IRS Exempt Organizations Continuing Professional Education for the Fiscal Year 2001

TABLE OF CONTENTS

TOPIC D - UPDATE ON HEALTH CARE

1. Introduction
2. Unrelated Business Income
3. Health Maintenance Organization (HMOs)
4. Section 4958 (Intermediate Sanctions)

TOPIC E - COLLEGE HOUSING

1. Introduction
2. Common Fact Pattern
3. Current Law
4. Discussion
5. Other Issues

TOPIC F - TRUST PRIMER

Introduction

PART I -- BASIC TRUST PRINCIPLES

1. Overview
2. Purpose of the Trust
3. Tax Law Concepts

PART II -- IRC 4947

1. IRC 4947(a)(1) Trusts
2. IRC 4947(a)(2)
3. Charitable Remainder Trusts, IRC 664
4. Tax Benefits of Charitable Remainder Trusts
5. Charitable Lead Trust
6. Pooled Income Fund
7. 4947(a)(1) and (a)(2) the Private Foundation Issues

PART III -- UBI

PART IV -- ESTATE ADMINISTRATION

1. An Exception to Self-dealing
2. A Clarifying Point
3. An Act of Self-dealing
4. Rockefeller v. U.S., constitutionality confirmed
5. Estate of Reis, gives a broad reading to 4941

PART V -- TERMINATION OF AN ESTATE ISSUES FOR TRUSTS AND ESTATES

1. 4947(a)(1)
2. 4947(a)(2)

PART VI – TRUSTS AND IRC 509(a)(3)

PART VII -- FILING REQUIREMENTS

1. Filing Requirements
2. Exempt Charitable Trusts
3. Pooled Income Funds under 642(c)(5)
4. Charitable Trusts under 642(c)(6)
5. Charitable Remainder Trusts under 664

6. Nonexempt Charitable Trusts under 4947(a)(1)
7. All other section 4947(a)(2) trusts treated as private foundations

PART VIII -- CURRENT TRUST ISSUES

1. Accelerated Trusts
2. Vulture Trusts

TOPIC G - CONTROL AND POWER: ISSUES INVOLVING SUPPORTING ORGANIZATIONS, DONOR ADVISED FUNDS, AND DISQUALIFIED PERSON FINANCIAL INSTITUTIONS

1. Introduction
2. IRC 509(a)(3) Supporting Organizations
3. Donor Advised Funds -- Power and Control Issues
4. Update on IRC 4941 -- Foundation Manager Bank's Use of Private Foundation Funds to Further Bank's Commercial Endeavors
5. Update on IRC 4940 Treatment of Distributions From Charitable Lead Trusts
6. Charitable Family Limited Partnerships
7. SOCheck on IRC 509(a)(3) -- A Checksheet Guide To Status Determinations
   SOCHECK (Checksheet Questionnaire for IRC 509(a)(3) Supporting Organizations Determinations)

TOPIC H - PRIVATE BENEFIT UNDER IRC 501(c)(3)

1. Introduction
2. Private Benefit -- Code and Regulations
3. Private Benefit and the Application Process
4. Private Benefit - Defined
5. Private Benefit in the Real World

TOPIC I - STATE CHARITABLE SOLICITATION STATUTES

1. Introduction
2. Charitable Organization Registration Requirements
3. Professional Solicitor and Fundraising Counsel Requirements
4. The Unified Registration Statement
5. Internet Solicitations
6. Prohibited Conduct
7. Conclusion

PART II

Current Developments

CUMULATIVE INDEX
Exempt Organizations Revenue Procedures

PART I - EXEMPT ORGANIZATIONS TECHNICAL TOPICS

A. TITLE HOLDING COMPANIES - by Ron Fowler, William W. Miller and Cheryl Chasin

INTRODUCTION

Since 1916 the tax code has provided for exemption of title holding companies. Committee reports reflect that Congress provided for exemption of title holding companies to overcome state law obstacles against the direct holding of title to property by exempt organizations. Title holding companies hold title to property on behalf of other exempt organizations, including pension trusts. One of the major reasons a tax exempt organization forms a title holding company is to protect itself from tort liability.

Currently, title holding companies are recognized as exempt under either IRC 501(c)(2) or under IRC 501(c)(25). IRC 501(c)(2) provides for recognition of exemption of single-parent title holding companies, whereas IRC 501(c)(25) describes multiple- parent title holding companies.

