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Introduction to Tax-Exempt Organizations

§1.01 INTRODUCTION TO THE EO COMMUNITY

The universe of tax-exempt organizations (sometimes referred to herein as EO) includes a broad range of nonprofit institutions — churches, schools, universities, public charities, private foundations, business leagues, political parties, and country and social clubs — all conducting a wide variety of pursuits intended to promote the public good. Some EOs share the common attribute of being organized for the

advancement of a particular group of persons. Others may promote industry or economic development. Some may be affiliated with or subsidized by the government. Some may be national organizations. Others may limit their attention and activities to a specific state or county. The federal tax laws afford special treatment for EOs in order to support their activities and purposes and because the Congress treats some EOs, those enumerated in the Internal Revenue Code (IRC) Section 501(c)(3) in particular, as essentially partners with the federal government.[1]

The common thread running through all types of EOs is the absence of private ownership and profit motive. An EO is generally a nonprofit organization that does not operate primarily to further the self-interest of its founders but rather engages in activities that further a proper exempt purpose. There are myriad types of EOs; the purposes for which an EO may be formed are diverse and essentially limited only by the founder's imagination.

Some nonprofits relieve the burdens of government by performing some of its functions. For example, many EOs have as their primary purpose the training of disadvantaged persons. Such activities are thought to serve to reduce the amount of governmental expenditures that would otherwise be required to provide such services. Many nonprofits are thus exempted from the levies that finance government, including income, sales, ad valorem, and other local property taxes. This special status recognizes the work they perform essentially on behalf of the government.

The personal income tax deduction for dues and donations paid to certain types of EOs further evidences the federal government's generally favorable inclination toward EOs. At the same time, this deductibility provides the EO with a major fund-raising tool. However, not all payments to an EO are deductible, as explained in Chapter 8.

§1.02 TYPES OF TAX-EXEMPT ORGANIZATIONS

Exempt organizations were first established by the Tariff Act of 1894, which provided for a single category of exempt organizations. These included charitable, religious, educational, fraternal, and certain building and loan, savings, and insurance organizations. Since then, the number of categories has expanded to include more than 30 distinct types of EOs.

The Internal Revenue Code (the Code) currently exempts from federal income taxation more than 30 types of organizations.[1] These organizations engage in a myriad of activities that touch on all aspects of American society.

Statutory exemptions include:[2]

- Section 501(c)(1): United States instrumentalities
- Sections 501(c)(2) and (c)(25): Title-holding organizations

§1.01 [1] *See generally* Steven D. Simpson, *Tax-Exempt Organizations: Organizational and Operational Requirements*, 869 T.M. A-1 *et seq.* (2000).

§1.02 [1] IRC §§501(a), (c), 521-530.

[2] Appendix D contains the Service's Publication No. 557, which lists the various categories of exempt organizations.

- Section 501(c)(3): Charitable organizations
- Section 501(c)(4): Social welfare organizations
- Section 501(c)(5): Labor, agricultural, and horticultural organizations
- Section 501(c)(6): Business leagues
- Section 501(c)(7): Social clubs
- Section 501(c)(8): Fraternal benefit societies
- Section 501(c)(9): Voluntary employees' beneficiary associations (VEBAs)
- Section 501(c)(10): Fraternal lodge societies
- Section 501(c)(11): Teachers' retirement fund associations
- Section 501(c)(12): Life insurance, irrigation, telephone, and similar organizations
- Section 501(c)(13): Cemetery companies
- Section 501(c)(14): Credit unions and mutual insurance funds
- Section 501(c)(15): Certain small insurance companies
- Section 501(c)(16): Crop-financing corporations
- Section 501(c)(17): Supplemental unemployment benefit trusts
- Section 501(c)(18): Employee-funded pensions trusts
- Section 501(c)(19): Organizations of past or present members of the armed forces
- Section 501(c)(20): Group legal service organizations
- Section 501(c)(21): Black lung benefit trusts
- Sections 501(c)(22) and (24): Certain ERISA trusts
- Section 501(c)(23): Armed forces organizations
- Section 501(c)(26): Certain health insurance pools
- Section 501(c)(27): Workers' compensation insurance pools
- Section 501(d): Religious and apostolic organizations
- Section 501(e): Cooperative hospital service organizations
- Section 501(f): Cooperative educational investment organizations
- Section 501(j): Amateur sports organizations
- Section 501(k): Childcare providers
- Section 501(n): Charitable risk insurance pools
- Section 521: Farmers' cooperatives
- Section 526: Shipowners' protection and indemnity associations
- Section 527: Political organizations and political action committees
- Section 528: Homeowners' associations
- Section 529: Qualified state tuition programs
- Section 530: Education individual retirement accounts

There are many other types of organizations that are also treated as tax-exempt for certain purposes. Such organizations include charitable remainder trusts, nonexempt charitable trusts under Section 4947(a)(1), and Section 4947(a)(2) split-interest trusts.

On the other hand, the Code specifically precludes exemption for organizations providing insurance as a substantial part of their activities[3] and for for-profit feeder organizations that pay all their profits to exempt organizations.[4]

[3]IRC §501(m).
[4]IRC §502.

[A] *Section 501(c)(3) Organizations*

Section 501(c)(3) tax-exempt organizations are among the most prevalent. Such organizations include religious organizations, charitable organizations, educational organizations, scientific organizations, and certain other types of organizations. Section 501(c)(3) organizations include both public charities and private foundations.

[1] Religious Organizations

The term "religious organization" under Section 501(c)(3) is not coextensive with the term "church" found in Code Sections 509(a)(1) and 170(b)(1)(A)(i). A religious organization may qualify as a church or it may not. For example, a camp owned for insurance purposes by a controlled affiliate of a church, which is available to be used only by members of the denomination, would qualify as a religious organization but is not a church. This is an important distinction. It would have to qualify as a public charity under Code Sections 509(a)(1) and 170(b)(1)(A)(vi), since it would not qualify under Code Section 170(b)(1)(A)(i) as a church. On the other hand, all churches necessarily are religious organizations.[5]

The Internal Revenue Service (the Service) has enumerated the following 14 factors in an attempt to adopt a definition of a church.[6] A church must have:

1. A distinct legal existence;
2. A recognized creed and form of worship;
3. A definite and distinct ecclesiastical government;
4. A formal code of doctrine and discipline;
5. A distinct religious history;
6. A membership not associated with any other church or denomination;
7. An organization of ordained ministers;
8. Ordained ministers who are selected after completing certain prescribed studies;
9. Its own literature;
10. An established place of worship, such as a sanctuary;
11. A regular congregation;
12. Regular religious services;
13. Sunday schools for the religious instruction of the young; and
14. Schools for the preparation of its ministers.

[2] Charitable Organizations

There are many types of charitable organizations under Section 501(c)(3). The regulations state that the term "charitable" includes the following organizations:[7]

[5]De LaSalle Inst. v. U.S., 195 F. Supp. 891 (N.D. Cal. 1961).

[6]IRM §321.3.

[7]Reg. §1.501(c)(3)-1(d)(2). *See also* American Guidance Found. v. U.S., 490 F. Supp. 304 (D.D.C. 1980), *aff'd in unpublished opinion* (D.C. Cir. 1982).

1. Relief of the poor or underprivileged;
2. Advancement of religion;
3. Advancement of education or science;
4. Erection or maintenance of public buildings, monuments, or works;
5. Lessening the burdens of government; and
6. The promotion of social welfare by organizations designed to accomplish any of the above purposes, or to accomplish any of the following:
   - Reduce neighborhood tensions;
   - Eliminate prejudice and discrimination;
   - Defend human or civil rights secured by law; or
   - Deter juvenile delinquency or community deterioration.

In *Bob Jones University v. United States*,[8] the Supreme Court held that a charitable organization exempt under Section 501(c)(3) must comply with all current notions of public policy. Thus, all Section 501(c)(3) organizations must comply with public policy, such as the prohibition on discrimination on the basis of race. Thus, for example, a Section 501(c)(3) organization that is a school may not discriminate on the basis of race in making admissions decisions.

Charitable organizations include organizations that provide housing for the underprivileged, legal aid organizations, organizations that litigate cases in the public interest, and organizations that provide functions that would otherwise be provided by the government, such as public transportation or assisting law enforcement agencies.

An important category of charitable organizations includes organizations that promote the health of the community, such as hospitals, nursing homes, and home health agencies. Certain types of health maintenance organizations can also qualify as exempt.

[3] Educational Organizations

Educational organizations are also exempt under Section 501(c)(3). Such organizations provide instruction or training of the individual or provide educational information for the benefit of the general public.[9] Thus, schools, colleges, and universities can be exempt. Other types of organizations exempt as educational organizations include those that provide marital counseling and promote the arts and nonprofit radio and television stations.

[4] Scientific Organizations

Organizations that are organized and operated exclusively for scientific purposes can also be exempt from taxation under Section 501(c)(3). Such organizations generally carry on scientific research that is in the public interest.[10]

[8] 461 U.S. 574 (1983).
[9] Reg. §1.501(c)(3)-1(d)(3)(i).
[10] Reg. §1.501(c)(3)-1(d)(5)(i).

[5] Other Organizations

Other types of Section 501(c)(3) organizations include literary organizations, organizations that test for public safety, and organizations that are formed and operated exclusively to prevent cruelty to children or animals. Certain amateur athletic organizations are also exempt.[11]

[B] Social Welfare Organizations

Another important category of exempt organizations consists of social welfare organizations under Section 501(c)(4). Section 501(c)(4) provides exemption for nonprofit civic organizations that are operated exclusively to promote the social welfare. Organizations exempt under Section 501(c)(4) include organizations formed to make loans to businesses to induce them to locate in economically depressed areas, those that arrange for housing for low-income or moderate-income individuals, and certain types of homeowners' associations.[12]

[C] Trade Associations

Trade associations are exempt under Section 501(c)(6). These organizations generally promote a particular line of business rather than perform particular services for members.[13] For example, the American Bar Association is a Section 501(c)(6) trade association whose members are attorneys.

§1.03 CHARACTERISTICS OF TAX-EXEMPT ORGANIZATIONS

An EO is distinguished from a nonexempt (i.e., taxable nonprofit or taxable for-profit) organization by its ownership structure, the motivation or purpose for its operations, its activities, and the sources of revenue with which it finances its operations. Under state law, EOs are commonly called nonprofits or not-for-profit organizations, which leads to a certain amount of confusion.

The complexity of this subject is illustrated by the simple fact that the Code does not contain the word "nonprofit." It refers only to exempt organizations. The term "nonprofit," or "not-for-profit," describes the type of organization created under the laws of most states and is widely used to identify tax-exempt organizations. The terms are often used interchangeably.

Legal requirements for organizing an EO vary from state to state. Most state laws prohibit nonprofit corporations from issuing stock. In some states, such as Califor-

[11] IRC §§501(c)(3), 501(j).
[12] Reg. §1.501(c)(4)-1.
[13] Reg. §1.501(c)(6)-1.

nia, exempt charitable institutions are called "public benefit" corporations. Business leagues and social clubs are sometimes called "mutual benefit" corporations.

[A] *Motivation for Operation*

Rather than being organized to generate profits for owners or investors, an EO generates resources to accomplish the purposes for which it was organized. What distinguishes the EO from the for-profit entity is its motivation for undertaking an activity that generates revenues. The mere fact that an EO charges for the services it performs is not determinative. A school, hospital, or any other type of exempt organization may pay all of its costs with fees collected from students, patients, and others using its facilities and services. Whether a hospital is exempt, for example, depends on whether it was organized and is primarily operated for the purpose of promoting the general public's health,[1] and not whether its expenses exceed its patient care revenue.

The inurement doctrine provides the primary distinction between EOs and taxable businesses. The focus of an EO's activity is outward, unselfish, and directed at accomplishing a public purpose. A nonprofit is permitted to engage in income-producing activity, such as selling goods and services. However, such income-producing activity cannot be conducted with the sole intention of producing a return on investment; it must also accomplish a proper exempt purpose. If it does not, the organization may be taxed on any resulting income.[2] Moreover, some of the money received by an EO is one-way money: donations or dues paid out of pure generosity with nothing being received or expected in return.

In contrast, privately owned businesses operate totally selfishly. Their sole purpose is directed at selling goods and services to reap return for their owners' investment. Goods or services are provided by the for-profit business in exchange for money only in order to pay dividends to its owners. Unless a for-profit business produces income in excess of expenses, it will not survive very long. In comparison, many public charities can rely upon gifts, grants, and contributions to make up any shortfall between their gross revenues and their expenses.

[B] *Permissible Business Activities*

The term "nonprofit" is a contradiction in one respect. To grow and be financially successful, an EO can and often must generate profits. An EO is certainly permitted to retain its income and need not spend all the money it generates, whether from contributions, fees, or other sources. Thus, the development of a reserve is certainly permissible and, in most cases, both desirable and prudent.

An EO can and should operate efficiently and profitably. Financial management tools such as strategic planning, investment management, responsive organizational structure, and budgeting can and should be employed by an EO.

§1.03 [1] *See* §2.02[A][3] *infra.*

[2] *See* discussion of unrelated business income tax, §1.03[C] *infra.*

An EO can generate revenues in excess of its expenses and accumulate a reasonable amount of working capital or unrestricted fund balances. It can save money to purchase a building, expand operations, protect itself with a reserve for lost or reduced funding, ensure a flow of cash to pay for continuous operations, or for any other valid reasons that serve its underlying exempt purposes. Many private foundations are heavily endowed with assets vastly exceeding annual expenditures, since they are required to pay out only 5 percent of the value of their investment assets each year.[3]

There is no specific tax limitation on the amount of assets that an EO can accumulate as long as the amount is not so excessive as to indicate that the EO is organized or operated other than for a proper tax-exempt purpose. A common rule of thumb is that an unrestricted reserve equal to one year's income budget is considered permissible. Smaller organizations may need to conserve a larger portion of their incomes. Larger organizations such as hospitals or universities may have a reserve that at first glance constitutes a large dollar amount, but which simply reflects the determination of the organization's governing board that that level of reserve is necessary to ensure its survival. On the other hand, public charities, business leagues, clubs, and other membership organizations that depend upon annual support may have modest asset levels.

