

Section 149(d)(1) provides that three types of advance refunding issues are not entitled to the interest exclusion for state and local bonds under § 103(a). These types are (1) advance refunding issues that refund private activity bonds other than qualified 501(c)(3) bonds, (2) advance refunding issues that are abusive transactions, and (3) advance refunding issues that do not meet certain specified requirements. Each type of advance refunding issue is discussed below.

ii. Tax-exempt Advance Refunding of Private Activity Bonds (Other than Qualified 501(c)(3) Bonds)

Section 149(d)(2) states that only governmental bonds and qualified 501(c)(3) bonds may be advance refunded. A private activity bond is any bond within an issue of bonds if that issue meets both of the private business tests in § 141(b) or meets the private loan financing test in § 141(c). The main focus of these tests is on the use of bond proceeds in the trade or business of an entity that is not a state or local governmental unit.

State issues the 1985 Bonds to finance the construction of classroom buildings at University. The classroom buildings will be used only by University, which is a state institution. Because there is no private business use of the classroom buildings and no private loan of proceeds, the 1985 Bonds are not private activity bonds under § 141. Therefore, the 1985 Bonds may be advance refunded by the 1990 Bonds.

Under § 1.103-7(d)(1), the proceeds of a refunding issue are considered to be used for the same purpose as the proceeds of the prior issue. Therefore, the 1990 Bonds are treated as if they were used to finance the classroom buildings, even though the proceeds of the 1990 Bonds actually are used to purchase the SLGS in the 1990 Escrow. Consequently, the 1990 Bonds are not private activity bonds, and they may be advance refunded by the 1993 Bonds.

iii. Abusive Advance Refunding Transactions

Section 149(d)(4) provides that the interest on an advance refunding issue will not be excluded from gross income under § 103(a) if a device is employed in connection with the issuance of the advance refunding issue to obtain a material financial advantage. The material financial advantage is based on arbitrage concepts under § 148 and does not include savings attributable to lower interest rates. Section 1.149(d)-1(b) provides that an advance refunding issue violates § 149(d)(4) if (1) the issue violates any of the anti-abuse rules under § 1.148-10, (2) the issue fails to meet the rebate requirements under § 1.148-3, or (3) the proceeds of the issue are invested in a certain type of escrow that contains both nonpurpose investments and tax-exempt obligations.

The 1990 Bonds and the 1993 Bonds are issued to take advantage of savings from lower interest rates. In addition, neither the 1990 Escrow nor the 1993 Escrow contain tax-exempt obligations. Assuming that the anti-abuse rules under § 1.148-10 are not violated and that State satisfies the rebate requirements, the 1993 Bonds do not violate the limitation under § 149(d)(4).

iv. Other Requirements for Advance Refunding Issues

Section 149(d)(3) generally provides that the interest exclusion under § 103(a) will not apply to any advance refunding issue unless the issue also meets the requirements discussed below.

*Number of Advance Refunding Issues Permitted* --

Section 149(d)(3)(A)(i) limits the number of times an issuer may advance refund an original bond issue. If the original bond issue was issued before 1986, two advance refundings are permitted. If the original bond issue was issued after 1985, only one advance refunding is permitted. In addition, § 149(d)(6)(B) treats an original bond issue issued before 1986 as having been advance refunded no more than once before March 15, 1986. For example, if an original bond issue issued in 1975 were advance refunded three times in 1978, 1981, and 1985, the three advance refundings would be counted as only one advance refunding. Under § 149(d)(3)(A)(i), therefore, the 1975 original bond issue would be eligible to be advance refunded one more time, even though the total number of advance refunding issues actually would be four.[14]

[14] In addition, § 1.149(d)-1(d) generally provides that the multipurpose rules under § 1.148-9(h) apply to determine the number of times the issuer has advance refunded an original bond of an issue. A complete analysis of the multipurpose rules is beyond the scope of this article. However, § 1.148-9(h) generally provides that the bonds of a multipurpose issue allocated to any separate purpose (e.g., refunding a separate prior issue or financing any clearly discrete governmental purpose) are treated as a separate issue for all purposes of § 148 except computing arbitrage

The 1985 Bonds are issued before 1986. Therefore, two advance refundings of the 1985 Bonds are permitted. The 1990 Bonds are the first, and the 1993 Bonds are the second, advance refunding issue of the 1985 Bonds. Consequently, the 1993 Bonds meet this requirement.

*Date by Which the Refunded Issue Must be Redeemed* --

Sections 149(d)(3)(A)(ii) and (iii) require that the refunded bonds of the prior issue be redeemed on or before a specific date.[15] If the prior issue was issued before 1986, the refunded bonds must be redeemed as soon as they may be redeemed at a premium of 3% or less. If the prior issue was issued after 1985, the refunded bonds must be redeemed as soon as they may be redeemed at any price. An exception to these rules is set forth in § 149(d)(3)(B), which provides that the issuer is not required to redeem the refunded bonds unless it will realize a debt service savings from the refunding issue on a present value basis. Also, the issuer need not redeem the refunded bonds within 90 days after the issue date of the refunding issue.[16]

The first date on which any of the 1990 Bonds may be optionally redeemed before maturity is April 1, 2001. State may only redeem the 1990 Bonds on this date if it pays principal, accrued interest, and a redemption premium equal to 2% of the outstanding principal. In addition, State will achieve a present value debt service savings by using the proceeds of the 1993 Bonds to advance refund the 1990 Bonds and redeem the 1990 Bonds on their first call date.

The 1993 Escrow is irrevocably pledged to pay debt service on the 1990 Bonds. Table 10 shows the anticipated receipts from the SLGS in the 1993 Escrow. These receipts plus the initial cash deposit in the 1993 Escrow are sufficient to provide for the debt service requirements of the 1990 Bonds shown in Table 11. This includes redemption of the remaining 1990 Bonds and payment of a 2% redemption premium on

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yield, rebate amount, the minor portion amount, and the reasonably required reserve or replacement fund amount of the bond issue. A multipurpose issue is a bond issue that is used to finance two or more separate purposes. For example, if original bonds issued in 1988 were used to finance Project 1 and Project 2 and the issuer subsequently issued tax-exempt bonds to advance refund only those original bonds allocable to Project 1, the original bonds allocable to Project 2 would still be eligible to be advance refunded with tax-exempt bonds. The 1985 Bonds, the 1990 Bonds, and the 1993 Bonds are not multipurpose issues.

[15] Remember that an issuer may refinance all or a part of the prior issue. If the issuer refunds part of the prior issue (a "partial refunding"), this requirement only applies to the bonds of the prior issue that are being refunded.

[16] If the first call date of the refunded bonds was within 90 days from the issue date of the refunding issue, requiring redemption of the refunded bonds on the first call date would cause the refunding issue to be a current refunding issue, which is not subject to these requirements.

April 1, 2001. Thus, the proceeds of the 1993 Bonds will be used to redeem the 1990 Bonds on the first date on which the 1990 Bonds may be redeemed. Consequently, the 1993 Bonds meet these requirements.

*Initial Temporary Periods Under § 148(c)* --

Section 149(d)(3)(A)(iv) sets forth limitations on the temporary period in the regulations under § 148(c) for both the refunding issue and the prior issue. Under § 149(d)(3)(A)(iv), the temporary period for the refunding issue is no later than 30 days after it is issued, and the temporary period for the prior issue is no later than the issue date of the refunding issue (i.e., an advance refunding issue cuts off the temporary period of the proceeds of the prior issue). Section 1.148-9(d)(2) of the 1993 regulations, which applies to the 1993 Bonds, also provides a 30-day temporary period for advance refunding issues.

The temporary period for the 1990 Bonds under the 1979 regulations ends on October 14, 1992, 2 years after issue date of the 1990 Bonds.[17] This is not later than July 1, 1993, the issue date of the 1993 Bonds. Consequently, the 1993 Bonds meet this requirement.

*Refunded Issue not Subject to § 148(e)* --

Section 148(e) permits an issuer to invest a minor portion of the proceeds of an issue in materially higher yielding investments. The minor portion is the lesser of 5% of the proceeds or $100,000. If § 148(e) did not apply to the prior issue, § 149(d)(3)(A)(v) restricts the amount of proceeds of the prior issue that can be invested at a materially higher yield.

Section 148(e) applies to the 1990 Bonds because they are issued on October 15, 1990. Therefore, this requirement does not apply to the 1993 Bonds.[18]

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[17] See § 1.103-14(e)(3) of the 1979 regulations.

[18] The 1985 Bonds are not subject to § 148(e). Consequently, the 1990 Bonds must meet this requirement. Because the debt service reserve fund for the 1985 Bonds is funded with a surety bond instead of cash and because all bond proceeds are expended on or before December 1, 1988, no proceeds of the 1985 Bonds are invested in higher yielding investments after the issue date of the 1990 Bonds. Thus, the 1990 Bonds meet this requirement.

v. Conclusion

The 1993 Bonds do not advance refund a private activity bond, are not an abusive advance refunding transaction, and meet all of the requirements under § 149(d)(3). Therefore, the 1993 Bonds are not any of the three prohibited types of advance refunding issues described in § 149(d)(1).

E. Yield Restriction Rules Under § 148(a)

i. General

Section 148(a) generally provides that a bond is an arbitrage bond if, on the issue date, the issuer reasonably expects to use the proceeds of the issue of which the bond is a part directly or indirectly (1) to acquire higher yielding investments or (2) to replace funds used directly or indirectly to acquire higher yielding investments. Section 148(a) also provides that a bond is an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which the bond is a part (1) to acquire higher yielding investments or (2) to replace funds used directly or indirectly to acquire higher yielding investments. Section 148(b)(1) defines "higher yielding investments" as any investment property that produces a yield over the term of the issue that is materially higher than the yield on the bond issue.

As explained in the 1996 Article, the analysis of whether a bond issue complies with the yield restriction rules can be broken down into the following steps:

*Step one:* Determine whether the bonds are part of the same issue;

*Step two:* Review the issuer's expectations concerning the use of bond proceeds and determine whether those expectations are reasonable;

*Step three:* Determine the amount of gross proceeds;

*Step four:* Determine the allocation of gross proceeds to investments and expenditures;

*Step five:* Determine whether any exceptions to the yield restriction rules apply; and

*Step six:* If no exceptions to the yield restriction rules apply, determine the permitted spread allowed to be earned on investments over the bond yield.

These steps can be used to determine compliance with the yield restriction rules regardless of whether the bond issue being analyzed is a new money issue or a refunding issue. As stated above, the 1993 Bonds are part of the same issue, and State's expectations regarding use of the proceeds of the 1993 Bonds are presumed to be reasonable. Therefore, the next step in the analysis is to determine the amount of gross proceeds of the 1993 Bonds.

ii. Determine the Amount of Gross Proceeds

Section 1.148-1(b) defines "gross proceeds" as any proceeds and replacement proceeds of an issue. "Proceeds" is further defined as any sale proceeds, investment proceeds, and transferred proceeds of an issue. In order to determine the amount of gross proceeds of the 1993 Bonds, therefore, the amount of sale proceeds, investment proceeds, transferred proceeds, and replacement proceeds of the 1993 Bonds must be determined.

*Sale Proceeds* --

Section 1.148-1(b) defines "sale proceeds" as any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount and accrued interest other than pre-issuance accrued interest.

As shown in Table 7, State receives $54,582,453.45 from the sale of the 1993 Bonds. This amount is equal to the par amount of the 1993 Bonds ($54,950,000) minus the discount resulting from the differences between the stated interest rates of, and the yields on, the bonds maturing in 2006, 2007, and 2014 ($367,546.55). Table 8 shows that the sale proceeds of the 1993 Bonds are divided among (1) the cash and the SLGS in the 1993 Escrow, (2) the underwriters' discount, (3) the premium for bond insurance, (4) the premium for the surety bond to fund the debt service reserve fund, and (5) the legal and other fees.

*Investment Proceeds* --

Section 1.148-1(b) defines "investment proceeds" as any amounts actually or constructively received from investing proceeds of an issue. As stated above, proceeds includes the sale proceeds, investment proceeds, and transferred proceeds of an issue. Therefore, investment proceeds are all amounts received from investing the sale proceeds, transferred proceeds, and investment proceeds (i.e., earnings on earnings) of an issue.

Of the various uses among which the sale proceeds of the 1993 Bonds are allocated, the deposit of the SLGS into the 1993 Escrow is the only use that generates investment income. As explained below, the 1993 Bonds also have transferred proceeds from the

1990 Escrow that generate investment income. Therefore, the investment proceeds of the 1993 Bonds include (1) the earnings received from the SLGS in the 1993 Escrow, (2) the earnings received from the transferred proceeds described below, and (3) the earnings on those earnings.

*Transferred Proceeds* --

In general, transferred proceeds are any proceeds of a prior issue that become proceeds of a refunding issue. Section 1.148-9(b)(1) provides that when proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue.[19]

The purpose of the transferred proceeds rule is to reflect which borrowing is supporting the investments originally made with the proceeds of the prior issue. Remember that generally the arbitrage restrictions (both yield restriction and rebate) compare the earnings on unspent gross proceeds of an issue with the yield on that issue. When a refunding issue discharges a prior issue whose proceeds have not been completely spent, the issue to which the comparison was being made (the prior issue) is no longer outstanding. After discharge of the prior issue, the issuer has an issue of obligations outstanding (the refunding issue) and unspent proceeds. This puts the issuer in the same position as it was before the refunding occurred. The issuer was required to comply with the arbitrage restrictions before the refunding and should not be able to avoid those restrictions merely by refunding the prior issue. Therefore, the transferred proceeds rule causes the unspent proceeds of the prior issue to become proceeds of the refunding issue. Consequently, the issuer must take into account the earnings on those proceeds for purposes of demonstrating that the refunding issue complies with the arbitrage restrictions.

The SLGS in the 1993 Escrow (proceeds of the refunding issue) shown in Table 10 will be used to pay the outstanding principal of the 1990 Bonds (prior issue) shown in Table 11. The 1990 Escrow contains unspent proceeds of the 1990 Bonds until April 1, 1996, the redemption date of the 1985 Bonds. This can be seen in Table 4 and Table 5. Therefore, when the SLGS in the 1993 Escrow are used to pay the principal of the 1990 Bonds on April 1, 1994, a portion of the proceeds of the 1990 Bonds becomes transferred proceeds of the 1993 Bonds. Similarly, when the SLGS in the 1993 Escrow are used to

[19] Section 1.103-14(e)(2)(ii) of the 1979 regulations and § 1.148-11(d)(1) of the 1992 regulations set forth a similar "principal to principal" transferred proceeds rule, which provides for a transfer of proceeds to the refunding issue only upon a discharge of "principal" of the prior issue. However, § 1.148-4T(e)(2)(i) of the 1989 temporary regulations sets forth a "dollar for dollar" transferred proceeds rule, which provides for a transfer of proceeds to the refunding issue upon a discharge of principal of, or interest or retirement price on, the prior issue.

pay the principal of the 1990 Bonds on April 1, 1995, more of the proceeds of the 1990 Bonds becomes transferred proceeds of the 1993 Bonds.

Section 1.148-9(b)(1) provides further that the amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is an amount equal to the proceeds of the prior issue on the date of that discharge multiplied by the following fraction:

the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge

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the total outstanding principal amount of the prior issue on the date immediately before the date of that discharge.

This fraction is sometimes referred to as the "transfer factor."[20]

The total amount of proceeds of the 1990 Bonds on any particular date is equal to the present value of the remaining receipts from the SLGS in the 1990 Escrow on that date using a discount rate equal to the yield on the 1990 Escrow.[21] The following table shows the present value of the remaining proceeds of the 1990 Bonds on April 1, 1994, and April 1, 1995:

[20] If the transfer of proceeds from the prior issue to the refunding issue results in an allocation of proceeds that exceeds the overall limitation on the amount of gross proceeds allocable to the refunding issue, the universal cap rules under § 1.148-6(b)(2) will cause the proceeds to transfer back to the prior issue or to some other issue as replacement proceeds. The universal cap rules do not apply here.

[21] Even though some of the SLGS have already matured, THE DISCOUNT RATE IS THE COMBINED YIELD ON ALL SLGS IN THE 1990 ESCROW because § 1.148-5(b)(2)(i) provides that the yield on each investment within a class of investments is blended with the yield on other investments within the class, whether or not the investments are held concurrently. Under § 1.148-5(b)(2)(ii), yield restricted nonpurpose investments, such as the SLGS in the 1990 Escrow, are a separate class of investments. In addition, § 1.148-5T(b)(2)(iii) permits an issuer to treat all yield restricted nonpurpose investments in a refunding escrow as a single investment having a single yield. Finally, § 1.148-5(d)(2) requires an issuer to value yield restricted investments at their present value.

**TABLE 12**
**Present Value of Remaining 1990 Bond Proceeds in 1990 Escrow on Transfer Dates**

| Date | Net Escrow Receipts Subject to Transfer on 04/01/94[22] | PV of Remaining Receipts at 1990 Escrow Yield of of 7.110979% to 04/01/94 | PV of Remaining Receipts at 1990 Escrow Yield of 7.110979% to 04/01/95 |
|---|---|---|---|
| 10/01/94 | $ 1,713,041.65 | $ 1,654,225.82 | $ --- |
| 04/01/95 | 3,657,965.45 | 3,411,091.32 | --- |
| 10/01/95 | 1,636,257.23 | 1,473,439.13 | 1,580,077.73 |
| 04/01/96 | 38,895,539.40 | 33,822,623.69 | 36,270,500.30 |
| | $45,902,803.73 | $40,361,379.96 | $37,850,578.03 |

After payment of principal of, and interest on, the 1985 Bonds on April 1, 1994, the amount of proceeds of the 1990 Bonds remaining in the 1990 Escrow is $40,361,379.96. As shown in Table 11, the principal amount of the 1990 Bonds discharged with proceeds of the 1993 Bonds on April 1, 1994, is $1,420,000, and the total outstanding principal amount of the 1990 Bonds immediately before the discharge on April 1, 1994, is $46,925,000 ($14,305,000 total maturing principal plus $32,620,000 principal to be redeemed). Therefore, the transfer factor on April 1, 1994, is computed as follows:

$$\text{Transfer Factor} = \frac{1{,}420{,}000.00}{46{,}925{,}000.00} = 3.026105\%.$$

The amount of proceeds of the 1990 Bonds that becomes transferred proceeds of the 1993 Bonds on April 1, 1994, is computed as follows:

Transferred Proceeds = $40,361,379.96 x 3.026105% = $1,221,377.74.

Similarly, after payment of principal of, and interest on, the 1985 Bonds on April 1, 1995, the amount of proceeds of the 1990 Bonds remaining in the 1990 Escrow is $37,850,578.03. However, 3.026105% of the proceeds in the 1990 Escrow transfers to the 1993 Bonds on April 1, 1994. Therefore, only 96.973895% (100% minus 3.026105%) of these proceeds ($36,705,179.61) remains subject to transfer on April 1, 1995. As shown in Table 11, the principal amount of the 1990 Bonds to be discharged with proceeds of the 1993 Bonds on April 1, 1995, is $1,510,000, and the total outstanding principal amount of the 1990 Bonds immediately before the discharge on April 1, 1995,

[22] These amounts are from Table 4.

is $45,505,000 ($46,925,000 minus $1,420,000 to be discharged on April 1, 1994). Therefore, the transfer factor on April 1, 1995, is computed as follows:

$$\text{Transfer Factor} = \frac{1{,}510{,}000.00}{45{,}505{,}000.00} = 3.318317\%.$$

The amount of proceeds of the 1990 Bonds that becomes transferred proceeds of the 1993 Bonds on April 1, 1995, is computed as follows:

$$\text{Transferred Proceeds} = \$36{,}705{,}179.61 \times 3.318317\% = \$1{,}217{,}994.21.$$

As shown in Table 4 and Table 5, all proceeds of the 1990 Bonds remaining in the 1990 Escrow will be used to redeem the 1985 Bonds on April 1, 1996. Consequently, no more proceeds of the 1990 Bonds transfers to the 1993 Bonds from this date on, even though proceeds of the 1993 Bonds continue to pay principal of the 1990 Bonds through and including April 1, 2001.

*Replacement Proceeds* --

Section 1.148-1(c) defines "replacement proceeds" of an issue as amounts that have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not actually used or expected to be used for that governmental purpose. Governmental purpose includes the expected use of amounts for the payment of debt service on a particular date.

The University revenues that State deposits into the debt service fund for the 1993 Bonds and the earnings on these revenues will be used by State to pay the principal of, and interest on, the 1993 Bonds each April 1 and October 1. Therefore, these amounts are replacement proceeds of the 1993 Bonds.

*Total Amount of Gross Proceeds* --

Thus, the amount of gross proceeds of the 1993 Bonds includes:

(1) the sale proceeds allocated to --
- (a) the cash and the SLGS in the 1993 Escrow,
- (b) the underwriters' discount,
- (c) the premium for bond insurance,
- (d) the premium for the surety bond in the debt service reserve fund, and
- (e) the legal and other fees;

(2) the investment proceeds from the SLGS in the 1993 Escrow;
(3) the investment proceeds from the transferred proceeds from the 1990 Escrow;
(4) the transferred proceeds from the 1990 Escrow; and
(5) the replacement proceeds in the debt service fund for the 1993 Bonds.

iii. Determine the Allocation of Gross Proceeds to Investments and Expenditures

As stated above, the arbitrage restrictions generally compare the earnings on unspent gross proceeds of an issue with the yield on that issue. In order to make this comparison, the issuer must allocate the gross proceeds of the issue to investments and expenditures.

The general allocation and accounting rules are set forth in § 1.148-6. In addition, some special allocation rules for refunding issues, such as the multipurpose rules and transferred proceeds allocation rules discussed above, are set forth in § 1.148-9.

*Expenditures* --

Section 1.148-6(b)(1) provides that amounts cease to be allocated to an issue as proceeds only when those amounts are allocated to an expenditure for a governmental purpose. Under the rules in § 1.148-6(d), gross proceeds of an issue may be allocated to expenditures using any of a number of reasonable, consistently applied accounting methods. Regardless of which method is applied, the issuer may not allocate gross proceeds to an expenditure unless the issuer has made a current outlay of cash.

State allocates a portion of the gross proceeds of the 1993 Bonds to the expenditures shown in Table 8, which are (1) the underwriters' discount, (2) the premium for bond insurance, (3) the premium for the surety bond to fund the debt service reserve fund, and (4) the legal and other fees relating to issuance of the 1993 Bonds. Each of these items involves a current outlay of cash, and each qualifies as an expenditure for a governmental purpose of the 1993 Bonds.

The remaining gross proceeds of the 1993 Bonds (i.e., the proceeds in the 1993 Escrow, the transferred proceeds from the 1990 Escrow, and the replacement proceeds in the debt service fund) must be allocated to specific investments.

*Investments* --

Section 1.148-9(c)(1)(i) provides that investments purchased with sale proceeds or investment proceeds of a refunding issue must be allocated to those proceeds (i.e., a specific tracing method of accounting must be used). The proceeds of the 1993 Bonds

in the 1993 Escrow are invested in the SLGS described in Table 9. Therefore, the proceeds in the 1993 Escrow are allocated to these SLGS.

Section 1.148-9(c)(1)(ii) sets forth the allocation rules for transferred proceeds. This section provides that when proceeds of a prior issue become transferred proceeds of a refunding issue, investments (and the related payments and receipts) of proceeds of the prior issue that are held in a refunding escrow for another issue are allocated to the transferred proceeds under the ratable allocation method. Under the ratable allocation method, which is described in § 1.148-9(c)(1)(iii), a ratable portion of each investment of proceeds of the prior issue is allocated to transferred proceeds of the refunding issue.

The proceeds of the 1990 Bonds that will become transferred proceeds of the 1993 Bonds are held in the 1990 Escrow (a refunding escrow) for payment of debt service on the 1985 Bonds (another issue). Therefore, State must use the ratable allocation method to allocate the SLGS in the 1990 Escrow (and related payments and receipts) to the transferred proceeds of the 1993 Bonds. This means that on April 1, 1994, State must allocate 3.026105% of the payments for, and receipts of, the four SLGS remaining in the 1990 Escrow on that date to the 1993 Bonds. Similarly, on April 1, 1995, State must allocate 3.318317% of the payments for, and receipts of, the untransferred portion of the two SLGS remaining in the 1990 Escrow on that date to the 1993 Bonds.[23]

The allocation of a ratable portion of the receipts from the SLGS in the 1990 Escrow requires multiplication of each remaining receipt (or, in the case of the transfers on April 1, 1995, the untransferred portion of each remaining receipt) by the appropriate transfer factor. Remember that an allocation of gross proceeds to investments is necessary for determining the yield on those investments. The yield on investments is the discount rate that results in the present value of the receipts equalling the purchase price of the investments. Therefore, a determination of the ratable portion of the payments for each of the SLGS (or purchase price) is also required.

The SLGS in the 1990 Escrow are actually purchased on October 15, 1990. For purposes of the transfer to the 1993 Bonds, however, they will be treated as purchased on the transfer dates at their then present values. Because the SLGS in the 1993 Escrow and the transferred portion of the SLGS in the 1990 Escrow are yield restricted nonpurpose investments, they will be treated as a single investment with a single yield. The computations required to take into account that these investments are purchased on different dates (the SLGS in the 1993 Escrow on July 1, 1993, and the transferred portion of the SLGS in the 1990 Escrow on each transfer date) involve a series of complex computations. However, there is another method of computing the yield on the yield

[23] See Table 12.

restricted nonpurpose investments (the SLGS in the 1993 Escrow and the transferred portion of the SLGS in the 1990 Escrow). This method requires computation of what is known as the "transferred proceeds penalty" and leads to the same answer as performing the series of complex computations. The transferred proceeds penalty computation is explained in paragraph v. below.

The University revenues that State deposits into the debt service fund for the 1993 Bonds are invested in short-term investments permitted under the documents for the 1993 Bonds. Under a specific tracing method of accounting, the replacement proceeds of the 1993 Bonds are allocated to these investments.

iv. Determine Whether any Temporary Period Exceptions Apply

Under § 148(c)(1), an issuer may invest bond proceeds in higher yielding investments for a "reasonable temporary period" until the proceeds are needed for the purpose for which the issue was issued.

The temporary period rules for refunding issues are contained in § 1.148-9(d). In general, the proceeds of a refunding issue (other than transferred proceeds) may be invested in higher yielding investments for a temporary period of 30 days from the issue date of the refunding issue.[24] Section 1.148-9(g) permits an issuer to waive the right to invest proceeds of a refunding issue in higher yielding investments during the permitted temporary period if the waiver occurs on or before the issue date of the refunding issue. On the issue date of the 1993 Bonds, State waives its right to invest the proceeds of the 1993 Bonds in higher yielding investments during the temporary period.[25] Therefore, no temporary period exception applies to the proceeds of the 1993 Bonds in the 1993 Escrow.

Section 1.148-9(d)(2)(iii) sets forth the temporary period for transferred proceeds. In general, the temporary period for transferred proceeds begins on the date of the transfer and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue. For example, if the proceeds of the prior issue were in a construction fund and were entitled to a 3-year temporary period and those proceeds transferred to a refunding issue during the 3-year temporary period, the transferred proceeds from the construction fund would be entitled to a temporary period equal to the remainder of the initial 3-year temporary period. Under § 1.103-14(e)(3) of the 1979

[24] Under § 1.148-9(d)(2)(ii), the temporary period for current refunding issues is 90 days.

[25] State makes this waiver to avoid having two classes of investments in the 1993 Escrow (e.g., "yield restricted nonpurpose investments" and "all other nonpurpose investments"). If there were two classes of investments in the 1993 Escrow, the yield on those two classes could not be blended. See § 1.148-5(b)(2).

regulations, the temporary period for the proceeds of the 1990 Bonds in the 1990 Escrow is 2 years and ends on October 14, 1992, which is before either of the two transfer dates. Therefore, no temporary period exception applies to the transferred proceeds from the 1990 Escrow.

Section 1.148-2(e)(5)(ii) provides that replacement proceeds in a bona fide debt service fund qualify for a temporary period of 13 months. As stated above, the debt service fund for the 1993 Bonds is a bona fide debt service fund. Therefore, the replacement proceeds in this fund are entitled to a 13-month temporary period.

v. <u>If no Temporary Period Exceptions Apply, Determine Whether the Yield on the Investments is Materially Higher than the Yield on the Bonds</u>

If any gross proceeds of an issue are not entitled to a temporary period exception from the yield restriction rules, the next step in the analysis is to determine whether the investments allocable to those proceeds are invested in higher yielding investments. Under § 1.148-2(d)(2)(i), "materially higher" is generally one-eighth of one percentage point (.125%). However, § 1.148-2(d)(2)(ii) provides that for investments in a refunding escrow and for replacement proceeds of an issue, "materially higher" is one-thousandth of one percentage point (.001%). This means that if the yield on the investments in a refunding escrow allocable to the gross proceeds of a refunding issue is more than .001% higher than the yield on the issue, then the issue violates the yield restriction rules of § 148(a), and the interest on the issue is not excluded from gross income under § 103(a).

The replacement proceeds in the debt service fund for the 1993 Bonds are entitled to the 13-month temporary period for bona fide debt service funds. Therefore, only the yield on the investments allocable to the proceeds in the 1993 Escrow and the transferred proceeds from the 1990 Escrow must be compared to the yield on the 1993 Bonds to determine whether the 1993 Bonds have met the yield restriction rules.

The yield on the 1993 Bonds is 4.912498%. In general, § 1.148-4(b)(1) provides that the yield on a fixed yield issue is the discount rate that, when used to compute the present value as of the issue date of all unconditionally payable payments of principal, interest, and fees for qualified guarantees on the issue, produces an amount equal to the aggregate issue price of the bonds of the issue. Both the bond insurance for the 1993 Bonds and the surety bond to fund the debt service reserve fund for the 1993 Bonds are qualified guarantees. Therefore, the premiums for these items must be taken into account to

compute the yield on the 1993 Bonds. The debt service schedule for the 1993 Bonds and the computation of yield on the 1993 Bonds are attached as Appendix D.[26]

Next, the yield on the SLGS in the 1993 Escrow and the portion of the SLGS in the 1990 Escrow that will become transferred proceeds of the 1993 Bonds must be computed. As stated above, § 1.148-5(b)(2) provides that yield restricted nonpurpose investments are treated as a single investment having a single yield, whether or not held concurrently. This means that the yield on the SLGS in the 1993 Escrow must be blended with the yield on the transferred portion of the SLGS in the 1990 Escrow.

Remember that the yield on the SLGS in the 1990 Escrow is 7.110979%, which is much higher than the yield on the 1993 Bonds. If these SLGS were sold and the proceeds reinvested in lower yielding SLGS, the lower yielding SLGS would not generate enough receipts to pay the debt service on the 1985 Bonds. Therefore, the SLGS in the 1990 Escrow cannot be sold, and the 1993 Escrow must contain enough "negative arbitrage" to compensate for the transfer of a portion of the SLGS yielding 7.110979%. Stated another way, the actual yield on the SLGS in the 1993 Escrow must be sufficiently lower than the yield on the 1993 Bonds so that the blended yield on the SLGS, including the transferred portion of the SLGS in the 1990 Escrow, is not materially higher than the yield on the 1993 Bonds. This blending is accomplished by computing what is known as the "transferred proceeds penalty."[27]

The amount of negative arbitrage that the 1993 Escrow must contain is determined by isolating the difference between the amount that the transferred portion of the SLGS in the 1990 Escrow actually earns (7.110979%) and the amount that the transferred portion of the SLGS in the 1990 Escrow would earn if the SLGS in the 1990 Escrow had a yield equal to the yield on the 1993 Bonds (4.912498%) during the period of time the transferred portion of the SLGS in the 1990 Escrow are allocated to the 1993 Bonds. One way to determine this amount is to:

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[26] See also, Appendix C of the 1996 Article, which describes how to compute the yield on a fixed yield issue, such as the 1993 Bonds.

[27] If an issuer had done a low-to-high refunding, which does not lower debt service payments but does permit release of the covenants of the prior bond documents, the reverse would also be true. For example, if the transferred investments had a yield of 5% and the refunding issue had a yield of 8%, the actual investments in the refunding issue would be permitted to earn more than 8% in order to blend up the combined yield on the yield restricted nonpurpose investments. The total amount of positive arbitrage permitted is known as the "transferred proceeds benefit."

(1) compute the present value on each transfer date of the remaining receipts from the SLGS in the 1990 Escrow using the yield on the 1990 Escrow as the discount rate;

(2) compute the present value on each transfer date of the remaining receipts from the SLGS in the 1990 Escrow using the yield on the 1993 Bonds as the discount rate;

(3) subtract the results for each transfer date computed in step (2) from the results computed in step (1);

(4) multiply the difference computed in step (3) by the percentage of the 1990 Escrow that should transfer on each transfer date;

(5) compute the present value of each of the results computed in step (4) to the issue date of the 1993 Bonds using the yield on the 1993 Bonds as the discount rate; and

(6) add the results computed in step (5).

These computations are set forth in the following table:

**TABLE 13**
**Computation of Transferred Proceeds Penalty for the 1993 Escrow**

| Date | Net Escrow Receipts Subject to Transfer | PV of Receipts at 1990 Escrow Yield of 7.110979% to Transfer Date | PV of Receipts at 1993 Bond Yield of 4.912498% to Transfer Date | Difference | Percentage of Escrow to Transfer | Adjusted Difference | PV of Adj. Difference at 1993 Bond Yield of 4.912498% to 7/01/93 |
|---|---|---|---|---|---|---|---|
| 04/01/94 | $ --- | $40,361,379.96 | $41,975,693.05 | $-1,614,313.09 | 3.026105% | $-48,850.82 | $-47,104.69 |
| 10/01/94 | 1,713,041.65 | --- | --- | | | | |
| 04/01/95 | 3,657,965.45 | 37,850,578.03 | 38,649,989.08 | -799,411.05 | 3.217901%[28] | -25,724.26 | -23,629.70 |
| 10/01/95 | 1,636,257.23 | --- | --- | | | | |
| 04/01/96 | 38,895,539.40 | --- | --- | | | | |
| | $45,902,803.73 | | | | | | $-70,734.39 |

[28] On April 1, 1995, the SLGS in the 1993 Escrow will have paid a total of $2,930,000 of outstanding principal of the 1990 Bonds ($1,420,000 plus $1,510,000), which is 6.244006% of the $46,925,000 in outstanding principal to be paid. However, 3.026105% of the SLGS remaining in the 1990 Escrow will transfer on April 1, 1994. Therefore, only 3.217901% (6.244006% minus 3.026105%) of the SLGS in the 1990 Escrow should transfer on April 1, 1995.

Thus, the transferred proceeds penalty is $70,734.39. This amount may either be included as a receipt on July 1, 1993, in the 1993 Escrow or may be subtracted from the purchase price of the SLGS in the 1993 Escrow to compute the blended yield. The following table shows the computation of yield on the SLGS in the 1993 Escrow (including the transferred portion of the SLGS in the 1990 Escrow):

**TABLE 14**
**Computation of Yield on SLGS in 1993 Escrow**

Purchase Price = $53,548,965.61[29] Yield = 4.9120175%

| Date | SLGS Receipts[30] | Present Value to 7/01/93 at 4.9120175% | Days (30/360) |
|---|---|---|---|
| 10/01/93 | $ 1,616,323.29 | $ 1,596,833.05 | 90 |
| 04/01/94 | 3,036,376.80 | 2,927,854.66 | 270 |
| 10/01/94 | 1,571,576.80 | 1,479,081.23 | 450 |
| 04/01/95 | 3,081,664.31 | 2,830,768.22 | 630 |
| 10/01/95 | 1,523,255.73 | 1,365,697.04 | 810 |
| 04/01/96 | 3,128,274.79 | 2,737,467.74 | 990 |
| 10/01/96 | 1,471,177.34 | 1,256,526.66 | 1170 |
| 04/01/97 | 3,181,110.37 | 2,651,844.08 | 1350 |
| 10/01/97 | 1,414,735.78 | 1,151,084.35 | 1530 |
| 04/01/98 | 3,239,701.72 | 2,572,760.78 | 1710 |
| 10/01/98 | 1,353,981.59 | 1,049,469.22 | 1890 |
| 04/01/99 | 3,299,008.79 | 2,495,760.95 | 2070 |
| 10/01/99 | 1,288,902.87 | 951,704.82 | 2250 |
| 04/01/00 | 3,363,819.69 | 2,424,249.72 | 2430 |
| 10/01/00 | 1,218,850.76 | 857,349.19 | 2610 |
| 04/01/01 | 36,706,216.28 | 25,200,513.90 | 2790 |
| | $70,494,976.91 | $53,548,965.61 | |

Thus, the blended yield on the SLGS in the 1993 Escrow and the transferred portion of the SLGS in the 1990 Escrow is 4.9120175%. This yield is not higher than 4.9124980%, which is the yield on the 1993 Bonds computed in Table D-2 in Appendix D.

[29] This amount is equal to the purchase price of the SLGS in the 1993 Escrow from Table 9 ($53,619,700) minus the transferred proceeds penalty ($70,734.39).

[30] These amounts are the net escrow receipts from Table 10.

vi. Conclusion

All unspent proceeds of the 1993 Bonds either qualify for a temporary period exception to the yield restriction rules or are not invested at a materially higher yield than the yield on the 1993 Bonds. Therefore, the 1993 Bonds meet the yield restriction rules under § 148(a).

F. Rebate Rules Under § 148(f)

The rebate rules under § 148(f) require an issuer to pay to the United States any excess earnings from the investment of bond proceeds in nonpurpose investments over the amount those proceeds would have earned if they had been invested at the yield on the issue of bonds. Section 148(f) provides exceptions to this requirement. The unspent proceeds of the 1993 Bonds are in the debt service fund for the 1993 Bonds and in the 1993 Escrow.

Under § 148(f)(4)(A), amounts in a bona fide debt service fund are not taken into account for rebate if (1) no bond in the issue is a private activity bond, (2) the average maturity of the issue is at least 5 years, and (3) the issue is a fixed yield issue. Because the 1993 Bonds meet each of these requirements, the bona fide debt service fund meets this exception to rebate.

The unspent proceeds in the 1993 Escrow, including the transferred proceeds, are invested at a yield lower than the yield on the 1993 Bonds. Accordingly, there are no excess earnings from the investment of these unspent proceeds, and a rebate computation is unnecessary.

Therefore, the 1993 Bonds meet the rebate rules under § 148(f).

# FOR INSTRUCTIONAL PURPOSES ONLY APPENDIX A

**NEW ISSUE--BOOK ENTRY ONLY**

*In the opinion of X, Bond Counsel, under existing law, and assuming continuing compliance with certain covenants as described under "TAX EXEMPTION" herein, interest on the 1985 Bonds is not included in gross income of the owners thereof for federal and state income tax purposes and will not be treated as an item of tax preference in computing federal alternative minimum tax of individuals or corporations, but will be taken into account in computing the federal corporate alternative minimum tax, as more fully discussed under the heading "TAX EXEMPTION."*

## $50,000,000
## STATE OF Z
## UNIVERSITY REVENUE BONDS
## (CLASSROOM BUILDINGS PROJECT),
## SERIES 1985

**Dated: December 1, 1985** **Due: April 1, as shown below**

The 1985 Bonds are being issued by State of Z ("State") to provide funds to finance the costs of constructing classroom buildings at University of Z ("University") and to pay costs of issuance of the 1985 Bonds, as more fully described herein. See "THE IMPROVEMENTS" herein.

Interest on the 1985 Bonds is payable on April 1, 1986, and semiannually thereafter on October 1 and April 1 of each year. Principal is payable on the dates set forth below. The 1985 Bonds are being issued in fully registered form and will be registered in the name of A Nominee, as nominee of B Trust Company, New York, New York ("B"). B will act as securities depository of the 1985 Bonds. Individual purchases of interests in the 1985 Bonds will be made in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. Purchasers of such interests will not receive certificates representing their interests in the 1985 Bonds. Principal of and interest on the 1985 Bonds are payable directly by C, as trustee (the "Trustee"), to B, which is obligated in turn to remit such principal and interest to B Participants for subsequent disbursement to the Beneficial Owners of the 1985 Bonds, as described herein. See "BOOK-ENTRY SYSTEM" herein.

The 1985 Bonds are subject to optional and mandatory redemption prior to their stated maturity, as more fully described herein.

Payment of the principal of and the interest on the 1985 Bonds when due will be guaranteed by a municipal bond insurance policy to be issued simultaneously with the delivery of the 1985 Bonds by D (the "Insurer").

The 1985 Bonds are special obligations of State, payable solely from Revenues of University and are secured by a pledge of Revenues; provided, however, that out of Revenues first there shall be applied all sums required for the payment of Maintenance and Operation Costs. The 1985 Bonds are issued on a parity with State's Parity Debt, heretofore or hereafter issued, as more fully described herein. See "SOURCES OF PAYMENT AND SECURITY" herein.

NEITHER THE FAITH AND CREDIT OF UNIVERSITY OR STATE NOR THE TAXING POWER OF STATE IS PLEDGED TO THE 1985 BONDS. THE 1985 BONDS DO NOT CONSTITUTE A DEBT OF UNIVERSITY OR STATE WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY DEBT LIMITATION OR RESTRICTION. UNIVERSITY HAS NO TAXING POWER.

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Maturity Schedule
$15,530,000 Serial Bonds

| Maturity (April 1) | Principal Amounts | Interest Rates | Yields | Maturity (April 1) | Principal Amounts | Interest Rates | Yields |
|---|---|---|---|---|---|---|---|
| 1987 | $1,125,000 | 6.600% | 6.600% | 1992 | $1,565,000 | 7.300% | 7.300% |
| 1988 | 1,200,000 | 6.700 | 6.700 | 1993 | 1,680,000 | 7.500 | 7.500 |
| 1989 | 1,280,000 | 6.800 | 6.800 | 1994 | 1,805,000 | 7.700 | 7.700 |
| 1990 | 1,370,000 | 6.900 | 6.900 | 1995 | 1,945,000 | 7.900 | 7.974 |
| 1991 | 1,460,000 | 7.100 | 7.100 | 1996 | 2,100,000 | 8.100 | 8.243 |

$34,470,000, 9.00% Term Bonds, Due April 1, 2006, Price: 100%

(Accrued interest to be added)

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This cover page contains only a brief description of the 1985 Bonds and the security therefor. It is not a summary of material information with respect to the 1985 Bonds. Investors should read the entire Official Statement to obtain information necessary to make an informed investment decision.

The 1985 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by X, Bond Counsel. Certain legal matters will be passed on for State by Law Firm 1. Certain legal matters will be passed upon for the Underwriters by their counsel, Law Firm 2. It is anticipated that the 1985 Bonds, in book-entry form, will be available for delivery to B in New York, New York on or about December 15, 1985.

Underwriting Firm

Dated: December 5, 1985

# FOR INSTRUCTIONAL PURPOSES ONLY APPENDIX B

**NEW ISSUE--BOOK ENTRY ONLY**

*In the opinion of X, Bond Counsel, under existing law, and assuming continuing compliance with certain covenants as described under "TAX EXEMPTION" herein, interest on the 1990 Bonds is not included in gross income of the owners thereof for federal and state income tax purposes and will not be treated as an item of tax preference in computing federal alternative minimum tax of individuals or corporations, but will be taken into account in computing the federal corporate alternative minimum tax, as more fully discussed under the heading "TAX EXEMPTION."*

## $50,085,000
## STATE OF Z
## UNIVERSITY REVENUE REFUNDING BONDS, SERIES 1990

**Dated: October 1, 1990** **Due: April 1, as shown below**

The 1990 Bonds are being issued by State of Z ("State") to provide funds (i) to refund in advance of maturity all of the outstanding University Revenue Bonds (Classroom Buildings Project), Series 1985 (the "Bonds Being Refunded") and (ii) to pay costs relating to the issuance of the 1990 Bonds, as more fully described herein. See "PLAN OF ADVANCE REFUNDING" herein.

Interest on the 1990 Bonds is payable on April 1, 1991, and semiannually thereafter on October 1 and April 1 of each year. Principal is payable on the dates set forth below. The 1990 Bonds are being issued in fully registered form and will be registered in the name of A Nominee, as nominee of B Trust Company, New York, New York ("B"). B will act as securities depository of the 1990 Bonds. Individual purchases of interests in the 1990 Bonds will be made in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. Purchasers of such interests will not receive certificates representing their interests in the 1990 Bonds. Principal of and interest on the 1990 Bonds are payable directly by C, as trustee (the "Trustee"), to B, which is obligated in turn to remit such principal and interest to B Participants for subsequent disbursement to the Beneficial Owners of the 1990 Bonds, as described herein. See "BOOK-ENTRY SYSTEM" herein.

The 1990 Bonds are subject to optional and mandatory redemption prior to their stated maturity, as more fully described herein.

Payment of the principal of and the interest on the 1990 Bonds when due will be guaranteed by a municipal bond insurance policy to be issued simultaneously with the delivery of the 1990 Bonds by D (the "Insurer").

The 1990 Bonds are special obligations of State, payable solely from Revenues of University of Z ("University") and are secured by a pledge of Revenues; provided, however, that out of Revenues first there shall be applied all sums required for the payment of Maintenance and Operation Costs. The 1990 Bonds are issued on a parity with State's Parity Debt, heretofore or hereafter issued, as more fully described herein. See "SOURCES OF PAYMENT AND SECURITY" herein.

NEITHER THE FAITH AND CREDIT OF UNIVERSITY OR STATE NOR THE TAXING POWER OF STATE IS PLEDGED TO THE 1990 BONDS. THE 1990 BONDS DO NOT CONSTITUTE A DEBT OF UNIVERSITY OR STATE WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY DEBT LIMITATION OR RESTRICTION. UNIVERSITY HAS NO TAXING POWER.

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Maturity Schedule
$27,945,000 Serial Bonds

| Maturity (April 1) | Principal Amounts | Interest Rates | Yields | Maturity (April 1) | Principal Amounts | Interest Rates | Yields |
|---|---|---|---|---|---|---|---|
| 1991 | $ 565,000 | 6.00% | 6.00% | 1999 | $1,945,000 | 6.70% | 6.70% |
| 1992 | 1,260,000 | 6.10 | 6.10 | 2000 | 2,075,000 | 6.75 | 6.75 |
| 1993 | 1,335,000 | 6.20 | 6.20 | 2001 | 2,215,000 | 6.80 | 6.80 |
| 1994 | 1,420,000 | 6.30 | 6.30 | 2002 | 2,365,000 | 6.85 | 6.90 |
| 1995 | 1,510,000 | 6.40 | 6.40 | 2003 | 2,525,000 | 6.90 | 6.95 |
| 1996 | 1,605,000 | 6.50 | 6.50 | 2004 | 2,700,000 | 6.95 | 7.00 |
| 1997 | 1,710,000 | 6.60 | 6.60 | 2005 | 2,890,000 | 7.00 | 7.05 |
| 1998 | 1,825,000 | 6.65 | 6.65 | | | | |

$22,140,000, 7.05% Term Bonds, Due April 1, 2011, Price: 98.929%

(Accrued interest to be added)

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This cover page contains only a brief description of the 1990 Bonds and the security therefor. It is not a summary of material information with respect to the 1990 Bonds. Investors should read the entire Official Statement to obtain information necessary to make an informed investment decision.

The 1990 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by X, Bond Counsel. Certain legal matters will be passed on for State by Law Firm 1. Certain legal matters will be passed upon for the Underwriters by their counsel, Law Firm 2. It is anticipated that the 1990 Bonds, in book-entry form, will be available for delivery to B in New York, New York on or about October 15, 1990.

Underwriting Firm

Dated: October 5, 1990

# FOR INSTRUCTIONAL PURPOSES ONLY APPENDIX C

**NEW ISSUE--BOOK ENTRY ONLY**

*In the opinion of X, Bond Counsel, under existing law, and assuming continuing compliance with certain covenants as described under "TAX EXEMPTION" herein, interest on the 1993 Bonds is not included in gross income of the owners thereof for federal and state income tax purposes and will not be treated as an item of tax preference in computing federal alternative minimum tax of individuals or corporations, but will be taken into account in computing the federal corporate alternative minimum tax, as more fully discussed under the heading "TAX EXEMPTION."*

## $54,950,000
## STATE OF Z
## UNIVERSITY REVENUE REFUNDING BONDS, SERIES 1993

**Dated: July 1, 1993** **Due: April 1, as shown below**

The 1993 Bonds are being issued by State of Z ("State") to provide funds (i) to refund in advance of maturity all of the outstanding University Revenue Refunding Bonds, Series 1990 (the "Bonds Being Refunded") and (ii) to pay costs relating to the issuance of the 1993 Bonds, as more fully described herein. See "PLAN OF ADVANCE REFUNDING" herein.

Interest on the 1993 Bonds is payable on April 1, 1994, and semiannually thereafter on October 1 and April 1 of each year. Principal is payable on the dates set forth below. The 1993 Bonds are being issued in fully registered form and will be registered in the name of A Nominee, as nominee of B Trust Company, New York, New York ("B"). B will act as securities depository of the 1993 Bonds. Individual purchases of interests in the 1993 Bonds will be made in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. Purchasers of such interests will not receive certificates representing their interests in the 1993 Bonds. Principal of and interest on the 1993 Bonds are payable directly by C, as trustee (the "Trustee"), to B, which is obligated in turn to remit such principal and interest to B Participants for subsequent disbursement to the Beneficial Owners of the 1993 Bonds, as described herein. See "BOOK-ENTRY SYSTEM" herein.

The 1993 Bonds are subject to optional and mandatory redemption prior to their stated maturity, as more fully described herein.

Payment of the principal of and the interest on the 1993 Bonds when due will be guaranteed by a municipal bond insurance policy to be issued simultaneously with the delivery of the 1993 Bonds by D (the "Insurer").

The 1993 Bonds are special obligations of State, payable solely from Revenues of University of Z ("University") and are secured by a pledge of Revenues; provided, however, that out of Revenues first there shall be applied all sums required for the payment of Maintenance and Operation Costs. The 1993 Bonds are issued on a parity with State's Parity Debt, heretofore or hereafter issued, as more fully described herein. See "SOURCES OF PAYMENT AND SECURITY" herein.

NEITHER THE FAITH AND CREDIT OF UNIVERSITY OR STATE NOR THE TAXING POWER OF STATE IS PLEDGED TO THE 1993 BONDS. THE 1993 BONDS DO NOT CONSTITUTE A DEBT OF UNIVERSITY OR STATE WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY DEBT LIMITATION OR RESTRICTION. UNIVERSITY HAS NO TAXING POWER.

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Maturity Schedule
$30,510,000 Serial Bonds

| Maturity (April 1) | Principal Amounts | Interest Rates | Yields | Maturity (April 1) | Principal Amounts | Interest Rates | Yields |
|---|---|---|---|---|---|---|---|
| 1994 | $1,300,000 | 2.70% | 2.70% | 2001 | $2,205,000 | 4.25% | 4.25% |
| 1995 | 1,770,000 | 3.15 | 3.15 | 2002 | 2,300,000 | 4.35 | 4.35 |
| 1996 | 1,825,000 | 3.45 | 3.45 | 2003 | 2,400,000 | 4.40 | 4.40 |
| 1997 | 1,885,000 | 3.70 | 3.70 | 2004 | 2,505,000 | 4.50 | 4.50 |
| 1998 | 1,955,000 | 3.95 | 3.95 | 2005 | 2,615,000 | 4.60 | 4.60 |
| 1999 | 2,035,000 | 4.05 | 4.05 | 2006 | 2,735,000 | 4.70 | 4.80 |
| 2000 | 2,115,000 | 4.15 | 4.15 | 2007 | 2,865,000 | 4.80 | 4.90 |

$24,440,000, 5.00% Term Bonds, Due April 1, 2014, Price: 98.720%

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This cover page contains only a brief description of the 1993 Bonds and the security therefor. It is not a summary of material information with respect to the 1993 Bonds. Investors should read the entire Official Statement to obtain information necessary to make an informed investment decision.

The 1993 Bonds will be offered when, as and if issued and received by the Underwriters, subject to the approval of validity by X, Bond Counsel. Certain legal matters will be passed on for State by Law Firm 1. Certain legal matters will be passed upon for the Underwriters by their counsel, Law Firm 2. It is anticipated that the 1993 Bonds, in book-entry form, will be available for delivery to B in New York, New York on or about July 1, 1993.

Underwriting Firm

Dated: June 21, 1993

## APPENDIX D

### Computing the yield on the 1993 Bonds

The following table shows the debt service schedule for the 1993 Bonds:

**TABLE D-1**
**1993 Bonds**
**Debt Service Schedule**

| Date | Principal | Interest | Debt Service | Annual Debt Service |
|---|---|---|---|---|
| 04/01/94 | $ 1,300,000.00 | $ 1,868,563.13 | $ 3,168,563.13 | $3,168,563.13 |
| 10/01/94 | --- | 1,228,158.75 | 1,228,158.75 | --- |
| 04/01/95 | 1,770,000.00 | 1,228,158.75 | 2,998,158.75 | 4,226,317.50 |
| 10/01/95 | --- | 1,200,281.25 | 1,200,281.25 | --- |
| 04/01/96 | 1,825,000.00 | 1,200,281.25 | 3,025,281.25 | 4,225,562.50 |
| 10/01/96 | --- | 1,168,800.00 | 1,168,800.00 | --- |
| 04/01/97 | 1,885,000.00 | 1,168,800.00 | 3,053,800.00 | 4,222,600.00 |
| 10/01/97 | --- | 1,133,927.50 | 1,133,927.50 | --- |
| 04/01/98 | 1,955,000.00 | 1,133,927.50 | 3,088,927.50 | 4,222,855.00 |
| 10/01/98 | --- | 1,095,316.25 | 1,095,316.25 | --- |
| 04/01/99 | 2,035,000.00 | 1,095,316.25 | 3,130,316.25 | 4,225,632.50 |
| 10/01/99 | --- | 1,054,107.50 | 1,054,107.50 | --- |
| 04/01/00 | 2,115,000.00 | 1,054,107.50 | 3,169,107.50 | 4,223,215.00 |
| 10/01/00 | --- | 1,010,221.25 | 1,010,221.25 | --- |
| 04/01/01 | 2,205,000.00 | 1,010,221.25 | 3,215,221.25 | 4,225,442.50 |
| 10/01/01 | --- | 963,365.00 | 963,365.00 | --- |
| 04/01/02 | 2,300,000.00 | 963,365.00 | 3,263,365.00 | 4,226,730.00 |
| 10/01/02 | --- | 913,340.00 | 913,340.00 | --- |
| 04/01/03 | 2,400,000.00 | 913,340.00 | 3,313,340.00 | 4,226,680.00 |
| 10/01/03 | --- | 860,540.00 | 860,540.00 | --- |
| 04/01/04 | 2,505,000.00 | 860,540.00 | 3,365,540.00 | 4,226,080.00 |
| 10/01/04 | --- | 804,177.50 | 804,177.50 | --- |
| 04/01/05 | 2,615,000.00 | 804,177.50 | 3,419,177.50 | 4,223,355.00 |
| 10/01/05 | --- | 744,032.50 | 744,032.50 | --- |
| 04/01/06 | 2,735,000.00 | 744,032.50 | 3,479,032.50 | 4,223,065.00 |
| 10/01/06 | --- | 679,760.00 | 679,760.00 | --- |
| 04/01/07 | 2,865,000.00 | 679,760.00 | 3,544,760.00 | 4,224,520.00 |
| 10/01/07 | --- | 611,000.00 | 611,000.00 | --- |
| 04/01/08 | 3,000,000.00 | 611,000.00 | 3,611,000.00 | 4,222,000.00 |
| 10/01/08 | --- | 536,000.00 | 536,000.00 | --- |
| 04/01/09 | 3,150,000.00 | 536,000.00 | 3,686,000.00 | 4,222,000.00 |
| 10/01/09 | --- | 457,250.00 | 457,250.00 | --- |
| 04/01/10 | 3,310,000.00 | 457,250.00 | 3,767,250.00 | 4,224,500.00 |
| 10/01/10 | --- | 374,500.00 | 374,500.00 | --- |
| 04/01/11 | 3,475,000.00 | 374,500.00 | 3,849,500.00 | 4,224,000.00 |
| 10/01/11 | --- | 287,625.00 | 287,625.00 | --- |
| 04/01/12 | 3,650,000.00 | 287,625.00 | 3,937,625.00 | 4,225,250.00 |
| 10/01/12 | --- | 196,375.00 | 196,375.00 | --- |
| 04/01/13 | 3,830,000.00 | 196,375.00 | 4,026,375.00 | 4,222,750.00 |
| 10/01/13 | --- | 100,625.00 | 100,625.00 | --- |
| 04/01/14 | 4,025,000.00 | 100,625.00 | 4,125,625.00 | 4,226,250.00 |
| | $54,950,000.00 | $32,707,368.13 | $87,657,368.13 | $87,657,368.13 |

The following table shows the computation of yield on the 1993 Bonds:

**TABLE D-2**
**Computation of Yield on 1993 Bonds**

Issue Price = $54,582,453.45[1] Yield = 4.9124980%

| Date | Issue Payments | Present Value to 7/01/93 at 4.9124980% | Days (30/360) |
|---|---|---|---|
| 07/01/93 | $ 126,801.90[2] | $ 126,801.90 | 0 |
| 07/01/93 | 262,972.10[3] | 262,972.10 | 0 |
| 04/01/94 | 3,168,563.13 | 3,055,305.81 | 270 |
| 10/01/94 | 1,228,158.75 | 1,155,868.36 | 450 |
| 04/01/95 | 2,998,158.75 | 2,754,038.72 | 630 |
| 10/01/95 | 1,200,281.25 | 1,076,118.23 | 810 |
| 04/01/96 | 3,025,281.25 | 2,647,306.77 | 990 |
| 10/01/96 | 1,168,800.00 | 998,252.17 | 1170 |
| 04/01/97 | 3,053,800.00 | 2,545,670.56 | 1350 |
| 10/01/97 | 1,133,927.50 | 922,589.37 | 1530 |
| 04/01/98 | 3,088,927.50 | 2,452,971.04 | 1710 |
| 10/01/98 | 1,095,316.25 | 848,957.18 | 1890 |
| 04/01/99 | 3,130,316.25 | 2,368,078.08 | 2070 |
| 10/01/99 | 1,054,107.50 | 778,312.94 | 2250 |
| 04/01/00 | 3,169,107.50 | 2,283,851.54 | 2430 |
| 10/01/00 | 1,010,221.25 | 710,573.40 | 2610 |
| 04/01/01 | 3,215,221.25 | 2,207,317.76 | 2790 |
| 10/01/01 | 963,365.00 | 645,515.10 | 2970 |
| 04/01/02 | 3,263,365.00 | 2,134,237.47 | 3150 |
| 10/01/02 | 913,340.00 | 583,003.44 | 3330 |
| 04/01/03 | 3,313,340.00 | 2,064,268.52 | 3510 |
| 10/01/03 | 860,540.00 | 523,278.38 | 3690 |
| 04/01/04 | 3,365,540.00 | 1,997,459.75 | 3870 |
| 10/01/04 | 804,177.50 | 465,839.97 | 4050 |
| 04/01/05 | 3,419,177.50 | 1,933,160.99 | 4230 |
| 10/01/05 | 744,032.50 | 410,581.93 | 4410 |
| 04/01/06 | 3,479,032.50 | 1,873,820.38 | 4590 |
| 10/01/06 | 679,760.00 | 357,344.11 | 4770 |
| 04/01/07 | 3,544,760.00 | 1,818,776.80 | 4950 |
| 10/01/07 | 611,000.00 | 305,981.61 | 5130 |
| 04/01/08 | 3,611,000.00 | 1,764,993.67 | 5310 |
| 10/01/08 | 536,000.00 | 255,706.64 | 5490 |
| 04/01/09 | 3,686,000.00 | 1,716,303.51 | 5670 |
| 10/01/09 | 457,250.00 | 207,804.06 | 5850 |
| 04/01/10 | 3,767,250.00 | 1,671,037.89 | 6030 |
| 10/01/10 | 374,500.00 | 162,134.42 | 6210 |
| 04/01/11 | 3,849,500.00 | 1,626,631.87 | 6390 |
| 10/01/11 | 287,625.00 | 118,624.16 | 6570 |
| 04/01/12 | 3,937,625.00 | 1,585,047.94 | 6750 |
| 10/01/12 | 196,375.00 | 77,153.53 | 6930 |
| 04/01/13 | 4,026,375.00 | 1,543,993.14 | 7110 |
| 10/01/13 | 100,625.00 | 37,661.58 | 7290 |
| 04/01/14 | 4,125,625.00 | 1,507,106.66 | 7470 |
| | $88,047,142.13 | $54,582,453.45 | |

[1] This amount is from Table 7.

[2] This amount is the premium paid for the surety bond, as shown in Table 8.

[3] This amount is the premium paid for the bond insurance, as shown in Table 8.