Prior CPE articles on title holding corporations include 1986, Topic C, IRC 501(c)(2) Title holding Corporations; 1989, Topic F, Update on Title holding Organizations; 1995, Topic C, IRC 501(c)(25)(E) -- Qualified Subsidiaries; and 1995, Topic D, Update on OBRA '93. The purpose of this article is to update and summarize the information provided in earlier articles, to identify issues arising in current cases, and to compare and contrast the provisions of IRC 501(c)(2) and 501(c)(25).

PART I -- IRC 501(c)(2)

1. ORGANIZATIONAL OBLIGATIONS

IRC 501(c)(2) describes "corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section. Rules similar to the rules of subparagraph (G) of paragraph (25) shall apply for purposes of this paragraph." The first sentence of this paragraph is substantially the same as the initial enactment in the Revenue Act of 1916. The second sentence, which permits receipt of otherwise disqualifying unrelated business income incidentally derived, was added in 1993 by P. L. 103-66.

The regulations under IRC 501(c)(2) deal largely with various issues related to unrelated business income of title holding corporations. Reg. 1.501(c)(2)-1(a) notes that since a corporation described in section 501(c)(2) cannot be exempt if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income as defined in section 512 other than certain special categories of unrelated business taxable income. The regulations, however, have not been updated to reflect the statutory changes in the second sentence of IRC 501(c)(2). There are, therefore, additional exceptions to the more general prohibition on unrelated business income. These exceptions are discussed in the section of this article dealing with unrelated business income.

Reg. 1.501(c)(2)-1(b) provides that a corporation described in section 501(c)(2) cannot accumulate income and retain its exemption, but it must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a).

The statute uses the term "corporation". Under IRC 7701(a)(3), this includes associations. This also includes business or commercial trusts classified as associations. An IRC 501(c)(2) organization cannot be an ordinary trust within the meaning of section 301.7701-4(a).

Organizations seeking exemption under IRC 501(c)(2) must be "organized for the exclusive purpose" of holding title to property and collecting income therefrom. An organization's purposes can be established by reviewing its activities, the actual language in the organizational documents and all events surrounding the incorporation of the organization. Any language in the organizational documents that empowers the organization to engage in any other business would be evidence that the organization was not formed for the "exclusive purpose" required by the statute. In a situation where the organizational documents are outside the purview of the "exclusive purpose" language, but the organization's activities appear to be permissible, the organization will be given an opportunity to amend the language to comply with the statute.

An IRC 501(c)(2) organization does not necessarily have to be a NONPROFIT corporation under state law. As long as the organizational documents do not impose any broad powers outside of holding title to property, collecting income, and turning over the income to an organization exempt under section 501(a), the requirements of the section will be satisfied.

Rev. Rul. 58-566, 1958-2 C.B. 261, describes an organization incorporated under state law with authority to acquire real and personal property; to construct, conduct, and operate buildings of all kinds for the accommodation of the public and of individuals, whether or not such buildings were the property of the organization; to conduct a general real estate business; to buy, sell, deal and trade in mortgages on or interest in real estate; and to acquire, deal in, pledge and dispose of shares of the capital stock, other securities, obligations and evidences of indebtedness issued by any corporations, syndicates, associations, firms, trusts or persons, public or private. The ruling concluded that that the corporation was not organized for purposes specified in section 501(c)(2) of the Code since its broad powers and business purposes are far beyond the scope necessary to a holding company.

2. PERMITTED PARENTS

The phrase "under this section" in IRC 501(c)(2) refers to organizations exempt under IRC 501(a) and therefore includes pension trusts described in IRC 401(a) and exempted by 501(a). Thus, a pension trust is an acceptable recipient for the income of an IRC 501(c)(2) organization. Also, a 501(c)(2) organization is itself an acceptable parent for another 501(c)(2) organization; see Rev. Rul. 76-335, 1976-2 C. B. 141.

The following GCM illustrates one application of this principle. GCM 38253 (dated January 23, 1980) involved a title holding company whose sole shareholder was an IRC 401(a) group trust recognized as exempt under IRC 501(a). The trust was composed of and controlled by eleven other pension and profit sharing trusts that were all exempt under IRC 401 and IRC 501(a). The title holding company and group trust were both created by a for-profit corporation that provided investment advice, handled the acquisition of real property and provided property management services. An agreement called the Group Trust Agreement existed which stated that the purpose of the Group Trust is to provide the individual investor- trusts with a medium for the pooling of their property in order that these funds may be economically diversified and thereby increase the ability of the individual investor-trusts to carry out their purposes. The GCM concluded that a corporation could be recognized as exempt under IRC 501(c)(2) when a group trust owns the corporation's common stock because the group trust itself constitutes a single tax- exempt parent.