An EO can also borrow money from private lenders to finance its activities, such as to establish a new office or acquire an asset. It can pay salaries and employee benefits comparable to those of a nonexempt business. As long as the overall compensation is reasonable,[4] an exempt entity can offer incentive compensation to its employees. The federal tax law prohibits many EOs from paying funds to individuals or businesses other than as reasonable compensation for goods sold or services rendered to the organizations. The net earnings of an EO are not permitted to inure to the benefit of any private shareholder or individual.

[C] Competition with For-Profit Entities

Although nonexempt businesses do not often operate soup kitchens or house the poor, they do operate schools, hospitals, theaters, galleries, and publishing companies and conduct other activities that are also carried on by EOs. The nature of the activity or business is often the same for both. There is the very real possibility that taxable entities and EOs may engage in the same or similar activity, resulting in competition between the two sectors.

On a limited basis, an EO is allowed to compete directly with nonexempt businesses and to operate a business that does not advance exempt purposes. The Code, however, places such an exempt organization on the same footing as competing nonexempt businesses by imposing an unrelated business income tax (UBIT)[5] on profits from an activity that constitutes an unrelated trade or business.

[3] IRC §4942.

[4] *See* §3.02[B][1] *infra*.

[5] IRC §§511-515. *See* Chapter 5, which considers the question of when a business activity is unrelated, describes the level of business activity allowed, and presents the myriad of exceptions and modifications that allow much of this type of income to escape taxation.

if the unrelated business activity becomes too substantial, the EO can lose its exemption.

A Section 501(c)(3) organization must be organized and operated "exclusively" for proper exempt purposes described in the Code. The Service interprets the term "exclusively" as meaning that the EO must operate primarily to further proper exempt purposes. Thus, "exclusively" does not mean 100 percent, and "primarily" can mean a little more than 50 percent.

However, the rulings and cases are widespread in this area, and few firm guidelines exist to provide guidance as to when an EO's income from an unrelated business is so excessive that its exemption is endangered. A numerical test is most often applied to gross revenues, but it can also be applied to net profits, direct costs, contributions, and the like. In each case the Service examines the facts and circumstances to determine whether continued exemption is appropriate.

§1.04. BOARD CONTROL; NO OWNERSHIP

As a general rule, directors or trustees may control and govern an EO but may not beneficially own it. The creators must understand and intend from inception that they will gain no personal economic benefit from the organization's operation and benefits, other than in the form of reasonable payments for goods sold or services rendered to the organization. Amounts in the nature of a dividend may not be distributed to its controlling persons.[1] Unlike a contribution to a for-profit business, which entitles the contributor to share in the profits of the business, a contribution to an EO is a gift in which the donor no longer has any interest. Those funds become the property of the EO and can be subsequently spent in accordance with the budgetary constraints set by and the purposes specified by the EO's governing board.

The assets of a Section 501(c)(3) organization must be permanently dedicated to charitable purposes. When such an organization ceases to exist, its remaining assets must be dedicated to a proper charitable purpose.[2] Upon dissolution, a Section 501(c)(3) organization can distribute funds only to another Section 501(c)(3) organization or in support of a charitable project,[3] and its charter must contain a binding dissolution clause.[4] None of the funds contributed to a Section 501(c)(3) organization may be returned to its individual contributors or its controlling persons.[5] A Section 501(c)(7) social club, however, may distribute its net assets to its members upon dissolution.[6]

The code of conduct for directors of EOs is most often found in state law defining fiduciary responsibility and embodies the duties of care, loyalty, and obedi-

§1.04 [1]Nevertheless, a mutual insurance company may properly reduce premiums by the profits earned on investments.

[2]Reg. §1.501(c)(3)-1(b)(4).

[3]*Id.*

[4]*Id.*

[5]*Id.*

[6]Rev. Rul. 58-501, 1958-2 C.B. 262.

ence. Those who control an EO are expected to manage the organization so as to accomplish a proper tax-exempt purpose, not to benefit themselves or their families. The net income of the organization may not inure to the benefit of the EO's officers and directors or other private persons.[7] If so, such persons may become subject to a tax on certain excess benefit transactions.[8] Specific rules, which prohibit self-dealing transactions between the foundation and its governing body, apply to private foundations.[9]

A common question concerning the exemption is whether paid staff members can serve on the organization's board of directors (the board). There is no federal tax rule that prohibits a paid staff member from also serving as a board member. However, such a dual position creates a potential conflict of interest and state laws differ on the issue. This question should be investigated under the laws of the state in which the EO was formed or in which it conducts its activities. To demonstrate that the interests of the organization rather than the individual are served, paid directors should not participate in votes approving their compensation or in other financial transactions that affect them.

The Service has promulgated certain guidelines for conflicts of interest specifically for tax-exempt health care organizations.[10] These guidelines do not have the force of law but are indicative of whether a tax-exempt hospital is operating to further the health of the community that it serves (the so-called community benefit test) or primarily to further the interests of local physicians.

A private foundation may compensate its nongovernmental officials for services subject to a tax for self-dealing on unreasonable compensation.[11] Public charities and Section 501(c)(4) organizations are subject to both the inurement proscription and intermediate sanctions. The activities of a Section 501(c)(3) organization are also subject to the additional restriction that exemption may be lost if they confer excessive private benefit upon private persons or entities.[12]

§1.05 THE ROLE OF THE INTERNAL REVENUE SERVICE

The Service does not grant or confer the exemption; it only recognizes an exemption granted by the Code.[1] Organizations that derive their exempt status from Section 501(c)(3) must apply for and receive the Service's recognition of exempt status.[2] To obtain recognition of exempt status, an organization applies for a "determination" from the Tax-Exempt/Governmental Entities Operating Division

[7] IRC §501(c)(3), (4).

[8] IRC §4958.

[9] *See* §6.04 *infra*.

[10] Lawrence M. Brawer and Charles F. Kaiser III, *Tax-Exempt Health Care Organizations Revised Conflicts of Interest Policy*, 2000 CPE Text at 44. This is an annual publication from the IRS.

[11] IRC §4941(d)(2)(E).

[12] Reg. §§1.501(c)(3)-1(c)(2), (d)(1)(ii).

§1.05 [1] IRC §501(a).

[2] IRC §508(a). *See* §7.01 *infra*, for a discussion of the recognition process.

(TE/GE Division) of the Service, using Form 1023 or 1024. To qualify for exemption from inception, a prospective Section 501(c)(3) organization must file a determination application within 27 months of its creation.[3] Later filing will result in a determination effective only from the date of filing, unless the Service grants retroactive relief.

For most other common types of EOs, establishment and operation according to the characteristics described in the Code is sufficient. Section 501(c)(4) and (6) entities may, but are not required to, apply for recognition of exemption. However, most organizations do need the Service's determination to secure proof of their status for local authorities and members (and in some cases the Service itself), and to ensure against penalties and interest due on their income if they do not qualify. Chapter 7 explains the process by which application is made.

Annual information returns (Forms 990, 990-EZ, or 990-PF) are filed by many exempt organizations. Detailed balance sheets, income statements, lists of directors and officers and their compensation, and descriptions of activities must be submitted, along with reports of any changes in the organization's form or purposes. The returns contain descriptions of the organization's exempt activity along with financial information. Forms 990, 990-EZ, and 990-PF are open to public inspection. Chapter 7 contains guidelines for completion of these forms. Sample Forms 990 and 990-PF are included in the Appendix.

The TE/GE Division of the Service is the result of an ongoing internal reorganization of the former Exempt Organizations Division. The Service now handles exempt organization matters from four regional offices located in Los Angeles, California (West); Dallas, Texas (Midstates); Brooklyn, New York (Northeast); and Baltimore, Maryland (Southeast). A central office in Cincinnati, Ohio, processes exemption applications. The Ogden, Utah, Service Center processes annual returns. The Service's National Office is located in Washington, D.C. This division examines returns of EOs to ascertain that continued tax exemption is allowed; subject to the statute of limitations, it can propose revocation.

§1.06 FACTORS TO CONSIDER BEFORE ESTABLISHING AN EXEMPT ORGANIZATION

Before embarking on the creation of an EO, some initial questions should be addressed. Although certain requirements are applied precisely according to published guidelines, the rules are often ambiguous and subject to varying interpretations. Because annual tax compliance responsibilities of EOs are similar to those of profit-motivated taxpayers, professional assistance from attorneys and accountants familiar with nonprofit matters should be sought to facilitate the process.

Before a new EO is formally established, four questions should be asked to

[3]Reg. §§1.508-1(a)(2)(i), (iii); §301.9100-2T(a)(2)(iv).

determine whether a proposed organization is suitable for qualification for tax-exempt status and ongoing operation as a nonprofit project.

Question 1 — Is a New Organization Really Necessary? Could the project be carried out under the auspices of an existing organization? Several factors will often indicate that a new organization is not necessary. If it is a short-term or one-time project with no prospect for ongoing funding, it probably is not worth the trouble to set up a new EO to handle it. Perhaps the project can operate as a branch of an existing EO. Perhaps there is a state or local affiliate of a national EO that could be persuaded to sponsor the project. Overall, if there would be a costly duplication of administrative effort, or if the cost of obtaining and maintaining independent exemption would be excessive in relation to the total budget, it makes sense to opt for another route.

Question 2 — Which Category of Exemption Is Appropriate? If the proposed organization passes the first test, the category of exemption best suited to the goals and purposes of the project must be chosen. Due to the rigidity and limitations of the Section 501(c)(3) exemption rules, certain activities may be suitable only for other categories of exemption. The Section 501(c)(3) rules include a complete prohibition against involvement in political campaigns and limitations on legislative activities and grassroots lobbying, as explained in Chapter 4. For such projects a Section 501(c)(4) organization may be more suitable for the purposes of the founding group. The downside is that contributions to Section 501(c)(4) entities are not deductible as charitable contributions under Section 170.

Some projects can conceivably qualify for more than one category. There are garden clubs classified as charities under Section 501(c)(3), social welfare organizations under Section 501(c)(4), and social clubs under Section 501(c)(7). An association of businesses in the same or similar line of business may qualify as a business league. If the activity of the group involves educational and/or charitable efforts, Section 501(c)(3) status, rather than Section 501(c)(6) status, might be sought, or two organizations — a Section 501(c)(3) and a Section 501(c)(6) — might be suitable. A breakfast group composed of representatives of many different types of businesses may not qualify under Section 501(c)(6) but might instead qualify under Section 501(c)(7).

The choice of category is driven by a number of different factors. Often the choice is influenced by the organization's desire to be eligible to receive contributions or dues that can be deducted by the donor or member. To be an eligible recipient of charitable contributions, an organization must have status as a charitable organization[1] or a veterans' organization.[2] Furthermore, Section 501(c)(3) organizations are subject to strict limitations on their lobbying activities.[3] Other types of EOs are the product of special interest legislation with limited application, such as Section 501(c)(21) black lung benefit trusts.

§1.06 [1]IRC §501(c)(3).

[2]IRC §501(c)(19).

[3]Section 501(c)(4) organizations should be utilized for goals that can be accomplished only through the passage of legislation. *See* §4.01 *infra*.

Question 3 — Do Expected Revenue Sources Indicate Nonprofit Character? Next, the proposed sources of revenues expected to support the project must be examined. EOs are traditionally supported by donations, member dues, and fees for performing exempt functions, such as admission fees to museums or fees for professional certification. Certain sources of revenue, such as income from certain insurance activities,[4] do not qualify. Moreover, excessive income from an unrelated trade or business may result in loss of exemption.[5] A public charity also must meet certain public support tests in order to avoid classification as a private foundation.

Question 4 — Are Creators Motivated by Selfish Goals? An EO as a rule must be established to serve persons other than its creators (though creators can participate in its affairs). This question examines the reasons why persons seek to establish the nonprofit organization. Do the organization's creators desire economic benefits from the formation or ongoing operation of the organization? Will the organization be operated to serve the self-interested purposes of its creators? If so, perhaps a for-profit entity should be formed. The one-way street characteristic of nonprofits is crucial to ongoing qualification for tax exemption. If the founders desire incentive compensation based on funds raised or wish to gain from profits generated, an EO may not be the appropriate form of organization.

For a variety of reasons, it is sometimes desirable to convert a for-profit business into a nonprofit one. In the health and human services field, for example, funding is often available for both for-profit and nonprofit organizations. An organization's direction may change or funds may become available only for tax-exempt organizations, such as for medical research programs. When an EO is created to take over the assets and operations of a for-profit entity, the buyout terms will be carefully scrutinized. Too high a price, ongoing payments having the appearance of dividends, and assumptions of debt are among the red flags faced in this situation.[6] Also, the Service's regulations under Section 337 may result in a tax on the conversion. Section 277 may also apply to limit deductions.

§1.07 INITIAL TAX AND FINANCIAL CONSIDERATIONS

A project that meets the criteria for an EO enumerated in the previous section also has significant other issues to consider before the nonprofit is formed. One important issue is organizational structure: whether to form a corporation versus a trust, how the board will be chosen, and what bylaw provisions are suitable, among others. Financial issues should also be considered and quantified: projections prepared, feasibility studied, and seed money sources identified.

[4] IRC §501(m).
[5] IRC §§511-515.
[6] *See* §3.02[C] *infra*.

[A] *Preliminary Planning*

An important start-up question concerns the type of entity to be created. Founders must decide the type of organization that should be formed: a corporation, a trust, or an unincorporated association. Each structure has its benefits and drawbacks. These are discussed fully in §1.08, *infra*.