## M. SECTION 457 DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENT AND TAX-EXEMPT EMPLOYERS

by
Cheryl Press and Robert Patchell

1. Introduction

Section 457 plans are nonqualified, unfunded deferred compensation plans established by state and local government and tax-exempt employers. These employers can establish either eligible (covered by 457(b)) or ineligible (covered by 457(f)) plans, and are subject to the specific requirements and deferral limitations of section 457 of the Internal Revenue Code of 1986 ("Code"). Certain other types of plans established by state and local government and tax-exempt employers are not subject to the requirements of section 457, however. The purpose of this article is to provide an overview of section 457, identify the differences between an eligible and an ineligible section 457 plan, and discuss those plans which are excepted from the rules and requirements articulated in section 457 and the regulations thereunder. This article will also try to highlight specific situations where plans may not be in compliance with section 457.

As originally enacted, the rules governing section 457 plans were developed based on nonqualified plan concepts. Section 457 plans therefore are subject to different, and often less stringent regulations than are funded, qualified plans, which must comply with complex rules to assure parity in who they cover, and how much can be deferred. An attendant feature of section 457 plans is that they may provide less security to participants than do qualified plans.

2. Section 457(b) "Eligible" Deferred Compensation Plans

Section 457(a) of the Code permits a participant to defer compensation to a deferred compensation plan of an "eligible employer," provided that the plan satisfies the eligibility requirements of section 457. Under section 457(a), compensation deferred pursuant to an eligible plan and the income attributable to such deferred compensation, are taxable in the year in which the deferred amounts are paid or made available to a plan participant or other beneficiary.

A. Eligible Employers

An eligible deferred compensation plan is defined as any plan, agreement or other arrangement that is established and maintained by an "eligible employer". Sections 457(b), 457(f)(3)(A). The term eligible employer is defined as a State (including the District of Columbia), political subdivision of a State, any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a government unit) exempt from tax under subtitle A of the Code. Section 457(e)(1), Section 1.457-2(c) of the Regulations. Section 457 therefore applies to all tax-exempt employers that maintain a deferred compensation plan, except churches, which are specifically excluded under section 457(e)(13). The application of section 457 to deferred compensation plans of exempt organizations became effective under the Tax Reform Act ("TRA") of 1986. Deferred compensation plans of agencies and instrumentalities of the Federal Government are not subject of Section 457.

B. Who May Participate in an Eligible Plan under Section 457(b)(1)?

(1) In General

Only individuals who perform services for the entity, either as employees or independent contractors, may be participants in a section 457 plan. Section 457(e)(2), 1.457-2(d). Corporations cannot be participants in a plan.

(2) Select Group of Employees of Non-governmental Tax-exempt Entities

While any employee or independent contractor of a governmental entity can be a participant, tax-exempt organizations that are non- governmental must limit participation to management and highly compensated employees . This is because of the rules under the Employee Retirement Income Security Act of 1974 ("ERISA"), which contains the applicable pension regulations under the jurisdiction of the Department of Labor.

ERISA generally requires that a plan which provides retirement benefits to employees must be funded by an irrevocable trust. Section 457 plans also provide such benefits. However, the rules of section 457 require such plans to be unfunded in order to obtain tax benefits. Therefore, an entity cannot attain tax deferral for its employees under a section 457 plan unless an exception to the funding requirement applies. Government plans are expressly exempt from the funding requirements of ERISA. Other tax-exempt employers may maintain section 457 plans, but only for management and highly compensated

employees, as the funding rules under ERISA do not apply to a "top hat" plan, a type of plan which specifically covers these types of employees. If the covered employees do not fall into these exceptions, the plans must be funded plans subject to the rules of ERISA.

Section 457 plans are not subject to the nondiscrimination rules, with which funded, qualified plans must comply. These rules are designed to insure that the highly compensated employees of an employer do not receive a disproportionate share of the benefits under qualified plans maintained by the employer. Neither the ERISA coverage rules nor the Code's coverage and nondiscrimination rules apply to unfunded top-hat plans, and no discrimination issue is raised by eliminating all rank and file employees from coverage under eligible 457 plans. In fact, section 457 plans of tax-exempt employers must do just that in order to be eligible plans. In contrast, qualified plans are developed for the rank and file as well as for highly compensated employees.

C. <u>Maximum Deferral Limitations under Sections 457(b)(2) and (3); Coordination Limitation under Section 457(c)(2)</u>

(1) <u>General Rule</u>

Under section 457(b)(2), a plan must provide that the annual amount that can be deferred is limited to the lesser of $7500, or 33 1/3% of a participant's "includible compensation". The $7500 limit includes both employer contributions and employee salary reduction deferrals.

(2) <u>"Includible Compensation"</u>

"Includible Compensation" for a taxable year includes only compensation attributable to services performed for the employer which is currently included in the participant's gross income for the taxable year, after taking into account amounts deferred (or otherwise not currently included in gross income) under section 457 and other provisions of the Code. Section 457(e)(5), Section 1.457-2(e)(2) of the Regulations. These other Code sections under which compensation is not includible in gross income include section 401(k) cash or deferred arrangements (CODAs or 401Ks), section 402(h)(1)(B) simplified employee pensions (SEPs) and section 403(b) tax-sheltered annuities (TSAs). The legislative history of section 457 indicates that in a typical arrangement, the 33 1/3% of includible compensation limitation is equal to 25% of the compensation that would have been received but for the salary reduction agreement. The amount of includible compensation is determined without regard to any community property laws. Section 457(e)(7).

Amounts payable on separation from service for unused sick and vacation leave accrued in prior years may not be deferred under an eligible plan pursuant to an election made in the final year of service, although these amounts would be used for determining includible compensation.

(3) Example

The following brief example illustrates how the deferral limitation operates to limit the amount of includible compensation that may be deferred under section 457(b). An employee who is scheduled to receive $24,000 during a taxable year could enter into a salary reduction agreement and elect to defer $6,000 for that year and be within the deferral limitation under 457(b), because this amount is equal to 25% of the employee's gross compensation of $24,000 and 33 1/3% of his or her includible compensation of $18,000 ($24,000 - $6,000).

(4) Catch-up Rule

An exception to the general deferral limitation under section 457(b)(2) does exist, however. Under section 457(b)(3), an eligible plan may provide that for one or more of a participant's last three taxable years ending before the attainment of retirement age, the amount which may be deferred is increased to the lesser of (A) $15,000, or (B) the sum of (i) the plan ceiling for purposes of 457(b)(2), plus (ii) so much of the plan ceiling established for purposes of 457(b)(2) for taxable years before the taxable year as has not previously been used under 457(b)(2) or 457(b)(3). (Catch-up Limitation).

With respect to the underutilized limitations and the limited catch-up rule, section 1.457-2(f)(2) of the Regulations provides, in part, that a prior year is taken into account only if (A) it begins after December 1, 1978, (B) the participant was eligible to participate in the plan during all or a portion of the taxable year, and (C) compensation deferred (if any) under the plan during the taxable year was subject to the plan ceiling established under 1.457-2(e)(1).

Section 1.457-2(f)(3) of the Regulations requires that the plan may not permit a participant to elect to have the limited catch-up provision apply more than once, whether or not the limited catch-up is utilized in less than all of the three taxable years ending before the participant attains normal retirement age, and whether or not the participant or former participant rejoins or participates in another eligible plan after retirement. An example found in the regulation points out that if the participant elects to utilize the limited catch-up for only one taxable year before normal retirement age, and after retirement at that age the participant renders services for the State as an independent contractor or otherwise, the plan may not permit the participant to utilize that limited catch-up for any taxable years subsequent to retirement.

(5) Normal Retirement Age

Section 1.457-2(f)(4) of the Regulations provides that a plan may define normal retirement age as any range of ages ending no later than age 70 1/2 and beginning no earlier than the earliest age at which a participant has the right to retire under the plan. If no normal retirement age is specified in the plan, then the normal retirement age is the later of the latest retirement age specified in the basic pension plan of the employer, or age 65. Where participants work past normal retirement age, the plan, within limits, may permit them to designate another normal retirement age for catch up purposes.

(6) Coordination Limitation

Under Section 457(c)(2), amounts excluded from income under certain types of plans must be treated as amounts deferred under section 457, and therefore counted against the $7500 annual limitation, or the 457(b)(3) $15,000 catch-up limitation. These plans are other section 457 plans, section 401(k) cash or deferred arrangements (CODAs), section 402(h)(1)(B) simplified employee pensions (SEPs), section 403(b) tax-sheltered annuities (TSAs), and plans for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18).

Generally, the effect of section 457(c)(2) is that an individual who defers compensation in both an eligible section 457 plan and in another plan such as a CODA, SEP, or TSA is limited to a total combined deferral of $7500 annually if the individual is to enjoy tax deferral on the combined amounts. If the combined deferral exceeds this amount, the amounts treated as excess in the eligible section 457 plan are taxable currently under section 457. However, an individual who, although eligible, does not defer any compensation under the 457 plan in any given year, is not subject to the $7500 annual limit of section 457(c)(2), even though the individual defers compensation under one of the other coordinated plans.

Section 457(c)(2) works as follows. Suppose that individual A participates in both an eligible section 457 plan and a section 401(k) arrangement. A defers the maximum amount of $7500 under the section 457 plan and $2000 under the 401(k) arrangement in 1996, for a total of $9500. A will have an excess deferral of $2000 under the 457 plan because of section 457(c)(2). The $2000 deferred under the 401(k) plan will first be applied towards the $7500 limit, and the amount deferred under the section 457 plan, $7500, will exceed the $7500 limit by $2000.

(7) Plans with Delayed Vesting Provisions

Another issue raised by the limitation requirement is found in plans with benefits that vest on a delayed basis. If the compensation deferred is subject to a substantial risk of forfeiture, then compensation deferred is taken into account at its present value in the plan year in which the compensation is no longer subject to a substantial risk of forfeiture. 1.457-2(e)(3) of the Regulations. Therefore, amounts deferred under an eligible plan over several years subject to a delayed vesting schedule will be combined for purposes of the maximum deferral limit in the year the amounts vest, i.e., are no longer subject to a substantial risk of forfeiture.

For example, if an employer sets aside $3000 per year for five years for a certain employee, and the employee's rights to these amounts vests only in year 5, the employee will be treated as having deferred $15,000 ($3000 x 5 years) in year 5, when the amounts vest. Because the employee may only defer $7,500 in year 5 under section 457(b), the aggregate of the amounts deferred, $15,000, is in excess of the limitation by $7,500, and the excess amount is includible in the gross income of the employee in that same year 5. Moreover, the excess deferral must remain in the section 457 plan because section 457 has no mechanism for distributing excess deferrals in advance of the normal distribution events listed in section 457(d).

(8) Present Value Requirement

Section 457(e)(6) requires that compensation deferred under a plan be taken into account at its present value in the plan year in which deferred. Thus, for example, an employer cannot use unreasonable actuarial assumptions or interest rates to calculate the present value of benefits or the increase in benefits for a defined benefit plan.

(9) Conclusion

In summary, whether a plan meets the requirements of section 457(b) and (c) of the Code will require a review of (1) whether the amounts being deferred under the plan are within the eligible plan limitations, (2) whether any of these amounts are subject to a substantial risk of forfeiture, and (3) whether the employees are participating in another plan requiring a coordination of benefits under section 457(c)(2). A pattern of continuous excess deferrals or other inconsistencies will require a further examination into whether the plan is being administered in compliance with section 457 of the Code.

D. The Plan Must be Unfunded Under Section 457(b)(6)

(1) Generally

Another of the requirements of eligibility is articulated in section 457(b)(6), which mandates that a section 457 plan be unfunded and that plan assets not be set aside for participants. Section 457(b)(6) states that an eligible plan must provide that:

> (A) all amounts of compensation under the plan, (B) all property and rights purchased with such amounts, and (C) all income attributable to such amounts, property or rights, shall remain (until made available to the participant or beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan) subject only to the claims of the employer's general creditors.

This is true whether the funds deferred originate with the employee or the employer. Therefore, amounts credited to an employee's section 457 account are legally considered to be funds belonging to the state (or local) governmental unit or tax-exempt entity until such amounts have been paid or made available to the employee. Any funding arrangement that sets aside assets for the exclusive benefit of participants is in violation of section 457 and will trigger immediate taxation under sections 402(b) and 83 of the Code. Any language in a plan that either contradicts or appears to contradict this requirement should result in a thorough review of the plan document. Section 457 plans may use a so-called "rabbi" trust arrangement, however, without violating this requirement.

(2) Proposed Legislation

Proposed legislation now before Congress would mandate that government plans be funded and amounts be set aside from the claims of the employer's creditors, while leaving other unfunded aspects of plans intact.

E. Timing of Elections/Constructive Receipt Issues

(1) Constructive Receipt

The tax consequences of nonqualified deferred compensation plans are governed by the constructive receipt doctrine embodied in the regulations under section 451 of the Code, and, in the case of state and local government and tax-exempt entities, by section 457.

Section 451(a) of the Code and section 1.451-1(a) of the regulations provide that under the cash receipts and disbursements method of accounting, an item of gross income is includible in gross income for the taxable year in which the taxpayer actually or constructively receives it. Section 1.451-2(a) of the regulations provides that income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart for him, or otherwise made available so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

(2) Election to Defer Under Section 457

A section 457 plan must provide that compensation for any month may be deferred only if the agreement providing for the deferral is entered into before the beginning of that month. However, with respect to a new employee, a plan may provide that compensation may be deferred for the calendar month during which that participant first becomes an employee, if an agreement providing for the deferral is entered into on or before the first day on which the participant becomes an employee. Section 457(b)(4), 1.457-2(g).

Generally, a participant or beneficiary may elect the manner in which the deferred amounts will be distributed. Moreover, amounts deferred under an eligible section 457 plan will not be considered made available solely because the participant is permitted to choose among various investment modes under the plan for the investment of such amounts whether before or after payments have begun under the plan. While the employer can give the participant a choice of investment methods, the employer is not required to do so.

Section 1.457-1(b) of the regulations states, in part, that for purposes of section 457(a) of the Code, amounts deferred under an eligible plan will not be considered made available if, under the plan, the participant may irrevocably elect prior to the time these amounts become payable (under the distribution provisions of the plan) to defer the payment of some or all of these amounts to a fixed and determinable future time. In order for the Service, as well as plan participants (or their beneficiaries) to ascertain when deferred amounts become payable, an eligible plan must specify a fixed or determinable time of payment by reference to the occurrence of an event (for example, retirement) that triggers the individual's right to receive or begin to receive the amounts deferred under the plan. A participant cannot change this election once a participant is otherwise eligible to receive a distribution under the plan.

Section 1.457-1(b) of the Regulations and the examples that follow provide some guidance as to when amounts deferred will or will not be considered to have been made available to the participant or beneficiary.

(3) Restriction on Distributions and Constructive Receipt

A participant in a section 457 plan cannot withdraw the deferred amounts at any time prior to the occurrence of a payout event set out in section 457(d)(1)(A). (See section 4 below on Timing of Distributions.) Under section 457 of the Code and the regulations thereunder, as well as under the long established doctrine of constructive receipt of income, if a plan participant were able to receive his deferred compensation at any time without restriction after he retired, he would be in constructive receipt of any amounts subject to being withdrawn in the taxable year of his retirement, even though these amounts were not actually paid. Under section 457(a) of the Code, the participant's ability to control the time when he would receive these amounts would make the deferred amounts available to him and includible in gross income for the year in which he retired, or if already retired, in the current taxable year.

F. Permitted Distributions Under 457(d)(1)

(1) Generally

Section 457(b)(5) provides that an eligible section 457 plan must meet the distribution requirements of section 457(d). Section 457(d)(1) provides that the plan must require that the amounts deferred under the plan will not be made available to participants or beneficiaries earlier than (i) the calendar year in which the participant attains age 70 1/2, (ii) when the participant is separated from service with the employer, or (iii) when the participant is faced with an unforeseeable emergency, determined in the manner prescribed by the Secretary in regulations. The first option (age 70 1/2) requires no further explanation. This section discusses separation from service, unforeseeable emergencies, and a series of other issues related to when distributions may be made. The next section discusses when distributions must be made.

(2) Separation from Service

a. Generally

A participant's separation from service with the employer is another event which may give rise to the distribution of amounts from the plan to the employee.

b. <u>What Constitutes Separation From Service</u>

Under the regulations, an employee is separated from service with the State if there is a separation from service within the meaning of section 402(d)(4)(A)(iii) (formerly section 402(e)(4)(A)(iii)), relating to lump sum distributions. Generally, an employee is not separated from service where the participant continues the same job in the same work environment with a different employer as a result of a merger, liquidation or other similar circumstances and the new employer continues the plan (so-called "same desk" rule). An employee is generally considered to be separated from service if the employee's job duties with the new employer are substantially different from the job duties performed for the old employer. A distribution is also considered to be made due to separation from service if it is made on account of the participant's death or retirement. Section 1. 457-2(h)(2).

c. <u>Special rules for Independent Contractors</u>

Separation from service with respect to an independent contractor is discussed in section 1.457-2(h)(3) of the regulations, which provides that:

> an independent contractor is considered separated from service with the State upon the expiration of the contract or in the case of more than one contract, all contracts under which services are performed for the State, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration will not constitute a good faith and complete termination of the contractual relationship if the State anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a State is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the State nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a State is considered to intend to again contract for the services provided under an expired contract, if the State's doing so is conditioned only upon the State's incurring a need for the services, or the availability of funds, or both.

The regulations go on to set out a safe harbor rule providing that no amounts payable under a plan will be considered to be paid or made available to the participant before the participant separates from service with the State if the plan provides that:

(A)No amount shall be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the State (or in the case of more than one contract, all such contracts expire), and

(B)No amount payable to the participant on that date shall be paid to the participant if, after the expiration of the Contract (or contracts) and before that date, the participant performs services for the State as an independent contractor or an employee.

Be careful to examine whether there has been an actual separation from service and not just an insignificant change in the nature of the services performed. For example, contracts between doctors and state or tax-exempt hospitals may deem there to have been a separation from service where the nature of the services performed has changed somewhat, but in fact the doctor has never left the service of the hospital. Look beyond the contract involved and to the individual facts and circumstances of each arrangement.

(3) Unforeseeable Emergencies

There is one exception to this general rule prohibiting withdrawals. The plan may permit a participant to accelerate the payment of an amount remaining payable in the event of an "unforeseeable emergency," as defined in section 1.457-2(h)(4) of the regulations. A Plan does not have to provide for emergency withdrawals. However, benefits would not be considered made available merely because the plan contained such a provision. IT IS IMPORTANT TO REALIZE THAT A WITHDRAWAL FOR AN 'UNFORESEEABLE EMERGENCY' IS MORE DIFFICULT TO OBTAIN AND DIFFERS SUBSTANTIALLY FROM A 'HARDSHIP WITHDRAWAL' UNDER A SECTION 401K PLAN.

Section 1.457-2(h)(4) defines "unforeseeable emergency" as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The circumstances that will constitute an unforeseeable emergency will depend on the facts of each case, but in any case, payment may not be made to the extent that such hardship is or may be relieved: (i) through reimbursement or compensation by insurance or otherwise, (ii) by liquidation of the participant's assets, to the extent the liquidation of the assets would not itself cause severe financial hardship, or (iii) by cessation of deferrals under the Plan. Examples of what are not considered to be unforeseeable emergencies include the need to send a child to college or the desire to purchase a home.

Withdrawals of amounts because of an unforeseeable emergency must only be permitted to the extent reasonably required to satisfy the emergency need.

Any plan that has a large number of hardship withdrawals should be reviewed to determine whether the withdrawals are being administered in compliance with the hardship regulations. If the plan permits an employee to draw down the accounts virtually at will, this is a clear violation of the rules. A section 457 account balance should not be treated as though it were a bank account balance; it belongs to the employer until the employee becomes entitled to a distribution by the occurrence of an event specified in section 457(d)(1).

(4) Loans

Unlike the statutory scheme for qualified employer plans, which are authorized to make loans that will not be treated as plan distributions in certain circumstances, loans from or against section 457 plan assets are not authorized by statute and are **NEVER** permitted. THIS IS ANOTHER SIGNIFICANT DIFFERENCE FROM WHAT IS PERMITTED UNDER A 401K PLAN.

(5) Offsets

To the extent a plan does not contain anti-alienation language and does contain a provision permitting the employer to offset an employee's interest in a plan against amounts owed to the employer, an issue arises as to whether an offset provides the participant with a right to assign an interest in plan assets in violation of section 457(b)(6), which requires that all amounts deferred under the Plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights will remain (until made available to the participant or beneficiary) solely the property and rights of the Employer, subject only to the claims of the Employer's general creditors.

Another issue raised by an offset is whether an employee has received an economic benefit equal to the amount of the offset, thus causing current taxation of that amount under the cash equivalency theory. See Cowden v. Commissioner, 32 T.C. 853 (1959), rev'd and rem'd, 289 F.2d 20 (5th Cir. 1961), on remand, 20 T.C.M. 1134 (1961).

(6) Transfers and Rollovers

Unlike the situation under a qualified plan, a participant who receives a distribution under a section 457 plan cannot further defer the funds tax free. The sole exception is transfers of the funds to another eligible 457 deferred compensation plan as is permitted under section 457(e)(10) of the Code. Under

section 457(e)(10), a participant is not required to include in gross income any amount payable to the participant just because there is a transfer of funds from one eligible deferred compensation plan to another eligible deferred compensation plan. No similar exception is provided for a rollover or transfer of funds to any other type of plan or arrangement, including an IRA. See Rev. Rul. 86-103, 1986-2 C.B. 62.

(7) Penalty and Excise Taxes

The 10% penalty tax of section 72(t) on early distributions from a tax-qualified plan, IRA or tax sheltered annuity does **not** apply to section 457. Neither does the 15% excise tax on excess distributions from these kinds of arrangements under section 4980A.

G. Minimum Distribution Requirements of 457(d)(2)

(1) In General

Section 1107 of the Tax Reform Act of 1986 added the minimum distribution requirements of 457(d)(2) in order to ensure that the tax-favored savings provided through section 457 are used primarily for retirement purposes. In general, the provisions are similar but not identical to those that apply to qualified plans and to arrangements under section 403(b) of the Code.

(2) Statutory Provisions

Section 457(d)(2)(A) provides that a plan meets the minimum distribution requirements for purposes of section 457 if the plan meets the minimum distribution requirements of section 401(a)(9). The general rule under section 401(a)(9) requires that a participant begin distribution of certain amounts under a plan not later than April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2. In the case of a governmental plan, but not the plan of a tax-exempt organization, the required beginning date is the LATER of the general rule state above or April 1 of the calendar year following the calendar year in which the employee retires.

Section 457(d)(2)(B) of the Code provides that in the case of a distribution beginning before the death of the participant, the plan must provide that the distribution will be made in a form under which the amounts payable with respect to the participant will be paid at times specified by the Secretary, which are not later than the time determined under section 401(a)(9)(G) (relating to incidental death benefits), and that any amounts distributed to the participant

during his life will be distributed after the death of the participant at least as rapidly as under the method of distribution being used under the previous rule as of the date of his death. In the case of a distribution which begins after the death of the participant, the entire amount payable with respect to the participant must be paid during a period that does not exceed 15 years, or the life of the surviving spouse, if the spouse is the beneficiary. Finally, the plan must meet the nonincreasing benefit requirement of section 457(d)(2)(C). Both the section 401(a)(9)(G) rule and the nonincreasing benefit requirement are discussed below.

a. Section 401(a)(9)(G) Rule

i. Legislative History

Prior to being amended by section 1101(e)(10) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), section 457(d)(2)(B)(i)(I) required that, in the case of a distribution beginning before the death of the participant, the distribution be made in a form under which "at least 2/3 of the total amount payable with respect to the participant will be paid during the life expectancy of such participant (determined as of the commencement of the distribution),..."

As amended by section 1011(e)(10) of TAMRA, the above quoted provision of section 457(d)(2)(B)(i)(I) now requires the distribution to be made in a form under which "the amounts payable with respect to the participant will be made at times specified by the Secretary which are not later than the times determined under section 401(a)(9)(G) (relating to incidental death benefits),..." The Senate Finance Committee Report accompanying TAMRA explains the above amendments by stating that the Secretary is instructed to "issue tables that implement the incidental death benefit rule [provided in section 457(d)(2)(B)(i)(I)]...that are similar to those applicable under section 401(a)(9) but require more rapid distributions. Generally, the extent to which more rapid distributions are to be required is to be similar to the extent to which the former section 457(d)(2)(B)(i)(I) rule required more rapid distributions than the former version of the incidental benefit rule." These tables have not yet been issued. However, as noted below, the tables applicable to qualified plans may be used pending issuance of section 457 tables.

ii. Section 401(a)(9) Regulations

Section 401(a)(9)(G) of the 1986 Code provides for an incidental death benefit rule designed to apply uniformly to the various types of plans designed to qualify under section 401(a). This rule replaces the incidental benefit rule

stated in section 1.401-1(b)-1 of the Income Tax Regulations, adopted under the 1954 Code, which requires that a plan qualified under section 401(a) be designed to provide benefits primarily to employees, but may provide for the payment of incidental death benefits by insurance or otherwise.

The minimum distribution tables found in section 1.401(a)(9)-2 of the Proposed Regulations are intended to implement the incidental death benefit rule required by section 401(a)(9)(G) of the Code by providing a simple and uniform method of determining the amount of benefits payable to employees during their expected lifetimes.

A section 457 plan now providing an incidental benefit rule based on the "at least 2/3" requirement may be liberalized to adopt the somewhat less rapid distribution rule provided under the section 1.401(a)(9)-2 table. Bear in mind, however, that if temporary or final regulations adopted are more restrictive than the 401(a)(9)(G) tables, the more liberal incidental death benefit rule would be required to be amended once again.

b. <u>Substantially Nonincreasing Amounts</u>

One of the distribution requirements, section 457(d)(2)(C), provides that when distributions under an eligible section 457 plan are payable over a period longer than one year, they must be paid in "substantially nonincreasing amounts" and paid not less frequently than annually. The committee reports accompanying the Tax Reform Act of 1986 offer no explanation for or discussion of this particular requirement.

The Service has not yet defined what constitutes "substantially nonincreasing amounts." Nor has the Service mandated that complex actuarial computations must support a distribution schedule of "substantially nonincreasing amounts." Until the section 457 regulations are revised with respect to section 457(d)(2)(C) or until Congress legislates a definition of "substantially nonincreasing amounts," the plain meaning of that phrase applies. Under the plain meaning, amounts distributed need not be equal but they also should not be too disparate. For example, we would likely conclude that a benefit increase from $1,750 to $3,500 a month, or $21,000 to $42,000 a year is a substantial increase under the plain meaning of the language, and would be a violation of section 457(d)(2)(C) of the Code.

An increase in the amount distributed each year that reflects earnings on the deferred amounts is acceptable.

(3) Penalty

In the event a participant (or beneficiary) fails to receive, or receives less than, the minimum distribution required, a penalty may be imposed by section 4974(a) of the Code. The penalty amounts to 50% of the difference between the distribution actually received, if any, and the required minimum distribution under section 457(d)(2). This penalty can be waived by the Service under appropriate circumstances such as an inadvertent error or good-faith effort on the part of the participant (or beneficiary) to comply with the requirements.

H. Correction Period

Under section 457(b)(6), a section 457 plan maintained by a government employer which is not administered by the employer in accordance with the requirements of section 457 ceases to be an eligible plan on the first day of the first plan year beginning more than 180 days after the date of written notification by the Internal Revenue Service that the requirements are not satisfied, unless the inconsistency is corrected before the first day of that plan year. This grace period does not, by its terms, apply to the plans of tax-exempt entities.

I. Employment Taxes

Section 3121(v) controls the timing of the payment of FICA taxes for purposes of section 457(b) plans. Section 3121(v)(2) provides, generally, that any amount deferred under a nonqualified deferred compensation plan is be taken into account for purposes of these employment taxes as of **the later of** when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amounts.

Amounts deferred (both elective and nonelective) under eligible plans are generally subject to FICA taxes at the time of deferral (when the services are performed) because at that time the amounts are no longer subject to a substantial risk of forfeiture. The fact that section 457 plans are unfunded plans and amounts credited under the plans are subject to the claims of the general creditors of the entity does not make the amounts subject to a substantial risk of forfeiture. On the other hand, amounts which are subject to a delayed vesting schedule (see section C.iii of this article) are subject to FICA taxes only when the amounts vest under the provisions of the plan.

3. Section 457(f) "Ineligible" Deferred Compensation Plans

Section 457(f)(1) of the Code governs the tax treatment of most nonqualified plans that are not eligible deferred compensation plans under section 457(b). However, transfers subject to section 83 are not subject to either set of section 457 rules. Generally, employers use an ineligible plan when they want to provide a benefit in an amount greater than the $7500 limit imposed on eligible plans or want to condition that benefit on the employee's future performance of services to the employer, or both. These are often called "golden handcuff" plans.

Section 457(f)(1) does not apply to that portion of any plan consisting of a transfer of property described in section 83 or to that portion of any plan consisting of a trust to which section 402(b) applies.

In general, section 457(f)(1)(A) of the Code provides that the amount of compensation that is deferred under a plan subject to section 457(f)(1) is included in the participant's or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation.

A. What is a Substantial Risk of Forfeiture?

Section 457(f)(3)(B) provides that the rights of a person to compensation are subject to a substantial risk of forfeiture if the participant's rights to the amounts deferred are conditioned upon the future performance of substantial services. Section 83 of the Code and the regulations thereunder provide additional assistance in determining what is a substantial risk of forfeiture and what kind of services are substantial for purposes of section 457(f).

Section 1.83-3(c)(1) of the Regulations provides that **whether a risk of forfeiture is substantial or not depends upon the facts and circumstances.** A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

For example, the regulations point out that requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture.

For ruling purposes, a risk of forfeiture based upon the employee's death, living to a specified age or the employer's insolvency, fall short of the section 83 requirement.

B. Are the Services Substantial?

Section 83 also requires that the future services to be performed in connection with the transfer of rights in property be substantial. Section 1.83-3(c)(2) provides illustrations of substantial risks of forfeiture and states that "**the regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial**. The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial."

Generally, any requirement for the performance or nonperformance of services over a period of less than twenty-four months tends to indicate that the services required are not substantial.

Section 1.83-3(c)(4), Example (1) of the regulations provides, that where a corporation transfers to an employee 100 shares of stock in the corporation, at $90 per share, and the employee is obligated to sell the stock to the Corporation at $90 per share if he terminates his employment with the Corporation for any reason prior to the expiration of a two year period of employment, the employee's rights to the stock are subject to a substantial risk of forfeiture during such two year period. If the conditions on transfer are not satisfied, it is assumed that the forfeiture provision will be enforced. Thus, requiring two years of service before vesting would generally be a substantial risk of forfeiture.

The regulations provide at least two additional examples where the services performed (or not performed) may not be substantial:

(1) Covenant Not To Compete

A covenant not to compete or a noncompetition clause which requires an employee not to compete with the employer once the employee separates from service often falls short of the section 83 requirement. Section 1.83-3(c)(2) provides that factors which may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of

the employer to enforce such covenants. Thus, a requirement that an employee not accept a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary.

(2) Incidental Consulting Services

A second area mentioned by the regulations is incidental consulting services. The regulations state that rights in property transferred to a retiring employee subject to the sole requirement that the property be returned unless he renders consulting services upon the request of the employer will not be considered subject to a substantial risk of forfeiture unless he is in fact required to perform such services. Another question raised in this analysis is whether the services to be performed are substantial or merely incidental. A facts and circumstances analysis is required to determine this. The example below provides such an analysis.

C. Sample Plan

The following sample plan exemplifies how difficult it can be to determine whether a substantial risk of forfeiture exists for purposes of section 83 and section 457(f), and why each case necessitates its own facts and circumstances analysis. Under the terms of a section 457(f) plan recently reviewed for ruling purposes, a participant doctor is entitled to receive benefits from a tax-exempt hospital upon the completion of certain employment requirements. Specifically, the doctor is required to 1) review cases and 2) provide consulting with regard to a department of the hospital. The Plan states that the doctor will be entitled to benefits only if he or she completes the services as reflected in this agreement. These services are not the regular services of the physicians, which are listed in each doctor's individual employment contract with the hospital. The case file did not reflect the regularity with which the consulting services required in the plan were to be performed or the actual amount of time spent, if any, in the performance of these services.

In this case, we questioned whether the amounts deferred were truly subject to a substantial risk of forfeiture. From the information contained in the file, there was no way for us to substantiate the regularity or amount of time to be spent in the performance of the services listed, or if, indeed, any time would be spent on the performance of these services. Even if the employee were performing the services listed, if the services required little time they might be NOT SUBSTANTIAL, and the risk of forfeiture would therefore also be NOT SUBSTANTIAL. The requirement is that substantial future services be required to

be provided. We believe this refers to the quantity of services rendered during a specific time period. Full-time services are definitely not required. However, mere consulting availability or sporadic consulting are not substantial and neither is a cursory review of a few patient's files.

The final determination, however, is based on a facts and circumstances analysis. Thus, each individual arrangement must be reviewed separately. Our position in this case was that absent detailed evidence with regard to the amount of time spent on these services, these services are not substantial, and that the income deferred should be currently taxable to the doctor-participant. In summary, such an arrangement should be reviewed very thoroughly to determine whether the purported substantial risk of forfeiture actually exists.

D. Salary Reduction Ineligible Plans

Another area of concern is ineligible arrangements funded purely by salary reduction. Typical 457(f) plans are used as a means of placing "golden handcuffs" on executives by conditioning retirement benefits on long term service or bonuses for shorter periods of service. These amounts are usually additional compensation to the employee and do not place the employee's regular compensation at risk.

Salary reduction 457(f) plans, however, must be placed under closer scrutiny because few employees would find such arrangements to be an acceptable alternative to current compensation, unless they are very near retirement and feel secure in their jobs. Even a doctor who is highly compensated is unlikely to place a substantial amount of his income at risk. Each such type of arrangement requires looking behind the documents and reviewing very carefully what services are being rendered, in order to determine whether there is truly a substantial risk of forfeiture involved.

E. Rolling Risk of Forfeiture

Another feature of an ineligible arrangement worth close scrutiny is what is known as a rolling risk of forfeiture. A rolling risk of forfeiture is essentially a provision in an arrangement which permits a voluntary extension of the period of forfeiture. Generally, when the period of risk lapses with respect to an employee arrangement, the deferred compensation will be includible in the gross income of that employee. The ability to extend the period of risk period would permit the employee to further defer the receipt of compensation to a future date, and avoid taxation on the amounts until that future date.

These plans should be subject to a higher level of scrutiny to determine whether a risk really exists. This is particularly true where the employee has the option to extend the risk period and does so shortly before the risk lapses.

F. Multiple Plans

An employer may simultaneously maintain several different types of plans. For example, an employer may sponsor a death benefit plan and a severance pay plan, which, if "bona fide," are excepted from the provisions of section 457(b), in addition to a section 457(f) plan. However, when viewed together, it may become apparent that the benefits paid from one plan offset benefits lost under the provisions of one of the others. If this is the case, while it may appear that there is a substantial risk of forfeiture, it is unlikely that a true risk of forfeiture exists since a participant can receive benefit payments under one or another of the plans in all events.

G. Taxation of Section 457(f) Plans

(1) Income Tax

Compensation deferred under 457(f) arrangements is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture. The tax treatment of any amount subsequently paid or made available under the plan to a participant or beneficiary is determined under section 72 of the Code, relating to the taxation of annuities. The legislative history of section 457 and the regulations provide that earnings credited on compensation deferred under the agreement or arrangement are includible in the gross income of the participant or beneficiary only when paid or made available, provided that such interest in the assets (including amounts deferred under the plan) of the entity or employer is not senior to the entity or employer's general creditors. Section 1.457-3(a)(1),(2) and (3) of the Regulations.

Section 457(e)(6) states that compensation deferred is taken into account at its present value.

(2) Employment Taxes

Section 3121(v) controls the timing of the payment of FICA tax for purposes of section 457(f) plans. Section 3121(v)(2) provides generally that any amount deferred under a nonqualified deferred compensation plan is taken into account for purposes of these employment taxes as of the later of when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amounts.

4. Grandfathered Plans of Tax Exempt Organizations

A. Section 1107 Exception From the Section 457 Rules

Section 1107 of the TRA of 1986 amended section 457 of the Code to apply its restrictions and limitations to the unfunded deferred compensation plans maintained by non-governmental tax-exempt organizations, effective for taxable years beginning after December 31, 1986, except as provided under section 1107(c) of the Act. Section 1107(c)(3)(B) addresses non-governmental tax-exempt organizations only and provides that section 457 does not apply to amounts deferred under a deferred compensation plan of such an organization that:

(i) were deferred from taxable years beginning before January 1, 1987, or

(ii) are deferred from taxable years beginning after December 31, 1986, pursuant to an agreement that

(I) was in writing on August 16, 1986, and

(II) on such date, provides for a deferral for each taxable year covered by the agreement of a fixed amount or of an amount determined pursuant to a fixed formula.

Section 1107(c)(3)(B) further provides that if there is any modification of the fixed amount or fixed formula, section 457 applies to any taxable year ending after the date on which the modification is effective.

B. Notice 87-13 Guidance

Notice 87-13, 1987-1 C.B. 432, gives guidance, in the form of questions and answers, with respect to certain provisions of the Act, including section 1107.

A deferral with respect to an individual is treated as fixed on August 16, 1986, to the extent that a written plan on such date provided for such deferral for each taxable year of the plan and such deferral was determinable on such date under written terms of the plan as a fixed dollar amount, a fixed percentage of a fixed base amount (e.g., regular salary, commissions, bonus, or total compensation) or an amount to be determined by a fixed formula. An example of a fixed formula is a deferred compensation plan that is in the nature of a defined benefit plan under which the deferred compensation to be paid to an employee in the future (e.g., on or after separation from service) is in the form

of an annual benefit equal to 1 percent of each of the employee's years of service with the employer times the employee's final average salary.

Q&A-28 of Notice 87-13 further provides that an amount of deferral pursuant to a written plan on August 16, 1986, will cease to be treated as fixed on such date, and thus will be subject to section 457, as of the effective date of any modification to the written plan that directly or indirectly alters the fixed dollar amount, the fixed percentage, the fixed base amount to which the percentage is applied, or the fixed formula.

Certain plan amendments do not affect the grandfathered status of a plan. For example, the election by a participant of an alternative payout option that does not alter the total amount credited to a participant under the plan for any fiscal year or the allocation of the total credits among the participants for any fiscal year is not a violation of this requirement. Additionally, changes to a plan's benefit commencement date or in the timing of certain elections, or modifications or clarifications to plan definitions would not cause a plan to lose its grandfathered status. We have also allowed changes to the plan that reduce the amount to be paid to a participant under the plan.

C. New Participants Not Grandfathered

Section 1011(e)(6) of TAMRA amended section 1107(c)(3) of TRA '86. The TAMRA amendment clarified that: (1) the grandfather rule applies to any deferred compensation plan of a tax-exempt employer that otherwise meets the requirements described above, whether or not the plan would be an "eligible deferred compensation plan" within the meaning of section 457(b); and (2) the grandfather rule applies only to individuals who were covered under the plan and agreement on August 16, 1986, and not to new employees or participants. S. Rep. No. 445, 100th Cong., 2d Sess. 148 (1988).

D. Reviewing Grandfathered Plans

When reviewing a so-called grandfathered plan, it is important to determine whether there have been any amendments to the plan that affect the fixed amount or formula requirement. For example, any election, annual or otherwise, which permits the participant to change the amount of his salary reduction deferral, obviously violates this requirement. Also, note whether the plan has new participants and whether they are participating in the grandfathered plan.

5. Bona Fide Vacation, Sick Leave, Compensatory Time, Severance Pay, Disability Pay and Death Benefit Plans Excepted From Section 457 Under Section 457(e)(11) of the Code

A. The Issue

Section 457 applies to all plans, both elective and nonelective, providing for the deferral of compensation. Since TRA '86, this has focussed attention on whether it should apply to a variety of plans that arguably defer compensation yet are not typically considered deferred compensation plans. These include a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or tax-exempt organization.

B. Service Guidance

In Notice 88-8, 1988-1 C.B. 477, the Service stated that:

> [A] bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or tax-exempt organization will not be subject to the provisions of section 457 for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to section 457. The exemption applies to such plans whether they are elective or nonelective.

In Notice 88-68, 1988-1 C.B. 556, the Service announced that the types of plans described in Notice 88-8, including bona fide severance pay plans, would not be treated as deferred compensation plans subject to section 457 when regulations were issued. The Notice also stated that this rule would apply without regard to whether such plan is elective or nonelective in nature. The Notice concluded with a comment that "{a} number of issues remain with respect to section 457, including when a vacation leave, sick leave, compensatory time or severance pay plan is bona fide, and not a mere device to provide deferred compensation." (Emphasis added).

C. Advantages of Bona Fide Plan

The advantage of having a plan qualify as a "bona fide" plan excepted from section 457 is that it may provide benefits in excess of the $7,500 deferral limit for eligible 457(b) plans and the amounts deferred need not be subject to a substantial risk of forfeiture as is otherwise required under 457(f). In fact, the benefits provided may amount to 10 to 20 times the annually permitted deferral

under an eligible section 457 plan, or even more. However, if such a plan is found to be a deferred compensation plan subject to section 457(f), then all amounts not subject to a substantial risk of forfeiture are currently taxable to the employees, for both income and employment tax purposes.

D. Section 457(e)(11)

Section 457(e)(11) of the Code, enacted as part of TAMRA, provides that "{a}ny bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan shall be treated as a plan not providing for the deferral of compensation." The legislative history of TAMRA indicates that this section was intended to codify Notice 88-68, but provides no further explanation. The Service has not yet provided any interpretative guidance, either in the form of regulations or otherwise, with respect to Section 457(e)(11).

Remember, however, that the substance is what matters. Thus, the mere designation of one of these plans as "bona fide" under 457(e)(11) is meaningless if the benefit package provided, as well as the spirit of the plan, is more in the nature of a deferred compensation plan.

E. Review of Plans

Any arrangement of a state or local government or tax exempt employer that is clearly equivalent to a nonqualified deferred compensation plan should be viewed as being subject to section 457 regardless of whether the plan is labelled otherwise. When reviewing section 457 plans generally, be sure to inquire as to whether the employer has a sick leave, vacation leave, severance, disability or death benefit plan, in addition to any section 457 plans. A review of the plan documents may indicate that these plans are not really excepted from the provisions of section 457. Look beyond what the plan says and see what it does. If the plan resembles a section 457 plan, question its status a plan exempted from section 457.

For a detailed article on severance pay plans and how to distinguish between severance pay plans and plans of deferred compensation, please see the article entitled, Severance Pay Plans of State and Local Government and Tax-Exempt Employers, found in the Exempt Organizations Continuing Professional Education, Technical Instruction Program for FY 1996, Topic H, page 182.

6. Section 457(e)(12) Nonelective Plans for Independent Contractors

Section 457(e)(12)(A) provides that section 457 does not apply to nonelective deferred compensation attributable to services not performed as an employee. For purposes of subparagraph (A), deferred compensation is to be treated as nonelective only if all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship to the payor are covered under the same plan **with no individual variations or options under the plan.** Section 457(e)(12)(B).

In the absence of regulations interpreting this section, a literal reading should be applied. For example, no individual variations or options in the plan can exist. Furthermore, when looking at the relationship of the independent contractors to the entity, make sure the same classes of independent contractors are grouped together, and not arbitrarily separated. For example, one case we reviewed separated every medical subspecialty of doctors into a different subgroup for purposes of applying individual variations and options under the plan. However, there were only one or two doctors with each subspecialty on staff, and not a whole group of specialists. We viewed each individual doctor as having the same relationship to the hospital, and no individual variations or plan options should have been permitted. This plan, therefore, should have been subject to section 457. A different conclusion might have been reached if each subspecialty consisted of several doctors and there were rational, objective differences in these relationships, such as may be the case at a large hospital.

7. Conclusion

There are several kinds of plans of state and local government and tax-exempt employers that fall under the requirements of section 457. A thorough review of all the factors discussed in this article will be necessary to determine whether the plans are in compliance with section 457. If the provisions of the plan appear to be in compliance with the requirements of section 457, a review of the administration of the plan may still uncover problems which merit a further analysis of the tax effects of the plan. If the plans of these employers purport not to be subject to section 457, it is still necessary to determine whether they are truly exempt from section 457 or exempt in name only. If a plan looks like a plan which should be subject to the requirements of section 457, question it's status as a plan other than a section 457 plan.

# N. INSURANCE: THE RULE OF '86

by
William W. Miller, Phyllis D. Haney and Kenneth J. Earnest

## Part I: Background on Exempt Organizations' Insurance Activities

### 1. Outline of this Topic

Exempt organizations may engage in a variety of insurance-related activities without jeopardizing their exemptions. Since 1986, IRC 501(m) has limited the amount of outright "commercial-type insurance" activity in which section 501(c)(3) and section 501(c)(4) organizations may engage. IRC 501(e) was amended that year explicitly to allow hospital cooperative service organizations to purchase insurance on a group basis. Changes to IRC 501(c)(15) in the same year made it much easier for taxable organizations to create their own tax-exempt insurance companies. Section 501(c)(15) organizations may be either stock or mutual insurance companies (other than life), which generally engage in insurance activities of a commercial nature.

Part I of this article outlines the current status of the permissible insurance activities of section 501(c)(3) and section 501(c)(4) organizations in light of IRC 501(m), as well as a brief discussion of what insurance activity is now permitted for hospital cooperative service organizations under IRC 501(e). Part II describes current developments under IRC 501(c)(15) in detail, which necessarily entails a discussion of developments in insurance company and policyholder tax treatment on the taxable side.

Part II of this article describes IRC 501(c)(15) in greater detail. Part II discusses the 1986 IRC amendment, prior CPE articles, and current concerns over IRC 501(c)(15) exemption.

### 2. Prior CPE Articles Related to this Topic

Earlier CPE articles have discussed insurance activities of exempt organizations. Preceding the amendments to the Internal Revenue Code effected by the Tax Reform Act of 1986, an article appeared in the FY 1981 training materials. The article, "Insurance Activities of Exempt Organizations" (page 272) mainly dealt with group insurance programs of section 501(c)(6) organizations, however, there was some mention of section 501(c)(3) risk pooling trusts as well as methods used by those organizations to provide benefits to their employees.

The Tax Reform Act of 1986 added IRC 501(m) and amended IRC 501(c)(15). IRC 501(m) provides that organizations described in IRC 501(c)(3) and IRC 501(c)(4) may only be exempt from tax under IRC 501(a) if no substantial part of their activities consists of providing commercial-type insurance. IRC subsection 501(m)(3) describes specific types of insurance that are not "commercial-type insurance". IRC subsection 501(m)(2) prescribes that section 501(c)(3) and section 501(c)(4) organizations that are still exempt (*i.e.*, less than a substantial part of their activities consists of providing commercial-type insurance) treat the activity of providing commercial-type insurance as an unrelated trade or business under IRC 513, and treat themselves as insurance companies for purposes of applying Subchapter L with respect to the insurance activity.

After the 1986 Act changes to the Internal Revenue Code, a CPE article, "The Tax Reform Act of 1986" appeared in the FY 1987 materials (page 194) and included a section on insurance activities of exempt organizations affected by the 1986 Act. That section discussed the new sections of the Code added by the 1986 Act, IRC 501(m) and IRC 833, specifically as they affected Blue Cross and Blue Shield organizations, many of which were formerly organizations described in IRC 501(c)(4).

The Technical and Miscellaneous Revenue Act of 1988 amended IRC 501(e), which describes "cooperative hospital service organizations". That section lists permitted services that an organization may perform for two or more exempt hospitals on a cooperative basis and be treated as an organization described in IRC 501(c)(3). The 1988 Act added "(including the purchasing of insurance on a group basis)" after the previously listed permitted service of "purchasing".

The 1990 EO CPE included an article updating the unrelated business income tax (page 109), which included a section on insurance (page 128). That section mainly dealt with section 501(c)(5) and 501(c)(6) organizations offering insurance to their members.

3. Pre-1986 Act Law

A. Single Exempt Organization Self-insuring

Exempt organizations have long set aside funds to cover their own potential risks. The entities created and controlled by the exempt organizations to accomplish this have themselves been recognized as exempt. For instance, in Rev. Rul. 78-41, 1978-1 C.B. 148, an exempt hospital created a trust in which to accumulate and hold funds to be used to satisfy malpractice claims against the hospital. The ruling found that the trust was operating as an integral part

of the hospital and performing a function that the hospital could do directly. It held that the trust was operated exclusively for charitable purposes and was exempt from tax under IRC 501(c)(3).

4. <u>Current Law under IRC Sections 501(c)(3), 501(c)(4), and 501(m)</u>

As mentioned in the previous description, IRC 501(m) bars exemption for organizations that would otherwise be recognized as exempt under sections 501(c)(3) and 501(c)(4) if a substantial part of their activities consists of providing commercial-type insurance. "Commercial-type insurance" is not defined in the IRC, but 501(m)(3) lists the following types of insurance that are *not* "commercial-type" for purposes of section 501(m):

(A) insurance provided at substantially below cost to a class of charitable recipients;
(B) incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations;
(C) and (D) property or casualty insurance, or retirement or welfare benefits, provided by a church or convention or association of churches for the organizations or their employees; and
(E) charitable gift annuities.

General Explanation of the Tax Reform Act of 1986 also states that "commercial-type insurance does not include arrangements that are not treated as insurance (i.e., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance)." (H.R. 3838, 99th Congress, Public Law 99-514, 585). The explanation then describes the fact pattern of Rev. Rul. 78-41 to illustrate such an arrangement. The longstanding Service position is that self-insurance (i.e., an organization setting aside reserves or funds itself to pay its future liabilities) by exempt organizations is not "commercial-type insurance". Entities created by exempt organizations for such a purpose generally continue to be recognized as exempt. (In fact, in general self-insurance is not insurance for tax purposes as discussed in Part II section B.)

For example, in GCM 39761 (October 24, 1988), a county government created a trust to provide workers' compensation benefits to its employees. Actuarial and separate accounting procedures were employed to determine contributions to the trust and to maintain the trust account. The GCM found that liability for workers' compensation claims was not shifted from the county to the trust, and therefore the arrangement did not constitute commercial-type insurance. The trust was recognized as exempt under IRC 501(c)(3) as an organization that lessens the burdens of government.

However, GCM 39703 (March 7, 1988) found that an organization created by a state's public high school athletic association to provide for the payment of certain health-care expenses of students injured during a school activity was not exempt under IRC 501(c)(4). Originally the corporation, created to reimburse high school students who were injured in school athletic events to the extent their health insurance did not cover them, was recognized as exempt under IRC 501(c)(4). The corporation gradually expanded the scope of its coverage to extend to all students of all schools of subscribing school districts for all approved school activities. IRC 501(c)(4) exemption was questioned on examination. The GCM found that tax exemption for the corporation was prohibited under IRC 501(m) because it provided commercial-type insurance, which was a substantial part of its activities.

Courts also have consistently found that "insurance pools" created by groups of tax-exempt organizations are not themselves exempt under IRC 501(c)(3) or IRC 501(c)(4) if they assume and distribute the pertinent risk to such an extent that they provide "commercial-type insurance". As insurance is usually the sole purpose and function of such an entity, it is a "substantial" part of its activities. Thus, these organizations cannot qualify as exempt under IRC 501(c)(3) or IRC 501(c)(4). Even if they could, they would violate IRC 501(m), which ultimately would prohibit their exemption. See Paratransit Insurance Corporation v. Commissioner, 102 T.C. 745 (1994) (exemption denied an organization providing automobile liability insurance to a group of section 501(c)(3) private social service entities that used automobiles to furnish transportation for the elderly, handicapped, and others); Nonprofits' Insurance Alliance of California, 32 Fed.Cl. 277 (Cl. Ct. 1994) (exemption denied a group self-insurance risk pool created as a mutual benefit corporation to provide automobile and miscellaneous professional liability coverages to tax-exempt organizations that operate, fund, or provide health or human services; did not meet IRC 501(m) "substantially below cost" exception). However, exemption under IRC 501(c)(15) may be possible. (See Part II for a comprehensive discussion of IRC 501(c)(15)).

The Service has recognized exemption under IRC 501(c)(3) of an organization whose principal activity is administering risk management funds for a group of exempt organizations where it found that the activity was related to the organizations exempt purpose of lessening the burdens of government. In TAM 9541003, a school board association created an organization to administer five cash/risk management funds. The funds were created for workers' compensation coverage; property, casualty and professional liability insurance; unemployment compensation; employee benefits; and cash management accounts, respectively. On examination, the Service found that the activities of the

organization constituted a related business. The Service also stated that the facts did not support a concrete finding that the entity was providing commercial-type insurance and declined to make a 501(m) determination in the TAM.

5. IRC 501(e)

As noted in Section 2., above, the 1988 Act amended IRC 501(e) to permit cooperative hospital service organizations to purchase insurance on a group basis. The brief legislative history stated that "[t]he provision clarifies that the purchasing activities that may be carried on by a tax-exempt hospital service organization include the acquisition, on a group basis, of insurance (such as malpractice and general liability insurance) for its hospital members. The provision applies to purchases made before, on, or after the date of enactment." Technical and Miscellaneous Revenue Act of 1988 Conference Report (H.R. 4333, 100th Congress, 2d Session, Public Law 100-647, v. II, 209).

Revised IRC 501(6) does not sanction all insurance arrangements. The Eleventh Circuit recently affirmed a Tax Court decision in favor of the Service on an IRC 501(e) issue. In Florida Hospital Trust Fund v. Commissioner, 71 F.3d 808 (11th Cir. 1996), trust funds were established to serve as medical malpractice risk management trust funds or a group self-insurer fund for workers' compensation claims. Members of all three funds involved were exempt government or charitable hospitals. Member hospitals entered agreements to pool their respective risks and reciprocally self-insure. Exemption under IRC 501(c)(3) was denied all three funds based on their failure to satisfy both IRC 501(e) and IRC 501(m). In addition, all three funds were determined to be "feeders" under IRC 502. The Tax Court had found that the trust funds were not organized and operated exclusively for exempt purposes. 103 T.C. 140 (1994). In accordance with the Supreme Court's analysis in HCSC-Laundry v. U.S., 1 (1981), the enumerated activity requirement of IRC 501(e) should be strictly construed. In upholding denial, the Eleventh Circuit stated that "the member hospitals are not '*self*-insuring' themselves through these trusts. . . Neither are they 'purchasing' insurance on a group basis through these trusts . . . [Rather] . . . these member hospitals [are] *providing insurance to each other, on a reciprocal basis*, using trust vehicles as their chosen method of operation." 71 F.3d at 812, footnote omitted.

The Service has ruled that a group of employers that "jointly and severally" agree to pay premiums and set aside a cash reserve fund for workers' compensation claims could be taxed as an insurance company under IRC 831, even where the state called the arrangement "self-insurance". Rev. Rul. 83-172, 1983-2 C.B. 107. The arrangement in Rev. Rul. 83-172 was similar to the "group

self-insurer fund for workers' compensation claims" in Florida Hospital Trust. As the following discussion will show, however, being an insurance company as described in Subchapter L does not prohibit tax exemption. IRC 501(c)(15) allows exemption of very small nonlife insurance companies. Changes made by the 1986 Act have made requirements for IRC 501(c)(15) exemption easier to meet, which has created the potential for abuse by taxable companies and their owners.

## Part II: Issues Raised By IRC 501(c)(15)

### A. Introduction

The 1986 Tax Reform Act of 1986 (the 1986 Act) liberalized IRC 501(c)(15) in two important respects. It allowed stock as well as mutual companies to qualify for exemption in an attempt to create parity between stock and mutual insurance companies, and it changed the measure of the dollar ceiling from a gross receipts test to a premium income test. (The changes are discussed in more detail in the 1989 CPE text at pp. 167-172.) IRC 501(c)(15) now provides that insurance companies (other than life) are exempt from federal income tax if their net written premiums (or if greater, direct written premiums) for the taxable year do not exceed $350,000. Premiums from all members of the taxpayer's controlled group (as defined in IRC 1563, with modifications) are aggregated for purposes of the $350,000 test.

The 1994 CPE article "The Blitz Since '86", explained the '86 Act in detail and presented an overview of the significant problem areas that have arisen as a result of the expansion of IRC 501(c)(15) to cover small for-profit insurance companies. The 1994 article covered the following areas:

(1) the various elements of an insurance contract, and the problems resulting from extended service contracts/warranties;

(2) the nature of captive insurance companies and how to identify sham companies;

(3) the problem of companies in liquidation;

(4) the dynamics of the $350,000 test, and the related areas of IRC 845 and 1563; and

(5) the life insurance company prohibition.

The changes to IRC 501(c)(15) resulted in a dramatic increase in the number of exemption applications filed under that section. We now average receipt of almost 100 applications per year, whereas before 1987 we averaged approximately two applications per year.

Some of the IRC 501(c)(15) applicant organizations only underwrite or reinsure risks from businesses in which their shareholders have a controlling or financial interest. Such businesses usually, in connection with either the financing or the sale/rental of various goods and products like automobiles, VCRs, etc., sell either credit life and credit accident and health (A&H), or service/warranty contracts.

B. Risk Shifting and Risk Distribution

(1) Background

To qualify for recognition of exemption under IRC 501(c)(15), an organization's primary and predominant activity must be that of an insurance company engaged in the business of issuing and servicing insurance contracts. An insurance contract must shift and distribute a risk of loss, and that risk must be an "insurance" risk, as stated in Helvering v. LeGierse, 312 U.S. 531 (1941).

The Service currently makes a sharp distinction between risk shifting and risk distribution. Simply put, risk shifting requires that a risk pass away from the insured to the insurer. Risk distribution requires the pooling by the insurer of a number of independent risks.

The Service has a longstanding position that "self- insurance" arrangements do not involve risk shifting or risk distribution and, therefore, are not insurance. Thus, a business cannot set aside a fund as an "insurance" reserve and claim a business expense deduction for insurance premiums paid under IRC 162 and Reg. 1.162-1(a). *See* Anesthesia Service Medical Group, Inc. v. Commissioner, 825 F.2d 241 (9th Cir. 1987) and Spring Canyon Coal Co. v. Commissioner.

(2) "Captive" Reinsurers

Risk shifting issues frequently arise in the case of captives. In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), the court defined a "captive", in footnote 1 on page 1298, as

> a corporation organized for the purpose of insuring the liabilities of its owner. At one extreme is the case presented here, where the insured is both the sole shareholder and only customer of the captive. There may be other permutations involving less than 100% ownership or more than a single customer, although at some point the term "captive" is no longer appropriate.

In Rev. Rul. 77-316, 1977-2 C.B. 53, as amplified and clarified by Rev. Rul. 88-72, 1988-2 C.B. 31, and Rev. Rul. 89-61, 1989-1 C.B. 75, the Service addressed whether a subsidiary which "insured" the risks only of its parent and the parent's other subsidiaries was an insurance company for tax purposes. The Service concluded that the economic reality of the situation was that the insurance agreement with each subsidiary was designed to obtain a deduction for the parent and its other subsidiaries by indirect means that would be denied if sought directly (with a fund set aside for self-insurance). The parent, its "insurance" subsidiary, and its other subsidiaries, though separate corporate entities, represent one economic family, with the result that those who bore the ultimate economic burden of loss were the same persons who suffered the loss. Thus, there was no economic shifting or distributing of risk of loss to the extent that the risks were not retained by an unrelated insurance company. The Service reasoned that since the offshore captive was not an insurance company, the payments by the parent and the other subsidiaries were not deductible as business expenses under Reg. 1.162-1(a), and the payments were not income to the offshore captive from the conduct of a business, but were capital contributions. Thus, payments made by the offshore captive were dividends to the extent of its earnings and profits.

However, in Rev. Rul. 78-338, 1978-2 C.B. 107, the Service concluded that since a foreign insurance company's 31 shareholders, who were the company's only insureds, were not economically related, the economic risk of loss was shifted and distributed among the shareholders, thus insurance payments made by the U.S. shareholders were deductible as ordinary business expenses under IRC 162.

Rev. Rul. 88-72, 1988-2 C.B. 31, clarified by Rev. Rul. 89-61, 1989-1 C.B. 75, explains the difference between risk shifting and risk distribution. Risk shifting occurs where a risk is shifted away from a corporate parent and its subsidiaries. Risk distribution occurs when an insurance company accepts a large number of independent risks, and thereby takes advantage of a statistical phenomenon known as the "law of large numbers." Although the potential loss exposure increases, the average loss incurred becomes increasingly predictable.