Although it may seem obvious that the parent must maintain its exemption for the title holding corporation to continue to qualify, this specific issue was considered in Rev. Rul. 68-371, 1968-2 C.B. 204. This revenue ruling described a situation in which a title holding corporation was organized and

operated for the exclusive purpose of holding title to real property, collecting income therefrom, and turning over the entire amount thereof, less expenses, equally to two organizations that were exempt under IRC 501(a). At the end of the third year of operation of the title holding corporation, one of the organizations to which it was required to make distributions of income ceased to qualify for exemption under IRC 501(a). However, the title holding corporation continued to make distributions of income to both organizations. This ruling concluded that after the third year of operation, the title holding corporation did not comply with the statute because it did not turn over its entire income less expenses to organizations exempt under IRC 501(a), since one of the two organizations to which it distributed its income had ceased to qualify for such exemption. Therefore, the title holding corporation did not continue to qualify for exemption beyond its third year of operation.

In Rev. Rul. 68-371, the title holding corporation had two parents. However, the revenue ruling should not be interpreted as permitting multiple unrelated parents. It is not clear from the facts as stated in the ruling what relationship, if any, existed between the two parents, or whether the two parents occupied the property in question. See the discussion of GCM 37351, below.

What if the parent is a church or a pre-1969 organization excepted from the requirement that it apply for tax exemption? We cannot require an organization to formally apply for exemption if it is otherwise specifically excepted from the requirement. However, we would need to secure sufficient information regarding the parent to determine that it would qualify for exemption if it applied. If the parent is not excepted from the application requirement, or it claims exemption under a Code section other than IRC 501(c)(3), it should be required to demonstrate that it has received a favorable ruling or determination letter.

3. REQUIRED RELATIONSHIP

The statute does not specify the relationship required between a title holding corporation and the exempt organization receiving its income. Traditionally, the relationship is parent and subsidiary, i.e. the exempt organization owns the title holding corporation.

This traditional view was made explicit in Rev. Rul. 71- 544, 1971-2 C.B. 227. In that case, a group of philanthropists organized a non-profit corporation to which they transferred income- producing stocks and securities. The purpose of the organization was to hold title to stocks and securities and at the end of each year to turn over its income, less expenses, to an exempt organization selected by its board of directors. The stock of the title holding corporation was owned by the group of philanthropists. The stock conferred no rights on the shareholders to receive dividends or to participate in liquidating distributions. The ruling invoked the Cambridge doctrine to conclude that Congress intended that a relationship similar to that of a parent and subsidiary exist between an exempt organization and its title holding corporation. [Note: The "Cambridge doctrine" is a basic rule of statutory construction, under which Congress is presumed to have employed words according to their legal significance at the time of the enactment of the particular provisions in which they are used. U.S. v. Cambridge Loan and Building Company, 278 U.S. 55 (1928)]

Control by the same individuals who control the exempt parent would also appear to be permissible. In Rev. Rul. 68-222, 1968-1 C.B. 243, a stock corporation was organized and operated for the purpose of holding title to a chapter house of a college fraternity exempt under IRC 501(c)(7). The stock of the corporation was owned by the members of the fraternity, who had no rights to receive profits. The ruling concluded that the ownership of the stock by the fraternity's members did not preclude exemption under IRC 501(c)(2) provided all the income, less expenses, would be paid over to the fraternity.

4. THE MULTIPLE PARENT MAZE

GCM 37351 (dated Dec. 20, 1977), considered the circumstances in which an IRC 501(c)(2) organization could have multiple parents. In this GCM, the title holding corporation was organized and incorporated by employees of a real estate investment fund to operate as a closed end real estate investment trust in which exempt organizations, primarily employee benefit pension trusts under IRC 401(a), would be solicited to engage in investments. The employees of the Fund personally solicited the management of qualified employee pension trusts to purchase or subscribe to the shares of the Fund. Once the required number of shares was issued, the Fund sought to purchase improved real estate property, including office buildings, shopping centers, and light industrial and warehouse properties. Income from the rental of the real property was paid to the Fund's shareholders.