Future sources of funds to operate the proposed nonprofit should next be projected in the planning stage. First and foremost, creators should evaluate the financial feasibility of their ideas. It is laudable to want to educate the general public on a matter of great public concern or interest; the question to ask at this stage is, Can the group put together enough funds to do so? Second, many categories of exempt organizations have special attributes and standards measured by their sources of funding. If the EO wishes to be classified as a public charity, for example, Code Section 509(a)(1) and (2) imposes certain levels of support from the general public that must be met. If these tests cannot be met, a Section 509(a)(3) supporting organization, which would provide economic support to another public charity, should be considered. Expected donation levels must be quantified to measure public support.

Whether the organization will operate as a membership group must be decided. The term "membership" is often misunderstood and misused. A membership organization is commonly thought of as one whose members elect the persons on the governing board, although some organizations use the term "member" to designate contributors who actually have no voting rights.[1] The democracy afforded by such a form of organization may or may not be desirable. A self-perpetuating board retaining control in the hands of a few persons may be appropriate. Moreover, dues paid by members who cannot vote have been treated as income from an unrelated trade or business by the Service.[2]

Bylaws set forth the rules by which a nonprofit organization is to be governed. The answers to the following questions, among many others, are found in the bylaws: How will officers be elected? When will meetings be held, and who can call them? Who will serve as advisers? Who signs checks? What credentials will be required of board members, and what length of term will they serve? A skilled attorney can be very helpful in designing appropriate bylaws, and tax considerations, such as determining control requirements for joint ventures or whether an activity rises to the level of a trade or business for unincorporated business income tax purposes, do apply. For groups affiliated with state or national groups, model bylaws may be available.[3]

[B] *Financial Management*

A nonprofit organization should be financially managed just like a business. To be financially viable, an EO needs sufficient capitalization similar to a for-profit

§1.07 [1]State laws determine the voting rights of members. *See, e.g.*, N.C. Gen. Stat. §55A-7-21 (articles of incorporation may preclude members from voting).

[2]American Postal Workers Union v. U.S., 925 F.2d 480 (D.C. Cir. 1991); National Ass'n of Postal Supervisors v. U.S., 91-2 U.S.T.C. ¶50,446 (Fed. Cir. 1991).

[3]Sample bylaws are included as part of the exemption applications in Appendix A.

organization, but it cannot issue stock in many states.[4] Therefore, the reliability of funding sources should be evaluated to ensure sustainable spending levels. Before the final decision to establish a new organization is made, the EO's future needs for capital and its ability to raise money must be projected.

These initial projections should be a starting point for an ongoing planning process to improve the financial prospects for the EO. Short-range budgets and long-range financial plans should be maintained and continually updated. Operating and capital budgets are recommended. For some types of EOs in regulated industries, such as health care or education, or those receiving government funds, financial controls may be mandated by law. Plans for maximizing yield on cash and other investment assets should be formulated, and the EO's funds should be kept in interest-bearing accounts. Professional investment managers can be sought once capital reserves exceed immediate needs.

An accounting system and procedures should be established to record, report, and internally control the financial resources in accordance with generally accepted accounting principles. The system should also maximize cash flow by billing customers and collecting from contributors as quickly as possible, while at the same time delaying payment of the organization's own bills for as long as is reasonable.

§1.08 CHOOSING THE FORM OF ORGANIZATION

The three common structural forms for a nonprofit organization are corporation, trust, or unincorporated association. The choice of organizational form is influenced by the laws of the states in which the nonprofit will operate. Certain categories of Section 501 organizations are limited in their choice of form. A title-holding company, for example, must be a corporation.[1] Some categories of exemption apply to clubs, associations, leagues, and posts and may have unique organizational structures. State law may also impose requirements that affect the decision, such as the organization of charter or private schools. An experienced attorney knowledgeable about nonprofit organizations can be extremely valuable when making this choice. If the project needs to seek volunteer or pro bono assistance due to limited funds, the local bar association and accountants' society may have such a program.

Whichever form of organization is chosen, the Code and regulations often have differing requirements from those of the state in which the nonprofit is established. Particularly for those seeking classification as a Section 501(c)(3) organization, the standards for federal exemption are very specific and commonly stricter than those of the state. A charter that allows a nonprofit to conduct those activities permitted under local law may not necessarily qualify for federal exemption. Caution must be used in drafting a charter.[2]

[4] *See, e.g.*, N.C. Gen. Stat. §55A-6-21.

§1.08 [1] IRC §501(c)(2).

[2] A sample charter is included as part of the exemption applications in Appendix A.

[A] *The Corporation*

Corporate status is usually the most flexible form of organization for a nonprofit and is the choice in most states. In most states, articles of incorporation are filed to create a nonprofit corporation. Tax rules govern certain provisions that are required to be included as well as those that should be included.[3]

Formation of a corporation as a separate entity creates a corporate veil that may shield the individuals governing and operating the nonprofit from liabilities incurred by the organization, unless they are negligent or somehow remiss in their duties. Volunteers serving as directors of Section 501(c)(3) entities may be eligible for certain immunity under a state's volunteer protection act. Also, some states have adopted immunity laws augmenting protection against liability for directors and officers of nonprofits. In North Carolina, for example, volunteer directors are generally immune from liability for any acts or omissions taken in their status as such.[4] The rules of the particular state in which the nonprofit operates should be carefully studied.

Many nonprofit organizations have members. An exempt corporation, however, can be formed with or without members. The primary role of members in this context is to elect the board, which in turn governs the organization. Members may broaden the base of financial support and involve the community in the organization's activities. In such cases there may be hundreds or thousands of individual contributors who, as a group, control the organization because they elect the directors. A practical concern, however, is whether a quorum to elect directors can be obtained.

In privately funded organizations, such as private foundations, the members may be family representatives who desire to retain control, or the organization may have no members. The founder of a charity (whether an individual or a controlling entity) can be named the sole member. Mutual benefit societies, unions, trade associations, clubs, and the like are usually controlled by their dues-paying members.

The other choice is to allow the board to govern the organization. Closer control can be maintained by a small, self-perpetuating board that chooses its own successors. The charter may also appoint representatives of specified organizations or institutions to occupy board positions. A city arts council board might designate a representative of the city museum, the college art department, the symphony orchestra, and an individual artist to serve with those directors elected by members. Elected representatives from the government (mayor, city council, or county board of commissioners) may serve by designation. Supporting organizations described in Section 509(a)(3) may have additional requirements.

An advantage of the corporate form, as compared with a trust, is that its organizational documents can be amended. Usually the currently serving board has authority to make changes to both the bylaws and the charter. Though such changes would require approval of both the state and the Service, they are allowed. A

[3]Reg. §1.501(c)(3)-1(c)(2).
[4]N.C. Gen. Stat. §55A-2-02(b)(4).

nonprofit corporation's articles can (and normally do) allow its directors and members to mold and change its provisions as the organization evolves.

[B] *The Trust*

The trust form of organization is often chosen for an individually funded or family-funded charitable organization. A trust created while one is living is called an inter vivos ("among the living") trust. A trust created by a bequest in the creator's will is called a testamentary trust. A trust is favored by some because, unlike a corporation, a trust can be totally inflexible; it can be created without provisions allowing for changes in its purpose or trustees. Thus, a donor with specific wishes may prefer this form of organization for a substantial testamentary bequest. Another advantage of a trust is that some states require no public registration.

Some trusts contain a provision allowing the trustee to convert the trust into an exempt corporation with identical purposes and organizational restraints if the trust form becomes disadvantageous. Exempt organization immunity statutes do not apply to trusts in some states, and more stringent fiduciary standards are often imposed upon trustees than on corporate directors. As a rule, trustees may be exposed to greater potential liability for their actions than corporate directors. The tax rates on unrelated business income of a trust are higher than the rates applied to corporations.[5]

[C] *The Unincorporated Association*

The unincorporated association form of nonprofit organization is the easiest to establish but generally is not advisable. This form is more common than one might expect. The American Bar Association and the National Football League are both unincorporated entities. To qualify for exemption, an unincorporated association must have organizing instruments outlining the same basic information found in a corporate charter or trust instrument. Rules of governance must be provided, and it must have regularly chosen officers. Particularly for Section 501(c)(3) status, the Service requires specific provisions in the documents.[6] Although there are few established statutes or guidelines to follow, national, statewide, and nonprofits with branches or chapters often furnish a uniform structural document.

An unincorporated group faces substantial pitfalls. The primary concern is lack of protection from liability for officers and directors. Also, banks and creditors may be reluctant to establish business relationships without personal guarantees by the officers or directors.

[5]IRC §§1(e)(2); 11.
[6]Reg. §§1.501(c)(3)-1(c)(2), (d)(1)(ii).

2

The Distinction Between Public Charities and Private Foundations

§2.01 BACKGROUND

Prior to 1969, Section 503 of the Code subjected certain Section 501(c)(3) organizations to loss of their exemption if they engaged in certain "prohibited transactions" with related persons such as founders, directors, or officers.[1] Under former Section 504, certain organizations forfeited their exemptions for unreasonable accumulations of income, substantial expenditures of funds for nonexempt purposes, and investments of income that jeopardized the performance of their exempt activities.[2] However, in view of continued congressional concern that family-controlled private foundations were utilizing tax-deductible contributions to further private rather than public interests, it was determined that legislation was required in order to ensure that tax-deductible contributions were expended only to further the public interest.[3]

The Tax Reform Act of 1969[4] imposed significant operating restrictions upon Section 501(c)(3) organizations that are treated as private foundations. The 1969 Act defined the term "private foundation" as all Section 501(c)(3) organizations that fail to qualify as public charities. The 1969 Act also required most new organizations to notify the Service that they claimed exemption under Section 501(c)(3) and to furnish information from which the Service could determine whether an organization would be recognized as a public charity or would be treated as a private foundation.[5]

Much of the 1969 legislation was drawn from the 1965 Treasury Department Report on Private Foundations.[6] The 1965 Report specifically recognized that private foundations "enrich the pluralism of our social order" and thus play an important role in private philanthropy. The 1965 Report defined private foundations as all organizations exempt from taxation under Section 501(c)(3) except (1) organizations that normally received a substantial part of their support from the general public or from governmental bodies; (2) churches and conventions or associations of churches; (3) educational organizations with regular faculties, curricula, and student bodies; and (4) organizations whose purpose is to test for public safety.[7] These organizations were thought to be sufficiently responsive to the public interest through their sources of support, so that it was unnecessary to extend the new operating restrictions to them.

In imposing the strict operating procedures upon private foundations, Congress relied in part upon Section 170(b)(1)(A) to define those organizations to which the restrictions would not apply. At the same time, it amended Section 170(b)(1)(A) to increase the maximum deductible contribution to public charities

§2.01 [1]Since its amendment, §503 applies only to certain employee retirement plans and trusts.

[2]An exception was made under §504 for organizations described in §503(b) as in effect prior to 1969.

[3]*See* 1969 Blue Book at 3-4, 40-41.

[4]P.L. 91-172, §101(a) (hereinafter the "1969 Act").

[5]A private foundation is defined by exclusion in §509(a) as all organizations described in §501(c)(3) other than the four categories of organizations that are treated as other than private foundations.

[6]Treasury Department Report on Private Foundations, 69th Cong., 1st Sess. (1965) ("1965 Report").

[7]*Id.* at 5.

from 30 percent to 50 percent of an individual donor's "contribution base." Such organizations are now commonly called "50 percent charities" and are specifically excluded from classification as private foundations.[8]

§2.02 SECTION 509: PRIVATE FOUNDATIONS AND PUBLIC CHARITIES

Section 509(a) defines a private foundation as any domestic or foreign organization described in Section 501(c)(3) other than the four types of Section 501(c)(3) organizations also described therein.[1] Section 509 creates two classifications: private foundations and organizations other than private foundations, more commonly known as public charities. An organization that qualifies under Section 501(c)(3) as an exempt organization must also meet the requirements of Section 509 to be treated as a public charity. There are four types of organizations that are excepted from private foundation status:

1. Organizations conducting certain favored types of activities;[2]
2. Organizations receiving a substantial amount of their support from the general public or from governmental entities;[3]
3. Organizations excluded from private foundation treatment due to their close association with other organizations treated as other than private foundations;[4] and
4. Organizations formed and operated exclusively to test for public safety.[5]

Under this statutory scheme, a Section 501(c)(3) organization may be exempt from federal income taxation and an eligible recipient of deductible charitable contributions and yet still be subject to the onerous private foundation operating requirements. Therefore, it is frequently preferable for an organization to qualify as a public charity if it is able to do so.

[A] Section 170(b)(1)(A)(i)-(v) ("Public") Organizations

The first group of organizations excepted from private foundation status consists of those organizations engaging in certain legislatively favored activities. Under Section 509(a)(1) domestic or foreign organizations described in Section

[1]IRC §§509(a)(1), 170(b)(1)(A)(i)-(vi).

§2.02 [1]*See* Reg. §1.509(a)-1.

[2]IRC §§509(a)(1); 170(b)(1)(A)(i)-(v).

[3]IRC §§509(a)(2); 170(b)(1)(A)(vi).

[4]IRC §509(a)(3).

[5]IRC §509(a)(4).

170(b)(1)(A)(i)-(v)[6] are excepted from private foundation status. Prior to the 1969 Act, Section 170(b)(1)(A) concerned only the deductibility of charitable contributions. Since 1969, that section has also defined certain types of public charities.