(3) Deductibility of Premium Cases

There have been a number of court decisions involving whether amounts paid to an offshore captive are deductible under IRC 162, and whether the contracts issued by the offshore captive are insurance or annuity contracts within the meaning of Reg. 1.801-3(a)(1). *See, e.g.*, Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), cert. denied, 454 U.S. 965 (1981); Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985); Beech Aircraft Corp. v. United States, 797 F.2d 920 (10th Cir. 1986); and Clougherty Packing Co., supra. Some of the fact patterns in these court cases are virtually indistinguishable from the fact pattern in Rev. Rul. 77-316. In such cases the courts have usually upheld the government's position that such contracts are not contracts of insurance. However, no court has expressly adopted the Service's economic family doctrine espoused in Rev. Rul. 77-316.

As discussed in the 1994 CPE article on IRC 501(c)(15), taxpayers have won several cases on fact patterns falling somewhere between those of Rev. Rul. 77-316 and Rev. Rul. 78-338. Several courts have held, contrary to Rev. Rul. 88-72, that substantial insurance business with unaffiliated insureds creates a pool allowing for risk shifting as well as risk distribution with regard to premium payments by a parent to its insurance subsidiary. See Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed. Cir. 1993) (44-66% unaffiliated business); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992) (52-74% unaffiliated business); The Harper Group v. Commissioner, 979 F.2d 1341 (9th Cir. 1992) (29-33% unaffiliated business); and Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992) (99% unaffiliated business).

In Humana Inc. and Subsidiaries v. Commissioner, 88 T.C. 197 (1987), affirmed in part and reversed in part sub nom Humana Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989), the Sixth Circuit affirmed the Tax Court's finding that the parent's insurance payments on its own behalf were not deductible insurance premiums. However, the Sixth Circuit overruled the Tax Court in favor of the appellant with regard to the payment of insurance premiums by its other subsidiaries, finding such payments to be insurance premiums deductible by the subsidiaries.

In Gulf Oil Corp. v. Commissioner, 914 F.2d 396 (3d Cir. 1990), the facts showed that Gulf formed a Bermuda subsidiary with $120,000 capitalization. Gulf and its affiliates purchased insurance from commercial carriers who reinsured their risks with the Bermuda subsidiary. Gulf executed agreements with the unrelated carriers guaranteeing indemnification in the event of default

by the Bermuda subsidiary. The Third Circuit distinguished the Gulf situation from Humana in disallowing the deduction for the premiums paid by Gulf and its affiliates. Unlike Humana, Gulf formed a thinly capitalized foreign insurance captive and the parent company entered into indemnification agreements with the unrelated insurers.

Some courts, even though not expressly adopting the economic family doctrine, have issued decisions favorable to the Service on economic factors other than the relationship between the insured and the insurer. These economic factors include whether there is a legitimate business purpose for the establishment of the offshore insurance company; whether the offshore insurance company is thinly capitalized; and whether the offshore's parent has furnished a guarantee to unrelated primary insurers of the performance of the offshore insurance company.

For example, in Malone & Hyde Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995), the facts showed that Malone & Hyde (MH) formed an offshore insurance subsidiary, Eastland Insurance, Ltd. (EIL), to reinsure the first $150,000 coverage of the insurance MH obtained from Northwestern National Insurance Company (NNIC) for itself and its subsidiaries. In 1989 the Tax Court held MH was not entitled to a section 162 deduction for the premium payments made to NNIC that were reinsured with EIL. Malone and Hyde, Inc. and Subsidiaries v. Commissioner, T.C. Memo 1989-604. Because of the intervening Humana decision by the Sixth Circuit, the Tax Court agreed to a rehearing of Malone and Hyde. T.C. Memo 1993-585. The Service argued that the hold harmless agreements, irrevocable letters of credit, and EIL's thin capitalization distinguished the subject organization in Malone & Hyde from the subject organization in Humana. The Tax Court found in favor of MH on the brother-sister subsidiary issue, and, with respect to the section 162 deductibility issue, followed the three part test from AMERCO, Sears, and The Harper Group, supra, for determining whether a transaction involves insurance for income tax purposes. The three part test concerns (1) whether the transaction involved "insurance risks"; (2) whether there is risk shifting and risk distribution; and (3) whether there is insurance in its commonly accepted usage.

On appeal, the Sixth Circuit concluded that the Tax Court should have first determined whether MH created EIL for a legitimate business purpose, or determined whether EIL was a sham corporation. The Sixth Circuit concluded that MH had no legitimate business reason for establishing EIL, whereas in the Humana case, Humana could not obtain insurance in the open market and thus had a legitimate reason for establishing a controlled captive. Further, the Sixth Circuit concluded that EIL was thinly capitalized, which had not been the case

in Humana. The Sixth Circuit held that EIL, a thinly capitalized captive foreign subsidiary, was a sham corporation propped up by its parent, MH. The Sixth Circuit in Malone & Hyde distinguished Gulf Oil from Humana, and reasoned that the result in Humana would have been different if Humana had set up a thinly capitalized foreign captive and entered into indemnification agreements with unrelated insurers. The court found the MH facts to be more similar to Gulf Oil than to Humana. The court concluded that even though the foreign subsidiary (EIL) met the minimum capitalization requirements of its country of incorporation, there was no risk shifting. Thus, since there was no shifting and distribution of the risk of loss to unrelated parties, there was no insurance.

As indicated in the 1994 article, the Service ordinarily will not rule on whether the risk shifting and distribution necessary to constitute insurance are present for purposes of determining if a company is an "insurance company" under Reg. 1.801-3(a), unless the facts are within the scope of Rev. Rul. 77-316 or 78-338. Rev. Proc. 96-3, 1996-1 I.R.B. 82, 90, sec. 4.39.

If an IRC 501(c)(15) applicant's insurance or reinsurance contracts lack the necessary elements of risk shifting and risk distribution, then the applicant fails to qualify as an insurance company, and therefore fails to qualify under IRC 501(c)(15). Generally, an applicant's reinsurance contracts contain the necessary elements of risk shifting and risk distribution where the risks involved are credit life or credit disability risks. The Service's captive analysis in Rev. Rul. 77-316, does not apply to credit insurance contract cases because the producer of the credit insurance, which is reinsured by the applicant, only sells credit insurance contracts written by unrelated third party issuers, and is not the insured under such contracts. However, where the producer and the applicant are controlled by the same persons, and the producer issues extended service contracts which are clearly its own risks and these are the only risks "reinsured" by the IRC 501(c)(15) applicant, then it is more likely that the Service may successfully assert the captive analysis (commonly referred to as the economic family doctrine) under Rev. Rul. 77-316 to reach a conclusion that the applicant is not engaged in the insurance business.

Even though the courts have ruled unfavorably on the economic family doctrine, the Service will litigate some cases involving the factors of Malone & Hyde. The Service will be selective with respect to using a "sham corporation" theory for offshore captives. The "sham corporation" issue or argument may be more successful (or more likely in fact) where offshore captives, rather than domestic captives, are involved.

Inadequate capitalization is a major symptom of a sham corporation as reflected in Malone & Hyde. The pre-Humana line of cases, Carnation and Beach Aircraft, supra, involved the issue of an undercapitalized captive, however, the Service did not raise the sham corporation issue in these cases. The Humana case distinguished these cases in discussing the inadequate capitalization issue. Further, the Humana court stated that "[a]bsent a fact pattern of sham or lack of business purpose, a court should accept transactions between related but separate corporations as proper and not disregard them because of the relationship of the parties." It is currently felt that more corporate groups with an insurance subsidiary are set up like the Malone & Hyde family, while the specific facts of Humana represent the unusual case.

C. Sham Corporations

(1) Common Offshore Captive Uses in IRC 501(c)(15) Context

In addition to reinsurance companies formed by owners of automobile dealerships, in the last two years we have received a number of applications from offshore reinsurers established by owners of loan companies, auto rental companies, TV and VCR rental companies, and other property rental companies.

The automobile dealerships, loan companies, auto rental companies, TV and VCR rental companies, and other property rental companies (hereafter collectively referred to as the Producers) sell credit life, credit A&H, and extended service/warranty contracts to their customers. Under most state jurisdictions, the extended service/warranty contracts are not contracts of insurance, however, state law characterization of such an arrangement is not controlling for federal tax purposes. See e.g., Rev. Rul. 83-172, supra, (40 member self-insurance group considered an insurance company for federal income tax purposes). The 1994 CPE article sets out a fact pattern with respect to applicant organizations seeking exemption under IRC 501(c)(15). Usually, the applicant organization is a reinsurance company, incorporated in a foreign jurisdiction, and owned by a Producer, or by the Producer's owners, officers, or directors. The applicant foreign reinsurer usually has no paid employees and no property of its own other than a bank account and a ledger. Sometimes the applicant's place of business is the headquarters of the Producer. Some applicant foreign reinsurers hire an Administrator to receive communications and to perform certain clerical and administrative functions.

With respect to credit life and credit A&H insurance contracts, a Producer acts as an agent for the direct writer when he/she sells an insurance contract

to a customer. With respect to extended service/warranty contracts, a Producer generally will contract with an Administrator, who will furnish it with the service/warranty agreements and promotional material to distribute to the Producer's customers. The Producer or the Administrator then will purchase an insurance contract from a "fronting company", which will insure the Producer's liability under the extended service/warranty contract.

By prearrangement with the Producer, the fronting company keeps the premiums necessary to underwrite the risk, and sometimes keeps an administrative fee, and then passes the remaining premiums on to the offshore reinsurer. The Administrator of the service contracts keeps an administrative fee of 10 to 15 percent.

The offshore reinsurer establishes a reserve fund for the payment of insurance claims and invests the funds. Generally, no claim is ever made on the reserve fund since all claims are usually processed and paid by the fronting company with current premiums. It appears that the offshore reinsurer's primary function is to hold the profits from the sale of insurance or service contracts and to make distributions or loans to its shareholders.

Generally, the characteristics of a sham company are that it has no business address, paid employees, or property other than a ledger and bank account. *See* Shaw Constr. Co. v. Commissioner, 35 T.C. 1102 (1961), aff'd, 323 F.2d 316 (9th Cir. 1963); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959). See also Kimbrell v. Commissioner, 371 F.2d 897 (5th Cir. 1967). Such characteristics may, or may not be present in an offshore insurer, or reinsurer. However, the critical factors with respect to an offshore insurer, or reinsurer is whether such entity assumes and distributes risk.

(2) Business Purpose Cases

When organizations that have the characteristics of a sham company, as described in the paragraph above, apply for exemption under IRC 501(c)(15), the Service may treat them as sham corporations and deny exemption. In Wright v. Commissioner, T.C.M. 1993-328 (July 26, 1993), the Service sought to treat certain reinsurers as sham corporations, conducting no business and having no purpose other than sheltering their shareholders' income. In the alternative, the Service sought to treat the reinsurance arrangement as self-insurance by the dealership and to recharacterize the income under IRC 845(a) or IRC 482.

In Wright, a foreign corporation, First Interstate Re, Inc. (FIR), "reinsured" credit insurance contracts sold by auto dealerships owned by the owner of FIR, and received the profits from service contracts sold by the dealerships. The Tax Court held that FIR was a sham, formed to avoid tax on income earned by the dealerships. The court based its decision on the following circumstances: the dealerships requested a reduction in sales commissions (below the state maximum on sales commissions) which diverted income to FIR; FIR set up greater reserves than those mandated by state law, which had the effect of understating income; the dealerships failed to report their profits on the sales of service contracts above cost, but funneled such profits through the service contract administrators to FIR through overstatement of the dealer cost, without any contractual agreement with FIR; FIR's shareholder failed to keep FIR's funds separate from the dealerships, taking numerous distributions and loans from FIR, and replacing funds in its custodial account with a letter of credit from one of the dealerships; FIR had no offices, furniture, or equipment; FIR was capitalized with only $1000; some of the dealerships that sold contracts reinsured by FIR were not listed in FIR's reinsurance agreement; and although FIR purported to reinsure contracts sold by unrelated entities for several years, it was unable to substantiate that such unrelated business existed.

The court distinguished the Wright situation from Alinco Life Ins. Co. v. United States, 373 F.2d 336 (Ct. Cl. 1967), on the grounds that in Wright, the dealerships received less commission than allowed by law; that FIR was not a qualified insurance company under state law and did not keep appropriate reserves; and that the only insurance policies reinsured by FIR were those sold by the related dealerships.

The Wright court also found two instances in which the purported "insurance" failed to shift and distribute risk and thus failed to qualify as insurance for federal tax purposes:

First, with regard to the "reinsurance" by FIR of the credit insurance contracts sold by the auto dealerships, the court reasoned that the dealerships were in effect the insureds under the credit policies, and a brother company (FIR) was the insurer. The court noted that FIR insured no unrelated business, and that one of the dealerships issued a letter of credit to the primary insurer.

Second, the court held that there was no risk shifting or distribution with regard to annuities purchased by an unrelated insurer of service contracts sold by the dealerships. Each annuity was used only for a single dealership's liabilities, the dealerships received the interest earned on the annuities, and the dealerships were entitled to the balance of the annuity proceeds after the

service contracts expired. These decisions in the Wright case were appealed to the Ninth Circuit.

The Tax Court modified the above decision in the Wright case by Order dated October 29, 1993, to, in effect, correct the inference that "the [Wright] dealerships were in effect the insureds under the credit policies".

On appeal (William T. and Lynne L. Wright, et. al. v. Commissioner 76 A.F.T.R.2d 95-8096 (9th Cir. 1995)), the Ninth Circuit found that there was ample evidence to support the Tax Court's findings that the taxpayers formed a sham reinsurance company to avoid taxes, fraudulently understated income, and claimed erroneous deductions and false annuity payments.

As indicated above in Malone & Hyde, the Sixth Circuit concluded that MH had no legitimate business reason for establishing EIL, whereas in the Humana case, Humana could not obtain insurance in the open market and thus had a legitimate reason for establishing a controlled captive. Further, the Court concluded that even though EIL, the foreign subsidiary, met the minimum capitalization requirements of its country of incorporation, there was no risk shifting. Since there was no shifting or distribution of the risk of loss to unrelated parties, there was no insurance.

D. Controlled Groups

The 1994 CPE article on IRC 501(c)(15) contained a lengthy discussion of the term "controlled corporations". As noted in the discussion, the term "controlled group" is defined in IRC 831(b)(2)(B)(ii), which in turn employs the definition of "controlled group of corporations" in IRC 1563(a), with certain modifications. IRC 501(c)(15)(B) provides for the aggregation of the net and direct written premiums received during the tax year by all other companies or associations which are members of the same controlled group. IRC 501(c)(15)(C) provides that for purposes of subparagraph (B), the term controlled group has the meaning given such term by IRC 831(b)(2)(B)(ii).

IRC 831(b)(2)(B)(ii) provides that:

> [f]or purposes of clause (i) the term 'controlled group' means any controlled group of corporations (as defined in section 1563(a)); except that -
>
> (I) 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a), and
>
> (II) subsections (a)(4) and (b)(2)((D) shall not apply.

Please note that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" each place it appears in section 1563(a). The 1994 CPE article erroneously quoted the phrase as "at least 50 percent".

As indicated in the 1994 CPE article, IRC 1563(a) provides for three types of controlled groups: parent-subsidiary, brother-sister, and combined. Hypothetical examples of these types of controlled groups were set out in the 1994 article.

We see the brother-sister type of group most. To determine whether two corporations are brother-sister corporations, we must apply the constructive stock ownership rules under IRC 1563(a).

IRC 1563(a)(2) defines the term "brother-sister controlled group" to mean:

> [t]wo or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing-- ... (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each corporation.
>
> IRC 1563(d)(2)(B) states that:
>
> [f]or purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations ... stock owned by a person who is an individual, estate, or trust means (A) stock owned directly by such person, and (B) stock owned with the application of subsection (e).

IRC 1563(e)(5) states, in pertinent part, that an individual shall be considered as owning stock in a corporation owned directly or indirectly by or for his spouse.

IRC 1563(e)(6)(A) states, in pertinent part, that an individual shall be considered as owning stock owned directly or indirectly by or for his children who have not attained the age of 21 years; and if the individual has not attained the age of 21 years, the stock owned directly or indirectly by or for his parents.

IRC 1563(e)(6)(B) states, in pertinent part, that an individual who owns 50 percent or more of the shares of stock in a corporation shall be considered as owning the stock in such corporation owned directly, or indirectly by or for his parents, grandparents, grandchildren and children who have attained the age of 21 years.

Three hypothetical situations follow that illustrate application of the constructive stock ownership rules set out above.

### SITUATION I

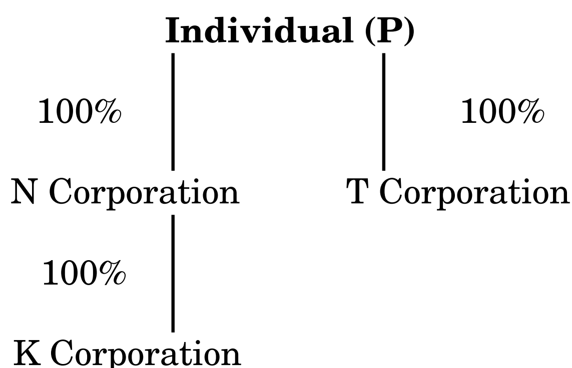
Two brothers **A** and **B** each own 50% of a Producer, which sells credit life, credit A&H and service warranty contracts to its customers. **A** has a 50% interest in **X**, an offshore insurance company, and a Family Trust in which **A** is the beneficiary owns the other 50% of **X.** **B** has a 50% interest in **Y**, an offshore insurance company, and a Family Trust in which **B** is the beneficiary owns the other 50% of **Y.** **X** and **Y** each reinsure 50% of the service warranty contracts sold by the Producer. **A** and **B** each own 50% of **Z** an offshore insurance company, that reinsures the credit life and credit A&H sold by the Producer. Because **A** has no interest in **Y**, and because **B** has no interest in **X**, then pursuant to IRC 1563, **X**, **Y** and **Z** are not controlled corporations within the meaning of IRC 1563.

### SITUATION II

A son and mother, **S** and **M** each own 50% of **O**, an offshore insurance company. **S** and his wife **W**, and **M** and her husband **H**, each own 25% of **P**, a Producer which sells service warranty contracts to its customers. Because **S** and **W** are husband and wife, and because **M** and **H** are husband and wife, under IRC 1563(e)(5) **S** is treated as owning **W**'s shares in **P**, and **M** is treated as owning **H**'s shares in **P**. Thus, both **S** and **M** are each treated as owning 50% of **P**. **O** and **P** are controlled corporations within the meaning of IRC 1563.

## SITUATION III

N owns 100% of **K**, an offshore insurance company. **K** only insures **T**. **N** and **T**'s sole owner is **P**. This is an example of a combined group. A diagram of this relationship would reflect the following:




**N**, **K**, and **T** are members of a combined group.

E. Current Developments

(1) Tax-avoidance Reinsurance Transactions

The 1994 CPE article discussed the implications of IRC 845(b), which authorizes the Secretary to make proper adjustments, in the case of any reinsurance contract having a significant tax avoidance effect, to eliminate the tax avoidance effect with respect to a party to the contract.

For example, the 1994 CPE article referred to TAM 9308003, in which the Service ruled that two reinsurance agreements had a significant tax avoidance effect, and therefore disregarded them in determining whether the reinsurance company qualified as a life insurance company. The reinsurance assumed had the effect of increasing the life reserves to greater than 50% of total reserves, and thus would have allowed the company to be taxed as a life insurance company had the reinsurance contracts not been disregarded.

In a court opinion dated April 30, 1996, in Trans City Life Insurance Company v. Commissioner, 106 T.C. No. 15, the Tax Court cited the Deficit Reduction Act of 1984 conference report (H.R. Conf. Rep. No. 861, 98th Cong., 1st Sess. 1062 (1984), 1984-3 C.B. 316) wherein it was stated that "[a] tax avoidance effect must be significant to one or both of the parties to a reinsurance agreement in order for the Commissioner to exercise her authority to make adjustments under section 845(b)." Further, the DEFRA conference report

stated that a tax avoidance effect is significant "if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties." The DEFRA conference report then set forth seven factors that help determine an agreement's economic substance. These factors include the following:

(a) the age of the business reinsured (reinsurance of a new block of insurance contracts has more economic substance than an old block);

(b) the character of the business reinsured (reinsurance of long-term insurance has more economic substance than short-term);

(c) the structure for determining the potential profits of each of the parties, and any experience rating;

(d) the duration of the reinsurance agreement;

(e) the parties' rights to terminate the reinsurance agreement, and the consequences of a termination;

(f) the relative tax positions of the parties; and

(g) the general financial situations of the parties.

In the opinion of Trans City, supra, the Tax Court discussed each of the above seven factors. Additionally, the Tax Court discussed an eighth factor, "risk transferred versus tax benefits derived", and a ninth factor, "state determinations". We are not sure what relative merit should be given to the eighth and ninth factors since they were not part of the DEFRA conference report.

In conclusion, the Tax Court ruled that IRC 845(b) is not unconstitutionally vague and that the Commissioner may rely upon IRC 845(b) prior to the issuance of regulations. However, the Tax Court concluded that the factors showed that the agreements in the Trans City case did not have a "significant tax avoidance effect" within the meaning of IRC 845(b).

The significance of Trans City is that IRC 845(b) has been ruled not to be unconstitutionally vague and that the Commissioner may rely upon IRC 845(b) prior to the issuance of regulations. The Service has not made a decision on what action to take in the Trans City case.

(2) Administration's Fiscal 1997 Budget Proposal - Captive Insurance Company Provisions

President Clinton's proposed fiscal 1997 budget includes provisions reforming the tax treatment for captive insurance arrangements. The proposed legislation creates a new code section, IRC 849, and includes a restriction on IRC 501(c)(15) exemption. The proposed legislation of March 1996 would amend Subchapter L (Insurance Companies) and Subpart F (Controlled Foreign Corporations) provisions, as well as IRC 501(c)(15).

a. Current Tax Treatment of Foreign Captives and their Domestic Shareholders

IRC sections 951 through 964 comprise Subpart F - Controlled Foreign Corporations. IRC 957(a) defines CFCs as foreign corporations in which more than 50 percent of the total combined voting power of all classes of stock or of the total value of the stock of the corporation is owned by United States shareholders on any day of the CFC's taxable year. The definition also includes corporations in which more than 25 percent of the total combined voting power of all classes of stock, or more than 25 percent of the total value of the stock is owned directly, indirectly or constructively by U.S. shareholders if the gross amount of premiums with respect to the issuing or reinsuring of an insurance or annuity contract exceeds 75 percent of all premiums.

IRC 951(a)(1)(A) provides that a U.S. shareholder of a CFC must include in gross income his *pro rata* share of the CFC's Subpart F income for the year, even if not distributed. IRC 952(a) defines the term "Subpart F income" to include "insurance income" and "foreign base company income" of the U.S. shareholder.

Pursuant to IRC 953, insurance income is income attributable to the issuing or reinsuring of any insurance or annuity contract that covers risks located outside the CFC's country of incorporation, which would be taxed under Subchapter L (Insurance Companies) if the CFC were a domestic company. IRC 953(b) makes certain adjustments to the normal Subchapter L rules, and IRC 953(c) prescribes special rules for certain captive insurance companies. IRC 953(d) allows an election by a foreign insurance company to be treated as a domestic corporation.

IRC 954(a)(1) defines foreign base company income to include foreign personal holding company income. IRC 954(c)(1)(A) includes dividends, interest, royalties, rent and annuities in foreign personal holding company income.

b. Administration's Proposed Changes

The March 1996 legislative proposal would amend Subchapter L rules to treat as derived from a business other than insurance amounts paid as "premiums" by large shareholders (or persons related to large shareholders) from the calculation of insurance premiums in applying a "primary and predominant business activity" test, which would be used to determine whether the captive is an insurance company. If a captive qualifies as an insurance company under this "primary and predominant business activity" test, premiums paid to the captive by its shareholders for *bona fide* insurance would be deductible to the extent that such amounts are deductible under current law.

If, however, a captive failed to qualify as an insurance company under the primary and predominant business activity test, amounts paid as "premiums" by its large shareholders (or persons related to its large shareholders) would not be deductible to them and would be excluded from the captive's gross income, and the captive would not be subject to Subchapter L. However, premiums paid by small shareholders or unrelated policyholders would continue to be deductible and would continue to be included in the captive's gross income. IRC 501(c)(15) would explicitly be made inapplicable to persons not treated as insurance companies under the new IRC 849 described above.

It is currently unclear if, when, or in what final form provisions reforming the captive insurance company area will become law.

(3) Subpart F Implications for Exempt Organizations

Under the current law of Subpart F, if exempt organizations are U.S. shareholders with respect to Controlled Foreign Corporations (CFCs), there may be an issue of whether the Subpart F income is unrelated business taxable income (UBTI). IRC 511 imposes the corporate rate tax on the UBTI of exempt organizations. IRC 512(a) generally defines UBTI, and IRC 512(b)(1) excludes dividends, interest, payments with respect to securities loans, and several other items of income from UBTI. IRC 512(b)(13) requires that interest, annuities, royalties, and rents derived from an organization controlled by a controlling exempt organization must be included in income. Thus, whether a Subpart F exclusion is UBTI depends upon how it is characterized. Rulings issued by the Service have adopted one of two separate approaches for characterizing a Subpart F inclusion for UBTI purposes.

Under one approach, the Subpart F inclusion is treated as a dividend. For example, in PLR 9024086 (March 22, 1990) an exempt organization's wholly

owned insurance company derived investment income from international arbitrage transactions, which was Subpart F income. The ruling held that the Subpart F income was excluded from UBTI under IRC 512(b)(1). The ruling stated that the Subpart F inclusion would be treated as if it were a dividend for UBTI purposes. With dividend treatment the income would not be subject to the "controlled organization" income inclusion rules of IRC 512(b)(13).

The other approach is a look-through approach. Under this approach the Subpart F inclusion is UBTI only to the extent the Subpart F income would have been UBTI if earned directly by the tax-exempt entity. PLR 9043039 (July 30, 1990) ruled that the CFC was not an insurance company for tax purposes because it only self-insured the controlling exempt organization. Therefore, the ruling letter concluded, the CFC's "premium" income is not treated as insurance income for Subpart F, but rather is treated as contributions of capital under IRC 118. The CFC's Subpart F income therefore consisted entirely of investment income. Under the look-through approach, if the tax-exempt entity had earned the income directly it would have been excluded from UBTI. Therefore, the Subpart F income was excluded under IRC 512(b)(1) and IRC 512(b)(5) for UBTI purposes.

The last letter considering this UBTI issue, PLR 9407007 (November 21,1993), looked at whether "premiums" the tax exempt parent paid to its captive constituted UBTI to the parent. That letter ruled that there was no "insurance" under the arrangement. The payments were treated as a dividend for purposes of the UBTI exclusion. The letter did not rule on the treatment of the captive's investment income. Based on the apparent return to the "dividend theory", it is probably not advisable to set up cases on the look-through theory at this time.

(4) <u>More Proposed Legislation Affecting Other Exempt Organizations' Insurance Activities</u>

A statutory provision for the exemption of state-sponsored organizations providing health coverage for high-risk individuals is included in the Senate-passed version of the Health Insurance Reform Act, H.R. 3103 (S. 1028). The legislation creates a new exemption section, 501(c)(26), for membership organizations established by states exclusively to provide coverage for medical care on a not-for-profit basis to certain individuals, either through insurance issued by the organization or a health maintenance organization. The individuals covered by these "high-risk pools" must be state residents unable to acquire medical care coverage, or able to acquire that coverage at an excess rate only, for certain medical conditions. The net earnings of the organization cannot

inure to the benefit of any private shareholder or individual. The provision would be effective for taxable years beginning after 1996.

(5) Summary

The 1994 CPE Article summarized various qualification requirements areas that must be examined when considering whether to grant exemption under IRC 501(c)(15), or when considering whether exemption under IRC 501(c)(15) should be continued or revoked. Specifically, the following qualification requirements should be considered:

(i) To be exempt under IRC 501(c)(15), an organization's primary business must be the issuance of insurance contracts or reinsurance of risks, or the servicing of liquidating claims if the organization is in liquidation;

(ii) Certain applicant organizations, such as organizations that primarily reinsure service contracts and/or seller's warranties issued by related Producers, might not be considered insurance companies because of a lack of risk shifting and risk distribution, which would disqualify them from exemption under IRC 501(c)(15);

(iii) Under some circumstances reinsurers of insurance contracts, which are sold by related persons, may be regarded as sham corporations, which will disqualify them from exemption under IRC 501(c)(15);

(iv) Applicant organizations which receive more than $350,000 in net written or direct written premiums (including premiums of the members of any controlled group) are disqualified from exemption under IRC 501(c)(15); and,

(v) Applicant organizations that are life insurance companies, as defined in IRC 816, are disqualified from exemption under IRC 501(c)(15).

As previously noted, the owners of other types of businesses, in addition to automobile dealerships, have established offshore insurance companies to reinsure the insurance contracts sold by their businesses. These businesses include loan companies, auto rental companies, TV and VCR rental companies and other rental companies. When examining the corporate returns of such businesses, an agent should inquire about the interest of the business owner in any offshore insurance company.

If the business owner has an interest in an offshore insurance company, information about the status of such offshore insurance company under IRC 501(c)(15) and its election under IRC 953 should be obtained. If the offshore

insurance company is exempt under IRC 501(c)(15), consideration should first be given to whether it continues to meet the threshold requirements for exemption. Secondly, it should be determined whether the contracts the offshore insurance company reinsures are, in effect, contracts of insurance.

If the offshore insurance company meets the threshold requirements for exemption under IRC 501(c)(15), and the contracts which it reinsures are purportedly contracts of insurance, then consideration should be given to whether there is any shifting or distribution of the risk from the insured to the insurer.

In addition, it should be determined whether there was a legitimate business purpose for establishment of the offshore insurance company. The factors present in the Malone & Hyde and Wright cases should be scrutinized to determine whether there was a legitimate business purpose for the formation of the offshore insurance company. It should be kept in mind that Wright is fact sensitive and that Malone & Hyde is the preferred case for this issue.

If the offshore insurance company has the characteristics of a "sham company" (no business address, paid employees, or property other than a ledger and bank account) and otherwise comes within Malone & Hyde and Wright, proposed revocation under IRC 501(c)(15) may be in order.

The constructive ownership rules under IRC 1563 should be used to consider whether the Producer of the insurance products and the offshore reinsurance company are "brother-sister" corporations.

When an agent concludes that there is a significant tax avoidance effect with respect to a reinsurance agreement, and gives consideration to making adjustments as provided for in IRC 845(b), the agent should critically analyze the pertinent facts to determine whether there is any economic substance to the agreement. This should be accomplished by determining whether any or all of the factors set out in Trans City are present in the case, specifically the seven factors contained in the DEFRA conference report.

If the agent decides that exemption should continue, consideration should be given to whether any of the CFC's Subpart F income is UBTI as discussed in Part II, section E.(3).

Finally, if the Administration's proposed changes (as set out in Part II, section E.(2)(b)) with respect to the treatment of CFCs is enacted, these changes would effect exemption under IRC 501(c)(15) of most, if not all CFCs, and could result in the prospective revocation of many current CFCs exempt under IRC 501(c)(15).

## O. UBIT: CURRENT DEVELOPMENTS

by
Bree Ermentrout and Charles Barrett

### 1. Introduction

The area of unrelated business income tax ("UBIT") continues to be both challenging and ever changing. In recent years, our CPE texts have contained various articles devoted to individual aspects of UBIT, such as royalties, associate member dues, sale of land, travel tours and corporate sponsorship.[1] These topics seem to be of perennial interest to exempt organizations and their representatives, who are interested in minimizing any potential tax liability through utilization of the many exceptions and modifications contained within the statutory construct. As organizations seek to uncover new sources of revenue to meet increasing needs, some of the more basic concepts within UBIT, such as what is a "trade or business" and whether an activity meets the "substantially related" test, merit renewed attention.

The purpose of this topic is to update previous CPE text discussions concerning a wide range of developments in the UBIT area. This topic will focus on relatively recent judicial opinions and administrative actions. These decisions have been grouped into such areas of interest as royalties, mailing lists and "affinity" credit cards, associate member dues, advertising, sale of real estate, and certain other activities, including insurance, museum gift shop sales and travel programs.

### 2. Sierra Club ("SC")

On June 20, 1996, the Court of Appeals for the Ninth Circuit decided Sierra Club, Inc. v. Commissioner, 1996 U.S. App. LEXIS 14869 ("SC III.") Confirming the Service's position that there is a distinction between payments for services and payments for the right to receive an intangible property right, the court held that royalties in IRC 512(b)(2) are defined as payments received for the right to use intangible property rights, and that royalties do not include payments for services. Based on this definition, the Court of Appeals upheld the decision of the Tax Court and found that income from mailing list rentals

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[1] Proposed regulations addressing corporate sponsorship have not yet been finalized. See Prop. Treas. Regs. 1.513-4.

constituted royalty income. The Ninth Circuit also reversed and remanded to the Tax Court the issue of whether SC received royalty income from an affinity credit card program.

A. Background

IRC 512(b)(2) excludes royalties from the computation of unrelated business taxable income. However, the term "royalty" is defined in neither the statute nor the regulations. Reg. 1.512(b)-1 states generally that whether a particular item of income falls within any of the modifications provided in IRC 512(b) shall be determined by all the facts and circumstances in each case. More specific guidance as to the definition of a royalty can be found in Rev. Rul. 81-178, 1981-2 C.B. 135, which states the following:

> Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.... Similarly, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily characterized as royalties.... On the other hand, royalties do not include payments for personal services.

As discussed in the 1994 CPE text at p. 114, SC is an organization described in IRC 501(c)(4) that was formed to protect and restore the natural and human environment and promote responsible use of the earth's ecosystem. SC maintains mailing lists complete with donor and member information. To expand its data bank, SC exchanged its lists with other organizations. In addition, it permitted other organizations to use its lists for a fee. Although SC contracted with others to maintain and administer the rentals, it set the rates for the list rentals and retained the right to review and approve all rental requests as well as proposed materials and schedules for user mailings.

In addition to revenues received from renting out its mailing list, SC also derived income from an affinity credit card program. Pursuant to agreements with commercial enterprises, the organization's name and logo were used in marketing a credit card. In the Service's view, SC actively endorsed and marketed the credit card, while retaining rights to approve all promotional material. Fees were paid to the organization based on the total sales volume generated by cardholders. Solicitations for the credit card were sent by mail to the organization's members under the SC letterhead. The organization disagreed with the Service's conclusion that the amounts in question constituted unrelated business taxable income.

SC brought action in the Tax Court with respect to amounts attributable to both mailing lists and affinity credit cards.

B. Mailing Lists

The Service has taken the position that income from the regular sale of membership mailing lists by an exempt organization is subject to the unrelated business income tax and is not a royalty under IRC 512(b)(2). The Tax Court, however, has not adopted this position. In Sierra Club, Inc. v. Commissioner, T.C. Memo. 1993-199 ("SC I"), the Tax Court held that the exchange of mailing lists, regardless of the tax status of the organizations involved, is a transaction which produces royalty income that is excludable from unrelated business taxable income. The Service argued that the legislative history of the unrelated business income tax indicated that only investment income was intended to be excluded as a royalty under IRC 512(b)(2). The Service also argued that IRC 513(h)(1)(B), while not generally applicable to IRC 501(c)(4) organizations, revealed Congressional intent that income received from mailing lists constituted unrelated business taxable income, absent an explicit exemption. IRC 513(h)(1)(B) states that exchanges or rentals of mailing lists between organizations, both of which are eligible to receive tax deductible contributions, do not constitute unrelated trade or business. Thus, an exchange of mailing lists between two IRC 501(c)(3) entities is not taxable. If, however, the exchange is, for example, between an IRC 501(c)(3) organization and an IRC 501(c)(6) entity, the exception is not available because the former may receive deductible contributions, but the latter may not. (For a more detailed review of the taxability of mailing lists, see the 1993 CPE text at p. 69.)

Notwithstanding the holding of the Tax Court in SC I, the Service's administrative position did not change. The continuity of this position is evidenced by TAM 95-02-009 (November 10, 1994), which held that the exchange of mailing lists between a nonprofit and other organizations generates unrelated business taxable income. This case involved an organization described in IRC 501(c)(4) that made its mailing list available on a reciprocal basis to other organizations. It used a commission paid broker for this purpose. The organization, whose mailing list was one of its most important assets, employed five individuals to maintain the list, remove stale names and add new ones. Because the exchange was not between exempt organizations to which contributions are deductible, the IRC 513(h)(1)(B) exception did not apply. The TAM concluded that the provision of mailing lists for a fee, whether for a cash payment or something of value, does not further exempt purposes. The TAM cited Disabled American Veterans v. United States, 227 Ct. Cl. 474, 650 F.2d 1178 (Ct. Cl. 1981) ("DAV I") and found that the extensive business activity in question precluded royalty treatment.

C. Affinity Credit Cards

One year after the Tax Court's opinion in SC I concerning mailing lists, the Tax Court addressed the issue of "affinity" credit cards. In Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994) ("SC II"), the Tax Court held that the revenue from an affinity credit card program did not constitute unrelated business income. Such credit card programs typically involve agreements between a for-profit and an exempt organization. Pursuant to one or more agreements, an exempt organization will authorize a credit card issuer to use the organization's name and logo in marketing the card to the organization's members along with access to the organization's mailing list. In return, the issuer typically pays a fee to the exempt organization.

In SC II, as noted earlier, the organization entered into an arrangement with American Bankcard Services (ABS) under which ABS would offer a credit card using SC's name and logo in marketing the credit card to SC members and supporters. ABS agreed to pay SC a fee based on the total sales volume generated by cardholders. SC also entered into an agreement with Chase Lincoln Bank, which would issue the credit cards, and SC would actively endorse and market the cards. Card solicitations were mailed to SC members under the SC letterhead, and SC retained rights to approve all promotional material. After examining the business activities of SC, the Tax Court concluded that no joint venture existed and that SC was not engaged in the business of selling financial services to its members. Further, the Tax Court concluded that revenues received by SC as part of its affinity card program were not received as compensation for services, but as payment for an intangible property right. Such compensation therefore constituted royalty income under IRC 512(b)(2).

In Alumni Association of the University of Oregon, Inc. v. Commissioner, T.C. Memo. 1996-63, the Tax Court adhered to its position that income produced from an affinity credit card program constitutes royalty income. The Tax Court held that a university alumni association's income from an affinity credit card program was royalty income and, as such, not unrelated business income.[2] The Alumni Association (the "Association") participated in an affinity credit card program to promote the University of Oregon among alumni and the general public, to provide a low cost credit card to alumni and University of Oregon supporters, and to provide revenue for its programs. The Association entered into an agreement with the United States National Bank ("USNB"), under which USNB agreed to provide announcements regarding activities and alumni

[2] The facts, analysis and conclusion in this case are essentially identical to those in Oregon State University Alumni Association, Inc. v. Commissioner, T.C. Memo. 1996-34.

news at USNB's expense and to place a full color advertisement in the Association's publication at the standard rate at least twice annually during the term of the agreement. In return, USNB received a list of names, addresses and graduation dates of alumni and the license to use the name, logo and official seal of the University of Oregon. In addition, the Association agreed to inform its members of the affinity credit card program, at its expense, at least once per year.

The court concluded that USNB paid for a valuable intangible property right, i.e., the Association's logo, a registered trademark. In doing so, the court distinguished DAV I, where the court held that the organization conducted a trade or business of renting its mailing list. DAV continuously rented its mailing list and employed two full-time employees to administer its rental lists. In contrast, the Association did not regularly rent its mailing list and devoted minimal time to the affinity card program. Finally, although the Association had a desire and intent to make money, it is not the expectation of gain which is dispositive, but whether a taxpayer engages in an "activity with continuity and regularity, and the primary purpose for engaging in the activity must be for profit."

The Service's administrative approach in the area of affinity credit cards can be found in TAM 95-09-002 (September 30, 1994). This case involved an organization described in IRC 501(c)(6), whose members were in a certain field of medical practice, and which had an affinity credit card program. For this purpose, the organization agreed to make its mailing list available to another entity three times per year, as well as actively promote the affinity card program among its members for a fee. The TAM concluded that such payments were not royalties and constituted unrelated business taxable income, based on the active promotion of the lists among the organization's members.

D. Court of Appeals Decision

In SC III, supra, the Court of Appeals for the Ninth Circuit took the opportunity to define "royalty." The Ninth Circuit first reviewed various definitions of royalties, including definitions from Webster's, Black's Law Dictionary and Rev. Rul. 81-178, supra. The court, however, was persuaded by the decisions of other courts, including DAV I, and Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995), Section 7, infra, which distinguished between payments for services and payments for the right to use an intangible property right. In addition, the court considered the purpose behind the unrelated business income tax. It noted that the tax, intended to level the playing field between exempt and taxable businesses, excludes categories of income "passive" in nature and hence less likely to create competition for taxable businesses.

Addressing the mailing list issue first, the Court of Appeals affirmed the Tax Court decision and concluded that SC received royalty income. In so concluding, the court noted that SC neither performed services relating to the mailing list rental nor marketed the mailing lists. SC merely collected a fee for the mailing list rental. The court, rejecting the argument that any active marketing activity would convert a royalty into a non-royalty, specifically noted that SC's activity in connection with the rental of its mailing list was substantially less than the amount of activity which other courts had found to preclude a finding of royalty income: "To hold otherwise would require us to hold that any activity on the part of the owner of intangible property to obtain a royalty renders the payment for the use of the right UBTI and not a royalty."

The Ninth Circuit's decision leaves unanswered the question of what services an exempt organization can perform in connection with mailing list rentals and still treat the income from them as royalty income. Although the court rejected the Tax Court's all inclusive definition of royalties as including "active" and "passive" income, it did not state what activities will cause an organization to have unrelated business taxable income. The court rejected the Government's argument that paying others to perform services does not change the reality that an exempt organization is engaged in the business of selling and marketing mailing lists. The court further ignored the significant review and approval rights maintained by SC.

The court in SC III also addressed the issue of whether income from an affinity credit card program constitutes unrelated business income. The Tax Court had earlier granted SC's motion for summary judgment on the question of whether income generated by the affinity card program constitutes royalties, concluding that the agreements entered into by SC were name and logo licensing agreements. Finding that the agreements were unclear as to whether they were licensing agreements or agreements for services, and that the Tax Court had failed to interpret the agreements in the light most favorable to the Service, the court reversed the partial grant of summary judgment and remanded the case to the Tax Court. As a result, we can anticipate at least an SC IV.

At the time this article was being prepared, no decision had been made as to what action, if any, the Government might take with respect to this case.

3. <u>Other Royalty Issues</u>

In PLR 95-52-019 (September 27, 1995), an IRC 501(c)(3) organization entered into an agreement whereby it was licensed, for a fee, to occupy land around a lake to be used for fishing. The organization planned to sell fishing

passes to the public and distribute revenue to its client social service and welfare agencies. Fishing passes entitled their owners to take fish, and to use parking and restroom facilities, a boat ramp and docks. The organization policed and supervised the area as well as provided utilities and trash removal. The ruling noted that the operation of the fishing facility was on a fee-for-service basis, with a fee charged that was similar to an admission fee to a private recreation center. The admission fee could not be characterized as a payment for the use of a valuable right, producing royalty income, but was more like a fee for the provision of services. Accordingly, the ruling concluded that the amounts in question constituted unrelated business taxable income.

PLR 95-03-024 (October 26, 1994) involved an IRC 501(c)(4) organization formed to participate in a federal program to provide certain groups in economically distressed Bering Sea coastal communities of Alaska with the opportunity to receive an allocation of the annual pollock fishing harvest off the coast of Alaska. The organization promoted the social welfare of the residents of the member communities. Pursuant to a requirement imposed by the State of Alaska, the organization entered into an agreement with an outside fish processing company whereby the company would harvest, process and market the quota in exchange for a royalty payment to the 501(c)(4). This company planned to make royalty payments based solely upon the number of metric tons of pollock harvested and a supplemental royalty amount based on the pollock roe produced and sold from the pollock harvest. The 501(c)(4) did not participate at all in harvesting, processing, or marketing. Relying on Rev. Rul. 81-178, supra, the ruling concluded that the revenues derived from the sale of the pollock allocation rights were royalties because they derived from the sale of a valuable right, and because the organization was not required to render any services in connection therewith.

4. Associate Member Dues

Tax-exempt organizations may offer their members various products and services which are conditioned upon membership status. For example, it is not unusual for a tax-exempt organization that provides group insurance to offer associate or limited membership categories to individuals interested solely in insurance rather than full membership rights. (For a more detailed discussion of associate member dues, see the 1995 CPE text at p. 67.)

The application of the unrelated business income tax to exempt organizations with associate members has become a recurrent theme. Rev. Proc. 95-21, 1995-1 C.B. 686, discusses an organization described in IRC 501(c)(5) that received income from associate member dues. The revenue procedure provides

that dues payments from associate members will not be treated as gross income from the conduct of an unrelated trade or business unless the associate member category was formed or availed of for the principal purpose of producing unrelated business income. To make this determination, the line of inquiry will focus on the purposes and activities of the organization rather than of its members.

It is expected that additional guidance will be forthcoming regarding the treatment of associate member dues. The 1996 Treasury Department-Internal Revenue Service Priorities List for Tax Regulations and Other Administrative Guidance provides that guidance on the unrelated business income tax treatment of associate member dues paid to IRC 501(c)(6) organizations is a priority.

National League of Postmasters of the United States v. Commissioner, T.C. Memo. 1995-205, aff'd, 86 F.3d 59 (4th Cir. 1996) provides yet another example of the attention focused on unrelated business income and associate member dues. The National League of Postmasters of the United States (the "NLP") was formed to assist postmasters to improve professionalism and professional skills and to protect the employment rights of postmasters. The organization sponsored a health insurance plan available to all federal employees and retired federal annuitants eligible for benefits under the Federal Employees Health Benefits Program (the "FEHBP"). Because of restrictions against providing benefits to nonmembers, the NLP created a special class of members to whom it provided access to its health plan as well as certain other limited benefits. This special class received limited voting rights. The Tax Court focused on the issue of whether the trade or business of servicing this special class contributed importantly to the accomplishment of the organization's exempt purpose, so as to meet the "substantially related" test. It asked, "whether the manner in which petitioner conducted its ... activity during those years evinces its intention to use that activity for the purpose of contributing importantly to the accomplishment of any of its exempt purposes or whether that manner manifests its intention to raise revenue."

The NLP argued that since the members of the special class were in fact bona fide members of the NLP, that in itself would suffice to conclude that the dues it received during those years from the special class were not includable in unrelated business income. In making this argument the NLP relied on Rev. Rul. 62-17, 1962-1 C.B. 87, as well as National Association of Postal Supervisors v. United States, 944 F.2d 859, 861 (Fed. Cir. 1991) and American Postal Workers Union v. United States, 925 F.2d 480 (D.C. Cir. 1991).

The Tax Court, however, found that the authorities cited did not support the NLP's claim. First, Rev. Rul. 62-17 holds that the payment by a labor organization of health and other similar benefits to its individual members with funds contributed by its members would not preclude exemption of that organization as a labor organization under IRC 501(c)(5), provided that such benefits are paid under a plan that has as its objective the betterment of the conditions of its members. As such, the ruling was consistent with the court's application of the "substantially related" test of IRC 513(a) and Reg. 1.513-1(d)(2). Further, the court found that the cases cited could not be read as supporting the proposition that a labor organization's provision of health insurance to persons who are limited members will necessarily be substantially related to the accomplishment of its exempt purposes.

The court concluded that the activity conducted with respect to the special class of members was done in a manner suggesting an intent to raise revenue to support the NLP's main purpose of aiding postmasters, and hence was not substantially related to purposes for which it was granted exemption. The Tax Court's opinion is consistent with the Service's position.

The Service's position received further vindication with the Fourth Circuit's decision on June 14, 1996, upholding the Tax Court. The Court of Appeals concluded that the NLP's activities with respect to its associate members were not substantially related to the NLP's exempt purposes. In reaching its decision, the court rejected the argument that the NLP's purposes as set forth in its articles of incorporation were sufficiently broad to encompass non-postal federal employees. It found that the provision of health insurance, marketed in a commercial manner and available to retired federal employees who had never been NLP members, indicated that the provision of health benefits was not substantially related to improving the working conditions of associate members. Although the NLP argued that the benefits provided to associate members made them legitimate members, the court found that the NLP had not shown that any associate members had opted out of health benefits. The benefits that were offered were in fact of limited utility to associate members.

At the time this article was being prepared, H.R. 3448 had passed both houses of Congress. The proposed legislation, which applies to agricultural and horticultural organizations described in IRC 501(c)(5), provides that mandatory annual dues not exceeding $100, as indexed for inflation, will be exempted from unrelated business income tax. This provision would apply to tax years beginning after December 31, 1994.

5. Advertising

The unrelated business income tax is an attempt to insure that tax-exempt organizations do not obtain an unfair competitive advantage over for-profit organizations. Absent such a tax, an exempt organization that receives advertising revenue could obtain such an advantage. Accordingly, IRC 513(c) provides that advertising is a trade or business, while Reg. 1.512(a)-1(f) provides that under IRC 513 and Reg. 1.513-1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business. Such advertising involves the exploitation of an exempt activity, namely the circulation and readership of the periodical developed through the production and distribution of the readership content of the periodical.

The Supreme Court has held that not all advertising by a tax-exempt organization may be subject to unrelated business income tax. In United States v. American College of Physicians, 475 U.S. 834, 106 S.Ct. 1591 (1986), the Court held that Congress did not intend to impose a blanket rule requiring the taxation of income from all commercial advertising by tax-exempt professional journals without a specific analysis of the circumstances. Nonetheless, the Court held that the advertisements in question were subject to tax since they were selected based not on educational purposes but for revenue potential.

In Chicago Metropolitan Ski Council v. Commissioner, 104 T.C. 341 (1995), the Tax Court held that Reg. 1.512(a)-1(f) applies to organizations described in IRC 501(c)(7). The case involved an organization that served its member ski clubs through the promotion of skiing activities. The organization also published a magazine funded, in part, by advertising. Ads generated net income while the editorial portion generated net losses. The Service disallowed the majority of publication expenses, allowing only those based solely on the fraction of total space taken up by advertising and ignoring such factors as the cost of advertising versus non-advertising space and the cost of color advertising. The Service argued that Reg. 1.512(a)-1(f) does not apply to social clubs, which are subject to the special rules contained in IRC 512(a)(3), rather than the general rules under IRC 512(a)(1). Moreover, it argued that allowing a deduction for all publishing expenses would frustrate Congressional intent by permitting social clubs to subsidize their social functions through the organizations' taxable income creating activities. The Tax Court rejected both arguments, finding that the legislative history of IRC 512(a)(3)(A) did not suggest an intent to exclude advertising income of social clubs from the directive of Reg. 1.512(a)-1(f), and that Regs. 1.512(a)-1(f)(3) and (4) provided adequate safeguards to prevent social clubs from gaining an unfair advantage over competing commercial enterprises.

The medical organization discussed in TAM 95-09-002 (September 30, 1994) published a monthly magazine with extensive advertising that it mailed to members and nonmembers. It also published a monthly newsletter that it mailed only to members. Although this newsletter normally contained no advertising, four special issues of the newsletter containing advertising paid for by pharmaceutical companies were distributed to all attendees of an annual convention. Another organization entered into an agreement that, in return for the exclusive right to sell advertising in the convention newsletter, it would "pay a royalty of $5x plus 10% of all collected advertising revenues in excess of $35x." In return, the IRC 501(c)(6) organization would provide an endorsement letter, exhibition list, contact names and phone numbers, and work space at the convention. The IRC 501(c)(6) organization retained final approval on all aspects of ad solicitation and on the actual ad copy.

The Service rejected the attempt to characterize payments received as a royalty. It found that the organization did not have a passive role with respect to the advertising. Further, although the organization argued that the publication of the newsletter only four times per year did not constitute an activity "regularly carried on," the TAM held that the solicitation and preparation of advertising were to be considered part of the activity.

The organization also argued that the convention newsletter was a qualified convention and trade show activity and, as such, any income was excluded from unrelated business income by virtue of IRC 513(d)(1). Although the TAM noted that a convention newsletter should be considered a "convention and trade show activity" within the meaning of IRC 513(d)(3)(A), it concluded that the advertising was an "exploitation" and, therefore, any income derived therefrom is subject to the unrelated business income tax. In addition, the TAM concluded that grants received from pharmaceutical companies, which rented exhibitor space from the organization and advertised in the monthly magazine, were convention and trade show activities used to fund traditional trade show activities and were therefore exempt under IRC 513(d)(1).

One of the monthly magazines contained a special section on a particular field of medical practice. The section consisted of four black and white pages containing information on health. It had two half page advertisements and one page containing health information which was sponsored by a pharmaceutical company. Although the organization argued that the sponsored page was educational in nature and exempt from unrelated business income tax, the TAM concluded that the four page insert had to be considered as a whole and that due to the commercial content of the advertisements, the insert as a whole did not meet the educational relatedness requirement. The TAM also concluded

that, although the insert had only been published twice and no such activity had been carried on previously, preparation time had to be taken into account. Such preparation time resulted in the activity being considered regularly carried on.

6. Sale of Real Estate

A. In General

IRC 512(b)(5) excludes gains or losses from the sale, exchange, or other disposition of property from the computation of unrelated business taxable income. IRC 512(b)(5)(A) and (B) provide that this exception does not apply to gains or losses from the sale of (A) inventory, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. (For a more detailed discussion of land sales, see the 1994 CPE text at p. 89.) The focus of the rulings in this area is whether property is held primarily for sale to customers in the ordinary course of the trade or business.

In PLR 95-05-020 (November 7, 1994) a school proposed to sell land which had been received by bequest and held for a significant period of time. The school's decision was prompted by the passage of legislation making it likely that the school would be forced to sell the land by condemnation suits to condominium lessees at prices significantly less than fair market value. Because the school was unsuccessful in its efforts to sell the land as a block to the condominium association, it proposed to make offers of the leased property directly to apartment owners.

In this case, the ruling concluded that the proposed transaction did not involve property held primarily for sale to customers in the ordinary course of business for purposes of IRC 512(b)(5). Therefore, the gain from its sale would not be taxed as unrelated business income. The ruling cited the following facts: the passage of legislation preventing the school from preserving the value of the land as an investment, the absence of advertising, the significant period of time during which the land was held, and the fact that the land was received by bequest and therefore not obtained with any investment intent.

Both PLR 95-10-039 (December 9, 1994) and PLR 95-09-041 (December 6, 1994) reached the same conclusion based on similar facts. As was the case with the school described in PLR 95-05-020, the organizations involved in these latter two rulings had held land received by bequest for a significant period of time, did not advertise, and faced condemnation proceedings. It was concluded that the sales would not result in unrelated business income since the land was not property held primarily for sale to customers in the ordinary course of business.

B. Special Rule for Social Clubs, et al.

IRC 512(a)(3)(D) governs the taxation of gains from real property sales by social clubs, VEBAs, supplemental unemployment compensation benefits trusts, and qualified group legal services organizations. These organizations recognize gain from the sale of property used directly in the performance of their exempt function only to the extent that the price of the old property exceeds that of new property used for the same purpose. IRC 512(a)(3)(D) applies, however, only if these organizations buy the new property within one year before the day they sell the old property or within three years after that day.

The Tax Court in Deer Park Country Club, T.C. Memo. 1995-567 (November 28, 1995, corrected December 4, 1995) reiterated its finding in Atlanta Athletic Club v. Commissioner, T.C. Memo. 1991-83, rev'd. 980 F.2d 1409 (11th Cir. 1993) that land subject to IRC 512(a)(3)(D) must be used for exempt functions prior to the sale. The Taxpayer in Deer Park was a country club described in IRC 501(c)(7) that purchased two tracts of land--one used for fishing and one as a golf course. It subsequently transferred the fishing property to the State of Illinois for cash and a 63.8 acre tract of farmland. From 1981 to 1986 the club rented the farmland. During this period it engaged a designer to develop plans for constructing an additional golf course, a swimming pool, and tennis courts. After consulting with banks regarding financing, the club agreed to devote 59 acres for recreational purposes and to subdivide for sale the remaining 4.8 acres.

The Tax Court held that IRC 512(a)(3)(D) requires a "use of assets or property that is both actual and direct in relation to the performance of its exempt function." The organization did not meet this test since the 4.8 acre tract had never been used for exempt purposes. In reaching its conclusion, the Tax Court noted that in IRC 512(a)(3)(D) Congress enacted a nonrecognition provision intended to be limited in scope. The court also noted that an organization's intent is irrelevant. Although the club may have originally intended to use the land for recreational purposes, the fact that the club never used the land in the performance of its exempt function was dispositive.

TAM 95-41-002 (February 3, 1995) considered the question of whether property was used directly in the performance of an organization's exempt function. The TAM discusses the application of IRC 512(a)(3)(D) to a hunting and fishing club described in IRC 501(c)(7). A logging company cleared club land that was part of the hunting range. The purpose of the clearing was to provide new growth and protection for grouse hunted on the land. The money received from the timber company was to be used to reconstruct four dams and for dam improvement, which would create a more manageable fishing environment and improve the aesthetic value of the club. Finding that the trees were

necessary for hunting purposes and that club members hiked on the property and enjoyed the aesthetic value of the trees when hunting did not occur, the TAM concluded that the timber was used directly in furthering the club's exempt purposes and, therefore, gain from the sale would be excluded under IRC 512(a)(3)(D).

7. Substantially Related

The heart of the unrelated business income tax may very well be the "substantially related" test. An activity is related to exempt purposes only where the conduct of the activity has a causal relationship to the achievement of exempt purposes (other than the need for income). It is substantially related where the conduct of the activity contributes importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of an exempt purpose depends in each case upon the facts and circumstances involved. Reg. 1.513-1(d).

A. Insurance Activities

Generally, most exempt organizations must report as unrelated business income any amounts received from their involvement in insurance activities, since the provision of insurance is considered a commercial activity. For example, in Rev. Rul. 60-228, 1960-1, C.B. 200, the fee an agricultural organization received for services it provided to insurance companies was held to be subject to the unrelated business income tax. Similarly, income received by an exempt organization for serving as an insurance company's agent is subject to tax. See United States v. American Bar Endowment, 477 U.S. 105 (1986).

Income is unrelated business taxable income if the activity giving rise to it is (1) a trade or business, (2) regularly carried on, and (3) not substantially related to the entity's exempt purposes. If the entity alleges that the income is royalty income, it must be determined whether it truly is a fee for the use of a valuable property right, or compensation for services. As noted in Section 2, supra, royalties include fees arising from the grant of a license for use of an organization's trade name, trademark, or logo. The organization may approve, without risking its claim that the income constitutes a royalty, the quality or style of the goods or services associated with its name or mark.

In Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995), the Texas Farm Bureau ("TFB") and other state agricultural organizations created two insurance companies to provide reasonably priced insurance to rural residents. TFB then entered into several agreements with the insurance companies. In these contracts, TFB agreed to license its name to the insurance

companies and to provide them with administrative and clerical services in connection with their insurance activities in exchange for a fee. The companies agreed to pay TFB a percentage of the premiums paid.

TFB sought to divide the payment from the insurance companies into two parts: reimbursement to TFB for administrative and clerical expenses and a royalty for the use of the name and logo. In reviewing the contracts, the court found that TFB was required to perform substantial services, i.e., to use its own offices and influence to promote the insurance companies and to provide stationery and postage, secretarial and clerical help and office equipment. Therefore, the income received was not a royalty.

The court further noted that TFB's association with the insurance companies was not substantially related to its exempt purpose. In its opinion, the court stated the following:

> ...no substantial causal relationship exists between the insurance sales and the improvement of agricultural products or the development of a higher degree of efficiency in agricultural occupations. Further, many of the people who benefitted from these insurance policies are not ranchers or farmers, and the sale of policies to such people cannot contribute to TFB's exempt purpose. Any agricultural benefits derived from Life and Casualty's insurance policies were incidental benefits. There was no substantial causal relationship between the insurance sales and the fulfillment of TFB's exempt purpose.

B. Administrative Services

The Tax Court in Ohio Farm Bureau Federation, Inc. v. Commissioner, 106 T.C. No. 11 (1996), applied a causal relationship test to determine that an organization's activities were substantially related to its exempt purposes. Ohio Farm Bureau Federation ("Ohio Farm") is an IRC 501(c)(5) agricultural organization that sought to educate Ohio farmers and promote agricultural cooperatives. It formed a statewide cooperative, Landmark, Inc., with which it entered into an agreement whereby it would perform educational and promotional activities, including advertising, public relations, promoting research in agricultural fields and cooperatives generally, on behalf of the cooperative in exchange for a fee. Pursuant to the contract, Ohio Farm agreed to promote Landmark and cooperatives in general. Upon Landmark's merger with another corporation, Landmark and Ohio Farm agreed to terminate their contractual arrangement. Under the terms of the termination agreement, Ohio Farm, in exchange for a fee, agreed not to sponsor or promote, on an exclusive basis, a

specific competing enterprise. However, Ohio Farm could support and promote cooperatives on a non-exclusive basis.