The organizations described in Section 170(b)(1)(A)(i)-(v) are the following:

1. A church or a convention or association of churches;[7]
2. An educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on;[8]
3. An organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital, or a medical research organization engaged in the continuous active conduct of medical research in conjunction with a hospital, and during the calendar year in which the contribution is made such organization is committed to spend such contribution for such research before January 1st of the fifth calendar year that begins after the date such contribution is made;[9]
4. An organization that normally receives a substantial part of its support, other than income from an exempt function, from the United States or any state or political subdivision thereof, or direct or indirect contributions from the general public, and that is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university that is described in Section 170(b)(1)(A)(ii) and that is an agency or instrumentality of a state or political subdivision thereof, or that is owned or operated by a state or political subdivision thereof, or by an agency or instrumentality of one or more political subdivisions;[10] and
5. A state, territory, or possession of the United States, or any political subdivision thereof, or the United States or the District of Columbia.[11]

An organization must meet the requirements of one of these five categories in order to qualify under Sections 509(a)(1) and 170(b)(1)(A)(i)-(v). The organization must carry on as a primary purpose activities that qualify it under one of these subsections. If it only incidentally engages in qualifying activities under Section 170(b)(1)(A), the organization will not qualify as a public charity under Section 509(a)(1).[12]

[6]Such organizations have been described as "public" institutions, which were not guilty of the abuses leading to the enactment of the 1969 Act. Bruce R. Hopkins and Jody Blazek, Private Foundations: Tax Law and Compliance §15.2 (1997). Section 170(b)(1)(A)(vi) organizations are discussed in conjunction with §509(a)(2) organizations. *See* Exempt Organizations Handbook, IRM 7751, §§300-3(10)0.

[7]IRC §170(b)(1)(A)(i).

[8]IRC §170(b)(1)(A)(ii).

[9]IRC §170(b)(1)(A)(iii).

[10]IRC §170(b)(1)(A)(iv).

[11]IRC §170(b)(1)(A)(v), (c)(1).

[12]Rev. Rul. 56-262, 1956-1 C.B. 131.

[1] Churches

A church or a convention or association of churches qualifies as a public charity under Section 170(b)(1)(A)(i). The term "convention or association of churches" generally refers to a central association or convention or a group of churches of the same denomination or to an organization of churches of differing denominations. Thus, a religious organization that has a membership consisting of churches of various denominations qualifies as an "association of churches" within the meaning of Section 170(b)(1)(A)(i).[13]

Neither the Code nor the regulations define the term "church." However, the unrelated business income tax (UBIT) regulations state that the term "church" includes a religious order or organization if it is both an integral part of a church and engaged in carrying out the functions of a church.[14] The degree of control by a church determines whether a religious order or organization is an integral part of a church. A religious order or organization is considered to carry out the functions of a "church" if its duties include both the ministration of sacerdotal (priestly) functions and the conduct of religious worship. The tenets and practices of a particular religious body will determine what constitutes the conduct of religious worship and the ministration of sacerdotal functions.[15] The Commissioner of the Service has stated that the two most important factors in determining church status are (1) a membership not associated with any other church or denomination and (2) regular congregations.[16]

The courts have often avoided the issue but have provided some assistance in defining the term "church." In *De LaSalle Institute v. United States*,[17] a United States district court stated:

> To exempt churches, one must know what a church is. Congress must either define "church" or leave the definition to the common meaning and usage of the word; otherwise, Congress would be unable to exempt churches. It would be impractical to accord an exemption to every corporation which asserted itself to be a church. Obviously, Congress did not intend to do this.[18]

In *Chapman v. Commissioner*,[19] the Tax Court stated that Congress used the term "church" more in the sense of a denomination or sect than in a generic or universal sense and added that it did not intend to imply that a group of persons must

[13]Rev. Rul. 74-224, 1974-1 C.B. 61. In Ann. 94-11, 1994-1 C.B. 335, the Service published a tax guide for churches and other religious organizations. The guide specifically states that a church must maintain books of account and other records necessary to justify a claim for exemption in the event of an audit.

[14]Reg. §1.511-2(a)(3)(ii), effective for tax years beginning before 1970. Churches were exempt from UBIT during such years.

[15]*Id.*

[16]Testimony of Service Commissioner Lawrence Gibbs, "Federal Tax Rules Applicable to Tax-Exempt Organizations Involving Television Ministries," *Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 100th Cong., 1st Sess. 29 (1987).

[17]195 F. Supp. 891 (N.D. Cal. 1961).

[18]*Id.* at 903.

[19]48 T.C. 358 (1967).

have an organizational hierarchy or maintain church buildings in order to fall within the meaning of the term "church." The court concluded that a group of missionary workers drawn from many Christian churches could not be said to be a "church." The group was interdenominational and independent of any connection with the churches with which its members were affiliated. It did not seek converts other than to the principles of Christianity generally, and it successfully urged those converts to establish their own native churches. It was merely a religious organization consisting of individual members who were already affiliated with various churches.

In *Gates Community Chapel of Rochester, Inc. v. United States*,[20] the Court of Federal Claims upheld the Service's determination that an organization operating a church facility, home, and school for young adults did not qualify as a "church" under Section 170(b)(1)(A)(i) despite a bankruptcy court's earlier finding that the organization did have a status as a church under the federal bankruptcy laws.

In *Foundation of Human Understanding v. Commissioner*,[21] the Tax Court considered whether an organization with substantial radio broadcasting activities could be considered a church. The estimated audience for the broadcast was two million people, with a regular audience of about 30,000. Broadcasting expenditures represented approximately one-half of the organization's total expenditures, and attendance at services at each of two locations ranged from 50 to 350 persons. The Tax Court concluded that although the radio programs of the organization reached more people than its religious services, its broadcasting activities did not overshadow the associational aspects. The organization held regular services, had an ordained minister, included religious instruction in its general education curriculum, and had a distinct, although short, religious history. It therefore qualified as a church.

Under *Foundation of Human Understanding*, so-called television ministries should qualify as Section 501(c)(3) religious organizations unless they fail to meet the other exemption requirements under Section 501(c)(3), such as the inurement prohibition.[22] In addition, if a television ministry exhibits substantial associational aspects — such as regular services, ordination of ministers, and establishment of religious schools — it should also qualify as a Section 170(b)(1)(A)(i) church. The television ministry would thus qualify as a church unless its broadcasting activities constitute a primary activity of the organization, such that the associational aspects become incidental to the broadcasting activity.

[2] Educational Organizations

Educational organizations described in Section 170(b)(1)(A)(ii) represent the second general category of organizations excepted from private foundation classification under Section 509(a)(1). Educational organizations that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of

[20] 96-1 U.S.T.C. ¶50,093 (Ct. Fed. Cl. 1995).
[21] 88 T.C. 1341 (1987).
[22] *See* Chapter 3.

pupils or students in attendance at the place where their educational activities are regularly carried on qualify as public charities. The organization's primary function must be the presentation of formal instruction.[23]

The "primary function" requirement was explained in several rulings published before the enactment of the 1969 Act.[24] In Revenue Ruling 56-262,[25] an organization organized for the primary purpose of engaging in medical research and offering formal instruction to professionals and graduate students as a secondary activity was held not to be a Section 170(b)(1)(A)(ii) educational organization. Thus, an organization that provides formal classroom instruction for students as merely an incidental activity will not qualify as an educational organization under Section 170(b)(1)(A)(ii).[26]

Section 501(c)(3) high schools, colleges, and universities are thus treated as educational organizations under Section 170(b)(1)(A)(ii). Federal, state, and other governmentally supported institutions may derive tax exemption as government instrumentalities rather than as educational organizations.[27] While a Section 170(b)(1)(A)(ii) organization may engage in other incidental activities, it must have as its primary function the presentation of formal instruction. For example, a university that as an incidental activity operates a museum or sponsors a concert series would still qualify as an educational organization described in Section 170(b)(1)(A) (ii). However, if a museum operates a school as an incidental and not its primary activity, the museum would not qualify under Section 170(b)(1)(A)(ii).[28]

The curriculum requirement for Section 170(b)(1)(A)(ii) status does not necessarily require that an organization must present courses in traditional academic subjects, such as English or mathematics. In Revenue Ruling 72-101,[29] the Service ruled that an organization operating a training school and presenting classes in developing skills useful for a particular type of industry qualified as a Section 170(b)(1)(A)(ii) educational organization. In Revenue Ruling 73-434,[30] an organization that taught survival techniques in a natural environment to young people was ruled to be an educational organization.

A school must normally maintain a regular curriculum, although a formal course program or formal classroom instruction is not necessarily required. This means that the organization's courses of study must be offered recurrently, such as on a quarterly or semester basis. Thus, if an organization merely offers a series of unrelated lectures or conferences, it will not meet the regular curriculum re-

[23] Reg. §1.170A-9(b)(1).

[24] According to the Service, rulings published before the enactment of the 1969 Act continue to have precedential value under §170(b)(1)(A)(ii), since the 1969 amendment thereto did not materially alter its intent or interpretation. IRM 7752, §233(2) (hereinafter the "Private Foundations Handbook").

[25] 1956-1 C.B. 131.

[26] Rev. Rul. 58-433, 1958-2 C.B. 102.

[27] IRC §115 excludes from gross income any income derived from any public utility or the exercise of any essential governmental function that accrues to a state or political subdivision thereof.

[28] Reg. §1.170A-9(b)(1); Rev. Rul. 76-167, 1976-1 C.B. 329.

[29] 1972-1 C.B. 144. *See also* Rev. Rul. 67-447, 1967-2 C.B. 141 (organization offering formal ballet training as well as traditional academic courses qualifies under §170(b)(1)(A)(ii)).

[30] 1973-2 C.B. 71.

quirement and cannot qualify under Section 170(b)(1)(A)(ii).[31] Similarly, a series of lectures open to the public on a general subject matter does not constitute a curriculum.[32]

A school described in Section 170(b)(1)(A)(ii) also must normally maintain a regular faculty. Generally, this requirement will be met if its classes, seminars, or other means of instruction are conducted by teachers, instructors, or other qualified persons who perform their duties on a recurrent basis. In Revenue Ruling 64-128,[33] it was determined that an organization did not normally maintain a regular faculty because its instructors did not keep up regular employment ties to the organization and individually presided over a series of unrelated lectures and conferences.

Under Section 170(b)(1)(A)(ii), an organization must also have a regularly enrolled body of pupils or students in attendance at the place where its educational activities are normally carried on. If students are not enrolled in a regular, recurring program of instruction, but merely attend occasional classes, the organization may be found not to have a regularly enrolled body of students.[34] The educational activities may be carried on at the school's own facilities or the facilities of another school or organization.[35]

[3] Hospitals and Medical Research Organizations

[a] Hospitals

An organization is described in Section 170(b)(1)(A)(iii) if (1) it is a hospital and (2) its principal purpose or function is the providing of medical or hospital care or conducting medical education or research.[36] The term "hospital" includes a rehabilitation institution, outpatient clinic, or community mental health or drug treatment center if its principal purpose or function is to furnish hospital or medical care.[37] If the principal purpose of an organization is the providing of medical education or research, it will not be considered a "hospital" for this purpose unless it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities on an inpatient or outpatient basis as an integral part of its medical education or research functions.[38] An "extended care facility" under 42 U.S.C. Section 1395x(j) may also qualify as a hospital if its principal purpose or function is the providing of hospital or medical care.[39]

Although the Code does not define the term "hospital," the Conference Report to the Tax Reform Act of 1986 (1986 Act) adopted a definition of the term "hos-

[31] *See, e.g.*, Rev. Rul. 72-430, 1972-2 C.B. 105.
[32] Rev. Rul. 78-82, 1978-1 C.B. 70. *See* Rev. Rul. 62-23, 1962-1 C.B. 200.
[33] 1964-1 (Part 1) C.B. 191.
[34] Rev. Rul. 64-128, 1964-1 (Part 1) C.B. 191.
[35] Rev. Rul. 69-492, 1969-2 C.B. 36.
[36] Reg. §1.170A-9(c)(1).
[37] *Id.*
[38] *Id.*
[39] *Id.*

contained in the House of Representatives' version of H.R. 3838, which became the 1986 Act. Under the Conference Report, the term "hospital" is defined as a facility that meets the following requirements:

1. It is accredited by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO), or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAHO;
2. It is primarily used to provide diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons as inpatients under the supervision of physicians;
3. It has a requirement that every patient be under the care and supervision of a physician; and
4. It provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed nurse or registered nurse on duty at all times.[40]

The term "medical care" includes the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided the cost of such treatment is deductible under Section 213 by the person treated.[41] The term "hospital" does not, however, include convalescent homes, homes for children or the aged, or institutions whose principal purpose or function is to train handicapped individuals to pursue a vocation.[42] A home health care organization also did not qualify, according to the Service, because it provided no outpatient medical or hospital services even though its activities were concededly health-related.[43]

Finally, a cooperative hospital service organization that meets the requirements of Section 501(e), thereby qualifying for exemption under Section 501(c)(3) as a charitable organization, is also treated as a hospital for purposes of Section 170(b)(1)(A)(iii).[44]

[b] *Medical Research Organizations*

A medical research organization qualifies under Section 170(b)(1)(A)(iii) if the organization's principal purpose or function is medical research and it is directly

H.R. Rep. No. 99-841, 99th Cong., 2d Sess. II-725 (1986). *See* 1986 Blue Book at 1188. The definition for the purposes of the exception for hospitals to the §145(b) limitation on §501(c)(3) tax-exempt bonds. The term "hospital" is also defined in the Social Security Act. 42 U.S.C. §1395x(e). *See* Rev. Rul. 69-545, 1969-2 C.B. 117 (a tax-exempt hospital must provide a benefit to the community rather than primarily benefiting the private interests of physicians practicing medicine within it).

Reg. §1.170A-9(c)(1).

Rev. Rul. 76-452, 1976-2 C.B. 60. *See also* Rev. Rul. 75-295, 1975-2 C.B. 437 (organization providing extensive disease-related educational programs did not qualify under §170(b)(1)(A)(iii) because its primary purpose was not to furnish medical care or hospital services).