The court found that neither this non-sponsorship/non-competition fee nor the service fee received by Landmark constituted unrelated business income. First, the Tax Court found that the service contract was substantially related to the organization's exempt purpose and benefited the members as a group. Second, the Tax Court addressed the non-sponsorship/non-competition fee and held that a one-time agreement not to compete in certain activities did not constitute a continuous and regular activity characteristic of a trade or business. Similarly, the one time agreement did not qualify as an activity regularly carried on.

The Chief Counsel's office had earlier reached a contrary conclusion on a similar issue in G.C.M. 39865 (December 12, 1991), which concerned an organization described in IRC 501(c)(13) that operated a mortuary as a wholly owned taxable subsidiary. In this G.C.M., a group of three individuals, who comprised the senior management group of both the mortuary and the cemetery, proposed to purchase the mortuary. As part of the sale, the cemetery agreed to enter into a covenant not to compete. In G.C.M. 39865, Chief Counsel stated that whether an activity is a trade or business depends on whether it is conducted with a profit motive, not whether it is active or passive. Further, the G.C.M. concluded that the covenant not to compete was a regularly carried on activity because the obligations continued throughout the term of the non-compete period. Since the operation of a mortuary is not part of the business of a cemetery, the obligation not to compete did not contribute importantly to the cemetery's exempt purpose.

In concluding that the yearly service fee did not constitute unrelated trade or business, the court emphasized the close connection between Ohio Farm and Landmark. From the time of Landmark's formation until 1955, the two organizations had common management. Until 1981 Ohio Farm had a controlling interest in Landmark. Ohio Farm's primary publication devoted editorial space to Landmark, and from 1981-1985 the two organizations shared office space. Ohio Farm referred its members to Landmark and was privy to Landmark's business plans, trade secrets, customer lists, and confidential trade practices. In 1985 Landmark was the only statewide cooperative.

In addressing the service fee, the court examined whether Ohio Farm's performance of these activities was substantially related to its exempt purpose. To determine whether a substantial relationship existed, the court adopted a two-part test set forth in Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982):

> Under the test, an income producing activity is substantially related to the exempt function of an exempt organization if (1) the activity is unique to the organization's tax-exempt purpose; and (2) if direct benefits flowing from the activities inure to its members in their capacities as members of the organization. In step one consideration is given to both the uniqueness of the relationship and the manner in which the organization carries on this endeavor. Under the second step it must be determined whether the activities benefit its members as members, rather than in their individual capacities.

With respect to the first prong, the court easily determined that Ohio Farm's educational activities were unique because they advanced the organization's exempt purpose of promoting cooperatives. Its distinctive relationship with Ohio farmers put it in a unique position to perform the activities covered by the service contract.

With respect to the second prong, the court cited as relevant factors to be considered whether fees are proportionate to benefits received, whether participation is limited to members, and whether the service in question is one commonly provided by for-profit entities. In finding the substantial relationship, the court distinguished Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, 801 F.2d 987 (7th Cir. 1986) and National Water Well Association, Inc. v. Commissioner, 92 T.C. 75 (1989).[3]

In Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, supra, a state association of independent insurance agents described in IRC 501(c)(6) provided its members errors and omissions (E & O) insurance that it actively promoted. The court held that the substantial profits made by the organization as well as its substantial involvement indicated that the activities of the organization constituted a trade or business. Any exempt function that the insurance program may have served was incidental to its purpose of raising revenues. Further, any benefits accrued to the agents, not the group. The court therefore concluded that the business of providing insurance was not substantially related to the organization's exempt purpose. In National Water Well Association, Inc. v. Commissioner, supra, the Tax Court held that premiums received by an IRC 501(c)(6) organization that actively sponsored and promoted an insurance program were not royalties. The Tax Court found that an organization's endorsement and sponsorship of an industry casualty program were not substantially related to its exempt purpose.

[3] Neither of these cases applied the "uniqueness" test.

In contrast to the organizations discussed in National Water Well Association, Inc. v. Commissioner and Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, supra, the Tax Court held that Ohio Farm educated its members, provided benefits not directly proportionate to the dues paid, and benefited members as a group.

Even assuming, for argument's sake, the validity of the "uniqueness test" set forth the Louisiana Credit Union League, the Tax Court ignored the fact that the relationship of Ohio Farm to Ohio farmers was no more unique than that of the National Water Well Association or the Illinois Association of Professional Insurance Agents to its members; the services it provided were standard administrative services. The Tax Court also ignored the fact that Ohio Farm existed to promote cooperatives in general, a purpose inconsistent with its promotion of one organization. It is possible that more statewide cooperatives would have existed had Ohio Farm been actively promoting cooperatives in general. Further, had Ohio Farm been protecting the interests of its members rather than its own profitability, it would have provided information on other insurance policies.

As of the time this article was being prepared, no decision had been made as to whether the Tax Court's opinion would be appealed.

TAM 95-50-001 (August 23, 1995) involved an organization described in IRC 501(c)(6) that was formed to promote the common business interests of the motor transport industry. It engaged in legislative activities such as monitoring legislation and lobbying conducted by an independent contractor; the publishing of a monthly newsletter; monthly educational seminars providing information to members; and conducting of various annual events including a convention, parade, truck driving championships, a golf tournament, legislative forum, a holiday party, the sale of forms and publications to members and nonmembers, a free yearbook paid for by advertising, and a fee based drug program. The TAM discussed the various activities and concluded as follows:

1) The sale of forms and publications was an ordinary commercial activity that did not contribute to the improvement of industry business conditions and, as such, was unrelated trade or business.

2) Although the yearbook's advertising was not related to the organization's exempt purpose, and ordinarily any advertising revenue would be unrelated business taxable income under IRC 512(a)(1), because the organization itself devoted little time to the activity as did an outside firm, which received little compensation, the sale of advertising was an intermittent activity and not regularly carried on, because it was conducted without the competitive and promotional efforts typical of commercial endeavors.

3) The golf tour, although not related to the organization's exempt purposes, was an intermittent activity covered by Reg. 1.513-1(c)(2)(iii)'s exemption for annually recurrent activities.

4) Since the annual convention featured educational programs on topics of interest to the trucking industry, it was a related activity.

5) The materials and services offered as part of the drug testing program were offered on a commercial basis to members and nonmembers, and as such were not an incident of membership. Therefore, the activity was held to be an unrelated trade or business.

6) The annual parade and truck driving competition, the monthly newsletter, seminars and the lobbying conducted by an independent contractor were all considered to be in furtherance of exempt purposes. However, amounts derived from advertisements in the monthly newsletter were unrelated business income generated by a commercial activity regularly carried on.

TAM 95-41-003 (June 19, 1995) involved an organization described in IRC 501(c)(3) on the basis of lessening the burdens of government. It was formed to administer funds established by State statute to provide insurance coverage to school districts. These school districts were members of the organization's founding and controlling organization that paid a fee for the management services. The TAM concluded that the services helped the school districts to perform their essential government functions in a more cost efficient manner. Therefore, the organization conducted an activity that was substantially related and contributed importantly to its exempt purpose of lessening the burdens of government. Thus, the administrative services did not constitute unrelated trade or business.

C. Museum Gift Shop Sales

TAM 95-50-003 (September 8, 1995) discusses whether the sale of merchandise from an exempt organization's gift shop, mail order catalogue and wholesale outlets constitutes unrelated business income. Although the organization conducted extensive off-site activities generating extensive income, the TAM held that the sale of merchandise by a museum at off-site locations was not necessarily unrelated trade or business. The TAM sets forth a method of analysis to be applied to each item sold:

> To determine if the sale of an item by a museum is related to its exempt purpose, it is necessary to examine the museum's primary purpose for selling the item. (The buyer's reasons for purchase are immaterial.) Where the primary purpose behind the production

> and sale of the item is to further the organization's exempt purpose, the sale is related, and income earned from that sale is exempt, even though the item has a utilitarian function or value. It is only where the primary purpose behind the production and sale of an item is to generate income, that the sale is taxable.

To determine whether this "primary purpose" test is met, a number of factors should be considered. Important factors include the degree of connection between the item and the museum collection, the extent to which an item relates to the form and design of the museum piece, and the relation of the overall impression derived from the article being sold to the original article.

The TAM then examined the various categories of merchandise sold by the museum to determine if the sale of the items was related to the museum's exempt purpose. The following items were found to be related:

1) books, tapes, records, films and compact discs on period topics and on restoration and collection activities undertaken by the museum;

2) toys, games, hats and flags;

3) non-prepackaged food products;

4) reproductions and adaptations of prototypes in the museum's collection;

5) contemporary products, such as film, batteries, flashbulbs, ponchos and umbrellas sold for the convenience of visitors;

6) some cards, ornaments and decorations; and,

7) note cards, calendars and postcards imprinted with representations of museum art work.

Items held to be unrelated to the museum's exempt purposes included:

1) miscellaneous contemporary products, such as newspapers, magazines, cigarettes and candy;

2) prepackaged foods, toiletries and tobacco products;

3) souvenirs and mementoes;

4) ornaments and decorations that were not part of the museum's collection;

5) products that were interpretations of or have designs taken from the historical period depicted by the museum other than reproductions or adaptations; and,

6) blank books, napkins, paper plates, stationery and address books.

Although raising the possibility of revisiting Rev. Rul. 73-104, 1973-1 C.B. 263, which holds that off-site sales of educational items in retail stores and through mail order catalogues can further an exempt purpose and are generally not subject to unrelated business income tax, the TAM reaffirmed Rev. Rul. 73-104. Finally, the TAM concluded that engraving done on-site, before on-lookers, and using a method used during the historical period depicted by the museum was related to the museum's exempt purpose, while income from engraving conducted off-site was subject to unrelated business income tax. Income from gift wrapping, done off-site, was also subject to tax.

D. Sale of Standard Forms

TAM 95-27-001 (January 30, 1995) involved sales by the local chapter of a national professional organization of various standard forms and agreements. The products were sold for use in the business activities of members and others. The purpose of the organization is to organize and unite in fellowship the members of a particular profession. The TAM relied on the two-part test applicable to business leagues for determining whether there is a substantial casual relationship between the activity and the accomplishment of the exempt purposes of the organization set forth in Louisiana Credit Union League v. United States, supra.

The TAM concluded that sales to the public were typical of commercial sales and distribution and hence not unique. Further, the forms helped members in their individual capacity rather than as members of the profession. Therefore, the TAM held that the sale of documents was not substantially related to the exempt purposes of the organization.

E. Travel and Similar Programs

TAM 95-21-004 (February 16, 1995) involved a travel program run by an organization formed to assist various children's shelters through financial contributions, fundraising and tutoring. The organization dedicated one room in its offices and one full-time employee to its travel agency operation. Operating a computer terminal, the employee booked local and international travel tours. The organization also had another full-time employee and two part-time employees, who dedicated most of their time to other fundraising activities and programs for children.

Sales were made via telephone calls or directly to individuals who entered the offices. This service was provided to the membership and to the general public via word of mouth of the membership. The organization advertised travel tours to its members through the use of fliers and brochures. Checks for travel services and all other fundraising activities were made payable to the organization.

The organization collected cash or credit card payments which were remitted to local commercial agencies from which the tickets were secured. It retained a commission from all cash payments, was remitted a commission from commercial agencies on credit card payments and received commissions from hotels as a result of the various local trips booked during the year. The TAM concluded that the travel service was a trade or business carried on for the production of income from the sale of goods or performance of services and did not contribute importantly to the accomplishment of its primary purpose of assisting children.

TAM 95-40-002 (May 31, 1995) discusses the operation of a golf and tennis program by an organization formed to broaden understanding and friendship with people of other nations through sports. The organization arranged various tours, consisting of parties, accommodations, meals and transportation for participants and families. It used related travel agencies for all travel arrangements. Although promoting international understanding is an exempt purpose, the TAM held that when a for-profit benefits substantially from the manner in which the activities of the related organization are carried on, the related organization is not tax-exempt. The TAM found that the program served substantial nonexempt purposes of promoting private business interests so as to preclude exemption, and that the income generated was not derived from an activity that contributed importantly to the accomplishment of exempt purposes.

# P. LOBBYING ISSUES

**by**

**Judith E. Kindell and John Francis Reilly**

## 1. Introduction

The last two years have witnessed a flurry of legislative activity regarding the lobbying activities of tax-exempt organizations. Concerns have been raised regarding the extent of their lobbying and whether additional limitations should be imposed. Last year, in response to some of these concerns, the Lobbying Disclosure Act of 1995 was enacted, to become effective January 1, 1996. 2 U.S.C. 1601 et seq. In addition to requiring organizations that engage in lobbying to register and report on their activities, the Act provides that IRC 501(c)(4) organizations that engage in lobbying are not eligible to receive Federal funds as an award, grant, or loan.[1] Debate concerning further, non-tax legislation continues.

Nevertheless, as Miriam Galston has noted in "Lobbying and the Public Interest: Rethinking the Internal Revenue Code's Treatment of Legislative Activities," 71 Tex. L. Rev. 1269 (1993), the primary vehicle for regulating organizations' legislative activities is the Internal Revenue Code. In her article, Professor Galston observes that the Code creates four separate and very different regulatory "regimes" regarding lobbying. Id. at 1275-81.

The first regime, which applies to IRC 501(c)(3) public charities, permits these organizations to lobby so long as they do not devote a "substantial part" of their activities to attempting to influence legislation. This system has two subsets, which employ different tests of substantiality. The older, enacted in 1934, applies facts and circumstances criteria to determine "substantial part." The newer was introduced in 1976, by the enactment of IRC 501(h) and IRC 4911. IRC 501(h) provides that certain public charities may make an election and have their lobbying activities governed by expenditure tests in lieu of being subject to the IRC 501(c)(3) "substantial part" test. If the expenditure limits are exceeded, a tax under IRC 4911 will be imposed or, if the limits are exceeded by 150 percent over a defined period, exempt status will be lost. The tests are discussed in Parts 2 and 3.

The second regime applies to IRC 501(c)(3) private foundations. Under this regime, any expenditures incurred for lobbying activities are treated as taxable expenditures under IRC 4945(d)(1) and subject to the tax imposed by IRC 4945(a). Part 4 discusses this topic.

The third regime involves other federally tax-exempt organizations. Outside of IRC 501(c)(3), there is no specific provision of IRC 501(c) that restricts lobbying activities. Consequently, the only limit imposed on the lobbying activities of non-IRC 501(c)(3) organizations is that the lobbying activities must be germane to the accomplishment of the organization's exempt purpose. As a result, the organization's sole activity in support of its exempt purpose may be lobbying without jeopardizing its tax exemption. This topic is discussed in Part 5.

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[1] See Robert A. Boisture, "What Charities Need to Know to Comply with the Lobbying Disclosure Act of 1995," 13 EOTR 35 (Jan. 1996) and Miriam Galston, "Simpson's Lobbying Provision: More Bark than Bite," 13 EOTR 45 (Jan. 1996) for descriptions of the provisions and effects of the Lobbying Disclosure Act.

The fourth regime concerns the lobbying expenditures of businesses. These rules are set forth in IRC 162. Until recently, this was not a subject that particular concerned exempt organizations. Now, however, because of the lobbying disallowance provisions of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), exempt organizations also must consider the provisions that disallow deductions for lobbying by businesses. Part 6 discusses this topic.

## 2. Lobbying Activities of IRC 501(c)(3) Nonelecting Public Charities

### A. Legislative and Regulatory History

#### (1) The Pre-Statutory Era

Prior to 1934, there was no specific statutory restriction on the lobbying activities of charities. Early regulations, however, provided that organizations "formed to disseminate controversial or partisan propaganda" were not "educational" within the meaning of the statute. Treas. Reg. 45, art 517 (1919 ed.); T.D. 2831, 21 Treas. Dec. Int. Rev. 285 (1919). The import of the regulation became the subject of litigation concerning the deductibility of a contribution or bequest to an organization. The deduction was disallowed in some cases. See Herbert E. Fales, 9 B.T.A. 828 (1927) (contributions to various temperance organizations); Joseph M. Price, 12 B.T.A. 1186 (1928) (contribution to the Civic Fund of the City Club of New York); Slee v. Commissioner, 42 F.2d 184 (1930), aff'g 15 B.T.A. 710 (1929) (contribution to the American Birth Control League); Henriette T. Noyes, 31 B.T.A. 121 (1934) (contribution to a women voters' league); Vanderbilt v. Commissioner, 48 F.2d 360 (1st Cir. 1937) (bequest to the National Women's Party). In other cases, the deduction was allowed. See Weyl v. Commissioner, 48 F.2d 811 (2nd Cir. 1931), rev'g 18 B.T.A. 1092 (1930) (contribution to the League for Industrial Democracy); Cochran v. Commissioner, 78 F.2d 176 (4th Cir. 1935), rev'g 30 B.T.A. 1115 (1934) (contribution to the World League Against Alcoholism). In one case, a contribution to an organization was allowed, while another, to a cognate organization, was disallowed. Leubuscher v. Commissioner, 54 F.2d 998 (2d Cir. 1932), modifying 30 B.T.A 1022 (1930) (bequest to two organizations to teach the ideas of Henry George relative to the single tax on land).[2]

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[2] Commentators differ on the overall import of these decisions. Dean E. Sharp, "Reflections on the Disallowance of Income Tax Deductions for Lobbying Expenditures," 39 B.U. L. Rev. 365, 387 (1959), simply notes that these cases, as well as cases decided after 1934, "are in conflict." Others have deduced a trend. William H. Lehrfeld, "The Taxation of Ideology," 19 Cath. U. L. Rev. 52, 59 (1969), emphasizes the controversial nature of the organization's agenda; he concludes that "[o]nly the meek inherited the tax exemption." Tommy F. Thompson, "The Availability of the Federal Educational Tax Exemption for Propaganda Organizations," 18 U.C. Davis L. Rev. 487, 498-501 (1985), contends that the determining factor in these cases was whether the organization attempted to influence legislation. (Thompson also states, at 498 n. 29, that "no evidence suggests that the Service actively discriminated against organizations that advocated extreme viewpoints, or in favor of organizations that advocated mainstream viewpoints. The evidence suggests that the Service did in fact apply the standard strictly and evenhandedly.") Laura B. Chisholm, "Exempt Organization Advocacy: Matching the Rules to the Rationales," 63 Ind. L.J. 201, 216 n. 78, after noting Mr. Lehrfeld's and Professor Thompson's analyses, concludes: "With a few exceptions, the cases seem to support the [legislative activity] contention at least as convincingly as they support the proposition that advocacy per se or controversiality was the basis for denial of exemption or deductibility."

Of all these cases, Slee is paramount. In Slee, the organization at issue, the American Birth Control League, gave free medical services to married women, collected and distributed information about birth control, and sought to enlist the support and cooperation of legislators in repealing and amending statutes preventing birth control. Judge Learned Hand, writing for a unanimous court, dismissed the controversial nature of the League's program as irrelevant: "We cannot discriminate unless we doubt the good faith of the enterprise." Slee, at 185. Instead, he focused on the League's legislative activity:

> *Political agitation as such is outside the statute, however innocent the aim, though it adds nothing to dub it "propaganda," a polemical word used to decry the publicity of the other side. Controversies of that sort must be conducted without public subvention; the Treasury stands aside from them.* Id.[3]

Immediately after this statement, however, Judge Hand made a distinction:

> *Nevertheless, there are many charitable, literary and scientific ventures that as an incident to their success require changes in the law. A charity may need a special charter allowing it to receive larger gifts than the general laws allow. . . . A society to prevent cruelty to children, or animals, needs the positive support of law to accomplish its ends. . . . We should not think that a society of booklovers or scientists was less "literary" or "scientific," if it took part in agitation to relax the taboos upon works of dubious propriety, or to put scientific instruments on the free lists. All such activities are mediate to the primary purpose, and would not, we should think, unclass the promoters.* ***The agitation is ancillary to the end in chief, which remains the exclusive purpose of the association.*** *Trinidad v. Sagrada Orden, 263 U.S. 578, 44 S. Ct. 204, 68 L. Ed. 458 [1924].* Id. (Emphasis added.)[4]

The League, however, did not come within this exception because there was no evidence that its legislative activity was "confined solely to relieving its hospital work from legal

[3] This holding was reflective of the common law regarding lobbying in England and in Massachusetts, but not in any other jurisdiction. See Girard Trust Co. v. Commissioner, 122 F.2d 108, 113-114 (Clark, J., dissenting); Elias Clark, "The Limitation on Political on Political Activities: A Discordant Note in the Law of Charities," 46 Va. L. Rev. 439, 447-448 (1960). Professor Clark, who is critical of the decision because it "assumes the validity of the restriction without attempting to justify it by argument or authority," nevertheless notes: "Later courts have accepted the principle as settled." Id. at 446-447.

[4] The citation of Trinidad is an obvious reference to the Court's observation in that case that the exemption statute "says nothing about the source of the income, but makes the destination the ultimate test of exemption." Trinidad, at 581. The practical result of the Court's statement was that an organization could qualify for tax exempt status so long as the income was used for exempt purposes; its source was irrelevant. This became known as the "destination of income" test, and was the pervading standard for congruence with charitable exemption until the passage of the unrelated business income tax and the feeder organization rules in the Revenue Act of 1950.

obstacles." Id. Therefore, contributions to the League were not deductible. This disallowance, accordingly, was based not upon the controversial nature of the League's activities, nor upon its attempts to influence legislation per se; instead, it was based upon the assumption (actually, the lack of evidence to refute the assumption) that its legislative activities went beyond its charitable purposes.[5]

What Slee proclaims is an analog to Trinidad's "destination of income" test -- a "destination of lobbying" test. As will be discussed in the next section, this did not become the precise formulation of the statutory restriction on lobbying; nevertheless, Slee served as the basis of what was to follow.

(2) The Lobbying Restriction

In 1934, the limitation on the lobbying activities of IRC 501(c)(3) organizations, requiring that "no substantial part of an organization's activities constitute carrying on propaganda or otherwise attempting to influence legislation," became part of the statute. Revenue Act of 1934. The legislative history is sparse.

What we do know is that the Senate Finance Committee staff drafted the provision and that it was added to the Revenue Act of 1934 as a floor amendment.[6] We also know that Senator David Reed, the ranking minority member of the Committee and the provision's apparent sponsor, was dissatisfied with its formulation:

> *There is no reason in the world why a contribution made to the National Economy League should be deductible as if it were a charitable contribution if it is a selfish one made to advance the personal interests of the giver of the money. That is what the committee was trying to reach; but we found great difficulty in phrasing the amendment. I do not reproach the draftsmen. I think we gave them an impossible task; but this amendment goes much further than the committee intended to go.* 78 Cong. Rec. 5,861 (1934).

It is not clear, however, to what extent Senator Reed was speaking for the entire Committee. If the Committee were so dissatisfied with the provision, they could have tabled it -- contributions to most charities are unselfishly motivated. Likewise, if the Congress or the Administration felt that the critical issue was that more prevention of cruelty societies and crippled children's organizations would be affected by its enactment than "selfish" organizations,

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[5] Judge Hand's decision made no mention of the Treasury regulation. The Board of Tax Appeals decision, in contrast, discussed it. Slee, 15 B.T.A. at 715.

[6] The provision also contained a restriction on "participation in partisan politics." The provision, however, was dropped in conference, so that only the lobbying restriction remained. H.R. Conf. Rep. No. 73-1385, 73d Cong., 2d Sess. 3-4 (1934). In explaining its deletion, one of the House managers, Representative Samuel B. Hill stated, "We were afraid this provision was too broad." 73 Cong. Rec. 7,831 (1934).

it would not have become law. One suspects that the provision was enacted simply because there was a general sentiment that lobbying by charities should be restricted.[7] This is not to doubt that the "selfish/unselfish" formula was what Senator Reed wanted drafted, nor that, as he stated, the Committee staff tried to draft it but found it impossible.[8] However, the reference to the National Economy League seems to indicate that the Senator had embarked on a personal crusade that may not have been taken too seriously by his colleagues, who seized the opportunity to enact a broader restriction.[9]

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[7] The Committee considered, and rejected, application of the provision to restrict contributions to war veterans' associations. Id. at 5,861 (remarks of Senator Pat Harrison, chairman of the Committee).

[8] The National Economy League is discussed in note 9. Senator Reed's view of the League as selfishly motivated was not universally shared. For example, in an editorial, the New York Times praised the League chairman's (and, by implication, the League's) "patriotism, disinterestedness, and loyalty." "Useful Service," April 27, 1933, at 16. The impossibility of starting with the National Economy League and drafting a "selfish/unselfish" standard is apparent.

[9] Senator Reed had been one of the leaders of the considerable number of "Old Guard" Republicans during the Harding, Coolidge, and Hoover administrations. After the 1932 election, however, their numbers had been drastically reduced, as had Reed's influence. A 1933 Newsweek portrait of the Senator, Reed: Hamiltonian, Mellon Attorney, and Penn. Senator, May 6, 1933, at 18-19, presents him as a beleaguered figure, having virtually no influence and being subjected to the abuse of the acid-tongued Senator Harrison. By the time he was denouncing his own bill on the Senate floor, his situation had worsened. He was locked in a nasty primary battle for renomination; the election occurred less than two months after his floor speech; the outcome was in doubt. His opponent was his ideological opposite, the Governor of Pennsylvania, Gifford Pinchot, a leader of the Progressive wing of the Republican Party. (In addition to their ideological differences, they detested each other: Harold Ickes observed that they had always fought "like two tomcats sitting on a fence." Arthur M. Schlesinger, Jr., The Coming of the New Deal, 346 (1959).) Pinchot was not Reed's only problem; he was also opposed by an organization that would appear to have been his natural ally, the National Economy League.

The National Economy League was one of the short-lived phenomena of the 1930's. Organized in 1932, apparently in reaction to the Bonus March, after two years of prominence, it vanished. A "revolt of the haves," dedicated to a radical reduction in government expenditures, its leadership was anything but obscure, however. Its chief spokesman was Admiral Richard Byrd (who served as chairman until he decided to travel to the Antarctic); Nicholas Murray Butler was its honorary chairman; its original six member advisory board consisted of a former President (Calvin Coolidge), a defeated candidate for the Presidency (Alfred E. Smith), two former Secretaries of State (Elihu Root and Newton D. Baker), General of the Armies John W. Pershing, and Admiral Williams Sowden Sims. "Byrd Quits as Head of Economy Group," N.Y. Times, April 26, 1933, at 5. Mr. Lehrfeld, supra, at 63, states that it had been accorded charitable status, and the right to receive tax-deductible contributions, in a ruling letter dated November 3, 1933. Soon thereafter, it submitted its own economic program to the President and Congress. The New York Times gave front page treatment to the event and printed the text of the entire program. "Roosevelt Warned Our Debt Will Rise 4 Billion in Year," Dec. 18, 1933, at 1.

The extent of benefits to war veterans was the League's foremost concern. It repeatedly urged that benefits be limited only to those wounded in war. (Appropriations to the Veterans Administration was no small budgetary matter. In praising the League's stand, the New York Times noted that the appropriations "had reached a point where they accounted for one-third of the entire cost of the Federal government, aside from service on the national debt." "Useful Service," April 26, 1933, at 16.) However, this position brought the League into conflict with Senator Reed, who also made the veterans' benefits his chief concern. Lurching unexpectedly leftward, outflanking Pinchot and even Roosevelt, in January 1934, Reed sponsored legislation to restore benefits cut the year before. "Reed Leads Fight on Veterans' Cuts," N. Y. Times, Jan. 9, 1934, at 5. The League responded by presenting its own plan and excoriating Reed's. "Plan to Simplify Veteran Aid Urged," N. Y. Times, Feb. 19, 1934, at 4. Reed's

It is widely accepted that the 1934 legislation represents a codification of the Slee position and a rejection of the strict Treasury point of view, as embodied in the 1919 regulation.[10] As a general statement, this is true. However, there is a significant difference between the two approaches, and it is not simply that the Congress did not share Judge Hand's distaste for the word "propaganda." Rather, the tests used by the two approaches are different. Slee's "destination of lobbying" approach is a purpose test; the legislation's "no substantial part" language signifies an activities test. Different results may be reached from this distinction -- under the "no substantial part" test, contributions to the American Birth Control League would remain deductible, regardless of the purpose of its legislative endeavors, if such lobbying were not "substantial;" conversely, if the prevention of cruelty societies' legislative activities were "substantial," deductibility would be lost regardless of the lobbying purpose.[11] Regulations

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stratagem was successful both as legislation and as the substantive centerpiece of his primary campaign. As Arthur Krock noted in his post-primary analysis of Reed's victory over Pinchot: "Before stripping for the fray, Mr. Reed took the precaution of getting into the money distributing class himself by leading a successful battle against the administration for added benefits and restored government pay. . . . This equipped him with at least half of Santa Claus's whiskers." "Republicans See Renewed Party in Victory of Reed," N. Y. Times, May 18, 1934, at 24.

The remainder of 1934 was not kind to either the League or the Senator. On July 23, less than three months after the effective date of the lobbying restriction, the ruling letter to the League was cancelled. Lehrfeld, supra, n. 2, at 64. On November 6, Senator Reed was defeated by Joseph F. Guffey, who became the first Democratic Senator elected from Pennsylvania in 60 years.

[10] See, e.g., Hearings on H. Res. 217 Before Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations, House of Representatives, 83d Cong., 2d Sess. part 1, 433 (1954) (statement of Assistant Commissioner (Technical) Norman A. Sugarman) and G.C.M. 34289 (May 8, 1970).

[11] Slee's purpose formulation still resonates in IRC 501(c)(3). Rev. Rul. 80-278, 1980-2 C.B. 175, holds that an organization that institutes and maintains environmental litigation as a party plaintiff operates exclusively for charitable purposes within the meaning of IRC 501(c)(3). In reaching this conclusion, Rev. Rul. 80-278 states:

> *In determining whether an organization meets the operational test, the issue is whether the particular activity undertaken by the organization is appropriately in furtherance of the organization's exempt purpose, not whether that particular activity in and of itself would be considered charitable.*
>
> * * *
>
> *Therefore, in making the determination of whether an organization's activities are consistent with exemption under section 501(c)(3) of the Code, the Service will rely on a three-part test. The organization's activities will be considered permissible under section 501(c)(3) if:*
>
> *(1) The purpose of the organization is charitable;*
>
> *(2) the activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions; and*
>
> *(3) the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose.*

written after the enactment of the lobbying restriction did not elaborate upon the statute. Reg. 86.101(6)-1 (as amended in 1935). The current "action" organization regulations were proposed early in 1959 (24 FR 1420 (Feb. 26, 1959)), and adopted later that year by T.D. 6391 (24 FR 5217 (June 26, 1959)).

(3) Subsequent Statutory Developments

As part of the Tax Reform Act of 1976, Congress enacted IRC 501(h) and IRC 4911 to provide a second test for determining the amount of allowable lobbying. These provisions are discussed in Part 3 of this article. In addition, Congress enacted IRC 504 to provide, with certain exceptions, that IRC 501(c)(3) organizations that lose exempt status due to excessive lobbying may not at any time thereafter be treated as IRC 501(c)(4) organizations. IRC 504 is discussed in Part 5.

In 1987, House Ways and Means Oversight Subcommittee Chairman J.J. Pickle announced that he was initiating an investigation into the lobbying and electioneering activities of IRC 501(c) organizations. The particular focus of concern was the National Endowment for the Preservation of Liberty (NEPL), an IRC 501(c)(3) organization. The organization reportedly received funds from the Iran-Contra arms sales and used the proceeds both to finance conservative Congressional candidates in the 1986 campaign and to run negative advertisements about Congressional incumbents who opposed aid to the Nicaraguan Contras. NEPL also engaged in a considerable amount of grass roots lobbying to garner support for Contra aid.[12]

The hearings resulted in the enactment of several statutes. One of these, IRC 4912, concerns the lobbying activities of nonelecting public charities. For years beginning after December 22, 1987, certain organizations whose IRC 501(c)(3) status is revoked because of substantial lobbying activities are subject to a five percent excise tax imposed by IRC 4912 on their "lobbying expenditures," for the year of loss of the exemption. "Lobbying expenditure" is defined in IRC 4912(d)(1) as any amount paid or incurred by a charitable organization in carrying on propaganda or otherwise attempting to influence legislation.[13]

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What distinguishes lobbying activity from litigation activity, therefore, is lobbying activity, regardless of its purpose, is expressly restricted by statute, whereas litigation activity is tested on the basis of whether the particular purpose of the activity is in furtherance of the particular organization's IRC 501(c)(3) purposes.

[12] For a history of the 1987 legislation, see Chisholm, supra, n. 2, at 203-204.

[13] H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1631 (1987) explains the reason for the provision:

> *The committee concluded that revocation of exempt status may be ineffective in the case of certain charitable organizations as a penalty or as a deterrent to engaging in more than insubstantial lobbying activities, particularly if the organization ceases operations after it has diverted all its tax-deductible contributions and exempt income to improper purposes but before it has been audited and any income tax liability has been assessed. Accordingly, the committee believes that in such cases the sanction of revocation of tax-exempt status should be supplemented by an excise tax, just as under present law excise taxes apply where a public charity electing under section*

IRC 4912 also imposes a similar tax at the same rate on any manager of the organization who willfully and without reasonable cause consented to making the lobbying expenditures knowing the expenditures would likely result in the organization's no longer qualifying under IRC 501(c)(3). There is no limit on the amount of this tax that may be imposed against either the organization or its managers.

IRC 4912(c)(2)(C) excepts private foundations from the IRC 4912 taxes because their lobbying expenditures are already subject to the tax imposed by IRC 4945. In addition, the IRC 4912 taxes are not imposed on any organization that has elected to be subject to the lobbying limitations of IRC 501(h) (IRC 4912(c)(2)(A)) or on churches and church-related organizations that are not eligible to make the IRC 501(h) election (IRC 4912(c)(2)(B)).

(4) The Constitutional Issue

In Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983), the Court addressed the question of whether the IRC 501(c)(3) restriction on lobbying violates constitutional guarantees.

Regan v. Taxation with Representation of Washington was foreshadowed by Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972); cert. denied, 414 U.S. 864 (1973), where the Tenth Circuit dismissed a claim that the IRC 501(c)(3) prohibition on lobbying and political activities was an unconstitutional restriction on the organization's freedom of speech. In so doing, the court stated:

> *In light of the fact that tax exemption is a privilege, a matter of grace rather than right, we hold that the limitations contained in section 501(c)(3) withholding exemption from nonprofit corporations do not deprive Christian Echoes of its constitutionally guaranteed right of freedom of speech. The taxpayer may engage in all such activities without restraint, subject, however, to withholding of the exemption, or, in the alternative, the taxpayer may refrain from such activities and obtain the privilege of exemption. . . . The congressional purposes evidenced by the 1934 and 1954 amendments are clearly constitutionally justified in keeping with the separation and neutrality principles particularly applicable in this case and, more succinctly, the principle that the government shall not subsidize, directly or indirectly, those organizations whose substantial activities are directed toward the accomplishment of legislative goals or the election or defeat of particular candidates.* 470 F.2d at 857.

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*501(h) exceeds the permitted lobbying expenditures or where a private foundation engages in any political lobbying activities.*

Taxation With Representation of Washington (TWR) attacked the IRC 501(c)(3) lobbying restriction not only on the ground that it violated the freedom of speech guarantee of the First Amendment, but also on the ground that it violated the equal protection language of the Fifth Amendment's Due Process Clause. The latter argument was based on the contention that those veterans organizations which qualify for exempt status under IRC 501(c)(19) and for deductible contributions under IRC 170(c)(3) are permitted to lobby; therefore, organizations qualifying for exemption under IRC 501(c)(3) and for deductible contributions under IRC 170(c)(2) should be permitted to lobby as well.

The Supreme Court unanimously held that the IRC 501(c)(3) restriction on lobbying activities violates neither the freedom of speech guarantee of the First Amendment nor the equal protection doctrine of the Fifth Amendment. Concerning the First Amendment issue, the Court stated that this aspect of the case was controlled by its decision in Cammarano v. United States, 358 U.S. 498 (1959). In Cammarano (which is discussed in Part 6, below), the Court upheld a Treasury Regulation (antecedent to the passage of IRC 162(e)), that denied business expense deductions for lobbying activities.

As to TWR's equal protection claim, the Court stated that the general rule of statutory classifications is that such classifications are valid if they bear a rational relation to a legitimate governmental purpose, and that "[l]egislatures have especially broad latitude in creating classifications and distinctions in tax statutes." 461 U.S. at 547. The Court noted that while statutes are subject to a higher level of scrutiny if they interfere with the exercise of a fundamental right, such as freedom of speech, the IRC 501(c)(3) legislative restriction does not infringe upon freedom of speech; therefore, the statutory distinction in treatment of IRC 501(c)(3) and IRC 501(c)(19) organizations need only have a rational basis. The Court found such a basis by concluding:

> *It is not irrational for Congress to decide that tax exempt charities such as TWR should not further benefit at the expense of taxpayers at large by obtaining a subsidy for lobbying.*
>
> *It is also not irrational for Congress to decide that, even though it will not subsidize substantial lobbying by charities generally it will subsidize lobbying by veterans organizations. . . . Our country has a long standing policy of compensating veterans for their past contributions by providing them with numerous advantages. This policy has "always been deemed to be legitimate." Personnel Administrator v. Feeney, 442 U.S. 256, 279 n. 25 (1979).* Id. at 550-551.

B. Specific Issues

(1) The Meaning of "Legislation"

**1. What is the general meaning of the term "legislation?"**

Reg. 1.501(c)(3)-1(c)(3)(ii) provides that the term "legislation" includes "action by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure."

**2. What is the meaning of "action" as used in the phrase "action by the Congress?"**

Reg. 1.501(c)(3)-1(c)(3)(ii) does not elaborate on the precise meaning of the word "action." In this situation, however, one should consider the meaning of the phrase "action by the Congress" for purposes of IRC 4911(e).[14] In IRC 4911(e), the phrase "action . . . by the Congress" is used in the definition of the term "legislation" and the term "legislation" is used to delineate the extent to which certain organizations described in IRC 501(c)(3) may conduct certain types of lobbying activities.

IRC 4911(e)(2) provides that, for purposes of IRC 4911, "[t]he term 'legislation' includes action with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment or similar procedure." In IRC 4911(e)(3), Congress limited the meaning of the term "action," as that term is used in IRC 4911, to the "introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items."

G.C.M. 39694 (Jan. 21, 1988) notes that it is unclear whether the phrase "action by the Congress" as used in the regulations implementing the lobbying restriction of IRC 501(c)(3) for nonelecting public charities is also limited to the introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items. Nevertheless, G.C.M. 39694 concludes that the administration of, and compliance with, IRC 501(c)(3), IRC 501(h), IRC 4911, and IRC 4945 would be best effectuated by the application of a single definition of "action by the Congress" as a phrase referring to the introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items.

The common denominator among Acts, bills, and resolutions is the fact that all are items that are voted upon by a legislative body. Resolutions differ from Acts in that they are a formal expression of opinion by a legislative body that has only a temporary effect or no effect at all as a legal matter. G.C.M. 39694, discussing 77 C.J.S. "Resolution" § 1 (1952); Black's Law

[14] Prior to amendment in 1990, the regulations under IRC 4945 also referred to "action by the Congress" in defining legislation. Reg. 53.4945-2(a)(1) now expressly adopts the definition of legislation in the IRC 4911 regulations.

**3. What is meant by "resolutions or similar matters?"**

Dictionary 1178 (5th ed. 1979). Therefore, the determining factor in whether an action is a "similar matter" is not the legal effect of the action, but whether it is an item voted upon by a legislative body.

**4. Does the term "legislation" include the Senate's vote on Executive Branch nominees?**

Yes. The confirmation vote comes within the category of a "similar item" since it is an item voted upon by a legislative body as discussed above. It is similar to a resolution, but is stronger than a resolution since it has a final force and effect. Notice 88-76, 1988-2 C.B. 392 (lobbying on confirmation vote on nominee for federal judgeship constitutes attempting to influence legislation for purposes of IRC 501(c)(3), IRC 4911, and IRC 4945(d)). See also Reg. 56.4911-2(b)(4)(ii)(B), Example (6) (mailing requesting recipients to write to Senators on the Senate Committee that will consider a nomination for a cabinet level post is a grass roots lobbying communication).

**5. Does the term "legislation" include actions by administrative bodies?**

Reg. 1.501(c)(3)-1(c)(3)(ii) limits the definition of legislation to actions by legislatures or by the public through referendum, initiative, constitutional amendment, etc. The implication that actions by administrative bodies do not constitute legislation is made explicit in the regulations under IRC 4911.

Reg. 56.4911-2(d)(3) provides that legislation does not include actions by executive, judicial, or administrative bodies. Reg. 56.4911-2(d)(4) provides that the term "administrative bodies" includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive. Accordingly, an organization would not be influencing legislation for purposes of IRC 4911, if it proposed to a Park Authority that it purchase a particular tract of land for a new park, even though such an attempt would necessarily require the Park Authority eventually to seek appropriations to support a new park.[15]

[15] Reg. 56.4911-2(d)(4) nevertheless concludes that, in such a case, the organization would be influencing legislation if it provided the Park Authority with a proposed budget to be submitted to a legislative body, unless such submission is described by one of the exceptions to influencing legislation.

**6. Does the term "legislation" include zoning matters?**

The consideration of zoning matters varies from jurisdiction to jurisdiction. As noted above, zoning boards may be considered administrative bodies whose actions will not constitute "legislation" within the meaning of IRC 501(c)(3). However, where zoning issues are under the jurisdiction of legislators, who express their will in the form of an Act, etc., the matter is within the purview of the term "legislation." See Rev. Rul. 67-6, 1967-1 C.B. 135, which holds that a historical preservation association engaged primarily in reviewing zoning variances may not qualify for recognition of exemption under IRC 501(c)(3) "since the association as a substantial part of its activities is engaged in attempts to influence local **legislative** representatives with respect to the association's programs." (Emphasis added.)

**7. Is the term "legislation" limited to actions by Federal, State, and local legislatures?**

No. Although the regulations refer specifically to Federal, state and local legislative bodies, the term "legislation" contemplates foreign as well as domestic laws. Rev. Rul. 73-440, 1973-2 C.B. 177. As with domestic governments, the critical issue here is whether there is a legislative body involved. Furthermore, legislative actions by Indian tribal governments also may be considered legislation since these governments are treated as State governments pursuant to IRC 7871.

**8. Is there a distinction between "good" legislation and "bad" legislation?**

For purposes of IRC 501(c)(3), there is no distinction between "good" legislation and "bad" legislation. For example, Rev. Rul. 67-293, 1967-2 C.B. 185, holds that an organization substantially engaged in promoting legislation to protect or otherwise benefit animals is not exempt under IRC 501(c)(3) even though the legislation it advocates may be beneficial to the community. See also Rev. Rul. 67-6, supra. This is in accord with a dictum of the Supreme Court to the effect that the statutory restriction on attempts to influence legislation simply "made explicit" a longstanding judicial principle that "political agitation as such is outside the statute, however innocent the aim." Cammarano v. United States, 358 U.S. 498, 512 (1959), citing Slee, supra. For a direct holding, see Kuper v. Commissioner, 332 F.2d 562 (3rd Cir. 1964), cert. denied, 379 U.S. 920 (1964). In Kuper, the Third Circuit stated that "it is immaterial . . . that the legislation advocated from time to time was intended to promote sound government and was for the benefit of all citizens rather than in the interests of a limited or selfish group." Id. at 563. Likewise, in Haswell v. United States, 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), the Court of Claims concluded:

> *An organization that engages in substantial activity aimed at influencing legislation is disqualified from a tax exemption, whatever the motivation. The applicability of the influencing legislation clause is not affected by the selfish and unselfish motives and interests of the organization, and it applies to all*

> *organizations whether they represent private interests or the interests of the public.* Id. at 1142.

See also League of Women Voters of the United States v. United States, 180 F. Supp. 379 (Ct. Cl. 1960), cert. denied, 364 U.S. 822 (1960).

(2) Attempts to Influence Legislation

**1. What activities are "attempts to influence legislation?"**

Attempts to influence legislation are not limited to direct communications to members of the legislature ("direct" lobbying). Indirect communications through the electorate or general public ("grass roots" lobbying) also constitute attempts to influence legislation. Of course, whether a communication constitutes an attempt to influence legislation is determined on the basis of the facts and circumstances surrounding the communication in question. Both direct and grass roots lobbying are nonexempt activities subject to the IRC 501(c)(3) limitation on substantial legislative action.[16] Reg. 1.501(c)(3)-1(c)(3)(ii).[17]

Reg. 1.501(c)(3)-1(c)(3)(ii) also provides that, more generally, advocating the adoption or rejection of legislation constitutes an attempt to influence legislation for purposes of the IRC 501(c)(3) lobbying restriction. This provision was tested in the case of Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972); cert. denied, 414 U.S. 864 (1973). Christian Echoes National Ministry published articles and produced radio and television broadcasts that urged recipients to become involved in politics and to write to their representatives in Congress to urge that they support prayer in public schools and oppose foreign aid. The organization argued that attempts to influence legislation would occur only if legislation were actually pending. The Tenth Circuit concluded that the regulation properly interpreted the statute, and that the organization was engaged in attempting to influence legislation, even if legislation was not pending.

**2. What is an "action organization?"**

The IRC 501(c)(3) regulations provide that an organization is not operated exclusively for exempt purposes if it is an "action" organization. Reg. 1.501(c)(3)-1(c)(3) uses the term "action" organizations to describe both organizations that

[16] For IRC 501(c)(3) purposes, the distinction between direct and indirect lobbying becomes important for public charities making the IRC 501(h) lobbying election. As discussed in Part 3, there are separate limits for total lobbying and for indirect lobbying. In addition, certain communications made to members are not considered attempts to influence legislation, while other communications to members are considered lobbying.

[17] The regulation, with its specific inclusion of grass roots lobbying, makes clear that the portion of the decision in Seasongood v. Commissioner, 227 F.2d 907 (6th Cir. 1955), that limited "attempting to influence legislation" to direct appeals to the legislature is not reflective of the statute.

attempt to influence legislation and organizations that intervene in political campaigns.

For purposes of the lobbying restriction, an organization is an "action" organization on either of two distinct grounds. The first occurs if a substantial part of the organization's activities involves attempting to influence legislation. Reg. 1.501(c)(3)-1(c)(3)(ii) states that an organization will be regarded as attempting to influence legislation if it does the following:

(A) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation, or

(B) Advocates the adoption or rejection of legislation.

The second ground is found in Reg. 1.501(c)(3)-1(c)(3)(iv), which provides that an organization is an "action" organization if it has the following two characteristics:

(A) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and

(B) It advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public.

In determining whether an organization has these two characteristics, all of the surrounding facts and circumstances, including the articles and all activities of the organization, are to be considered.

**3. How is nonpartisan analysis distinguished from attempts to influence legislation?**

Under IRC 501(c)(3), there are certain circumstances where nonpartisan analysis, study, or research of matters pertaining to legislation may be educational and will not constitute attempts to influence legislation.[18] This occurs where the material is available to the public, governmental bodies, officials, and employees, and where the organization does not advocate the adoption or rejection of legislation. See Reg. 1.501(c)(3)-1(c)(3)(iv). Several revenue rulings discuss this issue.

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[18] In Haswell v. U.S., 500 F.2d 1133, 1144 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), the Court of Claims explained what "nonpartisan" means as follows:

> *"Nonpartisan," as used in the statute and regulations, need not refer to organized political parties. Nonpartisan analysis, study, or research is oriented to issues and requires a fair exposition of both sides of the issue involved.*

In Rev. Rul. 64-195, 1964-2 C.B. 138, an IRC 501(c)(3) organization that conducted educational activities relating to the law, legal education, and lawyers became interested in the question of court reform in the particular state in which it was organized. A constitutional amendment requiring revision of the state's court system was agreed to by the state legislature and submitted to the public for approval. The organization embarked upon a program of study, research, and assembly of the materials necessary to make an evaluation of the legislation. Experts were assembled and employed to conduct an extensive analysis of all materials relating to court reform in the United States and a detailed study and analysis of the pertinent existing case and statutory law of the state. The organization did not expend any funds or otherwise participate in any campaign to present the bills or persuade the public to vote for the amendment. The revenue ruling finds that the organization clearly did not expend funds or participate in any way in the presentation of any proposed bills to the State legislature or advocate either approval or disapproval of the proposed constitutional amendment by the electorate. Instead, the organization's involvement with court reform consisted of the study, research, and assembling of materials on a nonpartisan basis and the dissemination of such materials to the public. Accordingly, the revenue ruling concludes that the organization is not an "action" organization as that term is defined in Reg. 1.501(c)(3)-1(c)(3). Therefore, this activity does not affect its IRC 501(c)(3) status.

In contrast, the IRC 501(c)(4) organization described in Rev. Rul. 68-656, 1968-2 C.B. 216, drafted legislation and presented petitions supporting such legislation. These activities placed the organization beyond the purview of engagement in nonpartisan analysis, study, or research of matters pertaining to legislation; it had crossed over into attempting to influence legislation.[19]

In Rev. Rul. 70-79, 1970-1 C.B. 127, an organization was created to assist local governments of a metropolitan region by studying and recommending regional policies directed at the solution of mutual problems. Although some of the plans and policies formulated by the organization could only be carried out through legislative enactments, the organization did not direct its efforts or expend funds in making any legislative recommendations, preparing prospective legislation, or contacting legislators for the purpose of influencing legislation. Rev. Rul. 70-79 holds that the organization qualifies for IRC 501(c)(3) status because of the educational nature of its activities and because it abstained from advocating the adoption of any legislation or legislative action to implement its findings.

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[19] The facts described in Rev. Rul. 64-195 and Rev. Rul 68-656 bear a distinct resemblance to the facts litigated in Dulles v. Johnson, 273 F. 2d 362 (2d Cir. 1959). In Dulles, the Second Circuit found that bequests to various Bar Associations were deductible from the taxable estate under the predecessor statute to IRC 2055, in part because "the legislative recommendations of the Associations . . . are designed to improve court procedure and or to clarify some technical matter of substantive law. They are not intended for the economic aggrandizement of a particular group or to promote some larger principle of governmental policy." Id. at 367. Rev. Rul. 64-195 also reaches a favorable conclusion, but on the basis of the absence of advocacy. By implication, therefore, it rejects the Dulles basis -- the nature of the legislation. Rev. Rul. 64-195, accordingly, is yet another repudiation of the "good/bad" or "selfish/unselfish" analysis.

The organization described in Rev. Rul. 70-79 can be distinguished from the organization discussed in Rev. Rul. 62-71, 1962-1 C.B. 85. The latter organization is a corporation formed for the purpose of supporting an educational program with regard to a particular doctrine or theory. It was the announced policy of the organization to promote its philosophy by educational methods as well as by the encouragement of political action. Most of the publications disseminated by the organization, together with a substantial part of its other activities, dealt with the theory advocated. This theory or doctrine can be put into effect only by legislative action.

Rev. Rul. 62-71 concludes that while the portion of the organization's activities that consisted of engaging in nonpartisan analysis, study and research and making the results thereof available to the public, when considered alone, may be classified as educational within the meaning of IRC 501(c)(3), the organization was primarily engaged in not only teaching but advocating the adoption of a particular doctrine or theory that can become effective only by the enactment of legislation. Since the primary objective of the organization can be attained only by legislative action, a step that the organization encouraged or advocated as a part of its announced policy, as opposed to merely engaging in nonpartisan analysis, study and research and making the results thereof available to the public, it is an "action" organization as that term is defined in Reg. 1.501(c)(3)-1(c)(3) of the regulations. Accordingly, the organization does not qualify for IRC 501(c)(3) exempt status.

In addition, it should be noted that activities which appear by themselves to be educational in nature may, in fact, be part of a broader purpose to influence specific legislative action. For example, in the case of Roberts Dairy Company v. Commissioner, 195 F.2d 948 (8th Cir. 1952), cert. denied, 344 U.S. 865 (1952), the organization prepared and distributed materials to inform its members and the public of certain tax disparities between business organizations. The court, apparently looking beyond the actual material distributed, held that since the ultimate objective was the revision of the tax laws, the organization was attempting to influence legislation.

**4. May appearances before legislative committees constitute attempts to influence legislation?**

Generally, if an organization appears before a legislative committee to discuss legislation, that action will be an attempt to influence legislation. However, attempting to influence legislation does not include such appearances when the organization appears before legislative committees in response to official requests for testimony. The Service has ruled that a university's exemption would not be jeopardized when, in response to an official request, it sent representatives who could advise a Congressional committee on the possible effects of specific legislation. See Rev. Rul. 70-449, 1970-2 C.B. 111, where the Service concludes that "attempts to influence legislation as described in the regulations imply an affirmative act and require something more than a mere passive response to a Committee invitation." While stating that the legislative history is silent on this point, the Service concludes that "it is unlikely that

Congress, in framing the language of this provision, intended to deny itself access to the best technical expertise available on any matter with which it concerns itself."[20]

**5. May requests to executive bodies constitute attempts to influence legislation?**

As noted above, legislation does not include actions by executive bodies. Therefore, requesting executive bodies to take some action would generally not constitute attempting to influence legislation. This is not the case where the organization requests the executive bodies to support or oppose legislation. Requesting executive bodies to support or oppose legislation is included in the purview of "attempting to influence legislation." Rev. Rul. 67-293, 1967-2 C.B. 185; Roberts Dairy Company v. Commissioner, 195 F.2d 948 (8th Cir. 1952), cert. denied, 344 U.S. 865 (1952); American Hardware and Equipment Company v. Commissioner, 202 F.2d 126 (4th Cir. 1953), cert. denied, 346 U.S. 814 (1953).

**6. May lobbying activities of individuals be attributable to IRC 501(c)(3) organizations?**

Where an IRC 501(c)(3) organization is involved, it is frequently necessary to determine whether a lobbying activity is attributable to the organization or merely the act of an individual. The Service has developed attribution rules to fit a number of situations. Questions involving lobbying activity, political campaign activity, and illegal activity have provided a body of administrative law that may be used to address issues of attribution.

As is noted in G.C.M. 34631 (Oct. 4, 1971) and G.C.M. 39414 (Feb. 29, 1984), principles of agency law apply to this determination. A further discussion of the standards used is found in G.C.M. 34523 (June 11, 1971), which addresses actions attributable to colleges and universities in considering their exempt status:

> *Only actions by the exempt organization can disqualify it from 501(c)(3) status. Since organizations act through individuals, it is necessary to distinguish those activities of individuals done in an official capacity from those that are not. Only official acts can be attributed to the organization. Provision is made in the articles of organization by which a school is created, by its bylaws, and by other valid and proper means, for delegating authority and*

[20] Publication of Rev. Rul. 70-449 was approved in G.C.M. 34289 (May 3, 1970). G.C.M. 34289 furnished a second rationale, i.e., the 1969 enactment of IRC 4945, with the exceptions for nonpartisan analysis, technical advice, and self-defense, was intended to restate, rather than revise, the existing definition of attempting to influence legislation. The same conclusion is expressed in G.C.M. 36127 (Jan. 2, 1975). Rev. Rul. 70-449 did not adopt this position, however; instead, as noted above, the revenue ruling states that the legislative history is silent on this point. As to whether the self-defense exception applies to nonelecting public charities, the Service has not published a precedential document adopting the favorable conclusion of G.C.M. 34289.

*responsibility for operating the school to various people; trustees, administrators, faculty members, student leaders, etc. Each are assigned various tasks. The school is responsible for their acts in discharging these assigned duties. Their personal activities (those not associated with official duties) are not attributable to the school, and are, therefore, not relevant to an investigation of the school's qualification for 501(c)(3) status.*

*Actions by a person in excess of his official authority should not, as a rule, be considered those of the school. If the school allows such usurpation of authority to go unchallenged, however, it impliedly ratifies the act.*

G.C.M. 34631, in considering the effect of possibly illegal activities by members of an organization, makes the following observation:

*We caution, however, that actions of [the organization's] members and officers do not always reflect on the organization. Only (1) acts by [the organization's] officials under actual or purported authority to act for the organization, (2) acts by agents of the organization within their authority to act, or (3) acts ratified by the organization, should be considered as activities of the organization.*

The activities of individuals who are not officials of the organization may also be attributed to an organization. In G.C.M. 39414, the political campaign activities of individual members were attributed to an IRC 501(c)(3) organization. The organization's publication stated that the organization would be sending members to work on political campaigns, members working on political campaigns identified themselves as representing the organization, the organization paid some of the costs incurred by members working on political campaigns, and officials of the organization knew about the members' political activities on behalf of the organization and made no effort to prevent the members' political activities.

On the other hand, in Rev. Rul. 72-513, 1972-2 C.B. 246, the legislative activities of a student newspaper did not jeopardize the exemption of the sponsoring university, despite the fact that the university provided office space and financial support for the publication of the student newspaper and made available several professors to serve as advisors to the staff. The student newspaper provided training for students in various aspects of newspaper publication (including editorial policy) and was distributed primarily to students of the university. Editorial policy was determined by the student editors and not by the university or the faculty advisors. A statement on the editorial page clearly indicated that the views expressed were those of the students and not of the university. The revenue ruling concludes that the legislative activities of the student editors are not attributable to the university despite the university's provision of support to the newspaper.

(3) Limits on Attempts to Influence Legislation

**1. When are attempts to influence legislation considered substantial?**

A determination of whether attempts to influence legislation constitute a "substantial" portion of an organization's total activities is a factual one and there is no simple rule as to what amount of activities is substantial. An often cited case on the subject, Seasongood v. Commissioner, 227 F.2d 907 (6th Cir. 1955), is of limited help. Seasongood held that attempts to influence legislation that constituted five percent of total activities were not substantial. The case presents limited guidance because the court's view of what set of activities were to be measured is no longer supported by the weight of precedent. Moreover, it is not clear how the court arrived at the five percent figure.

Most cases have either tended to avoid any attempt at percentage measurement of activities or, at least, have stated that a percentage test is not conclusive. Thus, in Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1974), the Tenth Circuit rejected the use of a percentage test to determine whether activities were substantial, stating that "[a] percentage test to determine whether activities were substantial obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances." In Haswell v. United States, 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), the Court of Claims cited percentage figures in support of its determination that an organization's lobbying activities were substantial. (The amount of the organization's expenditures for lobbying activities ranged from 16.6 percent to 20.5 percent of total expenditures during the four years at issue.) While the court stated that a percentage test is only one measure of substantiality (and not, by itself, determinative), it held that these percentages were a strong indication that the organization's purposes were no longer consistent with charity.

G.C.M. 36148 (Jan. 28, 1975) characterized the substantiality issue as a "problem [that] does not lend itself to ready numerical boundaries." The G.C.M. then stated:

> *Moreover, the percentage of the budget dedicated to a given activity is only one type of evidence of substantiality. Others are the amount of volunteer time devoted to the activity, the amount of publicity the organization assigns to the activity, and the continuous or intermittent nature of the organization's attention to it. All such factors have a bearing on the relative importance of the activity, and should be given due consideration in determining whether its conduct is reconcilable with the requirement that it operate exclusively for exempt purposes.*
>
> *We therefore think that the Service should not adopt a percentage of total expenditures test for the substantiality of nonexempt activities conducted by exempt organizations. We also think that ten percent would be unjustifiably high, even if a percentage test*

> *were merely adopted for use as a threshold for more intensive auditing in which the Service can give due consideration to the relative importance of volunteer services and the like.*

Nevertheless, while neither the Service nor the courts have adopted a percentage test for determining whether a substantial part of an organization's activities consist of lobbying, some guidance can be derived from Seasongood and Haswell. Under Seasongood, a five percent safe harbor has been frequently applied as a general rule of thumb regarding what is substantial. Similarly, lobbying activities that exceed the roughly 16 to 20 percent range of total activities found in Haswell are generally considered substantial. (Compare these percentages to the sliding scale of percentage of expenditures allowed to organizations that elect to be governed by IRC 501(h) as discussed below.)

**2. May supporting activities also be considered attempts to influence legislation?**

In determining whether an organization has engaged in attempts to influence legislation as a substantial activity, it is sometimes difficult to determine what supporting activities should be included with the proscribed attempts to influence legislation. This is often a problem where an organization has some activities that are admittedly educational. Frequently, much effort is devoted to research, discussion, and similar activities. The problem is how much of these back-up activities should be considered part of the attempts to influence legislation. In League of Women Voters of the United States v. United States, 180 F. Supp, 379 (Ct. Cl. 1960), cert. denied, 364 U.S. 882 (1960), the time spent in discussing public issues, formulating and agreeing upon positions, and studying them preparatory to adopting a position was taken into account and compared with the other activities in determining the substantiality of the attempts to influence legislation. Attempting to influence legislation does not necessarily begin at the moment the organization first addresses itself to the public or to the legislature. See also Kuper v. Commissioner, 332 F.2d 562 (3d Cir. 1964), cert. denied, 379 U.S. 920 (1964). Furthermore, all facts and circumstances must be considered in determining whether the lobbying activities of an IRC 501(c)(3) organization are substantial, not just the amount of expenditures made.

3. Lobbying Activities of IRC 501(c)(3) Electing Public Charities

A. Legislative and Regulatory History

(1) Enactment of the Statutes

During the period from 1934 to 1976, the lobbying limitation was subject to increasing public criticism. The passage of IRC 162(e) in 1962, permitting a business expense deduction for direct lobbying expenses, led to the argument that equal treatment should be given to charitable organizations. Meanwhile, the courts were having a difficult time measuring the "substantiality" of these activities.

Congress enacted IRC 501(h) and IRC 4911 as part of the Tax Reform Act of 1976.[21] These provisions were intended to remedy some of the problems that had arisen under existing law by setting specific permissible expenditure limits. The Joint Committee on Taxation, in its General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. (Vol. 2) 419-420, explains the reasons for enactment of these statutes:

> *The language of the lobbying provision was first enacted in 1934. Since that time neither Treasury regulations nor court decisions gave enough detailed meaning to the statutory language to permit most charitable organizations to know approximately where the limits were between what was permitted by the statute and what was forbidden by it. The vagueness was, in large part, a function of the uncertainty in the meaning of the terms "substantial part" and "activities."*
>
> *Many believed that the standards as to the permissible level of activities under prior law were too vague and thereby tended to encourage subjective and selective enforcement.*
>
> *Except in the case of private foundations, the only sanctions available under prior law with respect to an organization which exceeded the limits on permitted lobbying were loss of exempt status under section 501(c)(3) and loss of qualification to receive charitable contributions. Some organizations (particularly organizations which had already built substantial endowments) could split up their activities between a lobbying organization and a charitable organization. For such organizations, these sanctions may have had little effect, and the lack of effect may have tended to discourage enforcement effort.*
>
> *For other organizations which could not split up their activities between a lobbying organization and a charitable organization and which had to continue to rely on the receipt of deductible contributions to carry on their exempt purposes, loss of section 501(c)(3) status could not be so easily compensated for and constituted a severe blow to the organization.*
>
> *The Act is designed to set relatively specific expenditure limits to replace the uncertain standards of prior law, to provide a more rational relationship between the sanctions and the violation of standards, and to make it more practical to properly enforce the*

[21] For an account of the progress of the legislation until its enactment, see Bruce R. Hopkins, The Law of Tax-Exempt Organizations, 310-312 (4th ed. 1993). For another history, written just before passage of the legislation, see Pepper, Hamilton & Sheetz, "Legislative Activities of Charitable Organizations Other Than Private Foundations," in 5 Commission on Private Philanthropy and Public Needs, Research Papers, 2917, 2926-2928 (1975).

> *law. However, these new rules replace prior law only as to charitable organizations which elect to come under the Standards of the Act. The new rules also do not apply to churches and organizations affiliated with churches, nor do they apply to private foundations; prior law continues to apply to these organizations. The Act provides for a tax of 25 percent of the amount by which the expenditures exceed the permissible level. Revocation of exemption is reserved for those cases where the excess is unreasonably great over a period of time.*

At the same time, Congress enacted IRC 504.[22] This provision provided, with certain exceptions, that IRC 501(c)(3) organizations that lose exempt status due to excessive lobbying may not at any time thereafter be treated as IRC 501(c)(4) organizations. IRC 504 is discussed in Part 5.

(2) Overview of the Statutes

Eligible public charities (listed in IRC 501(h)(4)) may elect to be governed by the IRC 501(h) substantiality test. Non-electing organizations (whether eligible or not) will be subject to the ordinary facts and circumstances substantiality test of IRC 501(c)(3) as discussed above.

IRC 501(h) establishes a sliding scale of permissible "lobbying nontaxable amounts." Nontaxable amounts are computed for both total and grass roots lobbying. These amounts are deemed insubstantial, and expenditures under the nontaxable amounts will result in neither tax nor revocation. Expenditures in excess of the nontaxable amounts are "excess lobbying expenditures." An excise tax under IRC 4911 is imposed on excess lobbying expenditures. If lobbying expenditures exceed both the permitted total lobbying amount and the grass roots amount, the IRC 4911 tax is imposed on whichever excess is greater. "Affiliated" organizations generally are treated as a single organization for purposes of computing lobbying expenditures. IRC 501(h) applies for taxable years beginning after December 31, 1976.

For IRC 501(c)(3) organizations that elect to be covered by IRC 501(h), lobbying may cause revocation of exempt status only if the amounts spent on lobbying "normally" exceed 150 percent of either of the nontaxable amounts over a four year period. Therefore, the tests of whether an organization is an "action" organization, set forth in Reg. 1.501(c)(3)-1(c)(3), should not be used to determine whether an organization that has made the IRC 501(h) election has engaged in substantial lobbying activities.

[22] Prior to 1969, IRC 504 had provided a rule against unreasonable accumulations by charities. This provision was repealed as part of the Tax Reform Act of 1969 and replaced with IRC 4942, which applies only to private foundations.

(3) History of the Regulations

In 1986, proposed regulations were published to implement the provisions of IRC 501(h) and IRC 4911. 51 FR 40211 (Nov. 5, 1986). Controversy ensued. The particular areas of concern were the definition of grass roots lobbying and the allocation rules.

As the individuals who had primary responsibility for drafting the 1988 proposed regulations, James J. McGovern, Paul G. Accetura, and Jerome P. Walsh Skelly, observe in "The Revised Lobbying Regulations, A Difficult Balance," 41 Tax Notes 1426, 1428 (Dec. 26, 1988) (hereinafter "McGovern 1988"): "The nonprofit community was effectively mobilized by a number of umbrella groups and their constituent members." The Service and Congress received more than ten thousand letters from charities and their members requesting withdrawal of the proposed regulations. These comments were generated by concerns that the regulations were overly restrictive and would have a "chilling effect" on charities' involvement in the policy making process.[23]

Members of Congress also expressed concern. Sixteen members of the Senate Finance Committee wrote a letter asking the Service to withdraw the proposed regulations. The letter stated that the proposed regulations "appear to introduce ambiguity about what activities constitute lobbying by such groups, and we believe that may restrict lobbying in ways not intended by the 1976 Act." "Congressional Tax Writers Seek Withdrawal of Proposed Regs on Lobbying by Tax-Exempt Groups," 34 Tax Notes 929 (Mar. 2, 1987). House Ways and Means Committee Chairman Dan Rostenkowski also requested that the proposal regulations be withdrawn, suggesting that the Service consult with an advisory group comprised of representatives of the public and private sector. He emphasized, however, that he would "strongly resist any suggestion that the pending controversy be settled legislatively by the Congress." See "McGovern 1988" at 1428.

While the Service did not withdraw the 1986 proposed regulations, it publicly stated in an information release, IR-87-49 (April 9, 1987), that it would reconsider key portions of the regulations. Two days of public hearings were held in 1987. In June 1987, the Service announced the establishment of a Commissioner's Exempt Organizations Advisory Group (as had been suggested by Mr. Rostenkowski). At public meetings held on September 17, 1987, and February 26, 1988, possible revisions to the 1986 proposed regulations were discussed with this Advisory Group. Substantial revisions to the regulations were published in proposed form in

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[23] For example, approximately 200 organizations signed an Independent Sector position statement asking that the rules be permanently withdrawn. "Opposition to IRS Lobbying Rules Solidifies: Senate Tax Writers Join Cause," Daily Tax Report (BNA) No. 29, at G-5 (Feb. 13, 1987). Similarly, OMB Watch, an IRC 501(c)(4) organization formed to monitor activities of the Office of Management and Budget and other executive agencies, asked readers to contact Congress to tell the Service to withdraw these regulations "through passing a bill, a sense of Congress resolution, an appropriations rider denying funds to the IRS for any work on or enforcement of these regulations, or any other method Congress thinks best." "Congressional Support Sought for Protest of IRS Lobbying Proposal," Daily Tax Report (BNA) No. 15, at G-1 (Jan. 23, 1987). In addition, OMB Watch held community briefings throughout the country "to educate people about the proposed rules and encourage a grass roots campaign to force IRS to withdraw them." Id.

1988. 53 FR 51826 (Dec. 23, 1988). Messrs. McGovern, Accetura, and Walsh Skelly, "The Final Lobbying Regulations: A Challenge for Both the IRS and Charities," 48 Tax Notes 1305, 1306 (Sept. 3, 1990); 3 EOTR 766, 767 (Sept. 1990) (hereinafter "McGovern 1990"), explained the approach of the 1988 proposed regulations as follows:

> *The 1988 proposed regulations were an attempt to address charities' legitimate concerns without eliminating the statutory limits and thus opening the Service up to charges of failing to fulfill its statutory mandate. To accomplish this, the Service crafted a number of bright-line objective rules. Like all bright-line objective rules, these rules are imperfect: in certain cases, the rules will inevitably permit expenditures to be treated as nonlobbying even though the public would probably consider those expenditures to be clear examples of lobbying.*

In contrast to the reception accorded the 1986 proposed regulations, the publication of the 1988 proposed regulations resulted in less than 100 written comments. The comments were almost uniformly favorable. The 1988 proposed regulations were discussed with the Commissioner's Exempt Organizations Advisory Group at a public meeting held on January 10, 1989, and a formal public hearing was held on April 3, 1989. The final regulations were published in 1990 and contained few technical changes from the 1988 proposed regulations. They were made effective as of the date of publication. T.D. 8308, 55 FR 35579 (Aug. 31, 1990).

B. Specific Issues

(1) The IRC 501(h) Election

**1. What organizations may make an election under IRC 501(h)?**

IRC 501(h)(3) provides that the provisions of IRC 501(h) will apply to any eligible IRC 501(c)(3) organization that has elected to have those provisions apply.[24] To be eligible to make the IRC 501(h) election, the IRC 501(c)(3) organization must be an organization described in IRC 501(h)(4) and it must not be a disqualified organization described in IRC 501(h)(5). The IRC 501(c)(3) organizations described in IRC 501(h)(4) are as follows:

(1) Educational institutions as described in IRC 170(b)(1)(A)(ii);

[24] The Service's records indicate that, as of April 1996, 6,087 organizations have made the election by filing Form 5768 over the past five years. The IRC 501(c)(3) population eligible to make the election, as of March 1, 1996, is approximately 452,000 organizations.

In contrast, during that same time period, 2,407 organizations checked "yes" to the "attempted to influence legislation" question (Question 1, Part III of Schedule A, Form 990), but did not file Form 5768.

(2) Hospitals and medical research organizations as described in IRC 170(b)(1)(A)(iii);

(3) Organizations that support government schools as described in IRC 170(b)(1)(A)(iv);

(4) Organizations publicly supported by charitable contributions as described in IRC 170(b)(1)(A)(vi);

(5) Organizations publicly supported by admissions, sales, etc. related to their exempt purpose as described in IRC 509(a)(2); and

(6) Organizations that are public charities because they are a supporting organization described in IRC 509(a)(3) of an IRC 501(c)(3) organization that is described in IRC 509(a)(1) or IRC 509(a)(2).

**2. What organizations may not use the IRC 501(h) election?**

IRC 501(c)(3) organizations may not elect to be covered by the provisions of IRC 501(h) if they are not described under IRC 501(h)(4) or if they are disqualified under IRC 501(h)(5). The organizations that are ineligible to make an IRC 501(h) election are as follows:

(1) Churches or conventions or associations of churches as described in IRC 170(b)(1)(A)(i);

(2) Integrated auxiliaries of a church or convention or association of churches (IRC 508(c) and IRC 6033);

(3) Organizations described in IRC 501(c)(3) and affiliated with at least one church or convention or association of churches or an integrated auxiliary (an "affiliated group" within the meaning of IRC 4911(f)(2));

(4) Organizations that are public charities because they are a supporting organization described in IRC 509(a)(3) of certain organizations exempt under IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6);

(5) Organizations engaged in testing for public safety and thus described in IRC 509(a)(4); and

(6) Private foundations.

**3. Why are churches precluded from making an election under IRC 501(h)?**

Churches, along with church-related organizations, were precluded from making an election under IRC 501(h) at their own request. The Joint Committee on Taxation, in its General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. (Vol. 2) 415-416, notes that church groups expressed concern that any restriction on their lobbying activities might violate their rights under the First Amendment. More particularly, the church groups were concerned that including them among the class of organizations eligible to elect might imply Congressional ratification of the decision in Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973), which held that the limitations on lobbying were constitutionally valid and that First Amendment rights in the face of such limitations were not absolute.

By disqualifying churches and church-related organizations from making the election, Congress sought to remain neutral on the constitutional issue; in fact the Joint Committee on Taxation's Explanation explicitly states: "So that unwarranted inferences may not be drawn from the enactment of this Act, the Congress states that its actions are not to be regarded in any way as an approval or disapproval of the decision [in Christian Echoes], or of the reasoning in any of the opinions leading to that decision." Id. at 420.

**4. How is an election under IRC 501(h) made?**

An eligible IRC 501(c)(3) organization may make an IRC 501(h) election for any taxable year of the organization beginning after December 31, 1976, other than the first taxable year for which a voluntary revocation of the election is effective. Voluntary revocations are discussed below. The election is made by filing a completed Form 5768, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation*, with the appropriate Internal Revenue Service Center.

**5. When is an election under IRC 501(h) effective?**

Under IRC 501(h)(6), the election is effective with the beginning of the taxable year in which the Form 5768 is filed. For example, an eligible organization with the calendar year as its taxable year files Form 5768 making the IRC 501(h) election on December 31, 1996. The organization's IRC 501(h) election is effective for its taxable year beginning January 1, 1996. Once the IRC 501(h) election is made, it is effective (without again filing Form 5768) for each succeeding taxable year for which the organization is an eligible organization and which begins before a notice of revocation is filed. Reg. 1.501(h)-2(a).

A newly created organization may submit Form 5768 to elect the expenditure test under IRC 501(h) at the time it submits its Form 1023, *Application for Recognition of Exemption under*

**6. When may a newly created organization make an election under IRC 501(h)?**

*Section 501(c)(3) of the Internal Revenue Code.*[25] If the organization is determined to be eligible under IRC 501(h), the election will be effective with the beginning of the taxable year in which the Form 5768 is filed. However, if the organization is determined by the Service not to be eligible to make an IRC 501(h) election, the election will not be effective and the substantial part test will apply from the effective date of its IRC 501(c)(3) classification. Reg. 1.501(h)-2(c).

**7. How may an organization voluntarily revoke its IRC 501(h) election?**

An organization may voluntarily revoke an expenditure test election by filing a notice of voluntary revocation (Form 5768) with the appropriate Service Center. IRC 501(h)(6)(B), a voluntary revocation is effective with the beginning of the first taxable year after the taxable year in which the notice is filed.

For example, an eligible organization with the calendar year as its taxable year files Form 5768 revoking its IRC 501(h) election on May 31, 1996. The organization's IRC 501(h) election remains in effect for its taxable year beginning January 1, 1996, but is no longer in effect for its taxable year beginning January 1, 1997. When an organization voluntarily revokes its election, the substantial part test of IRC 501(c)(3) (as discussed above) will apply with respect to the organization's activities in attempting to influence legislation beginning with the taxable year for which the voluntary revocation is effective. Reg. 1.501(h)-2(d)(1).

**8. May an organization that voluntarily revoked its election make the election again?**

An organization that voluntarily revokes its election under IRC 501(h) may make the IRC 501(h) expenditure test election again. However, the new election may be effective no earlier than the taxable year following the first taxable year for which the voluntary revocation is effective. Reg. 1.501(h)-2(d)(2). Reg. 1.501(h)-2(d)(3) furnishes the following example:

> *X, an organization whose taxable year is the calendar year, plans to voluntarily revoke its expenditure test election effective beginning with its taxable year 1985. X must file its notice of voluntary revocation on Form 5768 after December 31, 1983, and before January 1, 1985. If X files a notice of voluntary revocation on December 31, 1984, the revocation is effective beginning with its taxable year 1985. The organization may again elect the*

[25] The organization may submit its Form 5768 to the appropriate key district office as long as its application for recognition of IRC 501(c)(3) exemption is being considered by that office.

*expenditure test by filing Form 5768. Under Reg. 1.501(h)-2(d)(2), the election may not be made for taxable year 1985. Under Reg. 1.501(h)-2(a), a new expenditure test election will be effective for taxable years beginning with taxable year 1986, if the Form 5768 is filed after December 31, 1985, and before January 1, 1987.*

**9. May an IRC 501(h) election be involuntarily revoked?**

If, while an election under IRC 501(h) by an eligible organization is in effect, the organization ceases to qualify as an eligible organization, its election is automatically revoked. The revocation is effective with the beginning of the first full taxable year for which it is determined that the organization is not an eligible organization. If an organization's expenditure test election is involuntarily revoked but the organization continues to be described in IRC 501(c)(3), the substantial part test of IRC 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the first taxable year for which the involuntary revocation is effective.[26] Reg. 1.501(h)-2(e).

(2) Limits on Lobbying Expenditures

**1. What are "excess lobbying expenditures"?**

As previously noted, a tax is imposed under IRC 4911(a)(1) on the excess lobbying expenditures of public charities that have elected to be covered by IRC 501(h). The tax imposed is equal to 25 percent of the amount of the organization's excess lobbying expenditures for the taxable year. IRC 4911(a)(2) provides that, for purposes of IRC 4911, the term "excess lobbying expenditures" for a taxable year means the greater of the following amounts:

(A) The amount by which the lobbying expenditures made by the organization during the taxable year exceed the lobbying nontaxable amount for such organization during such taxable year, or

(B) The amount by which the grass roots expenditures made by the organization during the taxable year exceed the grass roots nontaxable amount for such organization for such taxable year.

IRC 4911(c)(2) provides that the nontaxable amount of lobbying expenditures is the lesser of $1,000,000 or an amount determined under a sliding scale, set forth in the statute, of percentage of exempt purpose expenditures. The nontaxable amount of grassroots lobbying

[26] The situations contemplated here include, for example, an IRC 501(c)(3) public charity that becomes a private foundation or a public charity that continues to be described in IRC 501(c)(3) but becomes a supporting organization of an IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6) entity.

## 2. What are the nontaxable amounts?

expenditures is 25 percent of the nontaxable amount of lobbying expenditures. IRC 4911(c)(4). The following table sets forth the nontaxable amounts:

| Exempt Purpose Expenditures | Total Nontaxable | Grass Roots Nontaxable |
|---|---|---|
| Up to $500,000 | 20% | 5% |
| $500,000 to $1,000,000 | $100,000 + 15% of excess over $500,000 | $25,000 + 3.75% of excess over $500,000 |
| $1,000,000 to $1,500,000 | $175,000 + 10% of excess over $1,000,000 | $43,750 + 2.5% of excess over $1,000,000 |
| $1,500,000 to $17,000,000 | $225,000 + 5% of excess over $1,500,000 | $56,250 + 1.25% of excess over $1,500,000 |
| Over $17,000,000 | $1,000,000 | $250,000 |

## 3. What are the lobbying and grass roots <u>ceiling</u> amounts?

An IRC 501(c)(3) organization that has made the election to be covered by IRC 501(h) will not be denied exemption due to substantial lobbying activities unless it normally makes lobbying or grass roots expenditures in excess of the applicable ceiling amounts. The applicable ceiling amounts for lobbying expenditures is 150 percent of the lobbying nontaxable amount for the base years (IRC 501(h)(2)(B)) and for grass roots expenditures is 150 percent of the grassroots lobbying nontaxable amount for the base years (IRC 501(h)(2)(D)).

In general, the term "base years" means the determination year and the three taxable years immediately preceding the determination year.[27] The base years, however, do not include any taxable year preceding the taxable year for which the organization is first treated as described in IRC 501(c)(3). Reg. 1.501(h)-3(c)(7).

Reg. 1.501(h)-3(b)(2), however, provides a special exception for an organization's first election. Under this exception, for the first, second, or third consecutive determination year for which an organization's first expenditure test election is in effect, the organization will not be denied exemption from tax by reason of IRC 501(h) if, taking into account as base years only those years for which the expenditure test election is in effect the following conditions are met:

(A) The sum of the organization's lobbying expenditures for such base years does not exceed 150 percent of the sum of its lobbying nontaxable amounts for the same base years; and

[27] A taxable year is a "determination year" if it is a year for which the expenditure test election is in effect, other than the taxable year for which the organization is first treated as described in IRC 501(c)(3). Reg. 1.501(h)-3(c)(8).

(B) The sum of the organization's grass roots expenditure for those base years does not exceed 150 percent of the sum of its grass roots nontaxable amounts for such base years.

Thus, the mere fact that an organization pays tax under IRC 4911 does not indicate that it will lose its exemption under IRC 501(c)(3). On the contrary, using the election and occasionally paying the tax, if necessary, was designed to allow that leeway.

## 4. How are these rules applied?

Reg. 1.501(h)-3(e) provides a number of examples illustrating how excess lobbying expenditures are calculated, how the tax imposed by IRC 4911(a)(1) is calculated, and how the determination is made concerning whether the electing public charity is denied exempt status under IRC 501(c)(3) because of its lobbying activities.

One example involves an organization whose taxable year is the calendar year that has been recognized as an IRC 501(c)(3) organization for a number of years prior to making the expenditure test election under IRC 501(h) effective for taxable year 1979. The organization has not revoked the election. The following table contains information used in this example.

| Year | Exempt purpose expenditures (EPE) (dollars) | Calculation | Lobbying nontaxable amount (LNTA) (dollars) | Lobbying expenditures (LE) (dollars) | Grass roots nontaxable amount (25% of LNTA) (dollars) | Grass roots expenditures (dollars) |
|---|---|---|---|---|---|---|
| 1979 | 700,000 | (20% of $500,000 + 15% of $200,000 =) | 130,000 | 120,000 | 32,500 | 30,000 |
| 1980 | 800,000 | (20% of $500,000 + 15% of $300,000 =) | 145,000 | 100,000 | 36,250 | 60,000 |
| 1981 | 800,000 | (20% of $500,000 + 15% of $300,000 =) | 145,000 | 100,000 | 36,250 | 65,000 |
| 1982 | 900,000 | (20% of $500,000 + 15% of $400,000 =) | 160,000 | 150,000 | 40,000 | 65,000 |
| Total | 3,200,000 | | 580,000 | 470,000 | 145,000 | 220,000 |

In this example, the organization is liable for the tax imposed under IRC 4911 for 1980, 1981, and 1982 because its grass roots expenditures exceeded its grass roots nontaxable amount in each of those years, even though its total lobbying expenditures did not exceed the lobbying nontaxable amount. The tax imposed by IRC 4911(a) for 1980 is $5,937.50 which is equal to 25 percent of $13,750 (the difference between $60,000 and $36,250). For 1981, the tax is $7,187.50 and for 1982, the tax is $6,250. For the tax years 1979, 1980, and 1981, the organization meets the special exception under Reg. 1.501(h)-3(b)(2). However, for the taxable year 1982, the total grass roots expenditures for the base years (1979 through 1982) exceeds the grass roots ceiling amount of $217,500 (150 percent of $145,000). Consequently, for the taxable year 1983, the organization is denied tax exemption as an organization described in IRC 501(c)(3). The organization must again apply for recognition of exemption pursuant to Reg. 1.501(h)-3(d) for taxable years after 1983. Reg. 1.501(h)-3(e), Example (2).

Another example concerns an organization, whose taxable year is the calendar year, that made its IRC 501(h) election effective for its taxable year 1977, the first year it was treated as an organization described in IRC 501(c)(3). The organization has not revoked the election. The following table contains information used in this example.

| Taxable Year | Exempt purpose expenditures (EPE) (dollars) | Calculation | Lobbying nontaxable amount (LNTA) (dollars) | Lobbying expenditures (LE) (dollars) | Grass roots nontaxable amount (25% of LNTA) (dollars) | Grass roots expenditures (dollars) |
|---|---|---|---|---|---|---|
| 1977 | 700,000 | (20% of $500,000 + 15% of $200,000 =) | 130,000 | 182,000 | 32,500 | 30,000 |
| 1978 | 800,000 | (20% of $500,000 + 15% of $300,000 =) | 145,000 | 224,750 | 36,250 | 35,000 |
| Subtotal | 1,500,000 | | 275,000 | 406,750 | 68,750 | 65,000 |
| 1979 | 900,000 | (20% of $500,000 + 15% of $400,000 =) | 160,000 | 264,000 | 40,000 | 50,000 |
| Totals | 2,400,000 | | 435,000 | 670,750 | 108,750 | 115,000 |

In this example, the organization is liable for the tax imposed under IRC 4911 in 1977, 1978, and 1979 because its total lobbying expenditures exceed its lobbying nontaxable amount in each of those years. Although its grass roots lobbying expenditures exceeded its grass roots lobbying nontaxable amount in 1979, the tax is calculated based on the excess lobbying expenditures in all three years since that amount is greater. The tax for 1977 is 25 percent of the difference between $182,000 and $130,000 ($13,000). The tax for 1978 is $19,937.50 and the tax for 1979 is $26,000. Pursuant to Reg. 1.501(h)-3(c)(8), the organization is not required to determine if it continues to qualify for IRC 501(c)(3) exempt status for 1977 since that is its first year as an IRC 501(c)(3) organization. For 1978, the total lobbying expenditures and grass roots expenditures for the organization's base years (1977 and 1978) do not exceed 150 percent of its lobbying nontaxable amount or its grass roots nontaxable amount. However, for 1979, the total lobbying expenditures of the organization for its base years (1977 through 1979) do exceed $652,500 (150 percent of $435,000). As a result, for the taxable year 1980, the organization is denied tax exemption as an organization described in IRC 501(c)(3). The organization must again apply for recognition of exemption pursuant to Reg. 1.501(h)-3(d) for taxable years after 1980. Reg. 1.501(h)-3(e), Example (3).

(3) Exempt Purpose Expenditures

**1. What are "exempt purpose expenditures?"**

Reg. 56.4911-4 provides rules under IRC 4911(e) for determining an electing public charity's "exempt purpose expenditures." The regulation also provides that, in determining exempt purpose expenditures, no expenditure shall be counted twice by an organization.

Under Reg. 56.4911-4(b), amounts paid or incurred by an organization that are exempt purpose expenditures include the following:

(A) Amounts paid or incurred to accomplish a purpose enumerated in IRC 170(c)(2)(B) including certain transfers made by the organization;

(B) Amounts paid or incurred as current or deferred compensation for an employee's services in connection with an IRC 170(c)(2)(B) purpose;

(C) The allocable portion of administrative overhead and other general expenditures attributed to accomplishing IRC 170(c)(2)(B) purposes;

(D) All lobbying expenditures;

(E) Amounts paid or incurred for activities that are not considered lobbying because they are described in Reg. 56.4911-2(c), e.g., nonpartisan analysis, study, and research, or member communications described in Reg. 56.4911-5 that are not lobbying expenditures;

(F) A reasonable allowance for exhaustion, wear and tear, obsolescence or amortization, of assets to the extent used for one or more of the above purposes computed on a straight-line basis;[28] and

(G) Certain fundraising expenditures (but see IRC 4911(e)(1)(C) and Reg. 56.4911-4(c)(3) and Reg. 56.4911-4(c)(4)).

**2. What are not "exempt purpose expenditures?"**

Under Reg. 56.4911-4(c), exempt purpose expenditures do not include the following types of expenditures:

(A) Amounts paid or incurred that are not described in Reg. 56.4911-4(b);

[28] For this purpose, an allowance for depreciation will be treated as reasonable if based on a useful life that would satisfy IRC 321(k)(3)(A) as in effect on January 1, 1985.

(B) The amounts of any transfer described in Reg. 56.4911-4(e);

(C) Amounts paid to or incurred for a "separate fundraising unit" of the organization or of an affiliated organization;[29]

(D) Amounts paid to or incurred for any person not an employee, or any organization not an affiliated organization, if paid or incurred primarily for fundraising, but only if such person or organization engages in fundraising, fundraising counselling or the provision of similar advice or services;

(E) Amounts paid or incurred chargeable to a capital account, determined in accordance with the principles that apply under IRC 263 or IRC 263A, with respect to an unrelated trade or business;

(F) Amounts paid or incurred for a tax that is not imposed in connection with the organization's efforts to accomplish an IRC 170(c)(2)(B) purpose, such as taxes imposed under IRC 511(a)(1) and IRC 4911(a); and

(G) Amounts paid or incurred for the production of income.[30]

### 3. When are transfers exempt purpose expenditures?

There are two types of transfers that will be treated as an exempt purpose expenditure. The first is a transfer made to an organization described in IRC 501(c)(3) in furtherance of the transferor's exempt purposes that is not earmarked for any purpose other than one described in IRC 170(c)(2)(B). Therefore, a payment of dues by a local or state organization to, respectively, a state or national organization that is described in IRC 501(c)(3) is considered an exempt purpose expenditure of the transferor to the extent it is not otherwise earmarked.

[29] Reg. 56.4911-4(f)(2) provides that, for this purpose, a separate fundraising unit of any organization must consist of either two or more individuals a majority of whose time is spent on fundraising for the organization, or any separate accounting unit of the organization that is devoted to fundraising. Furthermore, for this purpose, amounts paid to or incurred for a separate fundraising unit include all amounts incurred for the creation, production, copying, and distribution of the fundraising portion of a separate fundraising unit's communication. (For example, an electing public charity that has a separate fundraising unit may not count the cost of postage for a separate fundraising unit's communication as an exempt purpose expenditure even though, under the electing public charity's accounting system, that cost is attributable to the mailroom rather than to the separate fundraising unit.)

[30] For purposes of this section, amounts are paid or incurred for the production of income if they are paid or incurred for a purpose or activity that is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational or other purpose or function constituting the basis for its exemption under IRC 501. For example, the costs of managing an endowment are amounts that are paid or incurred for the production of income and are thus not exempt purpose expenditures. Fundraising expenditures are not, for purposes of this section, amounts that are paid or incurred for the production of income. Instead, the determination of whether fundraising costs are exempt purpose expenditures must be made with reference to IRC 4911(e)(1)(C), Reg. 56.4911-4(b)(8), Reg. 56.4911-4(c)(3), and Reg. 56.4911-4(c)(4).

Reg. 56.4911-4(d)(2). The second type is a "controlled grant," but only to the extent of the amounts that are paid or incurred by the transferee that would be exempt purpose expenditures if paid or incurred by the transferor.[31] Reg. 56.4911-4(d)(3).

On the other hand, Reg. 56.4911-4(e) provides that three types of transfers cannot be considered exempt purpose expenditures. The first type is a transfer made to a member of any affiliated group (as defined in Reg. 56.4911-7(e)) of which the transferor is a member. Reg. 56.4911-4(e)(2).

The second type is a transfer that the Commissioner determines artificially inflates the amount of the transferor's or transferee's exempt purpose expenditures. The regulation provides that this determination generally will be made if a substantial purpose of a transfer is to inflate those exempt purpose expenditures. When this determination is made, the transfer will not be considered an exempt purpose expenditure of the transferor; rather, it will be an exempt purpose expenditure of the transferee to the extent that the transferee expends the transfer in the active conduct of its charitable activities or attempts to influence legislation. Standards similar to those found in Reg. 53.4942(b)-1(b) (relating to operating foundations) may be applied in determining whether the transferee has expended amounts in the "active conduct" of its charitable activities or attempts to influence legislation. Reg. 56.4911-4(e)(3).

The third type is a transfer that is not a "controlled grant" and is made to an organization not described in IRC 501(c)(3) that does not attempt to influence legislation. Reg. 56.4911-4(e)(4).

### 4. How are exempt purpose expenditures determined?

Reg. 56.4911-4(g) illustrates the provisions relating to the determination of exempt purpose expenditures by discussing the example of an organization that is an exempt organization described in IRC 501(c)(3) organized for the purpose of rehabilitating alcoholics. The organization elected to be subject to the provisions of IRC 501(h) in 1981. For 1981, the organization had expenditures as indicated in the following chart. Those expenditures are included in its exempt purpose expenditures to the extent indicated.

[31] Reg. 56.4911-4(f)(3) defines a "controlled grant" as a grant made by an organization eligible to elect the expenditure test to an organization not described in IRC 501(c)(3) that meets the following requirements:

(i) The donor limits the grant to a specific project of the recipient that is in furtherance of the donor's (nonlobbying) exempt purposes; and

(ii) The donor maintains records to establish that the grant is used in furtherance of the donor's (nonlobbying) exempt purposes.

| Description | Total (dollars) | Includible (dollars) |
|---|---|---|
| Cost of real estate purchased for use as half-way house for alcoholics, attributable to the following: | | |
| Land | 30,000 | |
| Building | 200,000 | |
| Depreciation (based on 40-year useful life) | | 5,000 |
| Expenses of operating its half-way house | 170,000 | 170,000 |
| Administrative expenses of the organization allocated to the operation of its half-way house | 95,000 | 95,000 |
| Depreciation and allowances for equipment | 10,000 | 10,000 |
| Expenses related to attempts to influence legislation (lobbying expenditures) | 40,000 | 40,000 |
| Amounts paid to Z by the Organization for fundraising | 35,000 | |
| Total | 580,000 | 320,000 |

Thus, for 1981, the organization's exempt purpose expenditures total $320,000. This amount includes both the direct costs of operating the half-way house as well as the administrative costs allocable to its operation. It also includes all lobbying expenses in full. Only depreciation computed on a straight-line basis is included in exempt purpose expenditures. The cost of capital expenditures (the land and building) is not included in exempt purpose expenditures. In addition, the $35,000 paid by the organization for fundraising is not included in the exempt purpose expenditures total.

(4) Direct Lobbying and Grass Roots Lobbying

**1. What are lobbying expenditures?**

For public charities that elect to be covered by IRC 501(h), lobbying expenditures are expenditures made for the purpose of influencing legislation (as defined in IRC 4911(d)). IRC 501(h)(2)(A). An electing public charity's lobbying expenditures for a year are the sum of its expenditures during that year for direct lobbying communications ("direct lobbying expenditures") plus its expenditures during that year for grass roots lobbying communications ("grass roots expenditures").

**2. What is the distinction between "direct" and "grass roots" lobbying?**

"Direct" lobbying involves attempts to influence legislation through communication with any member or employee of a legislative body. It also involves attempts to influence legislation through communication with any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation, but only if the principal purpose of the

communication is to influence legislation.[32] IRC 4911(d)(1)(B); Reg. 56.4911-2(b)(1)(i). "Grass roots" lobbying involves attempts to influence legislation through an attempt to affect the opinions of the general public or any segment of the public. IRC 4911(d)(1)(A); Reg. 56.4911-2(b)(2)(i).

### 3. What is "legislation?"

Reg. 56.4911-2(d)(1)(i) provides that "legislation" includes action by the Congress, any state legislature, any local council, or similar legislative body, or by the public in a referendum, ballot initiative, constitutional amendment, or similar procedure. (See the discussion regarding the meaning of "action of the Congress" for purposes of the lobbying restriction for nonelecting charities.) "Legislation" includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

### 4. What is "specific legislation?"

Under Reg. 56.4911-2(d)(1)(ii), "specific legislation" includes both legislation that has already been introduced in a legislative body and specific legislative proposals that the organization either support or oppose. In the case of a referendum, ballot initiative, constitutional amendment, or other measure that is placed on the ballot by petitions signed by a required number or percentage of voters, an item becomes "specific legislation" when the petition is first circulated among voters for signature.

Prior to amendment in 1990, the regulations under IRC 4945 provided that "attempts to influence legislation" included communications "with respect to legislation being considered by, or to be submitted imminently to, a legislative body." Reg. 53.4945-2(a)(1) (1990). When the regulations under IRC 4911 were finalized, the standard "to be submitted imminently" was not used in Reg. 56.4911-2(d)(1)(ii) and it was deleted from the IRC 4945 regulations. As the Preamble to the regulations explains, a temporal standard is inappropriate and underinclusive given the nature of the legislative process. For example, long before many specific legislative proposals are formally introduced as a bill, they are subject to intensive scrutiny, debate, and controversy. Moreover, effective lobbying could prevent a bill from ever being introduced. Consequently, reference to legislation proposed or adopted in one state that urges its adoption in another state constitutes a specific legislative proposal in the other state even though no such bill has been introduced there. Reg. 56.4911-2(d)(1)(iii), Example (2).

Legislation may be identified either by its formal name or by a term that has been widely used in connection with specific pending legislation, e.g., "the President's plan for a drug-free America." Reg. 56.4911-2(b)(4)(ii)(B), Example (1). Legislation may also be identified merely by its content and effect. See Reg. 56.4911-2(d)(1)(iii), Example (1).

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[32] In this regard, Reg. 56.4911-2(b)(4)(i), Example (4), notes that a letter sent to an administrative agency proposing standards for regulations implementing recently enacted legislation is not a lobbying communication.

**5. What is a direct lobbying communication?**

A communication with a legislator or government official will not be treated as a direct lobbying communication in accordance with Reg. 56.4911-2(b)(1) unless it both refers to "specific legislation" and reflects a view on such legislation. Reg. 56.4911-2(b)(1)(ii). Therefore, a position letter on a pending bill prepared by an organization's employee and distributed to members of Congress or personal contacts by the employee with members of Congress or their staffs to seek support for the organization's position on the bill would constitute direct lobbying. Reg. 56.4911-2(b)(4)(i), Example (1). In contrast, a letter sent to a member of Congress requesting that she write an administrative agency regarding proposed regulations recently published by that agency and also requesting that she state her support for a particular type of permit granted by the agency is not a direct lobbying communication. Reg. 56.4911-2(b)(4)(i), Example (2). Similarly, sending a paper to a state legislator on a particular state's environmental problems that does not reflect a view on any specific legislation that the organization either supports or opposes likewise is not a direct lobbying communication. Reg. 56.4911-2(b)(4)(i), Example (3).

**6. May some, but not all, of the expenses associated with a study be treated as direct lobbying expenditures?**

Yes. The regulations furnish an example of an organization that researched, prepared, and printed a safety code for electrical wiring. The organization sold the code to the public and it was widely used by professionals in the installation of electrical wiring. A number of states have codified all, or part, of the code of standards as mandatory safety standards. On occasion, the organization lobbied state legislators for passage of the code of standards for safety reasons. Because the primary purpose of preparing the code of standards was the promotion of public safety and the standards were specifically used in a profession for that purpose, separate from any legislative requirement, the research, preparation, printing and public distribution of the code of standards is not an expenditure for a direct (or grass roots) lobbying communication. However, costs, such as transportation, photocopying, and other similar expenses, incurred in lobbying state legislators for passage of the code of standards into law are expenditures for direct lobbying communications. Reg. 56.4911-2(b)(4)(i), Example (5).

**7. Will news media reports convert a communication from direct to grass roots lobbying?**

In some situations, the news media may report that an organization has communicated with the legislature in support or opposition to particular legislation. The mere fact that the organization's position on the legislation has been reported in the news media, and therefore communicated to the general public, does not convert it into a grass-roots lobbying communication. The communication remains a direct lobbying communication. Reg. 56.4911-2(b)(4)(i), Example (6).

**8. May indirect communications with a legislator that express a view on legislation not constitute direct lobbying?**

Yes, such a situation is set forth in Reg. 56.4911-2(b)(4)(i), Example (7). In the example, an organization monthly newsletter contained an editorial column that referred to and reflected a view on specific pending bills. One of the newsletter's 10,000 nonmember subscribers is a legislator. The editorial column in the newsletter copy sent to the legislator is not a direct lobbying communication because the newsletter is sent to her in her capacity as a subscriber rather than her capacity as a legislator.[33]

**9. What is a "grass roots" lobbying communication?**

Reg. 56.4911-2(b)(2)(ii) sets forth a three-part test for determining whether communications with the general public will be treated as grass roots lobbying communications. The communication will be considered a grass roots lobbying communication only if it meets all three of the following requirements:

(A) The communication refers to specific legislation;

(B) The communication reflects a view on such legislation; and

(C) The communication encourages the recipient of the communication to take action with respect to such legislation.

The third element (requiring the communication to encourage the recipient to take action) is commonly referred to as the "call to action" requirement. Essentially, what this requirement means is that no matter how clearly an organization identifies the specific legislation and comments on the merits of that legislation (for example, "passage of S. 549 would mean the end of civilization as we know it") when it communicates with the general public, the absence of any further statement that encourages the recipient to take action would mean that the communication

[33] The example notes, however, that the editorial column may be a grass roots lobbying communication if it encourages recipients to take action with respect to the pending bills it refers to and on which it reflects a view. A further cautionary note is set forth in Reg. 56.4911-2(b)(4)(i), Example (8), which states that if one of the legislator's staff members sees the editorial and requests additional information, and the organization responds with a letter that refers to and reflects a view on specific legislation, the letter would be a direct lobbying communication unless it is within one of the exceptions (such as the exception for nonpartisan analysis, study or research). (The letter would not be within the scope of the exception for technical advice or assistance because the letter is not in response to a written request from a legislative body or committee.)

could not be considered a grass roots lobbying communication. The lack of such a requirement was one of the major complaints directed at the 1986 proposed regulations.[34]

### 10. Are all communications to the general public "grass roots"?

As noted above, unless a communication with the general public meets all three of the Reg. 56.4911-2(b)(2)(ii) requirements, it will not be a grass roots lobbying communication. Furthermore, in certain cases, a communication that does meet all three of the requirements may not be a grass roots lobbying communication. Reg. 56.4911-2(b)(1)(iii) provides that, solely for

[34] The definition of grass roots lobbying was by far the most controversial part of the 1986 proposed regulations. The 1986 proposed definition of grass roots lobbying was patterned after a test set forth in proposed IRC 162(e) regulations published in 1980. 45 FR 78167, 78169 (Nov. 25, 1980). (Those proposed regulations have not been finalized.) Under the 1986 definition, grass roots lobbying included any communication that met the following requirements:

(A) The communication pertains to legislation being considered by a legislative body, or seeks or opposes legislation;

(B) The communication reflects a view with respect to the desirability of the legislation (for this purpose, a communication that pertains to legislation but expresses no explicit view on the legislation shall be deemed to reflect a view on legislation if the communication is selectively disseminated to persons reasonably expected to share a common view of the legislation); and

(C) The communication is communicated in a form and distributed to individuals as members of the general public, that is, as voters or constituents, as opposed to a communication designed for academic, scientific, or similar purposes. A communication may meet this test even if it reaches the public only indirectly, as in a news release submitted to the media. 51 FR 40211, 40222 (Nov. 5, 1986).

IRC 501(c)(3) public charities strenuously contended that the definition of grass roots lobbying was overly broad and included many communications that were not lobbying. In particular, they objected that communications were treated as grass roots lobbying even where the communications did not include some sort of "call to action." They also contended that the definition arbitrarily concluded that a discussion of legislation reflected a view solely on the basis of its dissemination.

At the second meeting of the Commissioner's Exempt Organizations Advisory Group, February 26, 1988, Service, Chief Counsel, and Treasury representatives stated they were considering revisions to the proposed regulations that would include a "call to action" requirement and would otherwise create rules different from those under IRC 162(e). All of the Group's members that spoke on the subject stated that a "call to action" requirement should be adopted. As to the issue of severing the IRC 4911 and 4945 proposed regulations from the proposed regulations under IRC 162(e), three of the Group's eighteen members dissented, stating they saw no reason for a difference in treatment. The remainder of the Group felt that a reading of the legislative histories discloses that the policy issues are different, as are the fiscal issues -- the consideration under IRC 162(e) is to police the tax base, whereas the exempt organization provisions regulate a segment of society that is entitled to more protection under the First Amendment than businesses. "Minutes [of] Commissioner's Exempt Organization's Advisory Group, February 25-26, 1988," EOTR, Jan. 1989, 7, 12-15.

The 1988 proposed regulations, as well as the final regulations, thus accommodated the concerns of charities by (1) creating rules different from those proposed in IRC 162(e), (2) removing the "dissemination" criterion, (3) adding a definition of "specific legislation," and (4) requiring a "call to action."

purposes of IRC 4911, where a communication refers to and reflects a view on a measure that is the subject of a referendum, ballot initiative or similar procedure, the general public in the State or locality where the vote will take place constitutes the legislative body, and individual members of the general public are considered legislators. Accordingly, if such a communication is made to one or more members of the general public in that state or locality, the communication is a direct lobbying communication (unless it comes under the exception for nonpartisan analysis, study or research (discussed below)).[35]

**11. What is meant by "encourages the recipient to take action?"**

Reg. 56.4911-2(b)(2)(iii) provides a definition of encouraging a recipient to take action with respect to legislation. To be considered a "call to action," a communication must do any one of the following:

(A) The communication states that the recipient should contact an individual described in Reg. 56.4911-2(b)(1)(i);

(B) The communication states the address, telephone number, or similar information of a legislator or an employee of a legislative body;

(C) The communication provides a petition, tear-off postcard or similar material for the recipient to communicate with any individual described in Reg. 56.4911-2(b)(1)(i); or

(D) The communication specifically identifies one or more legislators who will vote on the legislation as: opposing the organization's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Merely naming the main sponsor(s) of the legislation for purposes of identifying the legislation will not constitute encouraging the recipient to take action.

[35] "McGovern 1990" Tax Notes at 1311; EOTR at 771, discusses the rather tangled considerations that were brought to bear on this issue:

> *One factor that doubtless motivated the Service to carefully consider the issue in developing the final regulations was concern that the lobbying restriction not become a prohibition on influencing legislation, including legislation subject to defeat or approval at the ballot box. Because of the more restrictive limit on grass roots lobbying, and because of the inherently high costs of reaching voters (particularly in large states such as California), treating such lobbying as grass roots lobbying could amount to an effective prohibition, rather than the intended limitation. Accordingly, given the slight ambiguity in the statute, the final regulations treat such lobbying as direct lobbying.*

Therefore, adding an exhortation such as "oppose S. 549" to the previously discussed example ("passage of S. 549 would mean the end of civilization as we know it") would not affect the analysis. The statement still would not constitute grass roots lobbying because the exhortation does not reach the level of specificity set forth in the above paragraphs.

Furthermore, there is a distinction to be observed here. Communications described in paragraphs (A) through (C) not only "encourage," but also "directly encourage" the recipient to take action with respect to legislation. Communications described in paragraph (D), however, do not "directly encourage" the recipient to take action with respect to legislation. Therefore, a communication would "encourage" the recipient to take action with respect to legislation, but not "directly encourage" such action, if the communication does no more than identify a legislator who will vote on the legislation as opposing the organization's view with respect to the legislation. Reg. 56.4911-2(b)(2)(iv). Communications that encourage the recipient to take action with respect to legislation but that do not directly encourage the recipient to take action with respect to legislation may be within the exception for nonpartisan analysis, study or research and thus not be grass roots lobbying communications. Reg. 56.4911-2(c)(1)(vi). The distinction also assumes importance in the rules regarding membership communications. Reg. 56.4911-5(f)(6).

Legislators may be identified by name or by specific reference, e.g., "the junior Senator from State Z." Reg. 56.4911-2(b)(4)(ii)(C), Example (6). However, a more general reference, e.g., "most of the Senators from the Farm Belt states are inexplicably in favor of the bill," would not identify a legislator. Reg. 56.4911-2(b)(4)(ii)(C), Example (7).

### 12. Must volunteer activity costs be treated as lobbying costs?

Reg. 56.4911-2(b)(4)(ii)(C), Example (8), discusses an organization that trains volunteers to go door-to-door to seek signatures for petitions to be sent to legislators in favor of a specific bill. When the organization asks the volunteers to contact others and urge them to sign the petitions, it encourages those volunteers to take action in favor of the specific bill. The organization does not reimburse the volunteers for their time and expenses. Any costs incurred by the volunteers in carrying on this activity are not lobbying or exempt purpose expenditures made by the organization. Furthermore, the volunteers may not deduct their out-of-pocket expenditures. See IRC 170(f)(6). However, the organization's costs of soliciting the volunteers' help and its costs of training the volunteers are grass roots expenditures. In addition, the costs of preparing, copying, distributing, etc., the petitions (and any other materials on the same specific subject used in the door-to-door signature gathering effort) are grass roots expenditures.

Nevertheless, as noted in Reg. 1.501(h)-3(e), Example (5), the fact that numerous unpaid volunteers conduct lobbying activities with no reimbursement on behalf of an electing public charity will not be considered in determining whether the organization has engaged in substantial lobbying for purposes of its exemption under IRC 501(c)(3). Unlike the test for nonelecting public charities where such activities would be considered, the test under IRC 501(h) is solely based upon expenditures.

(5) Exceptions

i. Nonpartisan Analysis

**1. What is the exception for nonpartisan analysis?**

Pursuant to IRC 4911(d)(2)(A) and Reg. 56.4911-2(c)(1)(i), engaging in nonpartisan analysis, study, or research and making the results of such work available to the general public, or a segment or members thereof, or to governmental bodies, officials, or employees will not constitute a direct lobbying communication under Reg. 56.4911-2(b)(1) or a grass roots lobbying communication under Reg. 56.4911-2(b)(2).

**2. What is "nonpartisan analysis, study, or research?"**

Reg. 56.4911-2(c)(1)(ii) provides that "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of Reg. 1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion, as opposed to the mere presentation of unsupported opinion.

**3. May a communication that contains a "call to action" come within the exception?**

Reg. 56.4911-2(c)(1)(vi) provides that a communication that reflects a view on specific legislation is not within the nonpartisan analysis, study, or research exception if the communication directly encourages the recipient to take action with respect to such legislation. As set forth above, directly encouraging a recipient to take action with respect to legislation means that the communication:

(A) States that the recipient should contact legislators;

(B) States a legislator's address, telephone number, etc.; or

(C) Provides a petition, tear-off postcard or similar material for the recipient to communicate with a legislator.

Note, however, that a communication would encourage the recipient to take action with respect to legislation, but not directly encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: (1) opposing the organization's view with respect to the legislation; (2) being undecided with respect to the legislation; (3) being the recipient's representative in the legislature; or (4) being a member of the legislative committee or subcommittee that will consider the legislation.

Reg. 56.4911-2(c)(1)(vii), Examples (8) and (9), provide illustrations of the difference between "encouraging" and "directly encouraging." In Example (8), an analysis of a pending bill study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill. In Example (9), the facts are identical except that the study concludes: "You should write to the undecided committee members to support this crucial bill." The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

**4. How may nonpartisan analysis results be distributed?**

Reg. 56.4911-2(c)(1)(iv) provides that an organization may choose any suitable means to distribute the results of its nonpartisan analysis, study, or research, including oral or written presentations, with or without charge. This includes distribution of reprints of speeches, articles and reports; presentation of information through conferences, meetings and discussions; and dissemination to the news media, including radio, television and newspapers, and to other public forums. However, such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

**5. What happens when results are distributed in a series?**

Normally, whether a publication or broadcast qualifies as "nonpartisan analysis, study, or research" is determined based upon each presentation. However, if the results are presented as a series prepared or supported by the organization and the series as a whole meets the standards of Reg. 56.4911-2(c)(1)(ii), then any individual presentation within the series is not a direct or grass roots lobbying communication even though such individual presentation does not, by itself, meet the standards for "nonpartisan analysis, study, or research." Whether a presentation is considered part of a series will depend upon all the facts and circumstances of each particular situation. However, with respect to broadcast activities, all broadcasts within any period of six consecutive months will ordinarily be eligible to be considered as part of a series. Reg. 56.4911-2(c)(1)(iii).

Nevertheless, if an electing organization times or channels a part of a series in a manner designed to influence the general public or the action of a legislative body with respect to a specific legislative proposal, the expenses of preparing and distributing such part of the analysis, study, or research will be expenditures for a direct or grass roots lobbying communications, as the case may be. An example of such an circumstance is set forth in Reg. 56.4911-2(c)(1)(vii), Example (7). In the example, an organization presented within a period of six consecutive months a two-program television series relating to a pesticide issue. The organization arranges for the first program, which contains information, arguments, and conclusions favoring legislation, to be televised at 8:00pm on a Thursday. It arranges for the second program, which opposes such legislation, to be televised at 7:00am on a Sunday. The example concludes that

the organization's presentation is not within the exception for nonpartisan analysis, study, or research, since the organization disseminated its information in a manner prejudicial to one side of the legislative controversy since the program favoring the legislation was aired at a more convenient viewing time than the second program.

**6. What is the rule concerning "subsequent use"?**

Reg. 56.4911-2(c)(1)(v) provides that even though an activity is initially within the exception for nonpartisan analysis, study, or research, subsequent grass roots lobbying use may cause it to be treated as a grass roots lobbying communication that is not within this exception. However, subsequent use will never cause any analysis, study, or research to be considered a direct lobbying communication.

According to Reg. 56.4911-2(b)(2)(v), certain communications or research materials that are initially not grass roots lobbying communications under the three-part definition may be treated as such due to subsequent use of the materials for grass roots lobbying. However, this occurs only if the materials are considered "advocacy communications or research materials."

**7. What are "advocacy communications or research materials?"**

"Advocacy communications or research materials" are communications or materials that both refer to and reflect a view on specific legislation but that do not, in their initial format, contain a direct encouragement for recipients to take action with respect to the specific legislation. Reg. 56.4911-2(b)(2)(v)(B). Therefore, the subsequent use rules do not embrace such items as assemblages of raw data.

An example of an "advocacy communication" is described in Reg. 56.4911-2(c)(vii), Example (8). That example discusses an organization that distributes a study that indicates a pending bill is an appropriate remedy for problems discussed in the study and identifies certain senators who are undecided with regard to the bill. As discussed above, while this communication encourages the recipient to take action with respect to the legislation, it does not directly encourage such action. Since the study does refer to and reflect a view on the legislation without directly encouraging action with respect to that legislation, it is an advocacy communication. However, the communication discussed in Reg. 56.4911-2(c)(vii), Example (4), would not be considered an advocacy communication. In that example, an organization publishes a newsletter that contains notices and impartial summaries of proposed legislation. Although the newsletter refers to specific legislation, it does not reflect a view on that legislation.

Advocacy communications or research materials may be treated as grass roots lobbying communications when they are subsequently accompanied by a direct encouragement for recipients to take action with respect to legislation. For example, if the study discussed in Reg. 56.4911-2(c)(vii), Example (8), were subsequently distributed with a letter stating "You should write to the undecided committee members to support this crucial bill," the study itself could be treated as a grass roots lobbying communication. However, the advocacy

**8. When will "advocacy communications" become grass roots lobbying?**

communications or research materials themselves will not be treated as grass roots lobbying communications unless the organization's primary purpose in undertaking or preparing the advocacy communications or research materials was not for use in lobbying. If no such primary nonlobbying purpose is shown to exist, all expenses of preparing and distributing the advocacy communications or research materials will be treated as grass roots expenditures. Reg. 56.4911-2(b)(2)(v)(C).

**9. How is the primary purpose determined?**

Reg. 56.4911-2(b)(2)(v)(E) sets forth a safe harbor for determining the primary purpose of an organization when it undertakes or prepares advocacy communications or research materials. It states that the activity's primary purpose will not be considered to be for use in lobbying if the organization makes a substantial nonlobbying distribution of the advocacy communications or research materials (without the direct encouragement to action) prior to or contemporaneously with the use of those materials with the direct encouragement to action. In determining whether a distribution is substantial, all of the facts and circumstances will be considered, including the normal distribution pattern of similar nonpartisan analyses, studies, or research by that and similar organizations.[36]

If the organization does not meet the safe harbor because the nonlobbying distribution of advocacy communications or research materials is not substantial, Reg. 56.4911-2(b)(2)(v)(G) provides that all of the facts and circumstances must be weighed to determine whether the organization's primary purpose in preparing the advocacy communications or research materials was for use in lobbying. One factor that is particularly relevant is the extent of the organization's nonlobbying distribution of the advocacy communications or research materials, especially when compared to the extent of their distribution with the direct encouragement to action. Another particularly relevant factor is whether the lobbying use of the advocacy communications or research materials is by the organization that prepared the document, a related organization, or an unrelated organization. Where the subsequent lobbying distribution is made by an unrelated organization, clear and convincing evidence (which must include evidence demonstrating cooperation or collusion between the two organizations) will be required to establish that the primary purpose for preparing the communication for use in lobbying.

Yes. Under the "subsequent use" rule, the characterization of expenditures as grass roots lobbying expenditures regulation applies only to expenditures paid less than six months before the first time advocacy communications or research materials are used with a direct encouragement to action with respect to legislation. Reg. 56.4911-2(b)(2)(v)(D). The six month

[36] Reg. 56.4911-2(b)(2)(v)(F) provides a special rule for "partisan analysis, study or research," that is, in the case of advocacy communications or research materials that are not nonpartisan analysis, study or research, the nonlobbying distribution thereof will not be considered "substantial" unless that distribution is at least as extensive as the lobbying distribution thereof.

**10. Is there a time limit on the "subsequent use" rule?**

rule eliminates the possibility of years of research costs being retroactively characterized as lobbying costs.

ii. Other Exceptions

**1. What is the exception for examinations and discussions of broad social problems?**

The exception for examinations and discussions of broad social, economic, and similar problems in Reg. 56.4911-2(c)(2) is implicit in the definitions of direct lobbying and grass roots lobbying communications. The regulation provides that such discussions are neither direct lobbying communications nor grass roots lobbying communications even if the problems are of the type with which government would be expected to deal ultimately. In describing the scope of this exception, the regulation provides that communications regarding a subject that is also the subject of legislation before a legislative body will not be considered lobbying communications so long as the discussion does not address itself to the merits of a specific legislative proposal and does not directly encourage recipients to take action with respect to legislation. Both direct and grass roots lobbying communications must reflect a view on specific legislation so any communication coming within this exception would fail to qualify as either a direct or grass roots lobbying communication. The regulation provides that this exception excludes from grass roots lobbying an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions do not directly address the specific legislation being considered and do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation. Such discussions would also fail to qualify as grass roots lobbying under the three-part test of Reg. 56.4911-2(b)(2)(ii) since they do not reflect a view on the specific legislation.[37]

[37] Prior to the adoption of the final regulations under IRC 4911, the IRC 4945 regulations had included an exception for discussion of broad social problems. This exception was included in the IRC 4911 regulations to provide parity with the IRC 4945 regulations. However, as a substantive matter, the exception seems superfluous.

## 2. What is the exception for requests for technical advice?

Reg. 56.4911-2(c)(3) provides that a communication will not be considered a direct lobbying communication when it consists of providing technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either in response to a written request by that body, committee, or subdivision, as set forth in Reg. 53.4945-2(d)(2).

Requests made by individual members of a governmental body, committee, or subdivision of either will not qualify under this exception since Reg. 53.4945-2(d)(2)(i) requires that the request for assistance or advice must be made in the name of the requesting governmental body, committee or subdivision. Likewise, the response to such request must be available to every member of the requesting body, committee or subdivision to qualify for the exception. The regulations provide an example of a written response submitted to the person making a request for technical assistance in the name of a congressional committee, making it clear that the response is for the use of all the members of the committee. In that situation, the response will be considered available to every member of the requesting committee if the response is.

Oral or written presentation of technical assistance or advice coming under this exception does not need to qualify as nonpartisan analysis, study or research. The offering of opinions or recommendations will ordinarily qualify under this exception only if such opinions or recommendations are specifically requested by the governmental body, committee or subdivision or are directly related to the materials so requested. Reg. 53.4945-2(d)(2)(ii). The regulations illustrate these rules with the example of a Congressional committee that is studying the feasibility of legislation to provide funds for scholarships to U.S. students attending schools abroad. The committee made a written request to an organization that has engaged in a private scholarship program of this type to describe the manner in which it selects candidates for its program. If the organization's response not only included a description of its own grant-making procedures, but also its views regarding the wisdom of adopting such a program, the technical advice or assistance exception would still apply (because such views are directly related to the subject matter of the request for technical advice or assistance). Similarly, the exception would still apply if the organization was requested, in addition, to give any views it considered relevant and the organization's response included a discussion of alternative scholarship programs and their relative merits. Reg. 53.4945-2(d)(2)(iii), Examples (1), (2), and (3).

## 3. What is the exception for "self-defense"?

Under the "self-defense" exception of Reg. 56.4911-2(c)(4), a communication is not a direct lobbying communication if the communication is an appearance before, or communication with, any legislative body with respect to a possible action by the body that might affect the existence of the electing public charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to the organization, as set forth in Reg. 53.4945-2(d)(3). Reg. 56.4911-2(c)(4) also contains special rules for membership communications, as well as communications among an affiliated group and a limited affiliated group.

Under this exception, a charity may communicate with an entire legislative body, with committees or subcommittees of a legislative body, with individual legislators, with legislative staff members, or with representatives of the executive branch who are involved with the legislative process, so long as such communication is limited to the prescribed subjects. Similarly, under the self-defense exception, a charity may make expenditures in order to initiate legislation if such legislation concerns only matters which might affect the existence of the charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to such charity.