Reg. §1.170A-9(c)(1).

engaged in the "continuous, active conduct" of medical research in conjunction with a tax-exempt hospital, a federal hospital, or an instrumentality of a governmental unit referred to in Section 170(c)(1).[45]

Qualifying medical research must be carried on in conjunction with a hospital.[46] The organization need not be formally affiliated with a hospital to be considered primarily engaged directly in the continuous, active conduct of medical research in conjunction with a hospital, but there must be a joint effort on the part of the research organization and the hospital pursuant to an understanding that the two organizations will maintain continuing close cooperation in the active conduct of medical research.[47] The necessary joint effort is generally found to exist if the activities of the medical research organization are carried on in space located within or adjacent to a hospital, the organization is permitted to utilize the hospital's facilities on a continuing basis, and there is substantial evidence that hospital medical staff personnel and the research organization's own staff closely cooperate in the conduct of the research activities.[48]

[4] University Endowment Funds

Organizations described in Section 170(b)(1)(A)(iv) are endowment funds organized and operated in connection with public colleges and universities, typically land grant institutions. Such funds make expenditures for the normal functions of state colleges and universities such as the acquisition and maintenance of real property or buildings on the campus or expenditures for scholarships, libraries, and student loans.[49]

[5] Governmental Entities

Organizations treated as public charities pursuant to Section 170(b)(1)(A)(v) are governmental units referred to in Section 170(c)(1). These are states, possessions of the United States, or any political subdivision thereof, the United States itself, or the District of Columbia. However, states and municipalities do not qualify as charitable organizations under Section 501(c)(3), because their purposes are not limited exclusively to those enumerated therein.[50] A wholly owned state instrumentality organized as a separate entity may qualify under Section 501(c)(3), how-

[45]Reg. §1.170A-9(c)(2)(i), (ii). For purposes of qualifying as a public charity under §509(a)(1), a medical research organization need not be committed to spend every contribution for medical research before January 1 of the fifth year that begins after the date the contribution is made. Such commitment is required to qualify a contribution under §170, however. Reg. §§1.509(a)-2(b), 1.170A-9(c)(2)(i). See *generally* Private Foundations Handbook, §242.1.

[46]The affiliated hospital may not be a for-profit hospital. Rev. Rul. 66-245, 1966-2 C.B. 71.

[47]Reg. §1.170A-9(c)(2)(vii).

[48]*Id.*

[49]Reg. §1.170A-9(b)(2).

[50]Rev. Rul. 60-384, 1960-2 C.B. 172, *amplifying* Rev. Rul. 55-319, 1955-2 C.B. 172. Under §115 of the Code, the income of a state or political subdivision derived from an essential governmental function is excluded from federal income taxation. In State Bar of Texas v. United States, 560 F. Supp. 21 (N.D. Tex. 1983), the court held that some employees of the State Bar of Texas are exempt from FUTA taxes

ever, where it is a counterpart of a Section 501(c)(3) organization and its purposes are appropriately limited to those described in Section 501(c)(3).[51] To qualify as a political subdivision under Section 170(b)(1)(A)(v) for purposes of nonprivate foundation status, it is necessary that the organization possess the sovereign powers of the state, including the power of eminent domain, the power to levy or collect taxes, and the police power.[52]

The definition of "political subdivision" under Section 170(b)(1)(A)(v) was at issue in *Texas Learning Technology Group v. Commissioner*.[53] In this case, the organization was established under state law to develop and administer educational programs to assist in the improvement of student learning in public schools. The organization's board of directors consisted of a broad cross section of public school educators and administrators, some of whom were appointed by state agencies and public officials. The organization engaged in a number of activities that were intended to and did improve the delivery of educational services to students in the public schools. The Service recognized the organization's exemption under Section 501(c)(3) but held that the organization did not qualify as a political subdivision under Section 170(c)(1) and, therefore, was not a governmental unit under Section 170(b)(1)(A)(v). The Tax Court upheld the Service's determination.

The organization did not have the power of eminent domain or the power to levy or collect tax. The organization also did not have any police powers. These three elements are generally considered to be the critical elements of sovereign power for purposes of determining whether an organization qualifies as a "political subdivision."[54] The term "political subdivision," which is generally given a broad interpretation,[55] has the same meaning under Section 170 as under Section 103.[56] The court indicated that the possession of one or more of the three sovereign powers is different from the exercise of a governmental function: "A sovereign power always encompasses a governmental function, but it is one that inheres in a sovereign and is not exercisable by others without the sovereign's authorization. A governmental function, on the other hand, does not always constitute a sovereign power; it includes activities which are often more appropriately carried on by the sovereign but can alternately or additionally be carried on by others."[57]

In this case, the court concluded that the organization exercised the governmental function of assisting the provision of education, but did not exercise any sovereign power. The organization also argued that it qualified as a governmental unit

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because the Bar is an instrumentality of the State of Texas. The Service disagrees. Rev. Rul. 87-58, 1987-2 C.B. 224; GCM 39683 (December 21, 1987).

Indian tribal governments are treated as states under §7871 for certain purposes. A tribal organization that performs educational or cultural activities may qualify under §501(c)(3), but if its activities constitute the performance of an essential tribal government function, its exemption will be derived not under §501(c)(3) but under §7871. *See* Ltr. Ruls. 8941057 and 8737015.

[51] Rev. Rul. 60-384, 1960-2 C.B. 172.

[52] Texas Learning Tech. Group v. Comm'r, 96 T.C. 686 (1991), *aff'd*, 958 F.2d 122 (5th Cir. 1992).

[53] 96 T.C. 686 (1991), *aff'd*, 958 F.2d 122 (5th Cir. 1992).

[54] Philadelphia Nat'l Bank v. U.S., 666 F.2d 834 (3d Cir. 1981).

[55] Shamberg Estate v. Comm'r, 3 T.C. 131, 137 (1944).

[56] American Bus. Serv. Corp. v. Comm'r, 93 T.C. 449, 456 (1989).

[57] 96 T.C. at 695.

because it was an integral part of certain public school districts, which themselves constituted political subdivisions. The court held that the integral part doctrine is irrelevant to a finding as to whether the organization qualified as a political subdivision.

Under Sections 509(a)(1) and 170(b)(1)(A)(v), governmental units are not private foundations. As discussed above, however, most governmental units will have sovereign powers disqualifying them from Section 501(c)(3) exemption.[58] Moreover, rulings under Section 170(b)(1)(A)(v) must be referred to Associate Chief Counsel (Technical), since they are not within the jurisdiction of the Exempt Organizations Division of the Service.

Most governmental entities that qualify for exemption under Section 501(c)(3) qualify for nonprivate foundation status under another Section 509(a) classification. Most will qualify either as publicly supported organizations under Sections 509(a)(1) and 170(b)(1)(A)(vi), or Section 509(a)(2), or as supporting organizations of governmental units under Section 509(a)(3).

[B] Sections 170(b)(1)(A)(vi) and 509(a)(2) Publicly Supported Organizations

The second broad class of Section 501(c)(3) organizations treated as public charities includes those organizations receiving a substantial amount of their support from the public or governmental bodies. Such organizations are described in Sections 509(a)(2) and 170(b)(1)(A)(vi) and are classified as public charities due to their broad public support, which is thought to make them responsive to the needs of the general public.

[1] Section 170(b)(1)(A)(vi) ("Donative") Publicly Supported Organizations

An organization described in Section 170(b)(1)(A)(vi) is excluded from treatment as a private foundation under Section 509(a)(1). Section 170(b)(1)(A)(vi) provides that organizations described in Section 170(c)(2)[59] that normally receive a substantial part of their support, exclusive of income received in the exercise or performance by the organization of their exempt functions (meaning the purposes for which they are exempt under Section 501(c)(3)), from governmental units or direct or indirect contributions from the general public are treated as public charities. As such, these organizations are commonly referred to as "donative" organizations by reason of their reliance upon gifts, grants, and contributions for support

[58] Rev. Rul. 60-384, 1960-2 C.B. 172, *amplifying* Rev. Rul. 55-319, 1955-2 C.B. 172.

[59] Section 170(c)(2) generally tracks the language of §501(c)(3), except that organizations whose purpose is to test for public safety and foreign organizations are omitted from §170(c)(2). Under the regulations a foreign organization is treated as a §509(a)(1) public charity even though it would not qualify under §170(c)(2) (in the absence of a contrary tax treaty provision) if it otherwise meets the requirements of §170(b)(1)(A)(vi). Reg. §1.509(a)-2(a).

[a] Definition of Support

For purposes of the denominator of the Section 170(b)(1)(A)(vi) support fraction, the term "support" includes the following:

1. Gifts,[60] grants,[61] contributions, and membership fees;[62]
2. Net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business;[63]
3. Gross investment income, such as interest, dividends, rents, and royalties;
4. Tax revenues levied for the benefit of an organization and either paid to or expended on behalf of such organization; and
5. The value of services or facilities (exclusive of those generally furnished to the public without charge) furnished by a governmental unit referred to in Section 170(c)(1) to an organization without charge.[64]

The following three classes of receipts are not considered "support" and therefore are excluded from both the numerator and denominator of the support fraction:

1. Any amounts an organization receives from the exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption. Such amounts are generally those derived from activities that are substantially related to the organization's exempt purposes. Such income is generally referred to as exempt function income.[65]

[60]The §170 regulations adopt the definitions of the terms "gift" and "contribution" set forth in the §509 regulations. Reg. §1.170A-9(e)(7)(i). The §509 regulations state that the terms "gift" and "contribution" under §509(a)(2)(A) have the same meaning as under §170(c) and include any payment of money or transfer of property without adequate consideration. Reg. §1.509(a)-3(f)(1).

[61]A "grant" is defined as a payment made to encourage the recipient to carry on certain programs or activities in furtherance of its exempt purposes. Reg. §§1.170A-9(e)(7)(i), 1.509(a)-3(g)(1).

[62]The term "membership fee" means a payment for the basic purpose of providing support for the organization rather than to purchase admissions, merchandise, services, or the use of facilities. Reg. §1.170A-9(e)(7)(iii), cross-referencing Reg. §1.509(a)-3(h)(1). *See also* Home for Aged Men v. U.S., 80-2 U.S.T.C. ¶9711 (N.D. W. Va. 1980), *aff'd per curiam*, No. 80-1785 (4th Cir. 1981), holding that payments by new admittees were not membership fees but instead were receipts from a related activity (exempt function income) and, thus, not public support.

[63]This element of support apparently means only that amount of income from unrelated business activities after allowable deductions have been calculated and the §511 tax paid since that is the amount specified in §509(a)(2)(B) as entering into the denominator of the gross investment income fraction for §509(a)(2) publicly supported organizations.

[64]Reg. §1.170A-9(e)(7)(i), adopting the definition of the term "support" contained in §509(d)(1), (3), (4), (5), and (6).

[65]Reg. §1.170A-9(e)(7)(i)(a). In Rev. Rul. 83-153, 1983-2 C.B. 48, the Service ruled that Medicare and Medicaid payments received by §501(c)(3) health care organizations constitute gross receipts from the performance of exempt functions for purposes of the public support test under §170(b)(1)(A)(vi). The Service stated that since the patient ultimately controls the recipient of the payment through his selection of a health care provider and such health care services directly serve his health care needs, the payment is not considered support from a governmental unit under §170(b)(1)(A)(vi) and Reg. §1.170A-9(e)(8)(i). Such payments are thus fully excluded in determining whether the organization meets the support test under §170(b)(1)(A)(vi). Reg. §1.170A-9(e)(8)(i).

2. Any gain upon the sale or exchange of property that would be considered under any section of the Code as gain from the sale or exchange of a capital asset;[66] and
3. Contributions of services for which a deduction is not allowable.[67]

[b] Public Support Tests

An organization is publicly supported under Section 170(b)(1)(A)(vi) if it "normally" receives at least 33⅓ percent of its total support from governmental units, direct or indirect contributions from the general public, or a combination of these sources.[68] Such organizations must thus calculate their public support by constructing a support fraction, the denominator of which is total eligible support and the numerator of which is eligible public and governmental sources of support.

Even if it does not meet the 33⅓ percent test, an organization may, nonetheless be considered publicly supported if it "normally" receives a substantial part, which the regulations state is 10 percent or more, of its support from governmental units, the general public, or a combination of these sources and if it meets other factors tending to show that it is organized and operated to attract public and governmental support on a continuing basis.[69] Under this so-called facts and circumstances test, the organization must maintain a continuous and bona fide program for soliciting funds from the general public or conduct activities so as to attract support from governmental units or other publicly oriented organizations described in Section 170(b)(1)(A)(i) through (vi).[70]

The regulations state that in determining whether a continuous and bona fide solicitation program is maintained, the Service will look to three factors. The first is whether the scope of the organization's fund-raising activities is reasonable in light of its charitable activities. The second is that a new organization may rely on limited sources or amounts of support until it can expand its solicitation program or activities. The third is that the facts and circumstances of each case will be analyzed in accordance with the organization's nature and purpose.[71] For example, a high support percentage of investment income from endowment funds will normally be treated as an adverse factor, especially if such funds were originally contributed by a few individuals or members of their families. On the other

[66] IRC §509(d) (flush language).

[67] Reg. §1.170A-9(e)(7)(i)(b). Support received by an organization prior to changes made in its operations to permit it to qualify for exemption under §501(c)(3) is excluded from consideration in determining its qualifications as a publicly supported organization under §509. Rev. Rul. 77-116, 1977-1 C.B. 155.

[68] Reg. §1.170A-9(e)(2). An organization otherwise qualifying under §170(b)(1)(A)(i)-(v) may also qualify under §170(b)(1)(A)(vi) if it meets the public support test. Rev. Rul. 76-416, 1976-2 C.B. 57. Foundation of Human Understanding v. Comm'r, 88 T.C. 1341 (1987), *acq.*, 1987-2 C.B. 1, the Tax Court held that its declaratory judgment jurisdiction under §7428 extends to cases in which the Service has recognized nonprivate foundation status under a provision of the Code less favorable than that sought by the organization.

[69] Reg. §1.170A-9(e)(3)(i).

[70] Reg. §1.170A-9(e)(3)(ii).