Therefore, if a bill would cause an organization to lose its exemption from taxation if it engages in certain transactions, expenditures paid or incurred with respect to the organization's submissions on the bill do not constitute taxable expenditures since they are made with respect to a possible decision of Congress which might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation. Reg. 53.4945-2(d)(3)(ii), Example (1). However, the exception would not apply to expenditures incurred by an organization that appeared before an appropriations committee in order to attempt to persuade the committee of the advisability of continuing a contract research program whose discontinuance would affect the organization financially. Expenditures paid or incurred with respect to such appearance are not made with respect to possible decisions of the legislature that might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation, but rather merely affect the scope of the organization's future activities. Reg. 53.4945-2(d)(3)(ii), Example (4).

(6) Special Rules for Mass Media Advertising

**1. What are the rules concerning mass media advertising?**

Reg. 56.4911-2(b)(5) contains a special rule for certain mass media advertisements. Under this rule, a mass media advertisement that does not qualify as a grass roots lobbying communication under the three-part definition (as discussed above) may nevertheless be considered a grass roots lobbying communication. This special rule generally applies only to a limited type of paid advertisements that appear in the mass media.

Reg. 56.4911-2(b)(5)(ii) contains a presumption regarding certain paid mass media advertisements about highly publicized legislation. Under this presumption, if an organization's paid advertisement appears in the mass media within two weeks before a vote by a legislative body, or a committee (but not a subcommittee) of such body, on a highly publicized piece of legislation, the paid advertisement will be considered to be a grass roots lobbying communication if the paid advertisement both reflects a view on the general subject of such legislation and either refers to the highly publicized legislation or encourages the public to communicate with legislators on the general subject of such legislation. This presumption can be rebutted by demonstrating that the paid advertisement is a type of mass media communication regularly made by the organization without regard to the timing of legislation (that is, a customary course of business exception) or that the timing of the paid advertisement was unrelated to the upcoming

legislative action.[38] A mass media communication that otherwise meets the presumption but is made more than two weeks before a legislative vote will not be considered a grass roots lobbying communication under this rule, even if it is presented only one day more than two weeks. Reg. 56.4911-2(b)(5)(iv), Examples (2) and (4). Furthermore, there must be a legislative vote on the legislation for this rule to apply. If, because of public pressure resulting from an advertising campaign opposing a bill that would meet the presumption, the bill is withdrawn and no vote is ever taken, none of the advertisements will be considered a grass roots lobbying communication under this rule. Reg. 56.4911-2(b)(5)(iv), Example (5).

### 2. What is "mass media?"

For purpose of this special rule, the term "mass media" means television, radio, billboards and general circulation newspapers and magazines. Newspapers or magazines that are published by an IRC 501(c)(3) organization that has made an IRC 501(h) election will not be considered general circulation newspapers or magazines unless the total circulation of the newspaper or magazine is greater than 100,000 and fewer than one-half of the recipients are members of the organization (as defined in Reg. 56.4911-5(f)). Reg. 56.4911-2(b)(5)(iii)(A). Where an electing public charity is itself a mass media publisher or broadcaster, all portions of that organization's mass media publications or broadcasts are treated as paid advertisements in the mass media, except those specific portions that are advertisements paid for by another person. Reg. 56.4911-2(b)(5)(iii)(B).

### 3. What is "highly publicized?"

Reg. 56.4911-2(b)(5)(iii) provides that legislation is "highly publicized" for purpose of this special rule when it receives frequent coverage on television and radio, and in general circulation newspapers, during the two weeks preceding the vote by the legislative body or committee. In the case of state or local legislation, it is "highly publicized" when it receives frequent coverage in the mass media that serve the State or local jurisdiction in question. Even where legislation receives frequent coverage, it is "highly publicized" only if the pendency of the legislation or the legislation's general terms, purpose, or effect are known to a significant segment of the general public (as opposed to the particular interest groups directly affected) in the area in which the paid mass media advertisement appears.

[38] However, even if the organization successfully rebuts the presumption, a mass media communication is a grass roots lobbying communication if the communication would be a grass roots lobbying communication under the general rules of the three-part test.

(7) Earmarking

**1. What are the rules relating to transfers by electing charities?**

When an electing public charity makes a transfer that is earmarked for grass roots lobbying purposes, the transfer is a grass roots expenditure. Reg. 56.4911-3(c)(1). When an electing public charity makes a transfer that is earmarked for direct lobbying purposes or for direct lobbying and grass roots lobbying purposes, the transfer is treated as a grass roots expenditure in full except to the extent the electing public charity demonstrates that all or part of the amounts transferred were expended for direct lobbying purposes, in which case that part of the amounts transferred is a direct lobbying expenditure by the electing public charity.[39] Reg. 56.4911-3(c)(2).

A transfer for less than fair market value by an electing public charity to any organization (other than those described in IRC 501(c)) that makes lobbying expenditures is not an exempt purpose expenditure unless the public charity makes the benefit generally available at less than fair market value in the course of an activity that is substantially related to accomplishing the exempt purpose of the charity.[40] Reg. 56.4911-3(c)(3). Transfers for fair market value, whether to related or unrelated organizations, are not covered by this rule.

The amount by which the cost or fair market value (whichever is greater) of the transfer exceeds the value given to the electing public charity in return for the transfer is the amount subject to this rule. Reg. 56.4911-3(c)(3)(i)(E). This amount is treated as a grass roots expenditure to the extent of the transferee's grass roots expenditures. If the transferred amount exceeds the transferee's grass roots expenditures, the excess is treated as a direct lobbying expenditure to the extent of the transferee's direct lobbying expenditures. If the transfer exceeds both grass roots and direct lobbying expenditures by the transferee, the excess is not treated as a lobbying expenditure. Reg. 56.4911-3(c)(3)(ii). Reg. 56.4911-3(c)(3)(iii) illustrates this provision by the following example:

> *Organization C, an electing public charity, shares employee E with N, a noncharity that makes lobbying expenditures. N's grass roots expenditures are $5,000 and its direct lobbying expenditures are $25,000. Each organization pays one-half of the $100,000 in direct and overhead costs associated with E. E devotes one-quarter of his time to C and three-quarters of his time to N. In substance, this arrangement is a transfer (for less than fair market value) from C to N in the amount of $25,000 (one-quarter of the $100,000 of direct and overhead costs associated with E's work).*

[39] These rules do not apply to transfers that are not exempt purpose expenditures because they are described in Reg. 56.4911-4(e).

[40] This rule also does not apply to controlled grants or to transfers that are not exempt purpose expenditures because they are described in Reg. 56.4911-4(e).

*Accordingly, C is treated as having made a $5,000 grass roots expenditure (the lesser of N's grass roots expenditures ($5,000) or the amount of the transfer ($25,000)). C is also treated as having made a $20,000 direct lobbying expenditure (the lesser of N's direct lobbying expenditures ($25,000) or the remaining amount of the transfer ($20,000)).*

**2. When is a transfer earmarked for a specific purpose?**

To be treated as a lobbying expenditure in accordance with Reg. 56.4911-3(c)(1) or Reg. 56.4911-3(c)(2), a transfer must be "earmarked" for direct or grass roots lobbying purposes pursuant to Reg. 56.4911-4(f)(4). This regulation provides that a transfer, including a grant or payment of dues, is "earmarked" for direct or grass roots lobbying purposes to the extent the transfer meets either one of the following requirements:

(A) The transferor directs the transferee to add the amount transferred to a fund established to accomplish the direct or grass roots lobbying purpose, or

(B) The amount transferred or, if less, the amount agreed upon to the expended to accomplish the purpose, if there exists an agreement, oral or written, whereby the transferor may cause the transferee to expend amounts to accomplish the direct or grass roots lobbying purpose or whereby the transferee agrees to expend an amount to accomplish the direct or grass roots lobbying purpose.

(8) Allocation Rules

**1. What are the principles of the allocation rules?**

Reg. 56.4911-3 contains allocation rules for determining what portion of the costs of a lobbying communication is a direct lobbying expenditure, what portion is a grass roots lobbying expenditure, and what portion is not a lobbying expenditure. The general principle involved is that all costs of preparing a direct or grass roots lobbying communication are included as expenditures for direct or grass roots lobbying ("lobbying expenditures"), including both direct and indirect costs. Therefore, lobbying expenditures include amounts paid or incurred as current or deferred compensation for an employee's services as well as the allocable portion of administrative, overhead, and other general expenditures attributable to the direct or grass roots lobbying communication. For example, as a general rule, all expenditures for researching, drafting, reviewing, copying, publishing and mailing a direct or grass roots lobbying communication, as well as an allocable share of overhead expenses, are included as expenditures for direct or grass roots lobbying. Reg. 56.4911-3(a)(1).

**2. How are expenditures for nonmember communications allocated?**

When an electing public charity makes a lobbying communication that is not sent only or primarily to members and that also has a bona fide nonlobbying purpose, the allocable lobbying expenditures must include all costs that are attributable to those parts of the communication on the same specific subject as the lobbying message. Reg. 56.4911-3(a)(2)(i). All costs attributable to those parts of the communication that are not on the same specific subject as the lobbying message are not included as lobbying expenditures for allocation purposes. Whether or not a portion of a communication is on the same specific subject as the lobbying message will depend on the surrounding facts and circumstances.[41]

**3. When are portions of a communication "on the same specific subject?"**

A portion of a communication will be "on the same specific subject" as the lobbying message if that portion discusses an activity or specific issue that would be directly affected by the specific legislation that is the subject of the lobbying message. Moreover, discussion of the background or consequences of the specific legislation, or discussion of the background or consequences of an activity or specific issue affected by the specific legislation, is also considered to be on the same specific subject as the lobbying communication. Reg. 56.4911-3(a)(2)(i).

Reg. 56.4911-3(b), Examples (8) and (9), illustrate the "same specific subject" rule. In the examples, a nonmembership organization prepared and mailed a four page document. The first two pages, titled "The Need for Child Care," support the need for additional child care programs, and include statistics on the number of children living in homes where both parents work or in homes with a single parent. The two pages also make note of the inadequacy of the number of day care providers to meet the needs of these parents. The third page, titled "H.R. 1," indicates the organization's support of H.R. 1, a bill pending in the U.S. House of Representatives. The document states that H.R. 1 will provide for $10,000,000 in additional subsidies to child care providers, primarily for those providers caring for lower income children. The third page also notes that H.R. 1 includes new federal standards regulating the quality of child care providers. The document ends with T's request that recipients contact their Congressional representative in support of H.R. 1. The fourth page does not refer to the general need for child care or the specific need for additional child care providers. Instead, the fourth page advocates that a particular federal agency commence, under its existing statutory authority, licensing of day care providers in order to promote safe and effective child care. The examples

[41] With the exception of the definition of grass roots lobbying, the provision of the 1986 proposed regulations that created the biggest stir was the proposed rule that all expenditures for a fundraising communication would be treated as grass roots lobbying if any part of the communication also consists of grass roots lobbying. 51 FR 40211, 40222-3 (Nov. 5, 1986). The 1988 proposed regulations revised this allocation rule by providing two different rules: a "same specific subject" rule for nonmember communications and a reasonable allocation rule for membership communications. The 1990 regulations also adopted these rules.

conclude that the first three pages of the document are on the same specific subject; therefore, all expenditures of preparing and distributing those three pages are grass roots lobbying expenditures. However, the cost of the fourth page is not a lobbying expenditure since it is not on the same specific subject.

### 4. How are expenditures for member communications allocated?

Reg. 56.4911-3(a)(2)(ii) provides that in the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an electing public charity must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. For the purpose of applying this rule, if more than half of the recipients of a lobbying communication are members of the organization within the meaning of Reg. 4911-5, then the communication is considered to be sent only or primarily to members. (See the discussion below for the rules regarding communications with members.) The regulation further provides that an electing public charity that includes as a lobbying expenditure only the amount expended for the specific sentence or sentences that encourage the recipient to take action with respect to legislation has not made a reasonable allocation. Reg. 56.4911-3(b), Examples (10) and (11), illustrate these principles. A member organization that prepared and mailed a document primarily to members that discusses the need for child care, refers to and reflects a view on specific legislation concerning child care, and states that readers should contact the legislature regarding the specific legislation. The organization determines that the document has a bona fide nonlobbying purpose, educating its members about the need for child care. In Example (10), the organization allocates one-half of the preparation and distribution costs to lobbying, which the regulation concludes is reasonable. However, in Example (11), the regulations conclude that an allocation of only one percent of the costs to lobbying based upon the fact that only two lines out of 200 state that the recipient should contact the legislature was not reasonable.

### 5. How are mixed lobbying expenditures allocated?

Generally, a communication (to which the membership rules of Reg. 56.4911-5 does not apply) that is both a direct lobbying communication and a grass roots lobbying communication will be treated as a grass roots lobbying communication. However, to the extent the electing public charity demonstrates that the communication was made primarily for direct lobbying purposes, the organization may make a reasonable allocation between the direct and the grass roots lobbying purposes served by the communication. Reg. 56.4911-3(a)(3).[42]

[42] Under the proposed 1986 regulations, the organization had to demonstrate that the expenditure was incurred **solely** for direct lobbying purposes. 51 FR 40211, 40223 (Nov. 5, 1986).

(9) Special Rules for Membership Communications

**1. What are the rules concerning membership communications?**

Reg. 56.4911-5 provides that expenditures for certain communications between an organization and its members ("membership communications") are treated more leniently for purposes of IRC 4911 than are similar communications to nonmembers. Pursuant to the regulation, certain membership communication expenditures are not lobbying expenditures even though those expenditures would be lobbying expenditures if the communication were to nonmembers. In other cases, expenditures that would be grass roots expenditures if the communication were to nonmembers are direct lobbying expenditures when made to members.

**2. Who is a "member"?**

Under Reg. 56.4911-5(f)(1), a person is a member of an electing public charity if the person (either an individual or organization) pays dues or makes a contribution of more than a nominal amount, makes a contribution of more than a nominal amount of time, or is one of a limited number of "honorary" or "life" members who have more than a nominal connection with the electing public charity and who have been chosen for a valid reason (such as length of service to the organization or involvement in activities forming the basis of the electing public charity's exemption) unrelated to the electing public charity's dissemination of information to its members.

A person may be treated as a member of an electing public charity even though that person does not qualify as a member under the tests set forth in Reg. 56.4911-5(f)(1) if the electing public charity demonstrates to the satisfaction of the Service that there is a good reason for its membership requirements not meeting the above requirements and that its membership requirements do not operate to permit an abuse of these rules. This rule has been applied, for example, in PLR 93-32-042 (May 19, 1993), in which members of separately incorporated state and local organizations were treated as members of a national organization based upon coordinated activities and payment of a share of dues to the national organization.

**3. When are expenditures for member communications not lobbying expenditures?**

Pursuant to Reg. 56.4911-5(b), expenditures for a communication that refers to, and reflects a view on, specific legislation will not be considered lobbying expenditures if the communication satisfies the following four requirements:

(A) The communication is directed only to members of the organization;

(B) The specific legislation the communication refers to, and reflects a view on, is of direct interest to the organization and its members;

(C) The communication does not directly encourage the member to engage in direct lobbying (whether individually or through the organization); and

(D) The communication does not directly encourage the member to engage in grass roots lobbying (whether individually or through the organization).

**4. What happens when a member communication encourages direct lobbying?**

A communication that otherwise meets the requirements set forth in Reg. 56.4911-5(b) but does not come within that rule because it directly encourages the members to engage in direct lobbying will be treated as a direct lobbying communication. IRC 4911(d)(3)(A); Reg. 56.4911-5(c). Reg. 56.4911-5(f)(6)(i)(A) provides that a member communication directly encourages a recipient to engage in direct lobbying, whether individually or through the organization, if the communication does any of the following:

(A) The communication states the recipient should contact an individual described in Reg. 56.4911-2(b)(1)(i);

(B) The communication states the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(C) The communication provides a petition, tear-off postcard or similar material for the recipient to communicate his or her views to an individual described in Reg. 56.4911-2(b)(1)(i).

**5. What happens when member communications encourage grass roots lobbying?**

A communication that meets the requirements of Reg. 56.4911-5(b) that it be directed only to members and refer to and reflect a view on specific legislation of direct interest and concern to the organization and its members, but does not qualify under that rule because it directly encourages the members to urge persons other than members to engage in direct or grass roots lobbying is treated as grass roots lobbying. IRC 4911(d)(3)(B); Reg. 56.4911-5(d). Reg. 56.4911-5(f)(6)(ii) provides that a communication directly encourages recipients to engage individually or collectively (whether through the organization or otherwise) in grass roots lobbying if the communication does any of the following:

(A) The communication states the member should encourage nonmembers to contact an individual described in Reg. 56.4911-2(b)(1)(i);

(B) The communication states the recipient should provide to nonmembers the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(C) The communication provides (or requests the recipient provide to nonmembers) a petition, tear-off postcard or similar material for the recipient (or nonmember) to use to ask nonmembers to communicate views to an individual described in Reg. 56.4911-2(b)(1)(i). For example, a petition that has an entire page of preprinted signature blocks is considered to be provided to the member to ask nonmembers to communicate views. Similarly, where a communication is distributed to a single member and provides several tear-off postcards addressed to a legislator, the postcards are presumed to be provided for the member to use to ask nonmembers to communicate with the legislator.

**6. Is there a "self-defense" exception for members?**

Yes, in some instances a communication by an electing public charity on behalf of its members will come within the "self-defense" exception. Reg. 56.4911-2(c)(4)(iii) provides that the exception applies to an electing public charity when more than 75 percent of its members are other organizations that are described in IRC 501(c)(3). Appearances before, or communications with, any legislative body with respect to a possible action by the body which might affect the existence of one or more of the IRC 501(c)(3) member organizations, their powers, duties, or tax-exempt status, or the deductibility (under IRC 170) of contributions to one or more of the IRC 501(c)(3) member organizations are covered by this exception. However, the exception applies only if the principal purpose of the appearance or communication is to defend the IRC 501(c)(3) member organizations. It does not apply if the principle purpose is to defend any member organizations that are not described in IRC 501(c)(3).

In addition, Reg. 56.4911-5(f)(6)(i)(B) provides an exception for communications with members. A communication that directly encourages a member to engage in direct lobbying activities that would not be attempts to influence legislation because of the "self-defense" exception if engaged in directly by the organization is treated as a communication that does **not** directly encourage a member to engage in direct lobbying.

**7. What happens when written communications are not directed solely to members?**

While not treated quite as leniently as communications directed **only to** members of an organization, written communications that are designed **primarily for** the members but are not directed only to members also qualify for special treatment. Under Reg. 56.4911-5(e), expenditures for such written communications that refer to, and reflect a view on, specific legislation of direct interest to the organization and its members, are treated as expenditures for direct or grass roots lobbying depending upon the type of lobbying encouraged. For purposes of Reg. 56.4911-5(e), a communication is designed primarily for members of an organization if more than half of the recipients of the communication are members of the organization.

**8. What are the allocation rules for such communications that encourage direct lobbying but not grass roots lobbying?**

Reg. 56.4911-5(e)(2) provides allocation rules for a written communication distributed primarily to members (as described above) that directly encourages recipients (individually or through the organization) to engage in direct lobbying but does not directly encourage them to engage in grass roots lobbying. In those cases, the cost of preparing and distributing the communication is allocated between direct lobbying and grass roots lobbying expenditures. The regulation cross references the rules concerning computation of advertising income contained in Reg. 1.512(a)-1(f)(6) and indicates that the portion of the cost to be allocated includes all costs of preparing all the material with respect to which readers are urged to engage in direct lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material.

The amount to be allocated as determined above is then multiplied by the sum of the "nonmember subscribers percentage" and the "all other distribution percentage," both as defined in Reg. 56.4911-5(f)(7), to determine the amount allocable as a grass roots lobbying expenditure for the communication.[43] (Solely for purposes of this particular allocation, the nonmember subscribers percentage is treated as zero unless it is greater than 15 percent of total distribution.) The grass roots lobbying expenditure is subtracted from the amount to be allocated to determine the direct lobbying expenditure.

**9. What are the allocation rules for such communications that encourage grass roots lobbying?**

If a written communication is directed primarily for, but not only to, the members of the organization, as described above, and it directly encourages recipients to engage in grass roots lobbying (either individually or through the organization or otherwise), the expenditures for the communication are treated as a grass roots lobbying expenditure. The communication is treated as a grass roots lobbying communication even if it also encourages readers to engage in direct lobbying. As with the amount to be allocated between direct lobbying expenditures and grass roots lobbying expenditures as discussed above, grass roots lobbying expenditures includes all the costs of preparing all the material with respect to which readers are urged to engage in grass roots lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material. <u>See</u> Reg. 1.512(a)-1(f)(6)).

[43] With respect to the term "subscriber," Reg. 56.4911-5(f)(5) provides that a subscriber to a written communication is a person that either (1) is a member of the publishing organization and the membership dues expressly include the right to receive the written communication, or (2) has affirmatively expressed a desire to receive the written communication and has paid more than a nominal amount for the communication.

(10) Affiliated Groups

i. Affiliation Rules

**1. What are the affiliation rules?**

IRC 4911(f)(1) through IRC 4911(f)(3) contain a limited anti-abuse rule for affiliated organizations. In general, the rule prevents avoiding the sliding-scale percentage limitation on lobbying expenditures (as well as avoiding the $1,000,000 cap on lobbying expenditures) through creation of numerous organizations.[44] With one exception, this is accomplished by treating the members of an affiliated group as a single organization for purposes of measuring both lobbying expenditures and permitted lobbying expenditures.[45]

Therefore, if the expenditures of the group as a whole do not exceed the permitted limits, then each of the electing member organizations is treated as not exceeding the permitted limits. Conversely, if the expenditures of the group as a whole exceed the permitted limits, then each of the electing members is treated as having exceeded the limits and would pay tax on its proportionate share of the group's excess lobbying expenditures. Note, however, that only those members of the affiliated group that have made the IRC 501(h) election are subject to the tax, nonelecting members remain subject to the "no substantial part" test. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. Vol. 2 at 423.

As will be discussed more fully below, membership in an affiliated group includes only IRC 501(c)(3) organizations that are eligible to make the IRC 501(h) election. Organizations described in other subparagraphs of IRC 501(c)(3) are not eligible for membership in an affiliated group even if they are affiliated within the meaning of IRC 4911(f)(2) with an eligible organization.

**2. When are two organizations considered to be affiliated?**

For purposes of the regulations under IRC 4911, two organizations are affiliated if one organization is able to control action on legislative issues by the other organization because of interlocking governing boards or because of provisions in the governing

[44] For example, a large organization, by dividing in two, would increase its overall cap from $1 million to $2 million. Because of declining percentages at higher levels, creating a second organization allows additional permitted lobbying expenditures for organizations whose exempt purpose expenditures exceed $500,000. An organization with $1 million of exempt purpose expenditures is permitted to have $175,000 of total lobbying expenditures without incurring tax, but two organizations with $500,000 of exempt purpose expenditures each would be permitted to have $100,000 of total lobbying expenditures, for a total amount of $200,000.

[45] The single exception to the general rule relates to members of a "limited affiliated group of organizations" (organizations that are affiliated solely by reason of governing instrument provisions that extend control solely with respect to national legislation). IRC 4911(f)(4) and Reg. 56.4911-10.

instruments of the controlled organization (subject to the limitation described in Reg. 56.4911-7(a)(2)).[46] The organizations are affiliated due to the ability of the controlling organization to control action on legislative issues by the controlled organization, not because such control is exercised. Reg. 56.4911-7(a)(1).

**3. What is "action on legislative issues?"**

Reg. 56.4911-7(a)(3) provides that the term "action on legislative issues" includes taking a position in the organization's name on legislation, authorizing any person to take a position on legislation in the organization's name, and authorizing lobbying expenditures. "Action on legislative issues" does not include actions taken merely to correct unauthorized actions taken in the organization's name.

**4. What are "interlocking governing boards"?**

Reg. 56.4911-7(b)(1) provides that, in general, two organizations have interlocking governing boards if one organization (the controlling organization) has a sufficient number of representatives on the governing board of the second organization (the controlled organization) so that by aggregating their votes, the representatives of the controlling organization can cause or prevent action on legislative issues by the controlled organization. If two organizations have interlocking governing boards, the organizations are affiliated without regard to how or whether the representatives of the controlling organization vote on any particular matter.

Generally, Reg. 56.4911-7(b)(2) provides that the number of representatives of the controlling organization who are members of the controlled organization's governing board will be presumed sufficient to cause or prevent action on legislative issues by the controlled organization if it either (1) constitutes a majority of incumbents on the governing board, or (2) constitutes a quorum, or is sufficient to prevent a quorum, for acting on legislative issues. However, if under the governing documents of the controlled organization, it can be determined that a lesser number of votes than the number described in Reg. 56.4911-7(b)(2) is necessary or sufficient to cause or to prevent action on legislative issues, a number of representatives of the controlling organization who are members of the controlled organization's governing board that equals or exceeds that number will be considered sufficient to cause or prevent action on legislative issues. Reg. 56.4911-7(b)(3). Nevertheless, if the number of representatives of one organization is less than 15 percent of the incumbents on the governing board of a second organization, the two organizations are not affiliated by reason of interlocking governing boards. Reg. 56.4911-7(b)(4).

[46] The exception provided in Reg. 56.4911-7(a)(2) states that two organizations, neither of which is described in IRC 501(c)(3), are affiliated only if there exists at least one organization described in IRC 501(c)(3) that is affiliated with both organizations.

Furthermore, there is no affiliation through interlocking boards where the board consists of representatives of unrelated organizations, none of which satisfies the control tests. Therefore, where five unrelated organizations each appoint two members to the board of an organization, it is not affiliated with any of the five organizations due to interlocking governing boards. Reg. 56.4911-7(f), Example (2). This rule has been applied in situations involving national organizations that have boards consisting of delegates from separately incorporated state or regional associations. See PLR 91-45-039 (Aug. 14, 1991) and PLR 93-32-042 (May 19, 1993).

**5. When are board members considered representatives of another organization?**

There are three circumstances under which members of the governing board of the controlled organization are considered representatives of the controlling organization. The first occurs if the controlling organization has specifically designated that person to be a board member of the controlled organization. A board member of the controlled organization is specifically designated by the controlling organization if the board member is selected by virtue of the right of the controlling organization, under the governing instruments of the controlled organization, either to designate a person to be a member of the controlled organization's governing board, or to select a person for a position that entitles the holder of that position to be a member of the controlled organization's governing board. Reg. 56.4911-7(b)(5)(ii).[47] The second occurs when a member of the governing board of one organization serves on the governing board of a second organization. In this instance, the person is a representative of the second organization. Reg. 56.4911-7(b)(5)(iv). The third occurs when the board member is an officer or paid executive staff member of the other organization. In that situation, the person is a representative of the other organization. Although titles are significant in determining whether a person is a member of the executive staff of an organization, any employee of an organization who possesses authority commonly exercised by an executive is considered an executive staff member for these purposes. Reg. 56.4911-7(b)(5)(v).

**6. What are the rules relating to governing instruments?**

Reg. 56.4911-7(c) provides that the controlling organization is affiliated with the controlled organization due to the governing instruments of the controlled organization if those instruments limit the independent action of the controlled organization on legislative issues by requiring it to be bound by decisions of the controlling organization on such issues. Organizations also are affiliated if the controlled organization's governing instrument allows the controlling organization to veto positions on legislation that the controlled organization might take, even if the veto power is never exercised. Reg. 56.4911-7(f), Example (3).

[47] A board member of one organization who is specifically designated by a second organization, a majority of the governing board of which is made up of representatives of a third organization, is a representative of the third organization as well as being a representative of the second organization pursuant to the rules of Reg. 56.4911-7(b)(5)(ii). Reg. 56.4911-7(b)(5)(iii).

**7. May board actions establish affiliation other than through amendments to the governing instrument?**

To be affiliated under IRC 4911, two organizations must have interlocking boards or one organization must be bound by the other organization on legislative issues by provisions in its governing instruments. Assuming the organization does not have an interlocking board with another organization, actions by the organization's board of directors that do not constitute amendments to its governing instrument will not establish affiliation under IRC 4911. This is discussed in Reg. 56.4911-7(f), Example (4), the governing board of an organization resolves to adopt positions taken on legislative issues by another organization. The two organizations are eligible organizations and do not have interlocking governing boards. The governing instruments of the first organization do not mention the other organization and do not indicate that the first organization is to be bound by the decisions on legislation of any organization. The two organizations are not affiliated under IRC 4911.

**8. How are organizations that file a group return treated?**

A determination that organizations are not affiliated for purposes of IRC 4911 does not indicate that those organizations are not affiliated for purposes of filing a group return. In PLR 91-45-039, (Aug. 14, 1991) the Service concluded that "affiliated" has a broader meaning as used in Reg. 1.6033-2(d) than it does under IRC 4911. Therefore, the mere fact that organizations file a group return does not indicate that the organizations are affiliated under IRC 4911. Furthermore, a group return may be filed even if some of the organizations have made the IRC 501(h) election. However, pursuant to Reg. 56.4911-6, which sets out the record keeping requirements for electing organizations, the group return will include separate statements regarding each organization that has made the election. Furthermore, for purposes of determining the liability for tax under IRC 4911(a), a separate schedule on the group return must be completed for each organization (other than any that are part of an affiliated group under IRC 4911(f)) that has made the IRC 501(h) election. Each schedule must show the lobbying expenditures, the lobbying nontaxable amount, the grass roots expenditures, and the grass roots nontaxable amount for each electing organization. Computation of the IRC 4911 tax must be made for each such organization on Form 4720, *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*. The computation must be based only upon the amounts applicable to the individual organization; it may not be based upon the composite figures for the group. A separate Form 4720 must be filed for each electing organization with IRC 4911(a) tax liability.

**9. May organizations be indirectly affiliated?**

Yes, organizations may be indirectly affiliated either because they are controlled by the same controlling organization or because the controlling organization affiliated with one organization is a controlled organization affiliated with the other organization. When a controlling organization is affiliated with each of two or more controlled organizations, then the controlled

organizations are affiliated with each other. Reg. 56.4911-7(d)(1). Therefore, if two or more organizations are controlled directly by the same controlling organization, they are affiliated with each other even if the method of control is different. Under the "chain rule" of Reg. 56.4911-7(d)(2), if one organization is a controlling organization described in this section with respect to a second organization and that second organization is a controlling organization with respect to a third organization, then the first organization is affiliated with the third. Again, the method of control does not need to be the same at each level of the chain for the organizations to be affiliated. See Reg. 56.4911-7(f), Example (6), for an illustration of these rules.

**10. What happens if a controlling organization is not described in IRC 501(c)(3)?**

The same affiliation rules would apply if the controlling organization is not described in IRC 501(c)(3) since organizations may be indirectly affiliated, as noted above. This situation is discussed in Reg. 56.4911-7(f), Example (7). In the example, an organization that is described in IRC 501(c)(4) is affiliated, as the controlling organization, with two organizations that are described in IRC 501(c)(3) and are eligible to elect under IRC 501(h). The two IRC 501(c)(3) organizations are affiliated and will be an affiliated group if either makes an election under IRC 501(h). Even though the IRC 501(c)(4) organization is affiliated with the two IRC 501(c)(3) organizations, it is not a member of that affiliated group of organizations because it is not an eligible organization within the meaning of Reg. 1.501(h)-2(b)(1). The rules regarding an affiliated group of organizations are discussed immediately below.

ii. The Affiliated Group

**1. What is an "affiliated group of organizations?"**

For purposes of the anti-abuse rules of IRC 4911, Reg. 56.4911-7(e)(1) provides that an "affiliated group of organizations" consists of a group of organizations that meet each of the following conditions:

(A) Each of the organizations is affiliated with every other member for at least thirty days of the taxable year of the affiliated group (determined without regard to the election provided for in Reg. 56.4911-7(e)(5));

(B) Each of the organizations is eligible to elect the expenditure test; and

(C) At least one of the organizations is an electing member organization.

Each organization in a group of organizations that satisfies the above requirements is a member of the affiliated group of organizations for the taxable year of the affiliated group.

**2. May an organization be a member of more than one affiliated group?**

Yes, an organization may have multiple affiliated group memberships. That is, for any taxable year of the organization, it may be a member of two or more affiliated groups of organizations. Reg. 56.4911-7(e)(2).

**3. What is an "electing member organization?"**

An "electing member organization" is an organization to which the expenditure test election applies on at least one day of the taxable year of the affiliated group of which it is a member. For these purposes, the election is not considered to apply to the organization on any day before the date on which it files the Form 5768 making the IRC 501(h) election, notwithstanding Reg. 1.501(h)-2(a)). Reg. 56.4911-7(e)(4).

**4. What is the taxable year of an affiliated group?**

There are three different rules that can apply here. The first rule is that if all members of an affiliated group have the same taxable year, that is the taxable year of the affiliated group. The second rule applies when the members of an affiliated group do not all have the same taxable year. In that case, the taxable year of the affiliated group is the calendar year. Reg. 56.4911-7(e)(3). A third rule applies when all the members elect to be covered by the provisions of Reg. 56.4911-7(e)(5). Under Reg. 56.4911-7(e)(5), each member organization treats its own taxable year as the taxable year of the affiliated group. The election may be made by an electing member organization by attaching to its annual return a statement from itself and every other member of the affiliated group that contains: the organization's name, address, and employer identification number; and its signed consent to the election. The election must be made no later than the due date of the first annual return of any electing member for its taxable year for which the member is liable for tax under IRC 4911(a), determined under Reg. 56.4911-8(d). The election may not be made or revoked after the due date of the return except upon such terms and conditions as the Commissioner may prescribe.

**5. Is there an exception for "self-defense"?**

Yes, Reg. 56.4911-2(c)(4)(ii) provides that the "self-defense" exception applies to a communication by a member of an affiliated group of organizations (within the meaning of Reg. 56.4911-7(e)) that is an appearance before, or communication with, a legislative body with respect to a possible action by the body that might affect the existence of any other member of the affiliated group, its powers and duties, its tax-exempt status, or the deductibility of contributions to it. Therefore, such communications will not be considered lobbying communications.

**6. Is there a special membership communication rule?**

Yes, for purposes of the member communication rules of Reg. 56.4911-5, a person who is a member of an organization that is a member of an affiliated group is treated as a member of each organization in the affiliated group. Reg. 56.4911-5(f)(3).

iii. Excess Lobbying Expenditures

**1. How is an affiliated group treated for purposes of the IRC 4911 tax?**

Under IRC 4911(f), an affiliated group of organizations is treated as one organization for purposes of the IRC 4911(a) tax. Thus, the affiliated group's direct lobbying expenditures, grass roots lobbying expenditures, and exempt purpose expenditures are equal to the sum of such expenditures paid or incurred during the taxable year by each member of the affiliated group. Similarly, the lobbying and grass roots nontaxable amounts for the affiliated group are determined under the rules of IRC 4911(c)(2) and IRC 4911(c)(4) based on the sum of the group's exempt purpose expenditures. The group's lobbying and grass roots ceiling amounts are then calculated under the IRC 501(h) regulations. Reg. 56.4911-8(b).

**2. When is the IRC 4911 tax imposed on an affiliated group?**

The tax under IRC 4911(a) is imposed on an affiliated group if the group has excess lobbying expenditures. Reg. 56.4911-8(c) provides that the affiliated group's excess lobbying expenditures for any taxable year are the greater of the following amounts:

(A) The amount by which the group's lobbying expenditures exceed the group's lobbying nontaxable amount; or

(B) The amount by which the group's grass roots expenditures exceed the group's grass roots nontaxable amount.

**3. What is the tax liability of an electing member?**

Reg. 56.4911-8(d) provides three rules for allocating the IRC 4911(a) tax between the electing member organizations of an affiliated group. Each electing member organization is liable for all or a portion of the tax, but no member of the affiliated group that has not made an IRC 501(h) election is liable for any portion of the tax with respect to the affiliated group, even if they made direct or grass roots lobbying expenditures.

The first rule applies when the affiliated group's excess lobbying expenditures equal the amount determined under Reg. 56.4911-8(c)(1) and at least one electing member has made

lobbying expenditures. Each electing member organization is liable for a portion of the tax equal to the amount of the tax multiplied by a fraction, the numerator of which is the electing member organization's lobbying expenditures paid or incurred during the taxable year of the affiliated group, and the denominator of which is the sum of the lobbying expenditures of all electing member organizations in the group paid or incurred during the taxable year of the affiliated group. Reg. 56.4911-8(d)(2)

The second rule applies when the affiliated group's excess lobbying expenditures equal the amount determined under Reg. 56.4911-8(c)(2) and at least one electing member has made grass roots expenditures. The same rule is applied as described above, except that "grass roots expenditures" is substituted for "lobbying expenditures." Reg. 56.4911-8(d)(3).

The third rule applies when the affiliated group has excess lobbying expenditures, but no electing organization has made either lobbying or grass roots expenditures. Each electing member organization is liable for a portion of the tax equal to the amount of tax multiplied by a fraction, the numerator of which is the electing member organization's exempt purpose expenditures and the denominator of which is the exempt purpose expenditures of all the electing member organizations in the affiliated group. Reg. 56.4911-8(d)(4).

**4. When is an organization liable for the tax?**

Pursuant to Reg. 56.4911-8(d)(5), an electing member organization liable for the IRC 4911 tax of an affiliated group is liable for the tax as if the tax were imposed for its taxable year with which or in which the taxable year of the affiliated group ends.

**5. What if an organization is a member of two groups having excess lobbying expenditures?**

When an organization is a member of two or more affiliated groups and is liable for the IRC 4911 tax during a taxable year for the excess lobbying expenditures of more than one group, then the organization is liable only for the greater tax. Reg. 56.4911-8(d)(6).

**6. What happens when a member organization ceases to be a member of a group?**

An electing member organization that ceases to be a member of an affiliated group of organizations that had a taxable year different from its own, must thereafter determine its liability under Reg. 56.4911-1 for the IRC 4911 tax as if its taxable year were the taxable year of the affiliated group of which it was formerly a member. An organization to which this rule applies that is liable for the IRC 4911 tax is liable as if the tax were imposed for its taxable year in which ends the taxable year of the affiliated group of which it was formerly a member. The Commissioner may, at the Commissioner's discretion, permit an organization to disregard this rule and to determine any liability under IRC 4911(a) based upon its own taxable year. Reg. 56.4911-8(e).

iv. Application of IRC 501(h)

**1. When might affiliated group members lose exempt status?**

As with the calculation of IRC 4911 tax, affiliated groups are treated as one entity for purposes of determining whether members are denied exemption as organizations described in IRC 501(c)(3) pursuant to IRC 501(h). If, for a taxable year of an affiliated group, it is determined that the sum of the affiliated group's lobbying or grass roots expenditures for the group's base years exceeds 150 percent of the sum of the group's nontaxable amounts for the base years, then each member that was an electing member organization at any time in the taxable year shall be denied tax exemption beginning with its first taxable year beginning after the end of the taxable year of the affiliated group. Thereafter, exemption shall be denied unless the organization reapplies and is recognized as exempt as an organization described in IRC 501(c)(3). For purposes of this section, the term "base years" generally means the taxable year of the affiliated group for which a determination is made and the group's three preceding taxable years. Base years, however, do not include any year preceding the first year in which at least one member of the group was treated as described in IRC 501(c)(3). Reg. 56.4911-9(b).

**2. What happens to a nonelecting member of an affiliated group?**

An organization that is a member of an affiliated group of organizations but that is not an electing member organization remains subject to the "substantial part test" described in IRC 501(c)(3) with respect to its activities involving attempts to influence legislation. Reg. 56.4911-9(c).

**3. What are the filing requirements?**

The filing requirements for affiliated groups are set forth in Reg. 56.4911-9(c) and apply to each member of the group for the taxable year of the member in which ends the taxable year of the affiliated group. Each member of the group must provide to every other member, before the first day of the second month following the close of the affiliated group's taxable year, its name, identification number, and the information required under the reporting rules of Reg. 1.6033-2(a)(2)(ii)(k) for its expenditures during the group's taxable year and for prior taxable years of the group that are base years. For groups that elect under Reg. 56.4911-7(e)(5) to have each member file information with respect to the group based on its taxable year, each member shall provide the above information, treating each taxable year of any member of the group as a taxable year for the group. In addition to the information required by the reporting rules of Reg. 1.6033-2(a)(2)(ii)(k), each member of the group must provide on its annual information return the group's taxable year and, if the election under Reg. 56.4911-7(e)(5) is made, the name, identification number, and taxable year identifying the return with which its consent to the election was filed. Furthermore, in addition to the

information required above, each electing member organization must provide the following on its annual return:

(A) The name and identification number of each member of the group, and

(B) The calculation of the group's excess lobbying expenditures if the organization is liable for all or any portion of the IRC 4911 tax.

### 4. How are these rules applied?

Reg. 56.4911-9(e) provides an example illustrating the application of IRC 501(h) to an affiliated group of organizations, M, N, and O. M and O filed IRC 501(h) elections in 1979 and have not revoked them. N did not make an IRC 501(h) election. M's taxable year ends November 30, N's taxable year ends January 31, and O's taxable year ends June 30. Since the organizations have different taxable years, the calendar year is the taxable year of the group. The following tables summarize the group's expenditures for the calendar years indicated. (None of the lobbying expenditures were for grass roots lobbying.)

**Table I. Group's Expenditures**

| Year | Exempt purpose expenditures (EPE) | Calculation | Lobbying nontaxable amount (LNTA) | Lobbying expenditures (LE) |
|---|---|---|---|---|
| 1979 | $400,000 | (20% of $400,000 =) | $80,000 | $100,000 |
| 1980 | 300,000 | (20% of $300,000 =) | 60,000 | 100,000 |
| 1981 | 600,000 | (20% of $500,000 + 15% of $100,000 =) | 115,000 | 120,000 |
| 1982 | 500,000 | (20% of $500,000 =) | 100,000 | 220,000 |
| Total | 1,800,000 | | 355,000 | 540,000 |

**Table II. Expenditures of M and O**

| Year | Exempt purpose expenditures | | Lobbying nontaxable amount | | Lobbying expenditures | | M plus O |
|---|---|---|---|---|---|---|---|
| | M | O | M | O | M | O | |
| 1979 | 125,000 | 100,000 | 25,000 | 20,000 | 60,000 | 20,000 | 80,000 |
| 1980 | 100,000 | 50,000 | 20,000 | 10,000 | 40,000 | 40,000 | 80,000 |
| 1981 | 250,000 | 100,000 | 50,000 | 20,000 | 60,000 | 40,000 | 100,000 |
| 1982 | 200,000 | 100,000 | 40,000 | 20,000 | 160,000 | 40,000 | 200,000 |

The affiliated group had excess lobbying expenditures in each of the years shown and M and O are liable for the IRC 4911 tax. The tax is allocated between M and O based on the ratio of their lobbying expenditures for the year to the total lobbying expenditures the two of them incurred. N is not liable for any tax under IRC 4911. For 1979, the tax due is $5,000 (25% of $20,000). M is liable for $3,750 and O is liable for $1,250. For 1980, the tax is $10,000 and each owe $5,000. For 1981, M is liable for $750 and O is liable for $500. For 1982, M is liable

for $24,000 and O is liable for $6,000. In 1982, the sum of group's lobbying expenditures for the base years (1979 through 1982) exceeded 150 percent of the sum of the group's lobbying nontaxable amounts for those years ($532,500). Therefore, M and O are denied exemption as IRC 501(c)(3) organizations for their taxable years beginning in 1983 (beginning December 1, 1983 for M and July 1, 1983 for O). Whether N's lobbying expenditures disqualify it for tax exemption at any time after January 1, 1979, is determined under the substantial part test of IRC 501(c)(3).

v. Limited Affiliated Groups

**1. What is a limited affiliated group of organizations?**

IRC 4911(f)(4) provides for an exception to the general rules applicable to affiliated groups for certain limited affiliated groups of organizations. Reg. 56.4911-10(b) provides that a limited affiliated group of organizations consists of two or more organizations that meet each of the following requirements:

(A) Each organization is a member of an affiliated group of organizations;

(B) No two members of the affiliated group are affiliated by reason of interlocking governing boards;[48] and

(C) No member of the affiliated group is, under its governing instrument, bound by decisions of one or more of the other such members on legislative issues other than national legislative issues.

Each organization in an affiliated group of organizations that satisfies all three of these requirements is a member of the limited affiliated group. However, if any of these requirements are not met, the organizations will not be a limited affiliated group. Even if some organizations within the group would meet all three requirements, those organizations would not constitute a limited affiliated group if any organization within the group did not meet all three requirements. Reg. 56.4911-10(h), Example (6), illustrates this rule.

**2. What is a "national legislative issue?"**

Reg. 56.4911-10(g) provides that the term "national legislative issue" means legislation, limited to action by the Congress of the United States or by the public in any national procedure. If an issue is both national and local, it is characterized as a national legislative issue if the contemplated legislation is Congressional legislation.

48 See Reg. 56.4911-10(h), Example (5).

Reg. 56.4911-10(h), Examples (1) and (2) illustrate "national legislative issues." In Example (1), a state has an income tax law that uses definitions contained in the Code as it may be amended from time to time. Legislation to change a definition in the Code is pending in Congress. This is a national legislative issue even though Congressional action may affect state law. However, in Example (2), an organization takes a position favoring approval by Congress of a proposed amendment to the United States Constitution. This is a national legislative issue. After approval by Congress and submission to the states for ratification, the proposed amendment ceases to be a national legislative issue.

**3. What is "controlling member organization" and "controlled member organization?"**

Reg. 56.4911-10(c) provides that a member of a limited affiliated group is a "controlling member organization" if it controls one or more of the other members of the group. A member is a "controlled member organization" if it is controlled by one or more of the other members of the group. Whether an organization controls a second organization shall be determined by whether the second organization is bound, under its governing instruments, by actions taken by the first organization on national legislative issues.

**4. How are expenditures determined for "controlling" and "controlled" members?**

Expenditures for a controlling member organization that has made an election under IRC 501(h) are determined in accordance with the rules set forth in Reg. 56.4911-10(d), even if the organization is also a controlled member organization. In determining a controlling member organization's expenditures, no expenditure shall be counted twice. The direct lobbying expenditures of a controlling member organization that has made the IRC 501(h) election include the direct lobbying expenditures paid or incurred with respect to national legislative issues during the taxable year by each organization that is a member of the limited affiliated group and is controlled by the controlling member organization. Similarly, the grass roots lobbying expenditures of the controlling member organization include the grass roots lobbying expenditures of the controlled member organizations. However, the controlling member organization's exempt purpose expenditures do not include the exempt purpose expenditures (other than lobbying expenditures with respect to national legislative issues) of any organization that is a controlled member organization with respect to it.

A controlled member organization that has made an IRC 501(h) election but does not control any organization in the limited affiliated group determines its lobbying expenditures based on its own expenditures without regarding the expenditures of any other member of the limited affiliated group. Reg. 56.4911-10(e).

Reg. 56.4911-10(h), Example (3), illustrates these rules regarding determination of expenditures. The example concerns three organizations that constitute a limited affiliated group, all of whom have made the IRC 501(h) election. One of the controlled organizations engages

in direct lobbying on a national legislative issue. This cost is included in the direct lobbying and the exempt purpose expenditures of both the controlling and that controlled organization, but will not be included in the lobbying or exempt purpose expenditures of the other controlled organization. The controlling organization also engages in direct lobbying on the same issue, but the cost of hiring the lobbyist is includible only in the controlling organization's lobbying expenditures. Any lobbying expenditures incurred by either controlled organization on any issue that is not a national legislative issue will not be included in the controlling organization's lobbying or exempt purpose expenditures.

**5. What information must be reported by a controlling member organization?**

In addition to the information required by Reg. 1.6033-2(a)(2)(ii)(k), each controlling member organization that has made an election under IRC 501(h) must provide on its annual return the name and identification number of each member of the limited affiliated group. Reg. 56.4911-10(f)(1). Furthermore, each controlling member organization that has made the IRC 501(h) election must notify each member that it controls of its taxable year in order for the controlled organization to prepare the report required by Reg. 56.4911-10(f)(3).[49] Such notification must be made before the beginning of the second month after the close of each taxable year of the controlling member for which the election is in effect. Reg. 56.4911-10(f)(2).

**6. Is there a "self-defense" exception?**

Yes, Reg. 56.4911-2(c)(4)(iv) provides that the "self-defense" exception applies to a communication by an electing public charity that is a member of a limited affiliated group if it is an appearance before, or communication with, the Congress of the United States with respect to a possible action by the Congress that might affect the existence of any member of the limited affiliated group, its powers and duties, tax-exempt status, or the deductibility of contributions to it.

**7. Is there a membership communication rule?**

Yes, Reg. 56.4911-5(f)(4) provides that a member of an organization that is a member of a limited affiliated group are treated as members of each organization in the limited affiliated group, but only with respect to national legislative issues.

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[49] Reg. 56.4911-10(f)(3) requires every controlled member organization (whether or not the expenditure test election is in effect with respect to it) to provide to each member of the limited affiliated group that controls it, before the first day of the second month following the close of the taxable year of each such controlling organization, its name, identification number, and both the lobbying expenditures and grass roots expenditures on national legislative issues incurred by the controlled member organization.

4. Lobbying Activities of IRC 501(c)(3) Private Foundations

A. Legislative and Regulatory History

In the Tax Reform Act of 1969, Congress created the distinction between private foundations and public charities and imposed a number of excise taxes on certain activities of private foundations. One of these provisions is an excise tax on the taxable expenditures of private foundations and on foundation managers who agree to the making of the taxable expenditure. IRC 4945. A taxable expenditure includes any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation, as well as certain political campaign expenditures and grants to individuals and organizations. IRC 4945(d). Taxes on these types of private foundation expenditures did not seem likely when the House Committee on Ways and Means began its hearings on private foundation activities since the Chairman's press release, which outlined the hearings' agenda, made no mention of this kind of activity. Tax Reform 1969: Hearings Before the House Comm. on Ways and Means, 91st Cong., 1st Sess. 3-11 (1969) (press release of Chairman Wilbur D. Mills). However, testimony given almost at the outset of the hearings raised the specter of private foundation involvement in the political process generally (although nothing specific was alleged about the lobbying activities of private foundations), as well as raising concerns about various grants made to individuals by private foundations. For example, the President of the Ford Foundation became embroiled in a lengthy and often acrimonious discussion with various Committee members over both the Foundation's granting "Travel & Study Awards" to members of Senator Robert Kennedy's staff following his assassination and its involvement in political campaign activities including an extremely controversial school decentralization experiment in Brooklyn that included an election and the Foundation's financing of voter registration drives in Cleveland before the election of Mayor Carl B. Stokes.[50] Id. at 354-431 (statement and testimony of Mr. McGeorge Bundy). To a considerable extent, those incidents seem to have impelled enactment of IRC 4945(d).

The Staff of the Joint Committee on Internal Revenue Taxation, in its General Explanation of the Tax Reform Act of 1969, 48 (1969), explained the reasons for enactment of IRC 4945, and for the inclusion of lobbying activity as a taxable expenditure, as follows:

> *The Congress concluded that more effective limitations must be placed on the extent to which tax-deductible and tax-exempt funds can be dispensed by private persons and that these limitations must involve more effective sanctions. Accordingly, the Congress determined that a tax should be imposed upon expenditures by private foundations for activities that should not be carried on by exempt organizations (such as lobbying, electioneering and "grass roots" campaigning). The Congress also believes that granting*

[50] Although no activities that would be characterized as lobbying for IRC 501(c)(3) purposes were discussed during Mr. Bundy's testimony, there was some concern expressed regarding influencing members of Congress through payment of their travel and other expenses, such as when the Ford Foundation made a grant to sponsor a Japanese-American Assembly in Japan attended by several members of Congress.

> *foundations should take substantial responsibility for the proper use of funds that they give away.*
>
> *In general, the Congress' decisions reflect the concept that private foundations are stewards of public trusts and their assets are no longer in the same status as assets of individuals who may dispose of their own money in any lawful way they see fit.*

Regulations implementing the provisions of IRC 4945(d)(1) were proposed in 1971 (36 FR 5357 (Mar. 20, 1971)) and adopted the next year. T.D. 7215, 37 FR 23161 (Oct. 31, 1972). The regulations were amended by T.D. 8308, 55 FR 35579 (Aug. 31, 1990).

However, even though private foundations are subject to tax on their lobbying expenditures, they remain subject to the "no substantial part" test for determining whether they retain their exempt status. Staff of the Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969, 49 n. 21 (1969).

B. Specific Issues

**1. What is the tax on lobbying by private foundations?**

Pursuant to IRC 4945(d)(1), any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation is a taxable expenditure. IRC 4945 imposes on the private foundation an initial tax equal to 10 percent of the taxable expenditure and an additional 100 percent tax on taxable expenditures that are not corrected within the taxable period. In addition, an initial tax equal to 2½ percent of the taxable expenditure is imposed on foundation managers who knowingly agreed to the making of the taxable expenditure. Any foundation managers who refuse to agree to all or part of the correction are subject to a tax equal to 50 percent of the taxable expenditure.

**2. What is "attempt to influence legislation" under IRC 4945?**

Generally, the rules for determining what is an attempt to influence legislation for purposes of IRC 4945 are the same rules as for electing public charities, as are the exceptions. Where there are different, or additional, rules for private foundations, these are noted below.

**3. Is there a membership communication rule?**

No, Reg. 56.4911-5, which provides rules for electing public charities' communications with their members, does not apply to private foundations. Consequently, whether a private foundation's communications with its members (assuming it has any) are lobbying communications is determined solely under the general rules enunciated under Reg. 56.4911-2. However, where a private foundation makes a grant to an electing public charity, the membership

rules apply to the electing public charity's communications with its own members. Therefore, in the limited context of determining whether a private foundation's grant to an electing public charity is a taxable expenditure, the membership rules apply. For example, a grant is not a taxable expenditure when it is specifically earmarked for a communication from an electing public charity to its members that is a not considered lobbying because of the membership rules. Reg. 53.4945-2(a)(2).

**4. What are the rules relating to jointly funded projects?**

Reg. 53.4945-2(a)(2) provides that a private foundation will not be treated as having made a taxable expenditure merely because it makes a grant conditional upon the recipient obtaining a matching support appropriation from a governmental body. Furthermore, a private foundation will not be treated as making taxable expenditures for carrying on discussions with officials of governmental bodies that meet the following requirements:

(A) The subject of the discussions is a program that is or may be jointly funded by the foundation and the government;

(B) The discussions are undertaken for the purpose of exchanging data and information on the program's subject matter; and

(C) The discussions are not undertaken in order to make any direct attempt to persuade governmental officials to take particular positions on specific legislative issues other than the program.

**5. Is lobbying by the recipient of a program-related investment attributed to the foundation?**

Private foundations often make "program-related investments" (investments described in IRC 4944(c) and Reg. 53.4944-3). Reg. 53.4945-2(a)(4) provides that any amount paid or incurred by program-related investment recipients in connection with an appearance before, or communication with, any legislative body with respect to legislation or proposed legislation of direct interest to the recipient shall not be attributed to the investing foundation, if the following conditions are met:

(A) The foundation does not earmark its funds to be used for any activities that constitute attempting to influence legislation; and

(B) A business expense deduction under IRC 162 is allowable to the recipient for such amount.[51]

[51] Note, however, that IRC 162(e), as amended by OBRA 1993, now disallows most business expense deductions for amounts paid or incurred in connection with influencing legislation.

**6. What is the rule for general support grants?**

A general support grant by a private foundation to a "public charity" (organizations described in IRC 509(a)(1), IRC 509(a)(2), or IRC 509(a)(3)) is not a taxable expenditure if the grant is not earmarked to be used in an attempt to influence legislation, regardless of whether the public charity has made the IRC 501(h) election. Reg. 53.4945-2(a)(6)(i). One example of where this rule applies is when a public charity that has received a general support grant informs the grantor foundation that, as an insubstantial portion of its activities, it attempts to influence the State legislature with regard to changes in the mental health laws. The use of the grant is not earmarked for the legislative activities of the public charity. The grant is not a taxable expenditure even if it is subsequently used by the public charity in its legislative activities. Reg. 53.4945-2(a)(7)(ii), Example (1).

**7. What is the rule for specific project grants?**

A grant by a private foundation to fund a specific project of a public charity is not a taxable expenditure, even if the public charity engages in lobbying activities as part of the project, to the extent that each of the following requirements are met:

(A) The grant is not earmarked to be used in an attempt to influence legislation; and

(B) The sum of all grants made by the private foundation for the same project for the same year, does not exceed the amount budgeted, for the year of the grant, by the grantee organization for activities of the project that are not attempts to influence legislation.

For example, a private foundation makes a specific project grant of $150,000 to a public charity. In requesting the grant, the public charity stated that the total budgeted cost of the project is $200,000, of which $20,000 is allocated to attempts to influence legislation related to the project. The private foundation relied on the budget figures provided and had no reason to doubt their accuracy or reliability. The private foundation does not earmark any of the funds from the grant to be used for attempts to influence legislation, so the grant is not a taxable expenditure under IRC 4945(d)(1) because the amount of the grant does not exceed the amount allocated to specific project activities that are not attempts to influence legislation. Reg. 53.4945-2(a)(7)(ii), Example (3). Even if the grant letter to the public charity provides that the private foundation has the right to renegotiate the terms of the grant if there is a substantial deviation from those terms, this additional fact would not make the grant a taxable expenditure. Reg. 53.4945-2(a)(7)(ii), Example (4). However, if the specific project grant is $200,000, rather than $150,000, part of the grant would be a taxable expenditure under IRC 4945(d)(1) because the amount of the grant exceeds by $20,000 the amount the public charity allocated to specific project activities that are not attempts to influence legislation. Therefore, the private foundation has made a taxable expenditure of $20,000. Reg. 53.4945-2(a)(7)(ii), Example (5).

**8. What is the rule for multi-year specific project grants?**

If the grant is for more than one year, the rule applies to each year of the grant with the amount of the grant measured by the amount actually disbursed by the private foundation in each year or divided equally between years, at the option of the private foundation. The same method of measuring the annual amount must be used in all years of a grant. As with the rule for general support grants, this rule applies regardless of whether the public charity has made the IRC 501(h) election. Reg. 53.4945-2(a)(6)(ii).[52]

Reg. 53.4945-2(a)(7)(ii), Example (11), discusses a private foundation makes a specific project grant of $300,000 to a public charity for a three-year specific project studying child care problems. The private charity provides budget material indicating that the specific project will expend $200,000 in each of three years, with lobbying expenditures of $10,000 in the first year, $20,000 in the second year and $100,000 in the third year. The private foundation pays $200,000 in the first year, $50,000 in the second year and $50,000 in the third year. The amount actually disbursed by the private foundation in the first year exceeds the nonlobbying expenditures of the public charity in that year. However, because the amount of the grant in each of the three years, when divided equally among the three years is not more than the nonlobbying expenditures of the public charity on the specific project for any of the three years, none of the grant is treated as a taxable expenditure.

A less happy scenario is set forth in Reg. 53.4945-2(a)(7)(ii), Example (13), where a private foundation makes a $120,000 specific project grant to a public charity for a three-year project. The private foundation intends to pay the grant in three equal annual installments. The public charity provides budget material indicating that the specific project will expend $100,000 each year, of which the project's lobbying expenditures will be $50,000 each year. After the private foundation pays the first annual installment, but before it pays the second installment, reliable information comes to its attention that the public charity has spent $90,000 of the project's $100,000 first-year budget on lobbying expenditures, causing the private foundation to doubt the accuracy and reliability of the budget materials. The private foundation nevertheless pays the second-year installment. In the project's second year, the public charity once again spends $90,000 on lobbying expenditures. Because the private foundation doubts or reasonably should doubt the accuracy or reliability of the budget materials when it makes the second-year grant payment, it may not rely upon the budget documents at that time. Accordingly, although none of the first installment is a taxable expenditure, only $10,000 of the second-year grant

[52] Reg. 53.4945-2(a)(6)(iii) provides that for purposes of determining the amount budgeted by a prospective grantee for specific project activities that are not attempts to influence legislation, a private foundation may rely on budget documents or other sufficient evidence supplied by the grantee organization (such as a signed statement by an authorized officer, director or trustee of such grantee organization) showing the proposed budget of the specific project, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents.

payment is not a taxable expenditure. The remaining $30,000 of the second installment is a taxable expenditure.

**9. What happens if the grantee public charity loses its exempt status due to lobbying?**

Reg. 53.4945-2(a)(7)(i) provides that a grant to a public charity that subsequently ceases to be described in IRC 501(c)(3) due to its attempts to influence legislation will not be considered a taxable expenditure provided the following conditions are met:

(A) The grant meets the requirements of the rules relating to general support grants and specific project grants;

(B) The grantee had received a ruling or determination letter, or an advance ruling or determination letter, that it a public charity;

(C) Notice of a change in the grantee's status has not been made to the public, and the private foundation has not acquired knowledge that the Service has given notice to the grantee of a change in status; and

(D) The grantee is not controlled by the private foundation.[53]

5. <u>Lobbying and Tax-Exempt Organizations Not Described in IRC 501(c)(3)</u>

**1. What restrictions are imposed on the amount of lobbying by IRC 501(c) organizations?**

Unlike IRC 501(c)(3) organizations, other organizations described in IRC 501(c) may engage in an unlimited amount of lobbying, provided that such lobbying is related to the organization's exempt purpose. The Service enunciated this principle in Rev. Rul. 61-177, 1961-2 C.B. 117, which holds that a corporation that was organized and operated primarily for the purpose of promoting a common business interest is exempt under IRC 501(c)(6) even though its sole activity is influencing legislation germane to such common business interest. Rev. Rul. 61-177 notes that there is no requirement, by statute or regulations, that a business league or chamber of commerce must refrain from lobbying activities to qualify for exemption.