[71] *Id.*

d, if such endowments were originally contributed by a governmental unit the general public, this would be favorable to a conclusion that the organiza- is publicly supported.[72] An organization that does not normally receive at 10 percent of its support from a governmental entity or the public will not ify as a public charity under either the facts and circumstances test or the percent test.[73]

Under the 10 percent facts and circumstances test, the greater the organization's vernmental or public support in excess of 10 percent of total support normally ived, the lesser is its burden of establishing its publicly supported nature ough other factors, and vice versa.[74] Such other factors include the following:

1. If an organization's public support is derived from a representative number of persons rather than from members of a single family, this factor indicates a publicly supported nature. This factor is less important when dealing with a new organization or an organization whose activities can be expected to limit its appeal to a particular segment of the public.[75]
2. If an organization's governing body represents the broad interests of the public rather than the private interests of a limited number of donors, this factor indicates a publicly supported nature. In general, the broad interests of the public will be served by a governing body consisting of public officials or their representatives, persons with expertise in the organization's field of operation, and community leaders or persons elected by a broadly based membership.[76]
3. If an organization provides a facility or service directly for the benefit of the general public on a continuing basis, this factor indicates a publicly supported nature. Such organizations include museums and libraries whose facilities are open to the public, symphony orchestras, and senior citizens' homes providing housing or nursing services for the general public.[77]
4. Other factors useful in considering whether membership organizations have the requisite publicly supported nature include whether:
   - Solicitations for dues-paying members are designed to enroll a substantial number of persons in the community area or in a particular profession or field of interest;
   - Membership dues for individual members have been fixed at rates designed to make membership available to a broad cross section of the interested public; and
   - The activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case

[72]Reg. §1.170A-9(e)(3)(iii).
[73]Reg. §1.170A-9(e)(3)(i).
[74]Reg. §1.170A-9(e)(3)(iii).
[75]Reg. §1.170A-9(e)(3)(iv).
[76]Reg. §1.170A-9(e)(3)(v).
[77]Reg. §1.170A-9(e)(3)(vi)(*a*).

of symphony societies, or civic affairs in the case of parent-teacher associations.[78]

The importance of meeting the 10 percent of support test is illustrated by the following example from the regulations:[79]

EXAMPLE

N is an organization referred to in Section 170(c)(2). It was created to maintain public gardens containing botanical specimens and displaying statuary and other art objects. The facilities, works of art, and a large endowment were all contributed by a single contributor. The members of the governing body of the organization are unrelated to its creator. The gardens are open to the public without charge and attract a substantial number of visitors each year. For the four taxable years immediately preceding the current taxable year, 95 percent of the organization's total support was received from investment income from its original endowment. N also maintains a membership society that is supported by members of the general public who wish to contribute to the upkeep of the gardens by paying a small annual membership fee. Over the four-year period in question, these fees from the general public constituted the remaining 5 percent of the organization's total support for such period. Under these circumstances, N does not meet the 33⅓ percent of support test under Regulations Section 1.170A-9(e)(2) for its current taxable year. Furthermore, since only 5 percent of its total support is, with respect to the current taxable year, normally received from the general public, N does not satisfy the 10 percent of support limitation described in subparagraph (3)(i) of this paragraph and cannot, therefore, be classified as "publicly supported" under Regulations Section 1.170A-9(e)(3). For its current taxable year N, therefore, is not an organization described in Section 170(b)(1)(A)(vi). Since N has failed to satisfy the 10 percent of support limitation under Regulations Section 1.170A-9(e)(3)(i), none of the other requirements or factors set forth in Regulations Section 1.170A-9(e)(3)(iii)-(vii) can be considered in determining whether N qualifies as a "publicly supported" organization.

[c] Calculation of Public Support

In determining the extent to which an organization is normally publicly supported, the organization's total support forms the denominator of the support fraction. The numerator (public support) is generally determined from the support received from any combination of direct or indirect contributions from

[78] Reg. §1.170A-9(e)(3)(vii).

[79] Reg. §1.170A-9(e)(9), Example 2. *See* St. John's Orphanage, Inc. v. U.S., 89-1 U.S.T.C. ¶9176 (Ct. Cl. 1989) (organization did not meet 10 percent support test where support was derived from dividends, interest, and contributions subject to the 2 percent test under Reg. §1.170A-9(e)(6)(i)).

general public, support received from governmental units, and receipts from the remaining sources of qualified "support" discussed above.

EXAMPLE

An organization described in Section 170(c)(2) shows that it derived funds from the following sources: (a) interest and dividends — $80,000; (b) net income from unrelated business activities — $20,000; (c) gifts and contributions from the general public — $200,000; (d) capital gains — $5,000; (e) admission fees (amounts received from the exercise of its exempt function) — $5,000.

In this case, the organization's total support (denominator of the public support fraction) is $300,000, the sum of items (a), (b), and (c); items (d) and (e) are excluded because capital gains and income related to exempt functions are not included in the definition of support for purposes of Section 170(b)(1)(A)(vi). The organization's public support (numerator of the public support fraction) is $200,000, since only the gifts and contributions qualify as public support. The public support fraction is thus $200,000 / $300,000, or 66⅔ percent public support.[80]

Support from the general public means any direct or indirect contribution an organization derives from a donor. Thus, contributions from individuals, trusts, and corporations are included in full in the numerator and denominator of the recipient organization's public support fraction as direct or indirect contributions from the general public, unless the contribution exceeds 2 percent of the organization's total support.[81] If a donor's contribution exceeds 2 percent of an organization's total support, the contribution, while includible in full in the denominator of the fraction, is includible in the numerator only to the extent that the contribution does not exceed 2 percent of the denominator. Support received from a donor or from any person or persons related to the donor in a manner described in Section 4946(a)(1)(C) through (G) is treated as if made by one person for purposes of the 2 percent limitation.[82] The effect of the 2 percent limitation is to reduce the organization's percentage of public support.

Under *Home for Aged Women v. United States*,[83] investment income from a fund endowed with direct public contributions does not constitute an indirect public contribution. The court limited the term "indirect contributions from the general public" to contributions received from other exempt organizations, which themselves normally receive a substantial part of their support from direct contribu-

[80] *See* Private Foundations Handbook, IRM 7752, §342(2).

[81] Reg. §1.170A-9(e)(6)(i).

[82] *Id.* The 2 percent limitation generally does not apply, however, to nonearmarked contributions from other §170(b)(1)(A)(vi) organizations or governmental units. Reg. §1.170A-9(e)(6)(v).

[83] 86-1 U.S.T.C. ¶9290 (D. Mass. 1986). *See also* St. John's Orphanage v. U.S., 89-1 U.S.T.C. ¶9176 (Cl. Ct. 1989).

tions from the general public. The court also recognized that an exception to the foregoing rule applies where a donor to another exempt organization has earmarked a contribution as being to or for the benefit of the organization that claims nonprivate foundation status under Section 170(b)(1)(A)(vi).[84] Such earmarked grants will be subject to the 2 percent limitation on the public support fraction. The court concluded that "it is highly unlikely that the income from the restricted portion of an organization's endowment could be considered as indirect public contributions when the Treasury has chosen to disfavor, at least relatively, donor-earmarked contributions from one charitable organization to another."[85]

Membership fees are fully included (subject to the 2 percent limitation) in the numerator and denominator of the public support fraction if payment is made for the purpose of providing support to the organization, rather than to purchase admissions, merchandise, services, or the use of facilities.[86]

Generally, governmental support is accorded favorable treatment when determining whether an organization qualifies under Section 170(b)(1)(A)(vi). Any amount classified as support from a governmental unit is fully included in the numerator of an organization's public support fraction except for indirect contributions earmarked by individual donors. Governmental support includes only contributions received from governmental units and certain other amounts received in connection with contracts entered into with governmental units that constitute amounts paid for the performance of services or in connection with a government research grant.[87] Thus, if an organization participates in the Combined Federal Campaign, which is a program of periodic solicitations for funds from federal employees received via payroll deductions, the amounts received would be considered support received from the general public rather than from governmental units.

In the Service's view, the computation of an organization's public support includes support received only at a time when the organization was organized and operated exclusively for a proper exempt purpose. Therefore, if the organization did not qualify as a Section 501(c)(3) organization for one or more years during the applicable computation period, any support received in the nonqualifying years is not taken into account in calculating its public support fraction.[88]

[d] Definition of "Normally"

One year is not a sufficient period of time to reflect an organization's normal sources of support, since its sources of funds may vary from year to year. There

[84] Reg. §1.170A-9(e)(6)(v).

[85] 86-1 U.S.T.C. at 83,586.

[86] *See* Reg. §1.509(a)-3(h).

[87] *See* Reg. §1.170A-9(e)(8)(i). Payments received in the exercise of the organization's exempt function are not government support. *Id.* However, if the organization receives a payment from a governmental unit for the purpose of providing a service or facility for the direct benefit of the public, the payment is not treated as an amount derived from an exempt activity. Reg. §1.170A-9(e)(8)(ii).

[88] Rev. Rul. 77-116, 1977-1 C.B. 155. Similarly, support received prior to filing an organization's Form 1023, where Form 1023 is filed more than 15 months (now 27 months) after the end of the month in which it was organized, is not taken into account in calculating public support. Rev. Rul. 77-3[illegible] 1977-2 C.B. 263; Rev. Rul. 77-208, 1977-1 C.B. 153.

fore, the Service employs a four-year computation period to determine whether an organization is "normally" publicly supported within the meaning of Section 170(b)(1)(A)(vi). If an organization satisfies the 33⅓ percent support test or the 10 percent facts and circumstances test on an aggregate basis for the four preceding taxable years, the organization will then qualify as being "normally" publicly supported for the current year and the immediately succeeding taxable year.[89] For example, an organization meeting the one-third public support test on an aggregate basis for the years 1994, 1995, 1996, and 1997 will be considered "normally" publicly supported for the years 1998 and 1999.

The Service employs a special rule for newly created organizations to determine if the organization "normally" meets either the 33⅓ percent or 10 percent facts and circumstances test. An organization that has been in existence for at least one taxable year consisting of at least eight months, but for less than five taxable years, can substitute the number of taxable years it has been in existence prior to its current taxable year to determine whether it normally meets either public support test.[90]

[e] Advance Rulings to New Organizations

Many newly created organizations cannot meet either the four-year "normally" publicly supported provisions or the provisions for new organizations to qualify as "normally" publicly supported because they have not been in existence for a sufficient period of time. However, a newly created organization may request a ruling or determination letter that it will be treated as a Section 170(b)(1)(A)(vi) organization for its first five taxable years. This five-year period is referred to as the advance ruling period. The advance ruling will generally be issued if the organization can reasonably be expected to meet either the 33⅓ percent support test or the 10 percent facts and circumstances test. Its organizational structure, proposed activities, and intended method of operation must be such as to attract support from the general public, governmental units, and other public charities.[91] The regulations still reflect the Service's former practice of granting an initial two- or three-year advance ruling, with a three-year extension, if requested.[92] However, the Conference Committee Report to the Deficit Reduction Act of 1984 directed the Treasury Department to extend the advance ruling period to five years for new public charities.[93] Form 1023, Application for Recognition of

[89] Reg. §1.170A-9(e)(4)(i), (ii). If for the current taxable year there are substantial material changes in an organization's sources of support other than changes arising from unusual grants, a different computation period is used. Instead, a computation period consisting of the taxable year of substantial and material change and the four taxable years immediately preceding such year is substituted. Thus, for example, if a substantial material change in support occurred in 2003, then even though the organization might qualify as being normally publicly supported under the rules set forth in the Code, the organization will not meet the requirements of §170(b)(1)(A)(vi) unless it meets the 33⅓ percent support test or the 10 percent facts and circumstances test for the computation period consisting of the taxable years 1999 through 2003. Reg. §1.170A-9(e),(4)(v).

[90] Reg. §1.170A-9(e)(4)(vi).

[91] Reg. §1.170A-9(e)(5)(ii).

[92] Reg. §1.170A-9(e)(5)(i), (iv).

[93] See 1984 Blue Book at 705.

Exemption under Section 501(c)(3) of the Code, now refers to a five-year advance ruling.

Once the advance ruling has been received, and as long as the organization's exemption ruling letter is not revoked by the Service before the expiration of the ruling period, the organization is treated as normally meeting the 33⅓ percent support test or the 10 percent facts and circumstances test during the advance ruling period without regard to whether or not it actually meets those requirements. The advance ruling period extends from the date of the organization's inception and ends 90 days after the advance ruling period expires.[94] The advance ruling period will also be extended until a final determination of the organization's public charity status is submitted. Within such 90-day period, information needed to determine whether in fact the organization meets the requirements of the 33⅓ percent support test or the 10 percent facts and circumstances test for the advance ruling period must be submitted, even if the organization did not meet those requirements. However, the advance ruling does not protect the organization from liability for the Section 4940 private foundation excise tax.[95] Therefore, if the organization is treated as a private foundation from its inception, the Section 4940 tax may be due without regard to the advance ruling. In such a case, interest on any unpaid private foundation excise tax will be due, but the Service will not impose penalties under Section 6651.[96]

[2] Section 509(a)(2) ("Service Provider") Publicly Supported Organizations

Under Section 509(a)(2) a domestic or foreign organization will qualify as a public charity if two requirements are met.[97] First, the organization must normally receive more than one-third of its support (as defined in Section 509(d)) in each taxable year from any combination of:

1. Gifts, grants, contributions, and membership fees;[98] and
2. Gross receipts from admission fees, sale of merchandise, performance of services, or furnishing of facilities, to the extent that the activities do not constitute unrelated trades or businesses.[99]

The reason for the distinction between these two categories is that gross receipts in the second category are not taken into account as permitted support to the

[94] Reg. §1.170A-9(e)(5)(iii)(b). Within such 90-day period, the organization must submit evidence on Form 8734 that it in fact met the requirements of §170(b)(1)(A)(vi) during the advance ruling period.

[95] *See* §6.03, *infra*.

[96] Reg. §1.170A-9(e)(5)(iii)(a), (b).

[97] Such organizations have been commonly referred to as organizations deriving income from fees charged for services provided, thereby earning the sobriquet "service provider organizations." Bruce R. Hopkins and Judy Blazek, Private Foundations: Tax Law and Compliance §15.5 (1997). *See* Private Foundations Handbook, §§400-490.

[98] *See* §2.02[B][1][a] *supra* for definitions of these terms.

[99] IRC §509(a)(2)(A). Such income is usually referred to as exempt function income. *See* Reg. §1.509(a)-1(d)(4)(i).

extent that the receipts from any person or bureau of a governmental unit in any taxable year exceed the greater of $5,000 or 1 percent of an organization's total support during the taxable year. As an overriding limitation, all receipts from disqualified persons, as defined in Section 4946 (substantial contributors, foundation managers, and certain persons and entities related to them), are excluded, except that governmental units and organizations described in Section 509(a)(1) are not considered to be disqualified persons, regardless of the percentage of their grants and contributions to the organization's total support.[100]

Second, the organization must normally receive not more than one-third of its support in each taxable year from the sum of its gross investment income (as defined in Section 509(e)) and the excess, if any, of the amount of its unrelated business taxable income (as defined in Section 512) over the amount of tax imposed on that income by Section 511.[101]

Many organizations with dues-paying members may qualify under Sections 170(b)(1)(A)(vi) and 509(a)(1), and Section 509(a)(2), and, in such a case, the organization generally will be treated as a public charity under Section 509(a)(1).[102] The two tests under Section 509(a)(2) are designed to ensure that an organization is responsive to the general public rather than to a limited number of donors or other persons.[103]

[a] Definition of Support

In computing whether an organization meets the one-third support test of Section 509(a)(2)(A), the organization's total support (as defined in Section 509(d)) is the denominator of a fraction. Section 509(d) defines "support" as including, but not limited to, the following:

1. Gifts, grants, contributions, or membership fees;
2. Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity that is not an unrelated trade or business;
3. Net income from unrelated business activities, whether or not regularly carried on as a trade or business;[104]
4. Gross investment income (as defined in Section 509(e));
5. Any tax revenues levied for the benefit of the organization and either paid to or expended on behalf of the organization; and
6. The value of services and facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit to the organization without charge. Section 509(d) specifically excludes from the term "support" both (a) gain from the sale or other disposition

[100] IRC §509(a)(2)(A). *See* Reg. §1.509(a)-3(b) and (g)(2).
[101] IRC §509(a)(2)(B).
[102] Reg. §1.509(a)-6.
[103] Reg. §1.509(a)-3(a)(4).
[104] Net income means net of all deductible expenses and taxes imposed by §511. *See* §509(a)(2)(B)(ii).

of property, which would be a capital gain; and (b) the value of exemption from federal, state, or local taxation.[105]

[b] Public Support Test

The numerator of the support fraction, or the amount of the organization's support, is the amount of support received from:

1. Gifts, grants, contributions, or membership fees; and
2. The gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in an activity that is not an unrelated trade or business under Section 513. The public support in this second category is subject to the further limitation that if such receipts from any person or any bureau or similar agency of a governmental unit (as defined in Section 170(c)(1)) in any taxable year exceed the greater of $5,000 or 1 percent of the organization's total support, such excess is excluded from the numerator (but not the denominator) of the fraction.[106]

Support from both of these sources is includible in the numerator of the fraction only to the extent it comes from "permitted sources."[107] Persons (other than disqualified persons defined in Section 4946(a)(1)), governmental units described in Section 170(c)(1), and public charities described in Section 509(a)(1)[108] are permitted sources. Since disqualified persons are not permitted sources, support derived therefrom is wholly excluded from the numerator of the support fraction. Under Section 4946(a)(1)(A), a "substantial contributor" to an organization is a disqualified person and, thus, not a permitted source. Section 507(d)(2) defines a substantial contributor as a person who contributes more than $5,000 to an organization if the amount contributed exceeds 2 percent of the organization's total support during the year. If the organization is a trust, the creator of the trust is also considered a substantial contributor.

The following example derived from Regulation Section 1.509(a)-3(b)(2) illustrates the application of the one-third support test. The gross receipts referred to in the example are receipts from activities not constituting unrelated trades

[105]The term "support" also does not include amounts received in repayment of a loan made by the organization. Reg. §1.509(d)-1.

[106]IRC §509(a)(2)(A); Reg. §1.509(a)-3(a)(2), (b)(1); Rev. Rul. 75-387, 1975-2 C.B. 216.

[107]Reg. §1.509(a)-3(a)(2)(ii).

[108]In general, grants and contributions from §509(a)(1) public charities are includible in full in the numerator of the support fraction for the year in question, with exceptions for certain earmarked contributions. *See, e.g.*, Reg. §1.509(a)-3(j); Rev. Rul. 78-95, 1978-1 C.B. 71. Frequently a donor will make a contribution to a public charity that is intended to be an indirect contribution to another organization such as a new organization that has not yet received an advance ruling or determination letter. If the intended recipient received the amount as a grant from a public charity, it will be includible in full in the organization's public support under §509(a)(2)(A); if it is treated as an indirect contribution from the donor (often less a handling fee charged by the intermediate charity), and the donor is a substantial contributor (and disqualified person) with respect to the ultimate recipient, the amount will be excluded from the numerator of the support fraction.

businesses. Support from the general public in the example is support from other than disqualified persons (as defined in Section 4946) and other than persons from whom the organization receives amounts in excess of the greater of $5,000 or 1 percent of its support in any taxable year.

EXAMPLE

For the taxable year 2003, Y, an organization described in Section 501(c)(3), received support of $600,000 from the following sources:

Bureau O (gross receipts for services rendered)	$ 10,000
Bureau P (gross receipts for services rendered)	10,000
General public (gross receipts for services rendered)	150,000
General public (contributions)	40,000
Gross investment income	150,000
Contributions from substantial contributors	240,000
Total Support	$600,000

Since the $10,000 received from each bureau amounts to more than the greater of $5,000 or 1 percent of Y's support for 2003 (1 percent of $600,000 = $6,000), each amount is includible in the numerator of the one-third support fraction only to the extent of $6,000. Thus, for the taxable year 2003, Y received support from sources required to meet the one-third support test of Section 509(a)(2)(A) computed as follows:

Bureau O	$ 6,000
Bureau P	6,000
General public (gross receipts)	150,000
General public (contributions)	40,000
Total	$202,000

Therefore, in computing the support test set forth in Section 509(a)(2)(A), $202,000 is includible in the aggregate numerator and $600,000 is includible in the aggregate denominator of the support fraction. The organization passes the one-third support test of Section 509(a)(2)(A).

It is often difficult to determine whether a given item constitutes a gift, contribution, or grant, or a gross receipt from a related trade or business. The term "gross receipts" for purposes of Section 509(a)(2)(A)(ii) is an amount received from an activity that is not an unrelated trade or business if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor, rather than primarily to confer a direct benefit upon the general public.[109] A payment made primarily to enable the payor to realize or receive some eco-

[109] Reg. §1.509(a)-3(g)(2).

nomic or physical benefit as a result of the service, facility, or product obtained will be treated as a gross receipt, rather than a grant, with regard to the payee.[110] The term "grant" means a payment that is normally made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes.[111] A "gift" or "contribution" means a payment of money or transfer of property without adequate consideration.[112]

Determining whether an amount constitutes a grant or a gross receipt can be difficult. In determining whether an organization normally receives more than one-third of its support from public sources, all "grants" as defined by Section 509(a)(2)(i) received from permitted sources are includible in full in the numerator of the support fraction for each taxable year. On the other hand, "gross receipts" within the meaning of Section 509(a)(2)(A)(ii) from admissions, sales of merchandise, performance of services, or furnishings of facilities, other than from an activity that is an unrelated trade or business, are includible in the numerator of the support fraction for any taxable year only to the extent that such gross receipts do not exceed the greater of $5,000 or 1 percent of support. A grant is normally made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes.[113] Amounts received as grants are sometimes difficult to distinguish from amounts received as gross receipts from the carrying on of exempt activities.

The term "gross receipts" means amounts received from an activity that is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor rather than to primarily confer a direct benefit upon the general public.[114] In general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as a "gross receipt" with respect to the payee. For example, if a tax-exempt hospital engages a tax-exempt research organization to develop a more economical system of preparing food in its cafeteria for patients, personnel, and visitors, and it can be established that a for-profit hospital might engage the same services of the same organization to provide a similar benefit for its own economic improvement, the fact would constitute evidence that the payment received by the research organization constituted a gross receipt rather than a grant.

The regulations contain the following examples to illustrate these rules:[115]

EXAMPLE 1

M, a nonprofit research organization described in Section 501(c)(3), engages in some contract research. It receives funds from the government to develop a specific electronic device needed to perfect articles of space equip-

[110] *Id.*
[111] Reg. §1.509(a)-3(g)(1).
[112] Reg. §1.509(a)-3(f).
[113] Reg. §1.509(a)-3(g)(1).
[114] Reg. §1.509(a)-3(g)(2).
[115] Reg. §1.509(a)-3(g)(3), Examples 1, 2, 5.

ment. The initiative for the project came solely from the government. Furthermore, the government could have contracted with profit-making research organizations that carry on similar activities. The funds received from the government for this program are gross receipts and do not constitute "grants" within the meaning of Section 509(a)(2)(A)(i). M provided a specific product at the government's request and thus was serving the direct and immediate needs of the payor within the meaning of [the regulations].

EXAMPLE 2

N is a nonprofit educational organization described in Section 501(c)(3). Its principal activity is to operate institutes to train employees of various industries in the principles of management and administration. The government pays N to set up a special institute for certain government employees and to train them over a two-year period. Management training is also provided by profit-making organizations. The funds received are included as "gross receipts." The particular services rendered were to serve the direct and immediate needs of the government in the training of its employees within the meaning of [the regulations].

EXAMPLE 3

Q is an organization described in Section 501(c)(3) that carries on medical research. Its efforts have primarily been directed toward cancer research. Q sought funds from the government for a particular project being contemplated in connection with its work. In order to encourage its activities, the government gives Q the sum of $25,000. The research project sponsored by government funds is primarily to provide direct benefit to the general public, rather than to serve the direct and immediate needs of the government. The funds are therefore considered a "grant."

A skilled nursing service provider, intermediate care facility, or similar health care provider should qualify for status as a public charity under Section 509(a)(2) instead of Section 170(b)(1)(A)(vi). Under Revenue Ruling 83-153,[116] Medicare and Medicaid payments to health care organizations were ruled to constitute exempt function income under Section 509(a)(2)(A), and, thus, receipts for services provided to each individual patient would be includible as gross receipts to the extent of the greater of the $5,000 or 1 percent test on a per patient basis. On the other hand, the same ruling concluded that as gross receipts from an exempt function activity, those payments would be excluded entirely from the support calculation

[116] 1983-2 C.B. 48.

under Section 170(b)(1)(A)(vi). Therefore, a nursing facility providing skilled nursing services with a large number of Medicare or Medicaid patients may find status under Section 509(a)(2) easier to attain than that under Section 509(a)(1). Indeed, such an organization may not qualify under Section 509(a)(1).

[c] Gross Investment Income Test

For an organization to be excluded from private foundation status under Section 509(a)(2), it must also meet the gross investment income and unrelated business income test set forth in Section 509(a)(2)(B). An organization will meet this test only if it normally receives not more than one-third of its total support (as defined in Section 509(d)) in each taxable year from gross investment income (as defined in Section 509(e)) and from the excess of unrelated business taxable income[117] over the tax imposed on that income.[118] Therefore, the organization must construct a gross investment income fraction, of which the numerator is the sum of gross investment income and net unrelated business taxable income and the denominator is its total support.

Section 509(e) provides that the term "gross investment income" means the gross income from interest, dividends, payments with respect to securities loans, rents, and royalties, but not including any such income to the extent included in computing the tax imposed under Section 511. Section 512(a) defines the term "unrelated business taxable income" as the gross income, less deductions directly connected therewith, from any trade or business regularly carried on that is not substantially related to the exercise or performance by an organization of its function or purpose constituting the basis for its exemption under Section 501(c)(3), with certain exceptions.

The regulations provide that where the charitable purpose of an organization is accomplished through the furnishing of facilities for a rental fee or loans to a particular class of persons, such as the aged or sick, an amount received from any such person will be considered gross receipts from a related business rather than gross investment income.[119] However, if the organization also furnishes facilities or loans to persons who are not members of the class and such furnishing of the facilities does not contribute importantly to the accomplishment of the organization's exempt purposes, the support received from the latter activity will be considered rent or interest and therefore treated as gross investment income, provided it is not subject to tax under Section 511. In addition, if an organization seeking to qualify under Section 509(a)(2) receives an amount from a Section 509(a)(3) supporting organization or from a charitable trust, corporation, fund, or association, or a split-interest trust that is required by its governing instrument to distribute or that normally does distribute at least 25 percent of its adjusted net income to such organization, and such distribution normally constitutes an

[117] IRC §511.
[118] IRC §512.
[119] Reg. §1.509(a)-3(m)(1).

5 percent of such distributee's adjusted net income, such amount will retain character as gross investment income if so characterized in the possession of distributing organization.[120] Thus, such payments will not be treated as gifts contributions. If one of these organizations makes distributions to more than would-be Section 509(a)(2) organization, the amount of the gross investment come that is deemed to be distributed must be prorated among the distribu-ees.[121]

[d] Definition of "Normally"

Whether an organization is treated as a public charity under Section 509(a)(2) depends upon whether it "normally" meets both the one-third public support and the gross investment income tests.

An organization will be considered as "normally" meeting both the one-third public support and the gross investment income tests for its current taxable year and the taxable year immediately succeeding its current taxable year if, on an aggregate basis, it meets the tests for the four taxable years immediately preceding the current taxable year. After an organization meets the support tests for a computation period, it must thereafter fail the four-year tests for two consecutive taxable years before it will fail qualification under Section 509(a)(2).[122]

Under Regulation Section 1.509(a)-3(c)(1)(iv), if an organization has been in existence for at least one taxable year consisting of at least eight months but for fewer than five taxable years, it may substitute the number of years in which it has been in existence before the current year as the period for determining if it normally meets the requirements of Section 509(a)(2).