The rule set forth in Rev. Rul 61-177 applies to organizations described in the other subparagraphs of IRC 501(c). Outside of IRC 501(c)(3), there is no explicit statutory restriction on lobbying in IRC 501(c). As far as the regulations are concerned, the only mention of lobbying is positive. Reg. 1.501(c)(4)-1(a)(2)(ii) provides that a social welfare organization may

[53] A grantee organization is controlled by a private foundation for this purpose if the private foundation and its disqualified persons (as defined in IRC 4946(a)(1)), by aggregating their votes or positions of authority, can cause or prevent action on legislative issues by the grantee. Reg. 53.4945-2(a)(7)(i)(D).

qualify under IRC 501(c)(4) even though its activities are described in the "action organization" regulations, provided that it otherwise meets the IRC 501(c)(4) qualification requirements. See also, Rev. Rul. 67-6, 1967-1 C.B. 135; Rev. Rul. 67-293, 1967-2 C.B. 185; Rev. Rul. 68-656, 1968-2 C.B. 216; Rev. Rul. 71-530, 1970-2 C.B. 237; Rev. Rul. 76-81, 1976-1 C.B. 156; and G.C.M. 31864 (Aug. 21, 1961). In determining whether lobbying is allowable under the other subparagraphs of IRC 501(c), Slee lives.

**2. Why must lobbying be related to the organization's exempt purposes?**

The exempt status of an organization under IRC 501(c) depends upon whether its activities are consistent with the exempt purposes described in the subparagraph of IRC 501(c) under which it qualifies. The requirements imposed under the various subparagraphs of IRC 501(c) differ extensively. For example, an organization may continue to qualify for exemption under IRC 501(c)(4) so long as it is **primarily** engaged in promoting in some way the common good and general welfare of the people in the community. Reg. 1.501(c)(4)-2(i). Therefore, an IRC 501(c)(4) organization could engage in a substantial amount of lobbying on other matters without affecting its exempt status. At the other extreme are IRC 501(c)(2) title holding companies, which, under the terms of the statute, are limited to "the **exclusive** purpose of holding title to property, collecting income therefrom, and turning over the proceeds" to another exempt organization. Any lobbying by an IRC 501(c)(2) organization, therefore, would defeat its exempt status, unless, perhaps, the purpose of the lobbying was to preserve the exempt status of such title holders. (An unlikely possibility, since the IRC 501(c)(2) exemption has remained undisturbed since its enactment in 1916.)

**3. May an IRC 501(c)(3) organization have a related IRC 501(c)(4) lobbying organization?**

Yes, this is a rather common occurrence. So long as the organizations are kept separate (with appropriate record keeping and fair market reimbursement for facilities and services), the activities of an IRC 501(c)(4) organization will not jeopardize the related IRC 501(c)(3) organization's exempt status. The ability of an IRC 501(c)(3) organization to establish a related IRC 501(c)(4) lobbying organization was an important factor in the concurring opinion of Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983), in which the Supreme Court upheld the prohibition on substantial lobbying by IRC 501(c)(3) organizations. Taxation with Representation of Washington was the successor to two other organizations, an IRC 501(c)(3) organization and a related IRC 501(c)(4) organization, that applied for recognition of exemption from federal income tax as an organization described in IRC 501(c)(3). It was denied because it proposed to engage in substantial lobbying activity, although it would have qualified as an IRC 501(c)(4) organization.

This structure does raise issues regarding whether the resources of the IRC 501(c)(3) organization are used to subsidize lobbying activities of the IRC 501(c)(4) organization, particularly in situations where the two organizations share staff, facilities or other expenses or in which the two organizations conduct joint activities requiring an allocation of income and

expenses. Any allocation of income or expenses between the two organizations must be carefully reviewed to ensure that the allocation method is appropriate and that an arms' length standard is utilized. The determination of whether the method used is appropriate is based upon all the facts and circumstances.

**4. May an organization that loses IRC 501(c)(3) status due to lobbying qualify as an IRC 501(c)(4) organization?**

IRC 504(a) precludes an organization that has lost its IRC 501(c)(3) status due to attempts to influence legislation from qualifying as an IRC 501(c)(4) organization. In addition, an organization prohibited from qualifying as an IRC 501(c)(4) organization by IRC 504 may not be treated as any IRC 501(c) organization, except for IRC 501(c)(3). Reg. 1.504-1. Therefore, the only route that an organization revoked for excessive lobbying may take to return to exempt status is to reapply for recognition of exempt status under IRC 501(c)(3). The one exception to this rule is for churches and church-related organizations that are ineligible to make an IRC 501(h) election because they are described in IRC 501(h)(5) and Reg. 1.501(h)-2(b)(3). IRC 504(c); Reg. 1.504-1.

**5. May an IRC 501(c)(3) organization that anticipates loss of its status convert to an IRC 501(c)(4) organization?**

IRC 504(b) authorized the Secretary of the Treasury to prescribe regulations to prevent avoidance of this rule, including avoidance by transferring all or part of the assets of an IRC 501(c)(3) organization to an organization that is controlled by the same persons who control the IRC 501(c)(3) organization. These regulations are set forth in Reg. 1.504-2. In determining whether an organization has attempted to avoid IRC 504 by transferring any of its assets, the term "transfer" includes any use by, or for the benefit of, the recipient, except transfers made for adequate and full consideration. Generally, a transfer that involves the following five elements will cause loss of exemption to the recipient:

(A) The transfer is from an IRC 501(c)(3) organization that is determined to be an "action" organization or is denied exemption by IRC 501(h);

(B) At the time of the transfer or at any time during the recipient's next ten taxable years, the recipient is controlled (directly or indirectly) by the same persons who control the transferor;[54]

[54] For these purposes, the transferor will be presumed to control any organization with which it is affiliated within the meaning of Reg. 56.4911-7(a) (or would be if both organizations were described in IRC 501(c)(3)), and the recipient will be treated as controlled (directly or indirectly) by the same persons who control the transferor if the recipient would be treated as controlled under the private foundation qualifying distribution rules (Reg. 53.4942(a)-3(a)(3)) if the transferor were a private foundation. Reg. 1.504-2(f).

(C) The transfer is made (1) after the date that is 24 months before the earliest of the effective date of the determination IRC 501(h) that the transferor is not exempt, the effective date of the Commissioner's determination that the transferor is an "action" organization, or the date on which the Commissioner proposes to treat it as no longer described in IRC 501(c)(3), and (2) before the transferor again is recognized as an organization described in IRC 501(c)(3);

(D) The recipient is exempt from tax under IRC 501(a) but is neither an organization described in IRC 501(c)(3), nor a qualified pension plan described in IRC 401(a) to which the transferor contributes as an employer; and

(E) The amount of the transfer exceeds the lesser of 30 percent of the net fair market value of the transferor's assets or 50 percent of the net fair market value of the recipient's assets, computed immediately before the transfer.[55]

Furthermore, even if the transferor and recipient are not commonly controlled, or the amount of the transfer is less than the amount set forth in the fifth element above, or the recipient is eligible to elect the expenditure test, the Commissioner may determine, based on all the facts and circumstances, that the transfer was made to avoid IRC 504(a). In that case, the recipient will cease to be exempt under IRC 501(a). One fact the Commissioner may consider is whether the recipient engages, or has engaged, in attempts to influence legislation. The Commissioner may also consider any factors enumerated in the special exception described below. Reg. 1.504-2(c).

### 6. Is there any exception to this transfer rule?

The Commissioner may determine, based on all the facts and circumstances, that a transfer that does meet the five elements set forth above was not made to avoid IRC 504 and the recipient will not be denied exemption. Reg. 1.504-2(e). In making this determination, the Commissioner may consider all relevant factors including the following:

(A) Whether enforceable and effective conditions on the transfer preclude use of any of the transferred assets for any purpose that, if it were a substantial part of an organization's activities, would be inconsistent with exemption as an organization described in IRC 501(c)(3);

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[55] For these purposes, the amount of a transfer is the sum of the amounts transferred to any number of recipients in any number of transfers, all of which are described in the previous four elements, and the time of the transfer is the time of the first transfer so taken into account. Reg. 1.504-2(b)(6)(i). Furthermore, the amount of a transfer to a recipient is the sum of the amounts transferred to the recipient in any number of transfers, all of which are described in the previous four elements, and the time of the transfer is the time of the first transfer so taken into account. Reg. 1.504-2(b)(6)(ii).

(B) In the absence of conditions described above, whether the transferred assets are used exclusively for purposes that are consistent with the transferor's exemption as an organization described in IRC 501(c)(3);

(C) Whether the assets transferred would be described in the private foundation minimum investment return rules (Reg. 53.4942(a)-2(c)(3)) before and after the transfer if both the transferor and recipient were private foundations;

(D) Whether the transfer would satisfy the private foundation termination rules requiring unencumbered transfers (Reg. 1.507-2(a)(7) and Reg. 1.507-2(a)(8)) if the transferor were a private foundation;

(E) Whether all of the transferred assets have been expended during a period when the recipient was not controlled (directly or indirectly) by the same persons who controlled the transferor; and

(F) Whether all of the transferred assets were transferred, before the close of the recipient's taxable year following the taxable year in which the transferred assets were received, to one or more public charities described in IRC 507(b)(1)(A) none of which are controlled by the same persons who control either the original transferor or recipient.

**7. What is the tax status of a ballot measure committee?**

Expenditures to support or oppose initiatives, referenda, etc., generally are considered to be lobbying expenditures rather than political campaign activity. Consequently, a ballot measure committee cannot qualify as an IRC 501(c)(3) organization because it is an "action" organization. Furthermore, it cannot qualify as a "political organization" under IRC 527 since a political organization's "exempt function" involves, in general, influencing or attempting to influence the selection, nomination, election or appointment of an individual to a federal, state, or local public office or office in a political organization. IRC 527(e)(2). Reg. 1.527-2(c)(1) uses the term the "selection process" to encapsulate what is contemplated by "exempt function." Generally, expenditures to support or oppose a referendum or initiative measure are not for an exempt function activity, since this activity generally does not further the purpose of influencing or attempting to influence the selection process.[56] However, a ballot measure committee may qualify for exempt status under other subparagraphs of IRC 501(c), such as IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6).

[56] In addition to the statutory language ("individual") and the regulatory language (the "selection process"), the legislative history treats ballot measure expenditures as outside the purview of exempt function activity. See S. Rep. No. 93-1357, 93d Cong., 2d Sess. 27 (1974) reprinted in 1975-1 C.B. 517, 532, (stating, in discussing the primary activities test, that "a qualified organization could support the enactment or defeat of a ballot proposition, as well as support or oppose a candidate, if the latter activity was not its primary activity").

6. Lobbying and IRC 162(e)

A. Legislative and Regulatory History

(1) The Pre-Statutory Era

Like the restriction on lobbying by charities, the disallowance of a business expense deduction for lobbying first appeared as a Treasury regulation. T.D. 2137, 17 Treas. Dec. 48, 57-58 (1915). The validity of the regulation was first addressed by the Supreme Court in Textile Mills Security Corp. v. Commissioner, 314 U.S. 326 (1941). Textile Mills involved an attempt to deduct expenses made on behalf of German textile interests to pass special legislation that would enable the interests to recover property seized during World War I. The Court, without any dissent, concluded that the regulation did not contravene any Congressional policy and therefore upheld the denial of the deduction.[57]

The Supreme Court revisited the validity of the regulation almost two decades later, in the companion cases of Cammarano v. United States, 358 U.S. 498 (1959), and F. Strauss & Son, Inc. v. Commissioner, 358 U.S. 498 (1959). Both cases involved extensive grass roots lobbying campaigns by liquor distributors against prohibition or state control of liquor distribution proposals which would have destroyed the distributors' businesses. Again, the Court upheld the validity of the regulation, principally on the basis that the regulation had "acquired the force of law" because Congress had repeatedly reenacted the business expense deduction without rejecting the regulation. Cammarano, at 508-509.

(2) Allowance of the Lobbying Deduction

In 1962, Congress finally addressed the issue. Over the objection of the Treasury Department, it enacted IRC 162(e) as part of the Trade Expansion Act of 1962.[58] IRC 162(e)(1) specifically provided a deduction for direct lobbying expenses (including travel expenses, costs of preparing testimony, and a portion of dues) paid in carrying on a trade or business if such expenses are (1) in direct connection with appearances or communications involving legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with information communicated between the taxpayer and an organization of which it is a member as to legislation or proposed legislation of direct interest to the taxpayer and the organization. However, IRC 162(e)(2) provided that no deduction is allowed for any amount paid or incurred (by contribution, gift, or otherwise) for participation or intervention in any political campaign or

[57] It is difficult to imagine that there was any public dissent either, since the decision was handed down on December 8, 1941, the day after the attack on Pearl Harbor.

[58] Invoking the Slee principle, Secretary of the Treasury C. Douglas Dillon, in testimony before the Senate Finance Committee, set forth the Treasury position as follows:

> *We are not against lobbying. We think lobbying is fine, the more of it the better, because the representatives of the people know what the country wants. We are only saying that the Government should not pay for it.* Hearings on H.R. 10650 Before the Senate Comm. on Finance, 87th Cong., 2d Sess. 4,387 (1962).

in connection with any attempt to influence the general public with respect to legislative matters, elections, or referenda.

In explaining the reasons for the provisions, the House and Senate Reports stressed the difficulties of separating lobbying costs from other business costs. Even more important, the Reports stated, was the policy consideration that emanated from the "anomalous" proposition that permitted the deduction of expenses incurred from appearance with respect to executive or judicial matters, but not legislative ones.[59] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 17 (1962), reprinted in 1962-3 C.B. 405, 421; Sen. Rep. No. 1881, 87th Cong., 2d Sess. 22 (1962), reprinted in 1962-3 C.B. 707, 728.

(3) Disallowance of the Lobbying Deduction

In February 1993, the Treasury Department submitted a proposal to deny all business deductions for lobbying expenses. Page 45 of the Summary of the Administration's Revenue Proposals states, in pertinent part, as follows:

> *Reasons for Change*
>
> *The deduction for lobbying expenses inappropriately benefits corporations and special interest groups for intervening in the legislative process.*[60]
>
> *Proposal*
>
> *Businesses would no longer be allowed to deduct their lobbying expenses. Lobbying expenditures for this purpose would be defined similarly to the definition of expenditures to influence legislation in section 4911(d) and would include attempts to influence legislation through communications with the executive branch as well as the legislative branch of government. The current restrictions on deductions for expenses of grassroots lobbying and participation in political campaigns would remain. These rules would prevent charities from engaging in more than an insubstantial amount of lobbying. No deduction would be allowed for the part of membership dues that are used for lobbying, but as under current law, trade associations and similar organizations would not lose their exempt status for lobbying. Trade associations and similar organizations would be required to report to their members the portion of their dues used for lobbying activities.*

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[59] As we have seen, however, this "anomaly" persists for IRC 501(c)(3) organizations.

[60] This position was spelled out, at much greater length, in the 1962 legislative history of IRC 162(e). See Supplemental and Minority Views of Senators Paul Douglas and Albert Gore, 1962-3 C.B. 1092, 1116-1120.

On May 4, 1993, House Ways and Means Chairman Rostenkowski introduced the Administrations's bill, H.R. 1960. The Committee Report on the bill that emerged from the House, H.R. 2264, stated a different reason for change: "The committee has determined that, in the context of deficit reduction legislation, it is appropriate to limit the business deduction for lobbying expense." H.R. Rep. No. 103-111, 103d Cong., 1st Sess. 659 (1993) reprinted in 1993-3 C.B. 235.

What finally resulted was § 13222 of OBRA 1993. It amended IRC 162(e) by replacing the existing language with a new IRC 162(e) applicable to amounts paid or incurred after December 31, 1993.[61] The new IRC 162(e) disallows the deductibility of direct legislative lobbying expenses at the Federal and state (but not the local) level. It also disallows deductions for contacts with certain federal officials. Grass roots lobbying and political campaign expenditures continue to be nondeductible. In addition, IRC 162(e)(3) includes pass-through provisions affecting dues paid to exempt organizations, so organizations can not indirectly do what is disallowed directly.

The regulations under IRC 162 have, since their adoption in 1965, provided for the disallowance of dues paid to an organization to the extent the organization is engaged in an activity prohibited under IRC 162(e). Reg. 1.162-20(c)(3). However, no mechanism existed at the association level to ensure notification to members of the disallowance. Therefore, § 13222 of OBRA 1993 also amended IRC 6033, adding a new subsection to provide a system based on the disallowance of dues that builds in an incentive (or penalty) to ensure that associations notify their members. The trigger is contained in IRC 6033(e), which imposes reporting and notice requirements on tax-exempt organizations incurring expenditures to which IRC 162(e) applies. IRC 162(e)(3) denies a deduction for the dues (or other similar amounts) paid to certain tax-exempt organizations to the extent that the organization, at the time the dues are assessed or paid, notifies the dues payer that the dues are allocable to nondeductible lobbying and political expenditures of the type described in IRC 162(e)(1).[62]

An exempt organization subject to IRC 6033(e) has several options. It may provide a notice to its members when they pay dues that contains a reasonable estimate of the amount allocable to lobbying expenditures. If it does not give notification, it must pay a proxy tax at the highest rate imposed by IRC 11 (currently 35 percent) on its lobbying expenditures (up to the amount of dues and other similar payments received by the organization) during the taxable year. In addition, if the organization does provide notices to its members but underestimates the actual amount of lobbying expenditures, it is subject to the proxy tax on the excess lobbying expenditures paid during the applicable year that were not included in the notices. However, this tax may be waived if the organization agrees to include the excess lobbying expenditures in the following year's notices.

[61] A constitutional challenge to the provisions of § 13222 of OBRA 1993 was dismissed on jurisdictional grounds. American Society of Association Executives v. Bentsen, 848 F. Supp. 245 (D.D.C. 1994).

[62] Payments that are similar to dues include voluntary payments or special assessments used to conduct lobbying.

This mechanism allows a membership organization to elect not to provide its members with a disallowance notice in which case the organization will be required to pay the tax. If an organization elects the proxy tax option, no portion of any dues or other payments made by members of the organization will be deemed nondeductible as a result of the organization's lobbying activities.

(4) History of Regulations and Administrative Pronouncements

Reg. 1.162-20, dealing with expenditures attributable to grass roots lobbying, political campaigns, and certain advertising, was published in 1965 (T.D. 6819, 30 FR 5581 (Apr. 20, 1965)) and amended nearly four years later (T.D. 6996, 34 FR 835 (Jan. 18, 1969)). In general, the regulation provides that if expenditures for lobbying purposes do not meet the requirements of IRC 162(e)(1), such expenditures are not deductible as ordinary and necessary business expenditures. Reg. 1.162-20(c)(1).[63]

As a result of the OBRA 1993 legislation, the Service published final regulations providing allocation rules and rules concerning the definition of influencing legislation in 1995. T.D 8602, 60 FR 37568 (July 21, 1995). These new regulations also provide that to the extent the existing provisions of Reg. 1.162-20 are inconsistent with the new IRC 162, they are superseded. Reg. 1.162-20(c)(5). At the same time, the Service published Rev. Proc. 95-35, 1995-2 C.B. 391, to provide procedures for organizations to determine whether they were excepted from the reporting and notice requirements of IRC 6033(e) in accordance with IRC 6033(e)(3).

B. Specific Issues

(1) Organizations Excepted from the Reporting and Notice Requirements

**1. What organizations are excepted from IRC 6033(e)?**

IRC 6033(e)(1)(B)(i) provides that the IRC 6033(e) notice requirements do not apply to IRC 501(c)(3) organizations. In addition, IRC 6033(e)(3) provides an exception for organizations that establish to the satisfaction of the Secretary that substantially all of the dues or similar amounts received by the organization are not deducted by its members as business expenses. Most IRC 501(c) organizations do not receive dues that are deducted by their members as business expenses under IRC 162. Therefore, the Service provides in Rev. Proc. 95-35, § 4.01, that, pursuant to IRC 6033(e)(3), the requirements of IRC 6033(e) shall not apply to organizations recognized by the Service as exempt from taxation under IRC 501(a), other than (1) IRC 501(c)(4) social welfare organizations that are not veterans organizations, (2) agricultural and horticultural organizations described in IRC 501(c)(5), and (3) IRC 501(c)(6) organizations. Organizations otherwise subject to IRC 6033(e) whose lobbying expenditures consist solely of

[63] Proposed amendments to Reg. 1.162-20 were published in 1980 but have not been finalized. FR 78167 (Nov. 25, 1980).

in-house expenditures that do not exceed $2000 in a taxable year are also excepted from these requirements. IRC 6033(e)(1)(B)(ii).

**2. Which IRC 501(c)(4) and IRC 501(c)(5) organizations does Rev. Proc. 95-35 except?**

IRC 501(c)(4) veterans' organizations and IRC 501(c)(5) labor organizations are excepted by the Service from the IRC 6033(e) requirements in Rev. Proc. 95-35, § 4.01. Other IRC 501(c)(4) social welfare organizations and IRC 501(c)(5) agricultural and horticultural organizations that meet a safe harbor set forth in Rev. Proc. 95-35, § 4.02, also will be excepted from IRC 6033(e). The safe harbor provides that these organizations are not subject to IRC 6033(e) if more than 90 percent of their annual dues are received from (1) members paying annual dues of $50 or less,[64] (2) IRC 501(c)(3) organizations, (3) state or local governments, (4) entities whose income is exempt from tax under IRC 115, or (5) organizations excepted by § 4.01 of Rev. Proc. 95-35 as noted above. Organizations that do not meet the safe harbor may establish that they satisfy the requirements of IRC 6033(e)(3) by maintaining records establishing that at least 90 percent of the annual dues received by the organization are not deductible by its members (without regard to IRC 162(e)) and notifying the Service on its Form 990, *Return of Organization Exempt from Income Tax*, that it is described in IRC 6033(e)(3).[65] Rev. Proc. 95-35, § 5.06.

**3. What organizations described in IRC 501(c)(6) are excepted by Rev. Proc. 95-35?**

Generally, IRC 501(c)(6) organizations are subject to the IRC 6033(e) requirements. However, Rev. Proc. 95-35, § 4.03, provides an exception for IRC 501(c)(6) organizations if over 90 percent of their annual dues are received from (1) IRC 501(c)(3) organizations, (2) state or local governments, (3) entities whose income is exempt from tax under IRC 115, or (4) organizations excepted by § 4.01 of Rev. Proc. 95-35 4.01, as noted above. IRC 501(c)(6) organizations that do not meet this test may also establish that they satisfy the requirements of IRC 6033(e)(3) by maintaining records establishing that at least 90 percent of the annual dues received by the organization are not deductible by its members (without regard to IRC 162(e)) in the same manner as IRC 501(c)(4) and IRC 501(c)(5) organizations and notifying the Service on its Form 990 that it is described in IRC 6033(e)(3).[66] Rev. Proc. 95-35, § 5.06.

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[64] The $50 amount will be increased for years after 1995 by a cost-of-living adjustment under IRC 1(f)(3), rounded to the next highest dollar. Rev. Proc. 95-35, § 5.05.

[65] The organization may also request a private letter ruling to this effect in accordance with the procedures set forth in Rev. Proc. 96-4, 1996-1 I.R.B. 94. If an organization receives a favorable private letter ruling, the Service will not contest its entitlement to exemption under IRC 6033(e)(3) for a subsequent year so long as the character of its membership is substantially similar to its membership at the time of the ruling.

[66] IRC 501(c)(6) organizations may also request a private letter ruling as discussed above.

**4. What are "annual dues" and "similar amounts?"**

The term "annual dues" means the amount an organization requires a person to pay to be recognized by the organization as a member for an annual period. "Similar amounts" includes, but is not limited to, voluntary payments made by persons, assessments made by the organization to cover basic operating costs, and special assessments imposed by the organization to conduct lobbying activities. Rev. Proc. 95-35, § 5.01. "Member" is used in its broadest sense and is not limited to persons with voting rights in the organization. Rev. Proc. 95-35, § 5.02. If payment for a "membership" is intended to provide more than one person with recognition by the organization as a member for an annual period, annual dues is the full amount of payment request for that category of membership.

**5. How does Rev. Proc. 95-35 treat affiliated organizations?**

Rev. Proc. 95-35 provides a special aggregation rule that treats affiliated organizations (e.g., a national trade association that has state and local chapters) as a single organization for purposes of IRC 6033(e). The rule provides that if more than one organization described in IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6) share a name, charter, historic affiliation, or similar characteristics, and coordinate their activities, organizations in the affiliate structure are treated as a single organization. In applying the tests set forth in the safe harbor, only dues paid by the "ultimate members," whether paid to one level, which then remits the amounts to other levels in the structure, or paid separately to each level. Amounts paid by one organizational level to another are not considered, even if they are characterized as "dues." If the organization as a whole meets the requirements of IRC 6033(e)(3), (e.g., more than 90 percent of the dues are received from persons paying $50 or less) all organizations in the affiliated structure meet the requirements.[67] Rev. Proc. 95-35, § 5.03.

Rev. Proc. 95-35, § 5.04, provides an example applying the affiliation rule. A group of national, state, and local IRC 501(c)(4) organizations share a common name and work jointly to promote their purpose. Individuals or families pay annual dues of $40 to the local organizations, entitling them to membership in the national and state organizations. The local organizations remit a portion of the dues to the state and national organizations. These remittances by the local organizations exceed $50. The total amount received by all local organizations is $950x. In addition, corporations pay dues of $500 to and become members of the national organization. The total amount received from these members is $50x. Since the $950x exceeds 90 percent of the $1000x received from all members, all of the national, state, and local organizations meet the requirements of IRC 6033(e)(3). The transfers from the local organization are not considered in this determination.

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[67] If organizations within the affiliated structure are on different taxable years, the organizations may base their calculations of annual dues received on any single reasonable taxable year.

(2) Definitional Issues Regarding Lobbying

**1. What is the meaning of "influencing legislation?"**

IRC 162(e)(4)(A) defines "influencing legislation" as "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." This definition is essentially identical (as it relates to direct, as opposed to grass roots, lobbying) to IRC 4911, as discussed above in Part 3.

Reg. 1.162-29(b)(1) provides that "influencing legislation" involves the following activities:

(A) Any attempt to influence any legislation through a lobbying communication; and

(B) All activities, such as research, preparation, planning and coordination, including deciding whether to make a lobbying communication, engaged in for a purpose of making or supporting a lobbying communication.

Reg. 1.162-29(b)(2) provides that an "attempt to influence any legislation through a lobbying communication" is the act of making the lobbying communication, regardless of whether the attempt is successful.

**2. What is a "lobbying communication?"**

Pursuant to Reg. 1.162-29(b)(3), a "lobbying communication" is a communication (other than any communication compelled by subpoena, or otherwise compelled by federal or state law)[68] with any member or employee of a legislative body or any other government official or employee who may participate in the formulation of the legislation that does either of the following:

(A) The communication refers to specific legislation and reflects a view on that legislation; or

(B) The communication clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication.

[68] The "subpoena exception" follows the Conference Report (H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 607 (1993), reprinted in 1993-3 C.B. 485), which states that "any communication compelled by subpoena, or otherwise compelled by Federal or State law, does not constitute an 'attempt to influence' legislation or an official's action and, therefore, is not subject to the general disallowance rule."

The phrase "reflects a view" is of critical importance. After it appeared in the proposed regulations, several commentators suggested it should be defined to mean an explicit statement of support or opposition to the legislation. Some commentators also suggested that presenting a balanced analysis of the merits and defects of specific legislation should not constitute reflecting a view on legislation. However, neither recommendation was adopted in the final regulations. T.D. 8602, 60 FR 37568 (July 21, 1995).

Therefore, an organization can reflect a view on legislation without specifically stating it supports or opposes that legislation. Reg. 1.162-29(b)(7), Example 8, illustrates this with regard to an organization that writes a letter to a United States Senator discussing how a certain pesticide has benefited citrus fruit growers and disputing problems linked to its use. The letter discusses a bill pending in Congress and states in part:

> *This bill would prohibit the use of pesticide O. If citrus growers are unable to use this pesticide, their crop yields will be severely reduced, leading to higher prices for consumers and lower profits, even bankruptcy, for growers.*

Despite the fact that the organization does not explicitly state that it opposes the bill, its views on the bill are reflected in the statement. Thus, the communication is a lobbying communication, and the organization is attempting to influence legislation.

**3. Do the exceptions under IRC 4911(d)(2) apply for purposes of IRC 162(e)?**

No. A significant difference between the two statutes is that while IRC 4911(d) contains specific exceptions to the term "influencing legislation," IRC 162(e) does not. An example of this difference is the "self defense" exception under IRC 4911(d)(2)(C). IRC 162(e) contains no counterpart, and the legislative history strongly suggests that no exception is to be inferred. Statements in footnote 49 of the Conference Report (H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 597 (1993), reprinted in 1993-3 C.B. 475), H.R. Rep. No. 1447 (87th Cong., 2d Sess. 16-18 (1962), reprinted in 1962-3 C.B. 405, 420-422) and S. Rep. No. 1881 (87th Cong., 2d Sess. 21-24 (1962), reprinted in 1962-3 C.B. 707, 727-730) indicate that the holding of Cammarano v. United States, 358 U.S. 498 (1959) (upholding the validity of regulations denying a deduction for lobbying even when the expenses related to proposed legislation that affected the survival of the taxpayer's business) remains good law unless specifically contradicted by statute. Similarly, IRC 162(e) draws no distinction between influencing legislation and educating legislators, unlike the IRC 4911(d)(2) exceptions for making available the results of nonpartisan analysis, study, or research and for providing technical advice or assistance to a governmental body. See also, H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 607 (1993), reprinted in 1993-3 C.B. 485, where the Conference Report notes that exceptions contained in previous versions of the bill were not included in conference agreement. Therefore, IRC 162(e) disallows a deduction for some activities that would not be considered "direct lobbying" under IRC 4911. Accordingly, Reg. 1.162-29(a) specifically provides that the rules enunciated in the regulation have no bearing on IRC 4911 or IRC 4945.

## 4. What is "legislation?"

IRC 162(e) disallows the deduction for amounts spent or incurred to influence "legislation" considered by a "legislative body." IRC 162(e)(4)(B) provides that, for this purpose, "legislation" has the same meaning as under IRC 4911(e)(2) (discussed in Part 2). Consequently, Reg. 1.162-29(b)(4) provides that "legislation" includes any action on Acts, bills, resolutions and similar items by a "legislative body." "Legislation" includes a proposed treaty required to be submitted by the President to the Senate for and consent from the time the President's representative begins to negotiate a position with the prospective parties to the treaty.

## 5. What is "specific legislation?"

Under Reg. 1.162-29(b)(5), the term "specific legislation" is not limited to acts, bills, etc., that have been formally introduced before a legislative body. Therefore, specific legislative proposals are included as "specific legislation" even if never introduced. Accordingly, reference to a bill enacted in another state constitutes reference to "specific legislation" despite the fact that a similar bill has not been proposed in the state in question. Reg. 1.162-29(b)(7), Example 7. However, merely identifying a problem and indicating that a legislative body should do something about the problem without specifying what the legislative body should do will not constitute a specific legislative proposal. For example, an organization provides to legislators a paper that it has prepared stating that the lack of new capital is hurting the economy. If the organization merely indicates that increased savings and local investment will assist the economy and includes a cover letter stating, "You must take action to improve the availability of new capital," the organization has not referred to a specific legislative proposal. Reg. 1.162-29(b)(7), Example 5. However, if the organization indicates that lowering the capital gains rate would increase the availability of new capital and includes a cover letter stating, "I urge you to support a reduction in the capital gains tax rate," then it has referred to a specific legislative proposal. Reg. 1.162-29(b)(7), Example 6.

## 6. What are "legislative bodies?"

The term "legislative bodies" is defined in Reg. 1.162-29(b)(6). The term includes Congress, state legislatures, and other similar governing bodies. However, local councils and similar governing bodies are not "legislative bodies" for purposes of IRC 162(e). Executive, judicial, and administrative bodies are also not included. Administrative bodies includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar federal, state, or local special purpose bodies, whether elective or appointive.

Thus, communications with the administrative agency charged with writing regulations implementing a statute regarding recommendations concerning those regulations are not considered lobbying communications because the regulations are not legislation considered by a "legislative body." Reg. 1.162-29(b)(7), Example 3. Furthermore, testifying at a congressional oversight hearing concerning proposed regulations to implement a particular statutory enactment will not constitute a lobbying communication since the issue is the administrative action and not

specific legislation considered by a "legislative body," even though the hearings are before a "legislative body." Reg. 1.162-29(b)(7), Example 2.

**7. What is the exception for local councils and similar bodies?**

As noted above, IRC 162(e)(2) provides an exception to the general disallowance rule for certain lobbying expenditures related to local councils and similar governing bodies. IRC 162(e)(2) provides that two types of lobbying expenses are deductible. One is the ordinary and necessary expenses (including travel and preparation of testimony) in connection with appearances before, making statements to, or sending communications to the committees or individual members of a local council. The other is the expenses of communication with an organization of which the taxpayer is a member about local legislation or proposed legislation of direct interest to the taxpayer or the organization. The portion of the dues that are paid to an organization that are attributable to either of these activities is also not subject to the disallowance rule. However, grass roots lobbying on local government legislative actions is not covered by the exception. The legislative history indicates that the term "local councils or similar governing bodies" includes any legislative body of a political subdivision of a state, such as a county or city council. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 605 (1993), reprinted in 1993-3 C.B. 483. For purposes of the IRC 162 lobbying rules, Indian tribal governments are treated as "local councils or similar governing bodies." IRC 162(e)(7).

**8. What is a "covered executive branch official?"**

IRC 162(e)(1)(D) disallows a deduction for expenditures for any "direct communication with a covered executive branch official in an attempt to influence the official actions or positions of [the] official." Pursuant to IRC 162(e)(6), a "covered executive branch employee" includes the President, the Vice President, any person serving in level I of the Executive Schedule (e.g., a Cabinet Officer) or any other person designated by the President as having Cabinet-level status and their immediate deputies, the two most senior-level officers of each agency within the Executive Office of the President, and any other official or employee of the White House Office of the Executive Office of the President. The legislative history indicates that all written or oral communication with covered executive branch officials are included. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 605 n. 57 (1993), reprinted in 1993-3 C.B. 483. A communication with the covered executive branch official will be considered with that official if the official is intended as the primary recipient.

**9. What is the exception for de minimis in-house lobbying?**

IRC 162(e)(5)(B)(ii) excepts from the general disallowance rule organizations that are involved in a minimal amount of in-house lobbying. When an organization's total amount of in-house lobbying expenses does not exceed $2,000 (computed without taking into account general overhead costs otherwise allocable to lobbying), this exception applies. For purposes of this rule, in-house expenses include labor and material costs.

Payments made to a third-party lobbyist and dues payments allocable to lobbying are subject to the disallowance rules, regardless of whether or not the organization's in-house expenses are exempted. In addition, the de minimis in-house rule does not apply to expenses incurred for political activity, grass roots lobbying or foreign lobbying which continue to be disallowed under current law rules.

(3). Lobbying Purpose

**1. When is an activity engaged in for the purpose of making a lobbying communication?**

As noted above, Reg. 1.162-29(b)(1) provides that an "attempt to influence legislation" includes not only a lobbying communication but also all research and other preparatory activities engaged in for a purpose of making or supporting a lobbying communication. Reg. 1.162-29(c) sets forth a purpose test, which considers the original intent for engaging in a particular activity in order determine whether a lobbying activity, in whole or in part, has occurred. The general rule, set forth in Reg. 1.162-29(c)(1), provides that the purpose or purposes for engaging in an activity are determined on the basis of all the facts and circumstances, including (but not limited to) the following factors:

(A) Whether the activity and the lobbying communication are proximate in time;

(B) Whether the activity and the lobbying communication relate to similar subject matter;

(C) Whether the activity is performed at the request of, under the direction of, or on behalf of a person making the lobbying communication;

(D) Whether the results of the activity are also used for a nonlobbying purpose; and

(E) Whether, at the time the organization engages in the activity, there is specific legislation to which the activity relates.[69]

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[69] The proposed regulations provided two presumptions concerning the purpose for engaging in an activity that is related to a lobbying communication. Specifically, Prop. Reg. 1.162-29(c)(3) provided that if an activity relating to a lobbying communication is engaged in for a non-lobbying purpose prior to the first taxable year preceding the taxable year in which the communication was made, the activity is presumed to be engaged in solely for that non-lobbying purpose. The Commissioner could rebut this presumption in part by establishing that the activity was also engaged in for a purpose other than the non-lobbying purpose. Conversely, Prop. Reg. 1.162-(c)(4) provided that if an activity relating to a lobbying communication is engaged in during the same taxable year as the communication is made or the immediately preceding taxable year, and is not within the preceding presumption, the activity is presumed to be engaged in for the sole purpose of making or supporting a lobbying communication. An organization could rebut the presumption by establishing that the activity was engaged in for a non-lobbying purpose. 59 FR 24992, 24996 (May 13, 1994).

The regulations provide several examples of how the facts and circumstances test is applied. One example involves an organization that conducts a study and provides information to an administrative agency regarding the impact of proposed regulations on its business at a time when no specific legislative proposal on a similar topic is pending. The next year, in response to proposed legislation on the same subject, the organization sends a letter opposing the legislation to a legislator along with a copy of the study. Although the communication with the legislator is a lobbying communication, the organization conducted the study and submitted comments to the administrative agency at a time when no similar legislative proposal was pending. Therefore, it engaged in the study for a nonlobbying purpose. Reg. 1.162-29(c)(4), Example 1. Similarly, an organization that has entered into a contract with a government agency conducts tests regarding the project, submits the test results to the government agency and revises the project specifications in compliance with the contract. It subsequently prepares a summary of the test results and revised specifications which it submits to legislators to encourage them to support appropriations for the contract. The summary was prepared specifically for, and close in time to, the lobbying communication and so was for a lobbying purpose. However, the tests were conducted and the specifications revised pursuant to contract requirements and, thus, were solely for a nonlobbying purpose. Reg. 1.162-29(c)(4), Example 4. On the other hand, an organization that conducts a study at the request of its legislative affairs staff concerning the impact of proposed legislation on its business does so solely for a lobbying purpose, despite the fact that the organization subsequently used the study for labor negotiations with its employees. Reg. 1.162-29(c)(4), Example 2.

### 2. What if an activity is engaged in for multiple purposes?

Pursuant to Reg. 1.162-29(c)(2), if an organization engages in an activity both for a lobbying purpose and for some nonlobbying purpose, it must treat the activity as engaged in partially for the lobbying purpose and partially for the nonlobbying purpose. This division of the activity must result in a reasonable allocation of costs between nondeductible lobbying costs and other costs. (The allocation rules set forth in Reg. 1.162-28 are discussed below.) Reg. 1.162-29(c)(4), Example (5), illustrates this with regard to a person who travels to the state capital to attend a two-day conference. While there, he spends a third day meeting with state legislators to explain why his corporation opposes a pending bill unrelated to the subject of the conference. Although his trip is partially for a nonlobbying purpose, it also has a lobbying purpose since he refers to and reflects a view on the pending bill. Thus, his corporation must reasonably allocate his traveling expenses between these two purposes.

Reg. 1.162-29(c)(3) provides that certain activities are not engaged in for the purpose of making or supporting lobbying communications. These activities consist of those activities undertaken to comply with the requirements of any law (for example, satisfying state or federal securities law filing requirements), reading any publications available to the general public or

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Commentators contended that these presumptions undermined and complicated the purpose test. The final regulations eliminate the presumptions, replacing them with the list of facts and circumstances set forth in Reg. 1.162-29(c)(1). T.D. 8602, 60 FR 37568 (July 21, 1995).

### 3. May certain activities be treated as having no purpose to influence legislation?

viewing or listening to other mass media communications, and merely attending a widely attended speech. In addition, if, prior to evidencing a purpose to influence particular legislation (or similar legislation), an organization determines the existence or procedural status of that legislation, determines the time, place, and subject of any hearing to be held by a legislative body with respect to that legislation, or prepares or reviews routine, brief summaries of the provisions of that legislation, the organization is treated as engaging in that activity with no purpose of making or supporting a lobbying communication.

This provision is illustrated by Reg. 1.162-29(c)(4), Example 6, which discusses an organization whose legislative affairs staff prepares a summary of legislation that would affect the organization's business at the time it is proposed and continues to confirm the procedural status of the bill periodically. Two months after the bill was introduced, the organization assigns one of its employees to prepare a position letter on the bill to be delivered to legislators. The preparation of the original summary and the procedural status checks on the bill for the first two months are not considered to be for a lobbying purpose. However, once the organization made the determination to make a lobbying communication, the procedural status checks on the bill after that time were for a lobbying purpose.

### 4. What if activities support lobbying communications by another organization?

Reg. 1.162-29(d) provides that when an organization engages in activities for a purpose of supporting a lobbying communication to be made by another person, the organization's activities are treated as influencing legislation. For example, if an organization or its employee (as a volunteer or otherwise) engages in an activity to assist a trade association in preparing its lobbying communication, the organization's activities are influencing legislation even though the lobbying communication is made by the trade association. However, the personal activities an organization's employee outside the scope of employment will not be attributed to the organization.

### 5. What happens if a lobbying communication is not made?

In some instances, organizations engage in activity to support lobbying communications that they never make. Under Reg. 1.162-29(e), if the organization determines before the filing date of its return that it does not expect, under any reasonably foreseeable circumstances, to make a lobbying communication, the activity is treated as if it had not been engaged in for a lobbying purpose and the organization need not treat any amount allocated to that activity for that year as

an amount to which IRC 162(e)(1)(A) applies.[70] On the other hand, if the organization reaches the conclusion at any time after the filing date, then any amount previously disallowed with respect to that activity is treated as an amount that is paid at that time that is not subject to IRC 162(e)(1)(A). Thus, the organization is effectively treated as if it incurred the costs relating to the activity in the later year in connection with a nonlobbying activity. Exempt organizations to which IRC 6033(e) applies may treat such amounts as reducing (but not below zero) their lobbying costs. The organization may carry forward any amount not used to reduce lobbying costs to subsequent years.

**6. Is there an anti-avoidance rule?**

Yes, Reg. 1.162-29(f) provides that if an organization, alone or with others, structures its activities with a principal purpose of achieving results that are unreasonable in light of the purposes of IRC 162(e) and IRC 6033(e), the Commissioner can recast the organization's activities for federal tax purposes to achieve tax results that are consistent with the intent of these provisions and the pertinent facts and circumstances.

(4). Cost Allocations

**1. How must costs be allocated?**

As noted above, when an organization engages in an activity that has both a lobbying and a nonlobbying purpose, it must allocate the cost of the activity between the two using a reasonable method. Reg. 1.162-29(c)(2) and Reg. 1.162-28(b)(1). Reg. 1.162-28 describes costs that must be allocated to lobbying activities and methods that may be used to allocate those costs. Reg. 1.162-28 does not apply, however, to organizations that are engaged in the trade or business of conducting lobbying activities on behalf of another person.[71] Furthermore, the regulation is not intended to be applied for purposes of IRC 4911 and 4945 and the regulations thereunder. The organization must maintain records in accordance with IRC 6001 and its regulations.

**2. What is a reasonable method of allocation?**

Reg. 1.162-28(b) permits organizations to use any reasonable method to allocate costs between lobbying and nonlobbying activities. A method is considered reasonable if it is applied consistently, allocates a proper amount of costs to lobbying activities (including labor and administrative costs), and is consistent with the special rules regarding labor hours outlined in

[70] The filing date for this purpose is the earlier of the time the organization files its timely return for the year or the due date of the timely return.

[71] IRC 162(e)(5)(A) provides that organizations that are engaged in the trade or business of conducting lobbying activities on behalf of another person are not subject to the general disallowance rules. However, the rules do apply to payments by such other person to the organization for conducting the lobbying activities.

Reg. 1.162-28(2)(g). Reg. 1.162-28 describes three different allocation methods that are considered reasonable: a ratio method, a gross-up method, and an allocation method that applies IRC 263A principles. Whether any other allocation method is reasonable depends on the facts and circumstances of a particular case. The three specified methods, alone or in combination, do not establish a baseline allocation against which to compare other methods. Therefore, another cost allocation method is not unreasonable simply because it allocates a lower amount of costs to lobbying activities than any of the three specified methods.[72] However, Reg. 1.162-29(c)(2) provides that an organization's treatment of multiple purpose activities will not result in a reasonable allocation if it allocated to influencing legislation (1) only the incremental amount of costs that would not have been incurred but for the lobbying purpose or (2) an amount based on the number of purposes for engaging in that activity without regard to the relative importance of those activities.

### 3. What costs are allocable to lobbying activities?

Reg. 1.162-28(c) provides that the costs properly allocable to lobbying activities include labor costs and general and administrative costs. Labor costs include costs attributable to full-time, part-time, and contract employees. This includes all elements of compensation, including overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan. General and administrative costs include depreciation, rent, utilities, insurance, maintenance costs, security costs, and other administrative department costs (for example, payroll, personnel, and accounting.)

### 4. What is the "ratio method?"

Under the ratio method set forth in Reg. 1.162-28(d), an organization multiplies its total costs of operations (excluding third-party costs) by a fraction. The numerator of the fraction is the organization's lobbying labor hours and the denominator is the organization's total labor hours. The formula is expressed as follows:

$$\frac{\text{Lobbying labor hours}}{\text{Total labor hours}} \times \text{Total costs of operations}$$

The product of this calculation is added to the organization's third-party lobbying costs, as defined in Reg. 1.162-28(d)(5).[73] Third-party lobbying costs are amounts paid or incurred in whole or in part for lobbying activities conducted by third parties and amounts paid or incurred for travel (including meals or lodging while away from home) and entertainment relating in whole or in part to lobbying activities.) Thus, third-party costs include amounts paid to lobbying organizations and dues or other similar amounts allocable to lobbying paid to exempt organizations.

[72] Because some commentators interpreted the proposed regulations as treating only the three specified methods as reasonable, the final regulations clarify that organizations may use any reasonable method.

[73] Payments to independent contractors for lobbying purposes would not fall under labor costs. They would, however, be included in third-party lobbying costs.

Reg. 1.162-28(d)(2) provides that an organization may use any reasonable method to determine the number of labor hours spent on lobbying activities and may use the de minimis rule of Reg. 1.162-28(g)(1).[74] It further provides that an organization may treat as zero the hours spent by personnel engaged in secretarial, clerical, support, and other administrative activities as opposed to activities involving significant judgment with respect to lobbying activities.[75] Reg. 1.162-28(d)(3) defines total labor hours as the total number of hours of labor that an organization's personnel spend on the organization's trade or business during the year and provides that an organization may make reasonable assumptions concerning total hours spent by personnel on its trade or business. However, Reg. 1.162-28(d)(3) also provides that if the organization treats as zero the lobbying labor hours spent by personnel engaged in secretarial, maintenance, and other similar activities, it must also treat as zero the total labor hours of all personnel engaged in those activities.

Reg. 1.162-28(d)(6) illustrates the operation of the ratio method. In the example, three employees of an organization engage in both lobbying and nonlobbying activities. One spends 300 hours, another spends 1,700 hours, and the third spends 1,000 hours on lobbying activities, for a total of 3,000 hours for the year. The organization reasonably estimates that each of its three employees spends 2,000 hours a year working for the organization. The organization's total costs of operations are $300,000 and it has no third-party costs. Under the ratio method, the organization allocates $150,000 to its lobbying activities for the year, calculated as follows:

```
   Lobbying labor hours          Total        Allocable         Costs
--------------------------  X  costs of   +  third-party  =  allocable to
    Total labor hours         operations       costs          lobbying
                                                              activities

    [  (300 + 1,700 + 1,000)
    [----------------------------  X $300,000] + [0] = $150,000
    [           6,000
```

[74] Reg. 1.162-28(g)(1) provides that an organization may treat time spent by an individual on lobbying activities as zero if less than five percent of the person's time is spent on lobbying activities. Reasonable methods may be used to determine if that time is less than five percent. However, pursuant to Reg. 1.162-28(g)(2), any time spent by an employee on "direct contact lobbying" (including the hours spent by that employee in connection with direct contact lobbying, such as allocable travel time relating to direct contact lobbying) may not be excluded under the rule of Reg. 1.162-28(g)(1). "Direct contact lobbying" is defined as a meeting, telephone conversation, letter, or other similar means of communication with a federal or state legislator or covered federal executive branch official that otherwise qualifies as a lobbying activity. Reg. 1.162-28(g)(2) specifically provides that a person who engages in research, preparation, and other background activities related to direct contact lobbying but who does not make direct contact with a legislator or covered executive branch official is not engaged in direct contact lobbying.

[75] Therefore, as Reg. 1.162-28(d)(2) explicitly provides, the hours spent on lobbying activities by para-professionals and analysts may not be treated as zero.

## 5. What is the "gross-up method?"

Under the general gross-up method, which is described in Reg. 1.162-28(e)(1), an organization multiplies its basic labor costs for lobbying labor hours by 175 percent. Pursuant to Reg. 1.162-28(e)(3), basic labor costs are limited to wages or other similar costs, such as guaranteed payments for services. Costs attributable to pensions, profit-sharing, employee benefits, supplemental unemployment compensation plans, or similar items, are not included in basic labor costs. Third-party lobbying costs are then added to the result of the calculation to arrive at total lobbying costs.

Reg. 1.162-28(e)(2) provides an alternative gross-up method. Under this alternative, an organization may treat as zero the lobbying labor hours of personnel who engage in secretarial, clerical, support, or other administrative activities that do not involve significant judgment with respect to lobbying. However, if an organization uses this alternative method, it must multiply costs for lobbying labor hours by 225 percent.

Reg. 1.162-28(b)(2) provides that an organization (other than one subject to IRC 6033(e)) that does not pay or incur reasonable labor costs for persons engaged in lobbying activities may not use the gross-up method. Such organizations would include a partnership or sole proprietorship in which the lobbying activities are performed by the owners who do not receive a salary or guaranteed payment for services. This provision is significantly different from its predecessor in the proposed regulations. Under the proposed regulations, **any** organization that did not pay reasonable labor costs for people engaged in lobbying activities could use neither the ratio or gross up method. 58 FR 68330, 68332 (Dec. 27, 1993) Tax-exempt organizations contended that they would be prevented from using either or these methods if they used volunteers in their lobbying activities (since no labor costs were incurred). Under the final regulations, tax-exempt organizations can use either the ratio or gross-up methods even if their lobbying activities are conducted by volunteers. Because volunteers are not organizations' personnel, time spent by volunteers is excluded from the organization's lobbying labor hours and total labor hours (although the hours may be included in their own employer's lobbying labor hours or total labor hours).

Reg. 1.162-28(e)(4) illustrates the operation of the gross-up method to the same facts discussed above with regard to the ratio method. In this instance, the organization determines that its basic labor costs are $20 per hour for the first employee, $30 per hour for the second employee and $25 per hour for the third employee. Thus, its basic lobbying labor costs are $82,000 (($20 x 300) + ($30 x 1,700) + ($25 x 1,000)). Under the gross-up method, the organization allocates $143,500 to its lobbying activities for the year, calculated as follows:

```
                Basic lobbying      Allocable     Costs allocable
175%    X       labor costs of  +  third-party  =  to lobbying
                all personnel         costs          activities

                   [175% X $82,000] + [0] = $143,500
```

Many organizations engaged in lobbying activities are subject to the uniform capitalization rules of IRC 263A, therefore, the regulations permit organizations to use the principles of that section and the regulations thereunder to determine costs properly allocable to lobbying activities.

**6. What is the "IRC 263A method?"**

Specifically, under IRC 263A, lobbying is considered a service department or function. Therefore, an organization may use its IRC 263A methodology to determine the amount of costs allocable to its lobbying department or function for purposes of complying with the regulations. Organizations not subject to IRC 263A may also use the principles of that section and the regulations thereunder to determine the amount of costs allocable to lobbying activities.

(5) Exempt Organization Requirements

**1. How are exempt organizations taxed under IRC 6033(e)?**

As discussed above, organizations may not avoid the disallowance of the deduction for lobbying by deducting dues paid to tax-exempt organizations that engage in lobbying. Thus, to prevent this avoidance, IRC 6033(e) provides that organizations subject to its provisions are required to provide a notice to its members indicating the nondeductible portion of dues paid due to lobbying activities. If the exempt organization does not provide the notice or if its actual lobbying expenditures exceed the amount disclosed in the notice, the organization will be subject to a proxy tax on the amount that should have been included in the notice but was not. The proxy tax is equal to this amount multiplied by the highest corporate rate imposed by IRC 11. IRC 6033(e)(2). Thus, the organization has the option of providing a notice to its members of the amount of dues that is not deductible due to lobbying or paying the proxy tax.

**2. What notices must be provided to members?**

An organization subject to IRC 6033(e) is required to provide notice to each person paying dues of the portion of dues that the organization reasonably estimates will be allocable to the organization's lobbying expenditures during the year and, thus, is not deductible by the member. This estimate must be provided at the time of assessment or payment of the dues and must be reasonably calculated to provide the organization's members with adequate notice of the nondeductible amount. IRC 6033(e)(1)(A)(ii). The legislative history indicates that the notice should be provided in a conspicuous and easily recognizable format, referring to IRC 6113 and the regulations thereunder for guidance regarding the appropriate format of the disclosure statement.[76]

IRC 501(c)(4), IRC 501(c)(5), and IRC 501(c)(6) organizations are required to disclose information regarding their lobbying activities on Form 990, *Return of Organization Exempt from Income Tax*. If an organization is excepted from the IRC 6033(e) requirements either because substantially all of its dues were not deductible by its members or because its lobbying

[76] For guidance regarding IRC 6113, see Notice 88-120, 1988-2 C.B. 454. However, unlike IRC 6113, there is no penalty associated with failure to provide the disclosure notice in this format.

**3. What information must be disclosed on the Form 990?**

expenditures consisted solely of in-house expenditures that did not exceed $2,000, it must disclose this information on the Form 990. If the organization does not meet either of these exceptions, it must disclose the information necessary to determine if it is subject to the proxy tax. This information consists of the total dues received from members, the amount of its IRC 162(e) lobbying expenditures, and the amount it disclosed to its members as the nondeductible portion of dues. IRC 6033(e)(1)(A)(i).

**4. What amount is disclosed on the Form 990 as IRC 162(e) lobbying expenditures?**

The amount disclosed begins with the organization's lobbying expenses determined in accordance with IRC 162(e). Thus, direct lobbying of local councils or similar governing bodies with respect to legislation of direct interest to the organization or its members and in-house direct lobbying expenses if the total of such expenditures is $2,000 or less (excluding allocable overhead expenses) should be excluded from the amount disclosed. IRC 162(e)(2) and IRC 162(e)(5)(B). Amounts carried over from prior years, either because the lobbying expenditures exceeded the dues received in those years or because the organization received a waiver of the proxy tax imposed on that amount must be included. IRC 6033(e)(1)(C) and IRC 6033(e)(2)(B). The current year's lobbying expenditures should be reduced, but not below zero, by costs allocated in a prior year to lobbying activities that were cancelled after a return reporting these costs was filed in accordance with Reg. 1.162-29(e)(2).

**5. What amount is disclosed for nondeductible dues notices?**

If the organization notified its members in accordance with IRC 6033(e)(1)(A)(ii) of its estimate of the portion of dues that would not be deductible under IRC 162(e), it must disclose on Form 990 the total amount of dues that its members were notified were nondeductible. For example, if the organization timely notified its members that 25 percent of their dues would be nondeductible and the members paid a total of $100,000 of dues allocable to the year, the amount reported on Form 990 would be $25,000.

**6. What if lobbying expenditures exceed the estimated amount?**

If the actual lobbying expenditures of an organization subject to IRC 6033(e) exceed the amount that it notified its members was not deductible (either because the expenses were higher than anticipated or the dues receipts were lower), the organization is liable for a proxy tax

on the excess amount. IRC 6033(e)(2)(A). The organization may seek a waiver of the proxy tax.[77]

**7. How does an organization request a waiver?**

A waiver of the proxy tax is requested on Form 990. The organization checks a box agreeing to add the amount it entered as its taxable amount of lobbying expenditures to its dues estimate for the following year and enter the amount on the next year's Form 990. An organization may use this waiver procedure only if it sent dues notices at the time of assessment or payment of dues that reasonably estimated the dues allocable to nondeductible lobbying expenditures.

**8. How is the IRC 6033(e) proxy tax determined?**

As noted above, an organization subject to IRC 6033(e) must report on the Form 990 the total dues it received from members, the amount of its IRC 162(e) lobbying expenditures for the year, and the amount it disclosed to its members as the nondeductible portion of dues. The amount subject to the IRC 6033(e)(2) proxy tax is its IRC 162 expenditures less the amount disclosed to the members as nondeductible. However, if this amount is more than the amount by which the total dues received exceeds the amount disclosed to the members as nondeductible, then the tax is imposed on the lesser amount and the excess is carried over to the next year. For example, an organization reports on the Form 990 that its IRC 162(e) expenditures for the taxable year were $600x and the aggregate amount of nondeductible dues notices is $100x. If the total amount of dues received was $800x, then the taxable amount would be $500x ($600x - $100x). However, if the total amount of dues received was $400x, the taxable amount would be limited to $300x ($400x - $100x) and the excess $200x ($500x - $300x) would be carried over and included in the next year's IRC 162 expenditures.

The taxable amount is multiplied by the highest rate specified in IRC 11 to determine the IRC 6033(e) proxy tax. If the organization elects to pay the tax, it is reported on Form 990-T, *Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))*. When an organization elects to pay the proxy tax rather than to provide its members with an estimate of dues allocable to IRC 162(e) expenditures, all of the members' dues remain eligible for deduction to the extent otherwise deductible. The organization may also request a waiver of this tax if it made a reasonable estimate and agrees to adjust its notice of IRC 162(e) expenditures to members in the following year. Thus, in the second example above, if the organization requested a waiver, both the excess amount and the taxable amount would be carried over and included in the next year's IRC 162 expenditures.

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[77] It is also possible that an organization could overstate the portion of the dues that are not deductible in the notice of disallowance. It could do so by overestimating the amount of the disallowed expenses or underestimating dues income. The Conference Report indicates that guidance should be issued to cover this eventuality. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 608 n. 66 (1993), reprinted in 1993-3 C.B. 486. The matter is under study.

**9. Must estimated tax on the proxy tax be paid?**

No, organizations that are subject to IRC 6033(e) are not required to pay estimated tax on the IRC 6033(e) proxy tax, even if they do not provide notices to their members. The instructions for Form 990-T indicate that the proxy tax is not to be included when calculating estimated tax liability.

**10. What if lobbying expenditures are under-reported?**

Under-reported lobbying expenditures are subject to the IRC 6033(e) proxy tax for the year at issue only to the extent that the same expenditures (if actually reported) would have resulted in a proxy tax liability for that year. A waiver of the proxy tax for the taxable year only applies to reported expenditures. Under-reporting lobbying expenditures may also subject the organization to a $10 per day penalty under IRC 6652 for filing an incomplete or inaccurate return.

(6) Miscellaneous Rules

**1. May payments to charities that lobby be deducted?**

As stated above, IRC 501(c)(3) organizations are not subject to the IRC 6033(e) disclosure requirements. However, § 13222 of OBRA 1993 also added IRC 170(f)(9) which provides that contributors to charities that engage in lobbying activities cannot take an IRC 170 or IRC 162 deduction for the contribution if (a) the charities' lobbying activities are on matters of direct financial interest to the contributors' trade or business and (b) a principal purpose of the contribution is to avoid the general disallowance rule that would apply if the contributor conducted such lobbying activities directly.

**2. What is the "anti-cascading" rule?**

IRC 162(e)(5)(A) provides that in the case of an organization engaged in the trade or business of lobbying activities or an employee who receives reimbursements for lobbying expenses, the disallowance rule does not apply to expenditures of the organization or person in conducting such activities directly on behalf of a client or employer. Instead, the payments made by the client or employer to the lobbyist or employee are nondeductible as lobbying expenditures. The purpose of this rule is to insure that, when multiple parties are involved, the general disallowance rule results in the denial of the deduction at only one level. The rule only applies where the parties have a direct, one-on-one relationship and does not have any relevance to payments to membership organizations that further the interests of all members, rather than one particular member. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 610 (1993), reprinted in 1993-3 C.B. 488.

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# Q. TRANSFEREE LIABILITY

by

**Peter Bros and Terry Hallihan**

## 1. Introduction

The Service's Exempt Organizations field audit function deals primarily with examinations that determine whether an organization's activities are in furtherance of its exempt purposes. However, EO Agents do have responsibility for unrelated business income tax, excise taxes under Chapter 42, and employment taxes. While EO examinations do not normally involve organizations or individuals attempting to avoid payment of tax obligations by transferring assets to third parties to the extent that individual or corporate examinations do, EO Agents nonetheless should be aware of the possibility of such attempts, the types of transactions that normally result when such attempts are made, and the resources that are available should the occasion to assert transferee liability arise. The overriding lesson to be learned in any discussion of transferee liability is that an agent asserting it is doing so against an entity that is not under examination. As a result, District Counsel concurrence is always required in advance. IRM 5640 covers Transferee Liability and Fraudulent Conveyances.

## 2. Basic Principles

In order to protect the Government's interest in collecting taxes, a Federal tax lien attaches to a taxpayer's property or rights to property as soon as a tax has been assessed, a notice and demand for tax has been made, and payment in full has not been made within a specified time. A taxpayer might be taken unawares by the notice of the tax lien and scramble to get rid of assets upon which the Government can execute the lien. If the taxpayer creates an alter ego and that alter ego transfers assets, transferee liability may arise with respect to the recipient of the assets.

Unusually astute taxpayers might see the notice of tax lien coming, however, and might attempt to transfer assets after the liability has accrued but before the notice of assessed tax is sent. This second class of actions that gives rise to transferee liability is based on state fraudulent conveyance statutes.

3. Actions in Which A Federal Tax Lien Has Arisen

When property has been transferred after the Service has gone through the procedures necessary for the attachment of a lien, a tax has been assessed, a notice and demand for tax has been made and payment in full has not been made within a specified time, the lien follows the property. Note that this does not necessarily give rise to transferee liability as this is a general rule of enforceability of tax liens.

A. Creation of an Alter Ego

Alter egos are similar to the mail order ministry cases so familiar to EO personnel, but without the coloration of an exempt purpose. For instance, the taxpayer, Mr. X, has received a notice of assessed tax and has no intention of paying. He sets up a corporation and transfers all of his assets to it. The taxpayer continues to live in the transferred residence, but the corporation pays the principal, interest, taxes and insurance on the residence. In addition, the corporation pays for food, clothes, repairs on the residence, a new auto and vacations in the Caribbean for the taxpayer, his wife and children.

Under the facts, the corporation is Mr. X's alter ego. Under the alter ego doctrine, a corporate entity may be disregarded for purposes of determining ownership of property. The two basic requirements for finding that a corporation is an alter ego are (1) that the unity of interest and ownership is such that the separate personalities of the corporation and the individual no longer exist, and (2) that a fraud or inequity would result from the failure to disregard the corporate entity.

Once a corporation is found to be an alter ego of a taxpayer, the entire amount of the Federal tax lien can be asserted against the corporation.

B. Transfers of Assets to Nominees

Instead of setting up and transferring assets to an organization that cannot be distinguished from the taxpayer, a delinquent taxpayer might attempt to defeat the Federal tax lien by placing assets in another person's name. These nominee transfers of property are only simulated transfers of property. The delinquent taxpayer still maintains control of the property.

For instance, in attempting to assert a lien against the property where the delinquent taxpayer, Ms. Y, lives, an agent finds that the property is listed in her brother's name. Ms. Y's return shows that she is paying the property tax

and claiming interest deductions on a mortgage secured by the property. Further investigation shows that she also pays the utility bills.

The property is being held by the brother in name only. He is a nominee. When a nominee situation exists, the lien attaches to the specific property which is the subject of the simulated transfer. Unlike the alter ego situation, in which all of the assets of the corporation are owned by the delinquent taxpayer, nominee liens only attach to the specific property transferred. Further discussion of nominee liens is found in IRM 5355.33. Again, this does not necessarily give rise to transferee liability, but is part of the general rules of tax liens.

C. <u>Benefits, Limitations and Drawbacks</u>

There are a number of benefits, limitations and drawbacks to recommending nominee/transferee or alter-ego liens, as well as a number of requirements. The major drawback is that the lien is going against an entity that is not under examination. This exposes the Service to litigation such as wrongful levy actions, as well as clouding the title to the property. As a result, all proposed liens must be approved in advance by District Counsel. In addition, applicable reports must be made to District Counsel throughout the processing of the lien.

The lien is based on state law and the Uniform Commercial Conveyance Act. It puts the public on notice of the Government's claim. The lien attaches to the specific property in the nominee's name or to the property in the alter ego's name, and it can cover any type of tax since the lien is on specific property. The statute of limitations is the same as the ten year collections statute against taxpayer-transferor, and it takes precedence over the further encumbrance or transfer of the property.

4. <u>Transfer of Property Before the Federal Tax Lien Arises</u>

When property has been transferred after the Service has gone through the procedures necessary for the attachment of a lien, a tax has been assessed, a notice and demand for tax has been made, and payment in full has not been made within a specified time, the lien follows the property. However, if no tax lien has arisen when the transfer is made, there is no lien attached to the property when it is transferred and the Service has to demonstrate that the transferee is liable for the transferor's taxes. In general, the tax must arise before the transfer takes place. As discussed below, if the transferee liability arises by operation of law, the transferee is generally liable for the full amount of the transferor's taxes, regardless of the value of the property transferred. If transferee liability arises in equity, however, the transferee's liability is limited

to the lesser of the value of the property transferred or the amount of the transferor's liability.

A. Transferee Liability Arising By Operation of Law

The easiest way for the Service to attach a lien to transferred property is if there is transferee liability specified by law. In this case, all that is necessary is to demonstrate that the property was transferred and that the transferee is obligated to pay the liability either by statute or contract.

An example of statutory transferee liability is a state merger statute. Many of these statutes treat a successor corporation as responsible for the liabilities of the predecessor corporation. An example of contractual transferee liability is when a business or individual agrees to purchase the assets and assume the liabilities of a going concern. Since taxes are a debt, the purchasing party obligates itself for the transferor's taxes.

When transferee liability arises by law, there is no requirement to show that the transferor has been rendered insolvent by the transfer and thus could not pay the taxes involved. When transferee liability arises by operation of law, there is also no need to prove the value of the transferred assets. In fact, administrative collection actions against the transferor do not have to be exhausted.

B. Transferee Liability Arising in Equity

Transferee liability in equity is based on state fraudulent conveyance statutes. Most of these state statutes are based on the common-law principle that debtors may not transfer assets for less than adequate consideration if they are left unable to meet their obligations. Liability in equity exists if the transfer is fraudulent to creditors.

To prove actual fraud under state law requires a proof of intent. Intent is a state of mind and is not readily provable. If actual fraud can be proven, however, it is generally unnecessary to show that the transfer made the delinquent taxpayer insolvent.

Constructive fraud under state law does not require a showing of intent. To prove constructive fraud requires a showing that the transfer is not founded on good consideration and has left the delinquent taxpayer insolvent thereby impairing the rights of the creditors. The Service can establish transferee liability that arises in equity by showing five key factors: the transfer of assets was for less than full consideration; the transfer was made after the liability for

taxes accrued; the transferor is liable for the tax; all reasonable efforts have been made to collect the liability from the transferor taxpayer; and the transferor was insolvent when the transfer was made, or the transfer made the transferor insolvent.

When transferee liability arises in equity, the transferee's liability is limited to either the amount owed by the transferor or the value of the property transferred, whichever is less.

C. Protecting the Government's Interest

When transferee liability is suspected in cases where the transfer was made before the Federal tax lien attached, administrative actions under IRC 6901 should be attempted before legal action because of the costs involved in legal action and because of the uncertainty of success. However, administrative action may not be taken prior to consultation with District Counsel.

5. Example

Examination agents are accustomed to revoking organizations for private inurement, and, because the assets of the organization have been depleted, closing the case with a substitute 1120.

This strategy fails to take into consideration the benefits of the inurement, the fact that private parties may have taken excessive salaries, rental payments, and other unreasonable fees to enrich their own asset base.

In one case, an exempt organization had been carrying on gambling activities for the stated purpose of using the proceeds to carry on an exempt charitable program. However, the agent found that the controlling operator was actually converting gambling profits to his own personal use, which included purchasing real estate and acquiring "jumbo" certificates of deposit. In addition, he had accumulated a portfolio of securities.

At the time the revocation occurred, however, the operator was dead, and the exempt organization was a shell.

The agent found that the operator had left a very wealthy widow. The agent traced the assets from the exempt organization's profits to the widow and developed the revocation, substitute 1120, and the case for transferee liability.

The agent then contacted District Counsel who helped in the preparation of an assessment of transferee liability. The agent used the assessment of trans-

feree liability on the property bequeathed to the widow to obtain a closing agreement that recovered a substantial part of the property that had been obtained from the profits of the exempt organization.

While the gambling situation might well be obvious, there are many situations in which operations under the direction of a single individual could have resulted in inurement and produced a substantial buildup of personal assets over the years which are still in the possession of the private individual and could be used to pay a transferee liability assessment.

## R. JEOPARDY AND TERMINATION ASSESSMENTS

by
Donald Ketchum and Terry Hallihan

Jeopardy assessments are made in situations where, prior to the assessment of a deficiency, it is determined that the assessment or the collection of such deficiency would be endangered if regular assessment procedures were followed. There are three IRC sections authorizing jeopardy assessments.

IRC 6861 authorizes assessment where the due date for filing of a return has expired. IRC 6862 authorizes assessment of taxes other than income, estate, gift and certain excise taxes, even when the due date for filing a return has not expired and IRC 6867 authorizes assessment in situations where an individual is in possession of cash in excess of $10,000 and does not claim ownership of the cash or who claims the cash belongs to another individual, whose identity can be determined, and who claims ownership of the cash.

Prior to making a jeopardy assessment, at least one of the factors outlined in Policy Statement P-4-88 must be present. Those factors are: (a) the taxpayer is or appears to be designing quickly to depart from the United States or to conceal him/herself; (b) the taxpayer is or appears to be designing quickly to place his/her property beyond the reach of the government either by removing it from the United States, by concealing it, by dissipating it, or by transferring it to another person; or (c) the taxpayer's financial solvency is or appears to be imperiled. (This does not include cases where the insolvency is created by an assessment.)

Jeopardy assessments should be used prudently and care taken to avoid excess and unreasonable assessments. The amount of the assessment should be limited to an amount that reasonably can be expected to equal the liability due.

While jeopardy assessments may be appropriate in many types of cases, they most likely will be more prevalent in cases involving taxpayers engaged in organized crime, wagering cases, cases involving taxpayers who are believed to be receiving income from illegal sources, and cases involving taxpayers known or suspected of having plans to leave the United States without making provisions for tax payments.

All jeopardy assessments must be approved by the Assistant Commissioner (International) or the District Director. If neither of these can give the approval,

it must be given by the Assistant District Director, the Chief, EP/EO Division, the Chief, Collection Division, or the Chief, Criminal Investigation Division. IRM 7(10)(12)(19).3 contains a full listing of all individuals authorized to approve a jeopardy assessment.

The normal responsibility for recommending jeopardy assessments for cases under active consideration by EP/EO lies with that division. For EP/EO cases under active consideration by Criminal Investigation, the responsibility lies with CI. Collection Division has responsibility for all EP/EO cases not under active consideration by EP/EO or CI. However, a recommendation may also be received from another part of the Service, from Treasury or from Justice.

Within five days of the issuance of a jeopardy assessment, the taxpayer must be provided a written statement of the information upon which the Service relied in making the assessment. To the extent possible, every effort should be made to deliver the statement in person. The taxpayer has 30 days from the date of receiving the written statement of the reasons for making the jeopardy assessment, or 35 days from the date of the assessment to file a written request for review of the assessment action which will be reviewed by the Appeals Office. If possible, an immediate conference will be held and a decision made within 15 days after the request is filed. In addition, under the provisions of IRC 7429(b)(1), taxpayers can initiate judicial review of the assessment, if they have first requested an administrative review.

If administrative or judical review finds that the assessment was not proper or that it was excessive, abatement, in whole or in part, must be made.

Termination assessments are very similar to jeopardy assessments except that, under the provisions of IRC 6851, they are made only for the current or immediately preceding taxable year and can be made any time prior to the due date for filing those years returns. Termination assessment action makes the tax for those years immediately due and payable.

The conditions which must be present for a termination assessment to be made are contained in Policy Statement P-4-89 and include cases involving taxpayers engaged in organized crime, wagering cases, Strike Force cases, cases involving taxpayers who are believed to be receiving income from an illegal activity, cases involving taxpayers believed to be about to leave the country without making provisions for tax payment or cases outlined in IRC 6867.

Procedures involving assessment, review, abatement, etc., are contained in IRM 7(10)(12)(20).

# S. SOCIAL SECURITY ADMINISTRATION REPRESENTATIVE PAYEE ORGANIZATIONS (RPOs) UNDER IRC 501(c)(3) and 501(c)(4)

**by**
**John Chappell and Bill Brockner**

## 1. Introduction

Headquarters has received numerous applications for recognition of exemption under IRC 501(c)(3) and 501(c)(4) from organizations that desire to participate in the Representative Payee Organization (RPO) program of the Social Security Administration (SSA). RPOs, the subject of this article, with the authorization and approval of the Social Security Administration, are permitted to collect disability insurance and supplemental security insurance benefit funds on behalf of those who are mentally or physically debilitated because of drug or alcohol abuse, mental or physical impairments, or old age. The funds are intended to pay for the basic living expenses of the beneficiaries. The RPOs are authorized SSA fees for the services performed for the SSA and the beneficiaries.

This article will identify the criteria that RPOs must satisfy in order to qualify for recognition of exemption. In addition, the article will discuss the foundation classification of RPOs.

## 2. The SSA RPO Program and its Connection to IRC 501(c)

### A. The SSA RPO Program

#### (1) General

Section 5105 of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) included a provision permitting qualified organizations to collect a fee from beneficiaries for expenses (including overhead) incurred by the organizations in providing services performed as the beneficiaries' representative payee. This provision was effective July 1, 1991 until July 1, 1994. Section 201 of the Social Security Independence and Program Improvements Act of 1994 (P.L. 103-296) extended the authority for qualified organizations to collect fees for representative payee services beyond July 1, 1994. It also changed the definition of "qualified organization."

Specifically, section 205(j)(4)(B) of the Social Security Act provides the definition of a qualified organization. This section reads:

> ***... the term "qualified organization" means any state or local government agency whose mission is to carry out income maintenance, social service, or health care-related activities, any state or local government agency with fiduciary responsibilities, or <u>any community based non-profit agency</u> [emphasis added] which is bonded or licensed in each state in which it serves as a representative payee, if such agency, in accordance with any applicable regulations of the Commissioner of Social Security--***
>
> ***(i) regularly provides services as the representative payee, pursuant to this subsection or section 1631(a)(2), concurrently to 5 or more individuals; and***
>
> ***(ii) demonstrates to the satisfaction of the Commissioner of Social Security that such agency is not otherwise a creditor of any such individual.***

Before the 1994 SSA Act, only community-based non-profit social service agencies that were in existence on October 1, 1988, were included in the qualified organization category.

To further encourage these organizations to become representative payees, the 1994 Act authorized them to charge drug addicts and alcoholics an amount equal to the lesser of 10 percent of the monthly benefit or $50 (in the case of a beneficiary determined by the SSA to be disabled based on such addiction), indexed to the Consumer Price Index.

(2) <u>Qualified Organizations</u>

In 20 CFR 404.2040a of the Code of Federal Regulations, the SSA further defined qualified organizations as follows:

> ***a. A community-based nonprofit social service agency which meets the requirements set out in paragraph (b) of this section may request our authorization to collect a monthly fee from a beneficiary for providing representative payee services.***
>
> ***b. We will authorize an organization to collect a fee if all the following requirements are met:***

***(i) It is community-based, i.e., serves or represents one or more neighborhoods, city or county locales and is located within its service area.***

***(ii) It is a nonprofit social service organization founded for religious, charitable or social welfare purposes and is tax exempt under section 501(c) of the Internal Revenue Code.***

***(iii) It is bonded or licensed in the state in which it serves as representative payee.***

***(iv) It regularly provides representative services concurrently to at least five beneficiaries.***

***(v) It is not a creditor of the beneficiary.***

The SSA requires that organizations have a IRC 501(c) exemption letter from the IRS, which SSA accepts as proof that they are both a nonprofit and social service organization. Upon submission of this proof, and a determination by SSA that the other requirements are met, SSA will authorize collection of any appropriate fees.

(3) <u>Duties of RPOs: Extract from SSA Publication No. 05-100076, A Guide For Representatives, June 1994</u>

***a. <u>A Representative Payee's Duties</u>***

***As a representative payee, you need to keep informed of the individual's needs so that you can decide how benefits can best be used for his or her personal care and well-being... .***

***Any money left after meeting the beneficiary's current and reasonably foreseeable needs must be saved and maintained in the beneficiary's behalf. Periodically, Social Security will ask you to complete a form accounting for the funds you have received. A sample form is shown on page 13. There's a worksheet in the center of this booklet that you can use to help keep track of what you spend.****

***As a representative payee, you will need to keep Social Security informed of changes that may affect the beneficiary's eligibility for benefits.***

***Representative payees are required by law to use benefits properly. If a payee misuses benefits, he or she must repay the misused funds to the beneficiary. A Payee convicted of misuse may be fined and/or imprisoned.***

***b. <u>How To Use The Benefits</u>***

***First, make sure the beneficiary's day-to-day needs for food and shelter are met. Then, benefits may be used for the beneficiary's personal needs, such as clothing, recreation, and other expenses. Benefits also can be used to pay for medical needs (for example, eyeglasses and hearing aids) and dental care not provided by Medicare, Medicaid, or a residential institution.***

***If a beneficiary is in a nursing home or other institution, you should use benefits to pay the usual charges for care, as well as to buy personal items not normally provided by the facility.***

***Also, if the beneficiary lives in an institution and is eligible for Medicaid or is a member of a family that receives Aid to Families with Dependent Children (AFDC) payments, you should contact the local Social Security office about using benefits to support family members.***

*Copies of the SSA worksheet and form are attached as Exhibits A & B.

B. <u>The RPO Program and IRC 501(c) Exemption</u>

As may be gleaned from the SSA discussion above, RPOs must have religious, charitable, or social welfare purposes. Organizations qualifying to participate in the SSA RPO program must first be recognized by the IRS as exempt under IRC 501(c)(3) or 501(c)(4) since these are the only IRC 501(c) categories that would include social service organizations founded for religious, charitable, or social welfare purposes. The discussion that follows will focus on those organizations whose exclusive or primary activities are the performance of RPO functions. IRC 501(c)(3) or 501(c)(4) organizations engaging in RPO activities as secondary activities could have unrelated trade or business issues if the organizations did not operate within the parameters of the criteria discussed in 3 below. Also, private benefit issues could be raised. Private benefit is presumably a more significant concern with IRC 501(c)(4) organizations now because of the recent enactment of the Taxpayers' Bill of Rights 2

(TBOR 2) legislation that includes an inurement prohibition applicable to IRC 501(4)s similar to the prohibition applicable to organizations exempt under IRC 501(c)(3). See the Current Developments section of this EO CPE Text for a description of the TBOR 2 legislation.

3. <u>Exemption Recognition under IRC 501(c)(3) or IRC 501(c)(4)</u>

A. <u>RPOs May Further IRC 501(c)(3) and IRC 501(c)(4) Purposes</u>

RPOs may qualify for IRC 501(c)(3) exemption following two long-established IRC 501(c)(3) rationales. RPOs may further exempt purposes by lessening the burdens of government, specifically, in this case, lessening the burdens of the SSA. See Rev. Rul. 81-276, 1981-2 C.B. 128, describing a professional standards review organization (PSRO) that assumed the task of reviewing the professional activities of health care practitioners and institutions that were appropriate recipients of Medicare and Medicaid reimbursements. See generally EO CPE Texts of the following years: 1995 (p.53); 1993 (p.17); 1992 (p.156); 1987 (p. 139); and 1984 (p. 217).

RPOs may also further exempt purposes by relief of the poor and distressed. RPOs assist a class of individuals who are mentally or physically debilitated, or both. By providing, managing, and monitoring funds that pay for their basic necessities of living, an organization may be furthering section 501(c)(3) and 501(c)(4) purposes. See, in general, EOHB IRM 7751, sec. 343.

IRC 501(c)(3) and (c)(4) RPOs are RPOs servicing all eligible beneficiaries of the SSA RPO program. They are distinguishable from commercial trade or business organizations such as the one described in Rev. Rul. 72-369, 1972-2 C.B. 245. In the latter, the Service held that an organization providing managerial and consulting services at cost to unrelated charities as a primary activity did not qualify for exemption. RPOs that provide services directly to all eligible beneficiaries regardless of the potential fees, and otherwise meet the requirements under IRC 501(c)(3) or 501(c)(4), would not be viewed as commercial trade or business organizations.

B. <u>RPOs Serving Private Interests</u>

In addition to carrying out exempt purposes, RPOs must satisfy the IRC 501(c)(3) and Reg.1.501(c)(3)-1(d)(1)(ii) requirement that organizations must be operated for the benefit of public rather than private interests. In the case of IRC 501(c)(4) applicants, RPOs must satisfy the Reg.1.501(c)(4)-1(a)(2)(i) requirement that they are primarily engaged in promoting in some way the

common good and general welfare of the people of the community. As noted in 2B above, IRC 501(c)(4)s are now also subject to an inurement prohibition.

Some RPOs that have applied for recognition of exemption are, in essence, one or two person operations. Typically, such organizations are created and controlled by one or two people who are also the sole or controlling employees. If there are other employees, they may be related to the controlling individual(s). The boards of directors consist of the individual(s) and related persons. The controlling individual(s') compensation may be the RPO's primary expenses. RPOs may also be paying rent for use of the controlling persons' residences.

When an RPO is controlled by one or two individuals or a small, related group, there is an indication that the RPO operates primarily for the benefit of the principals, and not for exempt purposes.

C. Criteria for Determining If a RPO is Serving IRC 501(c)(3) or 501(c)(4) Purposes

In determining whether RPOs qualify for exempt status, the EO Division in Headquarters is applying the following criteria:

(1) The payee services should be provided to all eligible SSA RPO beneficiaries without regard to the benefit amount (and corresponding RPO service fee) that an eligible beneficiary may receive.

(2) The RPO's governing body should be composed primarily of members of the community who are not financially interested in the RPO's activities (i.e., persons other than compensated individuals of the organization or related parties).

(3) The governing body should have exclusive authority to determine compensation of employees and other parties that perform major services for the RPO. Those persons who are members of the governing body and who are also compensated for services provided to the RPO must not be eligible to vote on board decisions involving their personal compensation packages.

(4) The RPO governing body and key employees should demonstrate evidence of experience or background in the social services area.

(5) Officials of the RPO should represent that the organization will follow the operational requirements of the SSA including fulfilling the duties described in SSA Publication No. 05-10076, A Guide For Representative Payees, as revised or superseded. See 2A(3) above.

These criteria are not unique to determinations involving RPO-type organizations. Rather, they have long been applied to a variety of organizations seeking recognition of exemption. For example, requiring that such an organization be governed by a board of directors representative of the community served, rather than by "insiders" with a financial interest in the organization's activities, is consistent with published precedents requiring that health care providers and similar organizations have a "community board" rather than a governing body dominated by financially interested individuals. See, e.g., Rev. Rul. 69-545, 1969-2 C.B. 117; compare Rev. Rul. 55-656, 1955-2 C.B. 262 (community nursing bureau qualified for exemption under IRC 501(c)(3)), with Rev. Rul. 61-170, 1961-2 C.B. 112 (private duty nurses' registry distinguished from community nursing bureau on basis that public control and support of latter demonstrated operation for public vs. private benefit.) See also this EO CPE Text Topic C, Tax Exempt Health Care Organizations Community Board And Conflicts of Interest.

4. Non-Private Foundation Status under IRC 509(a)(2)

As discussed above, RPOs receive payments for services rendered on behalf of SSA recipients. RPO participants in the program are authorized by the SSA to collect fees for expenses incurred on the beneficiaries' behalf. All SSA payments (including the fee portion of the payments) to the RPOs are payments for the performance of the organization's exempt functions, and counted as "support" within the meaning of IRC 509(d).

In determining an RPO's public charity status, payments received in the manner described above are considered to be payments for the performance of the organization's exempt function. They are counted as "public support" under section 509(a)(2) in a manner similar to medicare and medicaid payments to health care organizations. See Rev. Rul. 83-153, 1983-2 C.B. 48. Thus, payments allocated for each beneficiary would be includible as RPO gross receipts to the extent of the greater of $5,000 or one percent of an organization's total support for a taxable year. In this way, the RPO will likely qualify as an IRC 509(a)(2) organization.

5. Conclusion

Headquarters is preparing Exempt Organization Handbook and other IRM instructions on the issues discussed in this article. We hope that application of the criteria outlined in the article will promote uniformity in processing applications from organizations seeking exemption as RPOs.

## Exhibit A

# INCOME AND EXPENSES WORKSHEET

| Month and Year | Amount of Social Security or SSI Benefits Received | Expenses for Food and Shelter | Expenses for Clothing, Medical/Dental, Personal Items, Recreation, Miscellaneous | Amount of Money Remaining |
|---|---|---|---|---|
| | | | | |
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| | | | | |
| Totals For Report Period | $____________ | $____________ Put this figure on line 3B of the Representative Payee Report | $____________ Put this figure on line 3C of the Representative Payee Report | $____________(1) |
| Show the amount remaining, if any, from earlier report periods. | | | | $____________(2) |
| Add lines (1) and (2). Put this figure on line 3D of the Representative Payee Report. | | | | $____________ |

For additional worksheets, you may photocopy this page before you use it, or contact Social Security.

# Exhibit B

# Representative Payee Report

Social Security Administration, P.O. Box XXXX, Wilkes-Barre, PA 18767-XXXX

FORM APPROVED
OMB NO. 0960-0068

| PAYEE'S NAME AND ADDRESS | REPORT PERIOD FROM: TO: | SOCIAL SECURITY NUMBER |
|---|---|---|
| | BENEFICIARY | FP |
| | ID PFC BIC | D TP CC GB PC DOC |
| | DOB MBC CF TAA | |

**This report is about the benefits you received between XX/XX/XX and XX/XX/XX for the beneficiary, XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. Please read the enclosed instructions before completing this form to help you answer each question.**

**1.** Were you (the payee) convicted of a crime considered to be a felony between XX/XX/XX and XX/XX/XX?
If YES, please explain in REMARKS on the back of this form — YES ☐ NO ☐

**2.** Did the beneficiary live with the same person or in the same institution from XX/XX/XX and XX/XX/XX?
If NO, please explain in REMARKS on the back of this form — ☐ ☐

**3.** Benefits paid to you between XX/XX/XX and XX/XX/XX = $00,000
Benefits you reported **saved** by you from prior years = $ 000
Total accountable amount = $00,000

**A.** Did you (the payee) decide how the $00,000 was spent or saved?
If NO, please explain in REMARKS on the back of this form. → YES ☐ NO ☐

DOLLAR AMOUNT (NO CENTS)

**B.** How much of the $00,000 did you spend for the beneficiary's food and shelter between XX/XX/XX and XX/XX/XX? → ☐☐,☐☐☐

**C.** How much of the $00,000 did you spend on other things for the beneficiary such as clothing, education, medical and dental expenses, recreation, or personal items between XX/XX/XX and XX/XX/XX? → ☐☐,☐☐☐

**D.** How much, if any, of the $00,000 did you **save** for the beneficiary as of XX/XX/XX? If none, show zeroes. → ☐☐,☐☐☐

**4.** If you showed an amount in 3.D. above, place an "X" in the boxes below to show how you are saving the benefits. If you have more than one account, you may mark more than one box in each question.

| **A. TYPE OF ACCOUNT** | | | | | **B. TITLE OR OWNERSHIP** | | |
|---|---|---|---|---|---|---|---|
| Savings/ Checking Account | U.S. Savings Bonds | Certificates of Deposit | Collective Savings/ Patient's Fund | Other | Beneficiary's Name by Your Name | Your Name for Beneficiary's Name | Other |
| ☐ | ☐ | ☐ | ☐ | ☐ | ☐ | ☐ | ☐ |

# PART II

## CURRENT DEVELOPMENTS

by
Toussaint Tyson and Conrad Rosenberg

I. Announcements and News Releases

1. Ann. 95-27, 1995-14 I.R.B. 15 (Apr. 3, 1995)

   Announces the most current update to Pub. 557, Tax-Exempt Status for Your Organization (Rev. Jan. 1995).

2. Ann. 95-51, 1995-25 I.R.B. 132 (June 19, 1995)

   Announces that the EP/EO determination letter program will be centralized, through a gradual process, in Cincinnati, Ohio. The public is reminded to submit requests for determination letters to the relevant key district offices until a further announcement is made.

3. Ann. 95-61, 1995-32 I.R.B. 54 (Aug. 7, 1995)

   Announces proposed examination guidelines for municipal financing arrangements and solicits public comments.

4. Ann. 96-13, 1996-12 I.R.B. 33 (Mar. 18, 1996)

   Implements a new program to develop procedures that would facilitate resolution of employment related issues including: record-keeping, employment taxes and worker classification.

5. Ann. 96-24, 1996-16 I.R.B. 30 (Apr. 15, 1996)

   Announces proposed examination guidelines for IRC 501(c)(12) rural electric cooperatives and solicits public comments.

6. IR 96-23 (Apr. 25, 1996)

   Reminds charitable organizations of the IRC 501(c)(3) proscription against intervention in political campaigns.

7. Ann. 96-33, 1996-18 I.R.B. 12 (Apr. 29, 1996)

   Announces a hearing on EE-53-95, which contains Prop. Reg. 1.501(c)(5)-1(b)(concerning the description of labor, agricultural and horticultural organizations).

8. Ann. 96-63, 1996-29 I.R.B. 1 (July 15, 1996)

   Announces that the processing of EO information and tax returns will be centralized, through a two-step process, in Ogden, Utah.

II. Notices and Revenue Procedures

1. Notice 95-47, 1995-35 I.R.B. 17

   This notice provides expedited treatment for exemption applications and temporary relief from certain Code provisions for organizations participating in Virginia flood relief.

2. Notice 95-56, 1995-45 I.R.B. 11

   This notice provides expedited treatment for exemption applications and temporary relief from certain Code provisions for organizations participating in Hurricane Marilyn relief in the Virgin Islands and Puerto Rico.

3. Notice 95-66, 1995-51 I.R.B. 19

   This notice provides expedited treatment for exemption applications and temporary relief from certain Code provisions for organizations participating in Hurricane Opal relief in parts of Alabama, Florida, and Georgia.

4. Notice 96-30, 1996-20 I.R.B. 11

   Notifies the public that an IRC 501(c) organization need not file the Form 3115 merely because the organization changes to the accounting methods specified in Financial Accounting Standards No. 116.

5. Rev. Proc. 95-21, 1995-1 C.B. 686

   Establishes when IRC 501(c)(5) associate member dues will be treated as gross income from an unrelated trade or business under IRC 512.

6. Rev. Proc. 95-35, 1995-32 I.R.B. 51

   Explains how tax-exempt organizations that lobby can establish exemption from the IRC 6033(e)(1) reporting requirements and the IRC 6033(e)(2) tax.

7. Rev. Proc. 95-48, 1995-47 I.R.B. 13, supplementing Rev. Proc. 83-23, 1983-1 C.B. 687

   In this revenue procedure, the Commissioner exercises her discretionary authority under Reg. 1.6033-2(g)(6) by specifying that neither governmental units nor affiliates of governmental units are required to file the annual information return, Form 990, Return of Organization Exempt from Income Tax.

8. Rev. Proc. 96-8, 1996-1 I.R.B. 187

   This revenue procedure supersedes Rev. Proc. 95-8, which contained the fee schedule for requests for letter rulings, determination letters, and certain other matters within the jurisdiction of the Assistant Commissioner (Employee Plans/Exempt Organizations), and replaces it with the new fee schedule.

9. Rev. Proc. 96-10, 1996-2 I.R.B. 17

   This procedure describes a class of organizations, affiliated with a church or convention or association of churches, and exempt from federal income tax under IRC 501(c)(3), that is not required to file the Form 990, Return of Organization Exempt from Income Tax. Rev. Proc. 83-23 is supplemented and Rev. Proc. 86-23 is obsoleted. (See reference to TD 8640, below.)

10. Rev. Proc. 96-15, 1996-3 I.R.B. 41

    Concerns a procedure a taxpayer may follow to request from the Service a Statement of Value, a reliance document, that can be used to substantiate the value of art for specific purposes such as the charitable contributions deduction under the Code.

11. Rev. Proc. 96-32, 1996-20 I.R.B. 14, supersed'g Notice 93-1, 1993-1 C.B. 290

    Provides guidance, for organizations providing low-income housing, on qualifying for tax-exemption under IRC 501(c)(3). The revenue procedure creates a safe-harbor rule that permits these organizations to offer a limited number of units to persons with income above the low-income limits.

III. Regulations

1. T.D. 8602, 1995-34 I.R.B. 5

    This document contains final regulations, modifying Reg. 1.162-20(c), adding Regs. 1.162-28 and 1.162-29, and removing Reg. 1.162-20T, and thereby provides guidance on complying with IRC 162(e)(3)(concerning the disallowance of an IRC 162 deduction for certain amounts paid by a taxpayer and allocable to an exempt organization's "influencing legislation.") This document includes guidance on the meaning of the term "influencing legislation" and on acceptable methods to allocate payments into deductible and nondeductible portions.

2. IA-44-94, 1995-37 I.R.B. 41, 60 Fed. Reg. 39896

    These proposed regulations, Prop. Regs. 1.170A-1(h), 1.170A-13, and 1.6115-1, provide guidance regarding the allowance of certain charitable contribution deductions, the substantiation requirements for charitable contributions of $250 (or more), and the quid pro quo contributions in excess of $75.

3. T.D. 8615, 1995-39 I.R.B. 5

    Provides guidance for determining whether certain scholarships, prizes and awards, fellowship grants and other grants (including those

described in IRC 4945(g)) are U.S. sourced and, therefore, subject to the income tax and withholding.

4. T.D. 8623, 1995-45 I.R.B. 4

   This document contains final regulations 1.170A-13(f), and addresses the substantiation of contributions made by payroll deduction and the substantiation of a payment to a donee organization in exchange for goods or services with insubstantial value.

5. T.D. 8628, 1995-52 I.R.B. 9

   This document containing final regulations amends Regs. 53.4955-1, 53.6011-1, 53.6012-1, 53.6071-1, 53.6091-1, 301.6213-1, 301.6852-1, 301.6861-1 and 301.6863-2 concerning excise taxes, filing returns, and accelerated tax assessments relating to certain political expenditures of charitable organizations; it also amends Reg. 301.7409-1, which concerns an action to enjoin certain political expenditures made by charitable organizations. This Treasury Decision implements an effort to effectuate changes made to the Code by OBRA '87.

6. T.D. 8640, 1996-2 I.R.B. 10

   This document finalizes, with some modifications arising from public comment, proposed regulations under IRC 508 and 6033, which had been published as EE-41-86, 1995-1 C.B. 841, 59 Fed. Reg. 64633. The regulation concerns integrated auxiliaries of churches and their exemption from filing information returns.

7. T.D. 8639, 1996-5 I.R.B. 12

   This document contains final regulations modifying Reg. 53.4941(d)-2, which provides that it will not generally be considered IRC 4941 self-dealing if a private foundation provides non-compensatory insurance or indemnification for the foundation manager against civil actions for misconduct arising out of actions the manager performed on behalf of the foundation. This regulation also describes when the indemnification and insurance payments would be considered compensatory or non-compensatory. ("Directors and Officers" insurance issue.)

8. EE-53-95, 1996-5 I.R.B. 23, 60 Fed. Reg. 66228

   This notice of proposed rulemaking contains a proposed regulation that may amend Reg. 1.501(c)(5) to clarify that the term "labor, agricultural and horticultural organizations" as that term is used in IRC 501(c)(5), does not include organizations principally engaged in managing retirement plans.

9. INTL-62-90, etc., 1996-19 I.R.B. 26, 61 Fed. Reg. 17614

   Prop. Reg. 1.1441-1(f)(3) provides guidance concerning payors' withholding requirements relating to qualified scholarships (as defined in IRC 117(a)) made to non-resident aliens, if such scholarships are U.S. sourced. Prop. Reg. 1.1441-9 provides guidance relating to the withholding rules applicable to certain foreign tax-exempt organizations (including private foundations).

IV. Court Decisions

1. Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995), rev'g (in part) 822 F.Supp. 371 (W. D. Tex. 1993)

   Texas Farm Bureau, an organization described in IRC 501(c)(5), had partial interests in two insurance companies and had entered into profitable agreements with both to provide, for a fee, administrative services and the exclusive right to use its name and logo in Texas. These agreements did not mention a royalty. For each of the litigated years, TFB filed timely returns reporting the fees as unrelated business taxable income and subsequently filed amended returns, unsuccessfully arguing to the Service that part of the fees was an IRC 512(b)(12) royalty. The District Court let the jury decide that part of the fees was a royalty; the Fifth Circuit reversed the District Court ruling that TFB's post hoc amended returns are insufficient evidence, as a matter of law, to show that the fees were, in part, royalties.

2. Southwest Texas Electrical Cooperative, Inc. v. Commissioner, 67 F.3d 87 (5th Cir. 1995), aff'g T.C. Memo 1994-363

   The Tax Court ruled that the exempt organization generated IRC 514 debt-financed income because it earned interest income from United States treasury notes purchased with borrowed funds where the court

found that the organization would not have purchased the treasury notes but for the incurred debt. The Fifth Circuit affirmed.

3. Florida Hospital Trust Fund v. Commissioner, 71 F.3d 808 (11th Cir. 1996), aff'g 103 T.C. 140 (1994)

   Three trust funds, which were established to provide malpractice and workers' compensation on a cooperative basis to Florida hospitals, were denied exemption because (1) they provided commercial-type insurance and, therefore, were precluded from exemption by IRC 501(m), and (2) although the **purchase** is, the **provision of** malpractice and workers' compensation is not a prescribed IRC 501(e)(1)(A) activity, and, therefore, none of the trusts could qualify for exemption under IRC 501(e). The Eleventh Circuit upheld the Tax Court's ruling on the IRC 501(e) issue and made no decision on the Tax Court's IRC 501(m) ruling.

4. Credit Union Insurance Corporation v. United States, 77 AFTR2d ¶ 96-712 (4th Cir. 1996), aff'g 75 AFTR2d 95-2507 (D.C. Md. 1995)

   Insurance Corporation, which was chartered under state law, insured the deposits of several state credit unions and successfully applied for recognition as a business league. However, the Service, relying on Rev. Rul. 83-166, 1983-2 C.B. 66, which posits that certain credit union insurers are specifically precluded exemption by IRC 501(c)(14)(B) and, therefore, cannot circumvent that proscription by claiming to be described in IRC 501(c)(6), revoked Insurance Corporation's exemption. The district court held for Insurance Corporation.

   The Fourth Circuit rejected the revenue ruling's reasoning and then ruled that insuring credit union deposits is not the kind of business that a for-profit business would or could engage in and, therefore, held for Insurance Corporation.

5. National League of Postmasters of the United States v. Commissioner, 77 AFTR2d ¶ 96-713 (4th Cir. 1996), aff'g T.C. Memo 1995-205

   National League of Postmasters is a labor organization whose purpose, as stated in its articles of incorporation, is to improve the working conditions of its members, of which it had two basic classes. One class' membership was affiliated with the postal system; and the second was affiliated with non-postal federal employment. The members of the second class, League Benefit Members (LBM's), paid dues and service

fees, which the Service determined to be unrelated business taxable income of the National League of Postmasters. The Tax Court upheld this determination.

The Fourth Circuit upheld the Tax Court's ruling that "members" as used in the League of Postmasters' articles of incorporation meant postmasters and (to a lesser extent) other postal workers. Thus, any service provided to other federal workers, LBM's or not, was unrelated to National League of Postmasters' exempt purpose. Further, the Fourth Circuit ruled that many of the benefits provided to the non-postal federal workers, even if such workers were bona-fide members, "failed to provide for the betterment of conditions for all federal employees."

6. Sierra Club, Inc. v. Commissioner, 78 AFTR2d ¶ 96-5002 (9th Cir. 1996), aff'g T.C. Memo 1993-199, rev'g 103 T.C. 307 (1994)

   The Ninth Circuit upheld the Tax Court's decision of Sierra Club I (T.C. Memo 1993-199), which held SC's receipts from third party use of its mailing lists were IRC 512(b) royalties, and reversed and remanded Sierra Club II (103 T.C. 307), which held that SC's participation in an affinity card program would not generate unrelated business taxable income because the resulting receipts are IRC 512(b) royalties.

   The Ninth Circuit decision is important because it appears to narrow the definition of royalty so that virtually any activity, seemingly even mere maintenance of a mailing list, could preclude IRC 512(b) royalty treatment of the related payment.

7. Lucky Stores, Inc. & Subs. v. Commissioner, 105 T.C. 420 (1995)

   Lucky Stores donated bread, and other baked goods, to charity four days after baking, except on Sunday, when such four-day old bread would be sold for full retail value. Lucky Stores claimed charitable deductions under Reg. § 1.170A-1(c)(2)(basis plus one-half the ordinary gain determined at full retail value); the Service argued Lucky Stores must determine its charitable deduction under Treas. Reg. § 1.170A-(c)(3)(basis plus one-half the ordinary gain determined at a discounted value). The Tax Court ruled that Lucky Stores was entitled to use Reg. § 1.170A-(c)(2).

8. Ohio Farm Bureau Federation, Inc. v. Commissioner, 106 T.C. No. 11 (1996)

   Farm Bureau Federation had a services contract with a farmers' cooperative, and subsequently entered into a covenant not to compete with that cooperatives' successor. The Service determined that the services contract and the covenant generated unrelated business income tax; the Tax Court upheld the Farm Bureau Federation.

   The Tax Court found that promotion of the cooperative was substantially related to Farm Bureau Federation's exempt purpose. Further the Tax Court found that performance under a covenant not to compete is not an IRC 513 trade or business and that the one-time entrance into a one-time covenant not to compete is not a "regularly carried on" activity.

9. Julius M. Israel Lodge of B'nai B'rith #2113 v. Commissioner, T.C. Memo 1995-439

   The Tax Court upheld the Service's determination that "instant bingo" is not an IRC 513(f) "bingo game," which denotes a game where the winners are determined and the distribution of prizes is made in the presence of all persons placing wagers. The court had found that under the relevant local law the "instant bingo" operator need not determine the winners nor distribute the prizes in the presence of all persons placing wagers in the game. Therefore, the Lodge's proceeds from instant bingo are subject to the unrelated business income tax under IRC 511(a).

10. Deer Park Country Club v. Commissioner, T.C. Memo 1995-567

    The club, described in IRC 501(C)(7), rented its 63.8 acre tract of land as farmland. During this lease term, the club decided to develop the tract for recreational uses, and engaged a layout designer to develop the necessary plans. Later, during the financing negotiations, the club was required by the lending banks to sell some of the land as homesites; the taxpayer so sold 4.8 acres. The Service determined that the proceeds were subject to the unrelated business income tax under IRC 512(a)(3)(A); the club argued that it had manifested an intent to use the entire 63.8 acres of property in the performance of its exempt function and that the proceeds were subject to the nonrecognition rules of IRC 512(a)(3)(D), which except from UBTI the gain on sales of property used for the club's exempt function if the property is replaced within three

years for the same purpose. The Tax Court found that IRC 512(a)(3)(D) requires that the property be used (not merely intended for use) in the performance of its exempt function, that the taxpayer had not so used the property, and consequently, the court upheld the Service's position with respect to the gain on the sale of the 4.8 acres.

11. Oregon State University Alumni Association, Inc. v. Commissioner, T.C. Memo 1996-34

    The Tax Court relying heavily on Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994)(Sierra Club II) ruled that payments received from a bank by an IRC 501(c)(3) alumni association for its participation in an "affinity credit card" program were not unrelated business taxable income. Instead, the Tax Court concluded that the association's income was received in exchange for the use of valuable intangible property rights, i.e. the association's mailing list, endorsement and logo. The court concluded in addition that it should not be inferred that the passage of IRC 513(h), which excepts certain rentals of mailing lists from unrelated business taxable income, was intended to imply that all list rentals not so excepted were intended to be taxed. Further, the court considered the association's services promotive of the affinity card program to be de minimis, when compared to the services performed by the organization in Disabled American Veterans v. United States, 942 F.2d 309 (6th Cir. 1991), rev'g 94 T.C. 60 (1990), for the tax years involved. The activities included the printing and mailing of promotional materials to 66,432 alumni in one of the years at issue. (The recent Ninth Circuit Sierra Club II decision puts the precedential value of this case into question.)

12. Alumni Association of the University of Oregon, Inc. v. Commissioner, T.C. Memo 1996-63

    The Tax Court relying heavily on Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994)(Sierra Club II) and Oregon State University Alumni v. Commissioner, T.C. Memo 1996-34 ruled that payments received from a bank by the IRC 501(c)(3) alumni association for its participation in an "affinity credit card" program were not unrelated business taxable income. Instead, the Tax Court concluded that the association's income was received in exchange for the use of valuable intangible property rights, i.e. its mailing list, endorsement and logo. The court concluded in addition that it should not be inferred that the passage of IRC 513(h), which excepts certain rentals of mailing lists from unrelated business taxable income, was intended to imply that all list rentals not so excepted

were intended to be taxed. Further, the court considered the taxpayer's services promotive of the affinity card program to be de minimis for the tax years involved. (The recent Ninth Circuit decision in Sierra Club II puts the precedential value of this case into question.)

13. Stephen D. Ruddel v. Commissioner, T.C. Memo 1996-125

    The Tax Court ruled that $80,000 paid to the police as part of the taxpayer's plea agreement was not a charitable contribution. Payments that proceed from a legal obligation are not a charitable gift. The taxpayer's plea agreement related to his narcotics trafficking activity.

14. Bob Jones University Museum and Gallery v. Commissioner, T.C. Memo 1996-247

    The Tax Court ruled against the Service's denial of the Museum's charitable status. The Museum absorbed the museum functions of Bob Jones University, an organization not described in IRC 501(c)(3). The court, limiting its analysis to the case's specific facts, ruled that where the Museum's activities promote education, the Museum is independent of the University, and the Museum pays fair market rates for services provided by the University, the Museum is described in IRC 501(c)(3).

15. University Medical Resident Services, P.C. and University Dental Resident Services, P.C. v. Commissioner, T.C. Memo 1996-251

    The Tax Court upheld the Service's denial of charitable status for the petitioners, UMRS and UDRS, which were nonprofit professional corporations established to aid certain medical and dental residency programs in upstate New York. A charitable organization administered the residency programs, the teaching hospitals handled the training, and medical schools supervised the quality of the teaching program. The petitioners, which had no administrative staff, paid the residents' compensation and had nominal power to hire and fire the residents.

    The petitioners argued they were charitable because they (1) advanced education; (2) lessened the burdens of the local government; and (3) were educational under the integral part theory. The court ruled that the petitioners' advancement of education was minimal; that the petitioners had failed to establish that either the medical schools or the teaching hospitals were governmental entities or that the petitioners reduced the cost of the training in any event; and that petitioners were merely shell

corporations providing the conduit through which compensation might be made to the medical and dental residents. Accordingly, the petitioners could not be conducting the integral functions of any charitable organizations.

16. The Church of the Living Tree v. Commissioner, T.C. Memo 1996-291

    In an IRC 7428 action, the Tax Court upheld the Service's determination that the organization, whose secondary purpose was promotion of the (hand) papermaking industry, was not described in IRC 501(c)(3). The organization also provided rent-free facilities to the founder, although the founder received no compensation for his work with the organization. The Service had determined that promotion of the papermaking industry was a substantial non-exempt purpose and that the organization provided private benefit to the founder. The court ruled that the organization had not carried its burden of proof to show the Service's determination was erroneous.

V. Bills Introduced or Passed During the 104th Congress

1. P.L. 104-117, 110 Stat. 827 (1996). This legislation extends the Service's user fee authority until October 1, 2003. Also confers "combat zone" status to American soldiers in the former Republic of Yugoslavia.

2. P.L. 104-168, 110 Stat. 1452 (1996) (Taxpayer Bill of Rights II) **(See copy of the Act, H.R. Rep. No. 506 104th Cong., 2nd Sess. 53 and an explanation of the Act at the end of this article)**

    Section 904 provides that the IRC 6672 penalty (concerning the willful failure to collect and pay over tax) is inapplicable to certain unpaid, volunteer boardmembers of tax-exempt organizations.

    Section 1311 (1) imposes a two-tier intermediate sanction excise tax on persons with substantial influence over an IRC 501(c)(3) organization if that person engaged in a transaction resulting in an excess benefit to such person and (2) adds new IRC 501(c)(4)(b), an anti-inurement provision similar to the anti-inurement provision of IRC 501(c)(3).

    Section 1312 increases the IRC 6033 reporting requirements applicable to organizations subject to the new intermediate sanction excise tax.

Section 1313 amends IRC 6104(e)(concerning the public inspection of annual returns and exemption applications) to require certain tax-exempt organizations to make copies of certain returns and exemption applications available to requesters; the amendment includes a provision to protect the affected exempt organizations from harassment campaigns.

Section 1314 increases the IRC 6652(c)(1) penalty applicable to organizations that fail to file timely and complete information returns.

3. H.R. 32. Among many other things relating primarily to estates and trusts, would provide for annual notice to charitable beneficiaries of their interests in charitable remainder trusts. The bill would also provide sanctions to encourage compliance.

4. H.R. 733. Would amend the Code to facilitate contributions to foreign private foundations and extend the due date for first quarter estimated tax by private foundations.

5. H.R. 1121. Section 13221 of the bill would clarify the IRC 6033(e)(1) reporting requirements of IRC 527 organizations.

6. H.R. 1299. Among other things relating primarily to insurance companies, this bill would provide exemption under IRC 501(c)(3) to an organization operated and organized solely to pool insurable member risk if the organization otherwise met the requirements of IRC 501(c)(3).

7. H.R. 1575. A bill to increase the amount of the charitable contribution deduction, and to allow such deduction to individuals who do not itemize.

8. H.R. 2491 (Balanced Budget Act of 1995; vetoed)

   Section 11271 would (1) impose a two-tier intermediate sanction excise tax on any person with substantial influence over an IRC 501(c)(3) or IRC 501(c)(4) organization if that person engaged in a transaction resulting in an excess benefit to such person and (2) add new IRC 501(c)(4)(b), an anti-inurement provision similar to the anti-inurement provision of IRC 501(c)(3).

   Section 11272 would increase the IRC 6033 reporting requirements applicable to organizations subject to the new intermediate sanction excise tax.

Section 11273 would increase the additions to tax, of IRC 6652(c)(1)(relating to annual returns required by IRC 6033), on organizations failing to file complete and timely returns.

Section 11276 would create a new IRC 501(n) which would treat certain cooperative service organizations as IRC 501(c)(3) charitable organizations, if such organizations are organized and operated for cooperative investment purposes and meet other requirements.

Section 11277 would add IRC 513(i) to provide that the term "unrelated trade or business" does not include certain corporate sponsorship payments.

Section 11278 would add IRC 512(d) to the Code to exclude from the unrelated business taxable income of organizations defined in IRC 501(c)(5) the receipt of required dues if the required dues do not exceed $100 (indexed for inflation).

Section 11377 would add IRC 512(b)(18) to the Code which would provide that unrelated business taxable income includes Subpart F (IRC 951(a)(1)(A)) insurance income.

9. H.R. 2676. This bill would provide, under IRC 1042, for the nonrecognition of gain attributable to the sale of stock to certain Subchapter T farmers' cooperatives.

10. H.R. 2741. A bill to include within the definition of IRC 1361 S-Corporation, an ESOP trust, and to make conforming changes to IRC 513 and IRC 512.

11. H.R. 2864. This bill would provide for IRC 501(c)(3) bonds a tax treatment similar to that available to governmental bonds.

12. H.R. 2910. This bill would amend the Code to allow IRC 501(c)(3) organizations to engage in a de minimis amount of electioneering.

13. H.R. 2919. This bill concerns the development and use of "brownfields," abandoned industrial sites in need of cleanup, and would provide that certain organizations, so-called "Hazardous Waste Remediation Reserves," be treated as trusts described in IRC 501(c)(21) (describing Black Lung Trusts).

14. H.R. 2994. Would extend some expiring tax provisions including employer provided educational assistance. Additionally, the bill would eliminate IRC 170(e)(5).

15. H.R. 3103. (In Conference) This bill, designed to improve portability of health insurance coverage, would describe, under new IRC 501(c)(26), a state sponsored membership health plan for the state's residents who are otherwise unable to acquire medical insurance for certain reasons.

16. H.R. 3448 (Small Business Job Protection Act: In Conference).

    Section 1114 would add IRC 501(n) to the Code providing for the tax-exempt status of certain charitable risk insurance pools that are exempt from state taxation and whose members are exclusively charitable organizations.

    Section 1115 would exempt from the unrelated business income tax required annual dues if they are $100 or less and paid to an organization described in IRC 501(c)(5) (describing labor, agricultural and horticultural organizations). The provision includes indexing for inflation.

    Section 1603 would treat as unrelated business income certain insurance income derived by a tax-exempt organization if that income is also described as IRC 951(a)(1)(A) insurance income.

17. S. 112. This bill would treat income for IRC 501(c)(12) from a nonmember telephone company as either member income or excludable from the IRC 501(c)(12)(i) 85% analysis. The bill would also amend IRC 512(c)(12) to provide more favorable treatment of certain investment income of such telephone companies.

18. S. 789. Would eliminate the IRC 170(e)(5)(D) limitation on contributions of appreciated publicly traded stock to private foundations and amend IRC 4942(g)(2) to facilitate private foundation grants to foreign organizations that are themselves treated as private foundations.

19. S. 793. Would amend IRC 501 to provide exemption from income tax for some common investment funds.

20. S. 846. Would allow a tax credit for charitable contributions to certain kinds of private charities providing assistance to the poor.

21. S. 1538. A bill to define the term "qualified medical entity" and to extend favorable treatment, under IRC 457(c)(2), to certain pension plans maintained by such entities.

22. S. 1568. A bill to "extend" several expired tax provisions including IRC 120 (concerning amounts received under qualified group legal services plans), IRC 127 (concerning employer-provided educational assistance programs) and IRC 170(e)(5)(D)(concerning appreciated publicly traded stock contributed to a private foundation).

The following is a copy of the "Intermediate Sanctions" portion of P.L. 104-178, 110 Stat. 1412 (popularly known as Taxpayer Bill of Rights 2) as passed by the House and Senate.

Subtitle B-Exicse Taxes on Amounts of Private Excess Benefits

Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452, (the Act) was enacted July 30, 1996. The Act amended various provisions of the Internal Revenue Code. This discussion summarizes aspects of the Act related to excise taxes (so-called Intermediate Sanctions) on excess benefit transactions, extension of the inurement prohibition to §501(c)(4) organizations, the increased disclosure requirement, changes to the §6033 filing requirements, and increased disclosure and failure to file penalties. This overview cannot answer all questions raised by the new provisions, as many issues will need to be clarified by regulations or other guidance. We are currently working with Chief Counsel and the Office of Tax Legislative Counsel to develop the needed guidance.

I. Excise Taxes On Excess Benefit Transactions In General

Section 1311(a) of the Act creates new §4958, which imposes excise taxes on excess benefit transactions. An **excess benefit transaction** subject to tax under §4958 is any transaction in which an economic benefit is provided by an organization described in §501(c)(3) (except for a private foundation) or 501(c)(4) directly or indirectly to, or for the use of, any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. Revenue sharing arrangements will be included in the definition of excess benefit transactions "to the extent prescribed in regulations, but only if the arrangement would constitute inurement under §§501(c)(3) and 501(c)(4)." A **disqualified person** is any person who was, at any time during the 5-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of the organization, even if such person is an employee of the organization's subsidiary, and not an employee of the organization. Disqualified persons also include family members and certain entities in which at least 35 percent of the control or beneficial interests are held by disqualified persons. An **organization manager** is an officer, director, trustee, or any individual having powers or responsibilities similar to those of an officer, director, or trustee.

There are three taxes under §4958:

> (1) pursuant to §4958(a)(1), a tax equal to 25 percent of the excess benefit amount which shall be paid by any disqualified person who engages in an excess benefit transaction with a §501(c)(3) (except for a private foundation) or §501(c)(4) organization;

(2) a tax equal to 200 percent tax of the excess benefit amount which shall be paid by any disqualified person if the excess benefit transaction is not corrected within the taxable period (§4958(b)). The taxable period runs from the date the transaction occurs to the time the 90 day letter is mailed or the intermediate sanctions tax is assessed, whichever is first; and

(3) pursuant to §4958(a)(2), a tax equal to 10 percent of the excess benefit of the excess benefit amount which shall be paid by any organization manager who knowingly participates in an excess benefit transaction.

There is no second tier tax on the organization manager whose role in the transaction is not that of a disqualified person. The tax to be paid by an organization manager shall not exceed $10,000. The taxes on excess benefit transactions are eligible for abatement under the general abatement rules of §§4961 and 4962.

Effective Date

The §4958 excise taxes apply to excess benefit transactions occurring on or after September 14, 1995. They do not apply, however, to any benefit arising from a transaction pursuant to any written contract that was binding on September 13, 1995, and continued in force through the time of the transaction.

II. Private Inurement Expressly Prohibited for §501(c)(4) Organizations

The Act also amends §501(c)(4) to expressly prohibit inurement of any part of the net earnings of an entity otherwise described in that section to the benefit of any private shareholder or individual. That amendment applies to inurement occurring on or after September 14, 1995. The provision does not apply, however, to inurement occurring prior to January 1, 1997, if that inurement results from a written contract that was binding on September 13, 1995, and continued in force through the time that the inurement occurred. (The statute also contains a grandfather provision for certain arrangements of cooperatives recognized under §501(c)(4). We expect this provision, which is not codified, to have very narrow applicability.)

III. Returns for Payment of Excise Taxes

Charities and other persons liable for certain Chapter 41 or Chapter 42 excise taxes must file returns on Form 4720 to calculate and report the taxes

due. This form, as revised for 1996, will be used to calculate the excise taxes imposed on excess benefit transactions by §4958.

IV. Other Reporting Requirements for §4958 Excise Taxes

Section 1312(a) of the Act amends §6033(b) to require §501(c)(3) organizations to report the amounts of the taxes paid under §4958 with respect to excess benefit transactions involving the organization, as well as any other information the Secretary may require concerning those transactions. Section 6033(f) is also amended to impose this same filing requirement on §501(c)(4) organizations. These amendments only apply to returns for taxable years beginning after July 30, 1996, the date of enactment of the Act. Accordingly, affected organizations are not required to file amended returns to include information on taxes paid under §4958, or any other information that may be required with respect to excess benefit transactions, for their taxable years ending before July 30, 1996.

V. Disclosure Requirements Related to Annual Information Returns

Section 1313(a) of the Act amends §6104(e)(1) with regard to the manner in which an exempt organization (other than a private foundation) must disclose its annual information return to the public. Prior law required tax-exempt organizations to show a requester copies of the organization's three most recent annual information returns at the organization's place of business. Although prior law required the organization to allow inspection of the returns and required the organization to allow the requester to take notes while inspecting the returns, it did not require the organization to provide a photocopy that the requester could take from the organization's office.

The following two rules, as well as the penalties for failure to comply with them, do not become effective until relevant regulations are promulgated. However, the Service is encouraging voluntary compliance with these new disclosure rules. First, §6104(e)(1)(A), as amended, provides that if a person requests a copy of one or more of the three most recent information returns, either in person or in writing, the organization must provide the copies to the requester without charge other than a reasonable fee for any reproduction and mailing costs. If the request is made in person, the copies must be provided immediately. If the request is made in writing, the copies must be provided within 30 days.

Second, §6104(e)(2)(A), as amended, applies this rule to the exempt organization's application for recognition of exemption under §501(a) (together

with a copy of any papers submitted in support of such application and any letter or document issued by the Service with respect to such application).

Under new §6104(e)(3), the new requirement to provide copies without charge (other than a reasonable fee for any reproduction and mailing costs) does not apply if, in accordance with regulations promulgated by the Secretary, the organization has made the requested documents widely available. Neither does the new §6104(e)(3) requirement apply if the Secretary determines, upon application by the organization, that the request is part of a harassment campaign and that compliance with the request is not in the public interest.

VI. Increases in Certain Penalties

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

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

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

The amended penalties in §6652(c)(1) apply to returns for taxable years ending on or after July 30, 1996.

Until further guidance is issued, you should address all questions concerning TBOR2 issues to Toussaint Tyson in Projects Branch 1 (CP:E:EO:P-1) at (202)622-8363.