[e] Advance Rulings to New Organizations

As under Section 170(b)(1)(A)(vi), there are special rules for determining whether a new organization's sources of support will be such as to qualify it under Section 509(a)(2).

A ruling or determination letter will not be issued to an organization prior to the end of its first taxable year of at least eight months, but the organization may obtain an advance ruling or determination letter that treats the organization as a Section 509(a)(2) public charity for its first five taxable years if it can reasonably

[120] Reg. §1.509(a)-5(a)(1), (2).

[121] Reg. §1.509(a)-5(a)(1)(ii).

[122] Reg. §1.509(a)-3(c)(1)(i). There are detailed rules for excluding unusual grants and material changes in support in determining an organization's normal sources of support. Reg. §1.509(a)-3(c)(1)(ii), (3). Rev. Proc. 89-23, 1989-1 C.B. 844, sets forth rules relating to §§4942 and 4945 under which grant-making private foundations will not be responsible for substantial and material changes in the support of an organization described in §170(b)(1)(A)(vi) or §509(a)(2). Rev. Proc. 81-7, 1981-1 C.B. 621, sets forth certain requirements for a gift or grant automatically to be treated as an unusual grant and excluded from an organization's support calculation.

be expected to meet the Section 509(a)(2) tests during the advance ruling period. The advance ruling permits the organization to be treated as a Section 509(a)(2) organization for the duration of its advance ruling period, and for 90 days thereafter. If within such 90-day period the organization submits information that will allow the Service to determine whether, in fact, the requirements of Section 509(a)(2) were met during the advance ruling period, the ruling period is further extended until a final determination is made.[124]

An advance ruling or determination is not a ruling that an organization will, in fact, meet the requirements of Section 509(a)(2) during its advance ruling period. Thus, organizations that receive an advance ruling or determination letter must, at the expiration of the advance ruling period, establish their status under Section 509(a)(2) for the years covered by the advance ruling period. The Service permits an additional 90 days following the expiration of the advance ruling period within which to furnish the required information as to whether the organization "normally" met the support tests during the advance or extended advance ruling period. If an advance ruling is received, the ruling is effective (assuming the organization's exemption letter has not been revoked) for the entire period whether or not the organization, in fact, actually met the requirements under Section 509(a)(2).

For example, if a calendar year organization described in Section 501(c)(3) and formed in July 2001 can reasonably be expected to meet the one-third support and gross investment and unrelated business income test for its first five taxable years, it may receive an advance ruling or determination letter that it may reasonably be expected to qualify as an organization described in Section 509(a)(2) during such period.[125] The ruling or determination letter is effective for a five-year advance ruling period that consists of taxable years 2001 through 2005.[126] Within 90 days after December 31, 2005, the organization must submit information to show that in fact it met the requirements of Section 509(a)(2) during the advance ruling period. At any time during the five-year period, it may request a final determination of its nonprivate foundation status so long as it has completed one taxable year of at least eight months. If no prior request for a final determination is made, a final determination will be made at the end of the advance ruling p

[123]Reg. §1.509(a)-3(d)(4). The request for an advance ruling under §509(a)(2) is made on Form 1 at the same time the organization files its notice under §508(b) that it is not a private foundation. Rev. Rul. 77-115, 1977-1 C.B. 154. Form 1023 refers only to a single five-year advance ruling per in compliance with the direction in the Conference Report to the 1984 Act to extend the advance ru period to five years. *See* 1984 Blue Book at 704-05. However, the regulations under §509 have not be amended to reflect the change. The regulations provide for an initial two- or three-year advance ru period, followed by a three-year extension. Form 872-C is required to be submitted with the organi tion's Form 1023 to extend the statute of limitations for assessment of the §4940 excise tax on investment income in the event that the organization is determined not to qualify under §509(a)

[124]Reg. §1.509(a)-3(e)(2). Form 8734 is used for this purpose.

[125]Reg. §1.509(a)-3(d)(1).

[126]In order to receive an advance ruling, the organization must consent to extending the statut limitations for the assessment of the tax on investment income imposed by §4940 to one year the date otherwise imposed by law for the assessment of a deficiency for the final year of the adv ruling period. *See* Reg. §1.509(a)-3(d)(4)(i). This consent is made on Form 872-C, which must be sub ted with Form 1023.

riod. If the organization's first taxable year consists of eight months or more, it may establish Section 509(a)(2) status at the end of that year.

COMMENT

Where a new organization does not receive an advance ruling or determination under Section 509(a)(2), neither the organization nor its grantors or contributors can rely on the possibility that it will ultimately be described in Section 509(a)(2) rather than as a private foundation. In these circumstances, the organization should comply with the private foundation rules under Sections 4940-4945 before receiving an initial determination of its status under Section 509(a)(2). If the organization ultimately is found to qualify under Section 509(a)(2), any private foundation excise tax paid will be refunded and Section 509(b) (relating to continuation of private foundation status) will not apply.[127]

[C] *Section 509(a)(3) Supporting Organizations*

The third category of Section 501(c)(3) organizations exempted from private foundation status consists of those organizations described in Section 509(a)(3). Section 509(a)(3) excludes from the definition of private foundation an organization that meets the following requirements:

1. It is organized and operated exclusively[128] for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in Section 509(a)(1) or (2);
2. It is operated, supervised, or controlled by, or in connection with, one or more organizations described in Section 509(a)(1) or (2); and
3. It 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 Section 509(a)(1) or (2).

The organizations described in Section 509(a)(3) are excluded from private foundation status due to their supporting relationship to one or more organizations described in Section 509(a)(1) or (2).[129] Scrutiny of the Section 509(a)(3) orga-

[127] Reg. §1.509(a)-3(e)(4)(ii).

[128] The term "exclusively" means solely for this purpose. Reg. §1.509(a)-4(e)(1).

[129] The organization may be excepted from private foundation treatment if its supported or parent organization is exempt from taxation under §501(c)(4), (5), or (6), but would qualify as other than a private foundation under §509(a)(2) if the parent organization were exempt under §501(c)(3). §509(a)(3) (flush language); Reg. §1.509(a)-4(k). Thus, many §501(c)(6) trade associations have organized controlled §501(c)(3) affiliates that are treated as other than private foundations under §509(a)(3), to receive foundation or government grants and to obtain the other advantages afforded to §501(c)(3) organizations. Such an organization is not limited to §509(a)(3) status, however; it could qualify under either §509(a)(1) or (2) if its sources of support permit. The supported organization may be a foreign organization so long as it qualifies under §509(a)(1) or (2). Rev. Rul. 74-229, 1974-1 C.B. 142.

nization by the supported organizations is thought to prevent the abuse of the supporting organization's exempt status, which led to the provisions of the 1969 Act.[130]

Three types of relationships are contemplated under Section 509(a)(3), all of which stem from the requirement that the supporting organization be "operated, supervised, or controlled by or in connection with" the qualified supported organization. First, if an organization is "operated, supervised, or controlled by" the supported organization or, second, the organization is "supervised or controlled in connection with" the supported organization, the requisite relationship is found if the supported organization controls at least a majority of the supporting organization's governing body. The third alternative relationship, that the supporting organization be "operated in connection with" the supported organization, requires that the subordinate organization be responsive to and have significant involvement with the supported organization.[131]

If the organization is "operated, supervised, or controlled by" or "supervised or controlled in connection with"[132] a supported organization, the articles of incorporation of the supporting organization need not identify the supported organization by name so long as the supporting organization's articles of incorporation require that it be operated to support or benefit one or more supported organizations designated by class or purpose, which include (1) one or more publicly supported organizations or (2) publicly supported organizations that are closely related in purpose or function to the organizations described in (1). On the other hand, if the organization is "operated in connection with" a supported organization, the supported organization must be specified by name within the articles of organization.[133]

Each type of relationship must ensure that the supporting organization is responsive to the needs or demands of one or more publicly supported organizations and that it is an integral part of, or maintains a significant involvement in, the operations of one or more publicly supported organizations.

The distinguishing feature of a supporting organization that is "operated, supervised, or controlled by" one or more publicly supported organizations is the presence of a "substantial degree of direction" by the publicly supported organization over the conduct of the supporting organization.[134] This relationship is in the nature of a parent/subsidiary relationship. In the case of supporting organizations that are "supervised or controlled in connection with" one or more publicly supported organizations, the distinguishing feature is common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors.

In the case of a supporting organization that is "operated in connection with"

[130] Quarrie Charitable Fund v. Comm'r, 70 T.C. 182, 190 (1978), *aff'd*, 603 F.2d 1274 (7th Cir. 1979).

[131] Windsor Foundation v. U.S., 77-2 U.S.T.C. ¶9709 (E.D. Va. 1977); Reg. §1.509(a)-4(f)(4).

[132] For a discussion of §509(a)(3) upstream parents in hospital reorganizations under the "operated in connection with" test, *see* GCM 39508 (June 2, 1986).

[133] Reg. §1.509(a)-4(d)(2), (4).

[134] Reg. §1.509(a)-4(f)(4).

one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to and significantly involved in the operations of the publicly supported organizations.[135]

The Tax Court interpreted the term "operated in connection with" as set forth in Section 509(a)(3) in *Cockerline Memorial Fund v. Commissioner*.[136] The organization was a testamentary trust under which the income was to be used to furnish scholarships for residents of a particular state who attended in-state colleges and universities. Preference was to be given to students attending a particular school. The president of that school was a member of the board of trustees of the trust. Each member of the board of trustees of the trust was a member of a church that supported the favored school. The board of trustees had total control over and responsibility for the organization's activities. During the years at issue the favored school received an average of two-thirds of all grants made by the trust.

The court held that the trust met the requirements to be considered "operated in connection with" a publicly supported organization. The court noted that the regulations require that the supporting organization under this relationship must generally meet a "responsiveness test" and an "integral part test."[137] The responsiveness test is intended to ensure that the supported organization has the ability to influence the activities of the supporting organization. The court determined that the presence of a common member on the governing bodies of both organizations met this test. The responsiveness test also requires that the supported organization have a significant voice in the policies of the supporting organization and in otherwise directing the use of the income. In this case, that test was met, the court concluded, since the favored school dominated the scholarship committee of the trust. The trust also met the "integral part" test, the court stated, since it paid substantially all of its funds to the favored school and the amount paid to that school was sufficient to ensure its attentiveness to the supporting organization's activities.

In *Roe Foundation Charitable Trust v. Commissioner*,[138] the "operated in connection with" requirement was also discussed. In this case, the organization intended to supply financial assistance to low-income individuals in a particular state. The organization would choose recipients of its financial assistance based on referrals from churches and other charitable organizations. The Tax Court held that the organization was not operated in connection with a public charity under Section 509(a)(3)(B). There was no historic and continuing relationship created with any public charity under its governing document, and none was specified with particularity.

Section 509(a)(3) is intended to relieve certain subordinate organizations from private foundation treatment due to their close relationship to a qualified public charity. For instance, if a large public charity operated an annual fund-raising event, such as a charity ball, for liability purposes it may incorporate a separate

[135] *Id.*

[136] 86 T.C. 53 (1986).

[137] Reg. §1.509(a)-4(i)(1).

[138] T.C. Memo 1989-566.

nonprofit organization to conduct the event. But for Section 509(a)(3), the supporting organization may encounter difficulty qualifying under Section 509(a)(1) or (2) as other than a private foundation.

[D] Section 509(a)(4) Organizations

Under Section 509(a)(4), organizations that are organized and operated exclusively for testing for public safety are excepted from private foundation treatment. The 1965 Report recommended that such organizations be excluded apparently because contributions to such organizations did not and do not qualify as a deductible charitable contribution under Section 170(c)(2). No other reason is known for this special exclusion. The Treasury Department's own files contain only scant information on Section 509(a)(4), and the Section 509 regulations, which are otherwise fantastically detailed and intricate, only briefly mention Section 509(a)(4).[139]

§2.03 PRIVATE FOUNDATIONS GENERALLY

Section 509(a) defines a private foundation as any organization described in Section 501(c)(3) other than those organizations described in Section 509(a)(1) through (4). The 1969 Act imposed significant operating restrictions on private foundations. Among these restrictions are the following:

1. A tax of 2 percent (1 percent under certain circumstances) of the net investment income of a private foundation (other than an exempt operating foundation) for the taxable year is imposed under Section 4940(a);
2. Section 4941 imposes a tax on various acts of self-dealing;
3. Section 4942 imposes minimum requirements for distribution of a private foundation's income;
4. A private foundation is prohibited from retaining excess business holdings under Section 4943;
5. A tax is imposed by Section 4944 on a foundation's investment of its assets in such a manner that jeopardizes the carrying out of its exempt purposes;
6. Certain restrictions are imposed upon a private foundation's expenditures under Section 4945; and
7. Section 507 imposes a tax upon the termination of an organization's status as a private foundation unless it meets certain requirements.

Private foundation excise taxes are discussed more fully in Chapter 6.

[139] Reg. §1.509(a)-1.

§2.04 ADVANTAGES TO CLASSIFICATION AS A PUBLIC CHARITY

Public charities described in Section 509(a)(1)-(4) enjoy the following advantages that are not available to private foundations:

1. Public charities are not subject to the tax on net investment income and the regulatory excise tax provisions imposed by Sections 4940-4945;
2. Public charities (other than Section 509(a)(4) organizations that test for public safety, and foreign organizations) are "50 percent charities" for purposes of the Section 170 charitable contribution deduction;
3. Public charities, which file an annual Form 990, are not required to submit the same detailed information required of private foundations on Form 990-PF;[1]
4. Public charities are not subject to the tax on the termination of private foundation status (Section 507(a));
5. Certain small public charities need not file Form 990 or may file Form 990-EZ, whereas private foundations must file a Form 990-PF regardless of size;[2] and
6. Public charities are eligible to make a limited amount of lobbying expenditures, whereas private foundations may make none.[3]

§2.04. [1]*See* IRC §6033(a), (b).
[2]IRC §6033(a)(2)(A)(ii).
[3]*See* IRC §501(h).