The Service concluded that a corporation whose stock was owned by several unrelated exempt organizations was not a title holding company within the meaning of IRC 501(c)(2) because the multiple parents evidenced pooling of assets for a cooperative venture, which altered the fundamental character of the corporation from mere holding title to property on behalf of a charitable organization to the active conduct of a trade or business. Consequently, the purpose of the organization and the end to which its resources were dedicated was the conduct of investment activities and the maximization of gains and profits for the financial benefit of the investing charities, not as beneficiaries of a charity or charitable trust, but as owners and investors. Therefore, the title holding company was being used for purposes not contemplated by Congress.

This GCM also discussed exceptions to the general rule that an IRC 501(c)(2) organization may have only one parent. Multiple parents may be allowed if related organizations create a title holding company to hold title to a building used at least in part by the organizations themselves. Multiple parents may also be allowed when unrelated organizations that jointly own real property used in part by such organizations transfer their interests in this property to a title holding corporation they create.

GCM 39460 (dated September 12, 1985) described another multiple parent situation. In this case, five hospitals, all exempt under IRC 501(c)(3), created a title holding corporation to hold shares of stock in a company which reinsured various types of insurance. The hospitals were all members of a 501(c)(6) organization. The GCM concluded that this common membership was not a relationship that would bring the title holding corporation within the limited exception discussed in GCM 37351. The second exception, regarding jointly owned real property, likewise did not apply because the property transferred to the title holding corporation was stock, not real property.

5. PERMISSIBLE PROPERTY AND ALLOWABLE ACTIVITIES

The statutory language makes clear that IRC 501(c)(2) organizations are strictly limited to holding title to property and collecting the income therefrom. They generally may not, with certain exceptions discussed below, have income from an unrelated trade or business. Investments in stocks, bonds, certain types of oil and mineral interests, and real estate are all traditional and generally permissible sources of income for IRC 501(c)(2) organizations. A title holding corporation may also hold an interest in a limited partnership, but see the discussion of GCM 39597, below.

Permitting title holding corporations to invest in real estate implies that they can earn income by renting this real estate to the general public. Rev. Rul. 69-381, 1969-2 C.B. 113, describes a corporation that holds title to a building containing offices that are rented on annual leases to the general public. It collects the rents, pays the expenses incident to operation and maintenance of the building, and turns over the remainder to its parent, a charitable organization exempt from Federal income tax under section 501(c)(3) of the Code. The title holding company renders no substantial services to the tenants other than normal maintenance of the building and grounds. The tenants are not related in any way to the title holding company or the charitable organization for which it holds title. The revenue ruling concludes

that income from renting offices to the general public does not preclude exemption under IRC 501(c)(2). Under the facts stated, this organization qualifies for exemption from Federal income tax under IRC 501(c)(2). Note that the title holding corporation itself collected the rent, paid the expenses, and provided normal maintenance services. There is no requirement that a title holding corporation hire a management company to carry out these activities.

Regarding oil and mineral interests, only non-working interests are permitted. A working interest, in which the holder of the interest is responsible for a portion of the operating costs of oil or mineral production, is not a permissible holding for a 501(c)(2) organization. See Rev. Rul. 66-295, 1966-2 C. B. 209.

Renting personal property independent of real estate has consistently been treated as the conduct of a trade or business. Rev. Rul. 69-278, 1969-1 C. B. 148, describes a title holding corporation renting real estate and trucks under separate, unrelated leases. There was no direct relation between the rental of the building and the rental of the trucks, even though the lessees were the same. The income from truck rentals was a substantial part of the title-holding corporation's net earnings. The title holding corporation did not qualify for exemption because it was engaged in the business of renting personal property.

However, even an otherwise permissible activity such as renting real property to the general public is not allowed if the activity could not be carried on by the title holding corporation's exempt parent. In U.S. v. Fort Worth Club of Fort Worth, Texas, 345 F. 2d 52, modified and reaffirmed 348 F. 2d 891 (1965), the 5th Circuit Court of Appeals upheld the revocation of the Club's exemption under IRC 501(c)(7). The Club created a wholly-owned subsidiary to hold title to its building. The Club used seven of the thirteen floors for its social activities. The remaining floors were leased to commercial tenants, from which activity the Club derived a substantial amount of income. The court concluded that the Club was not exempt because it derived "substantial and recurrent profit from a business altogether unrelated to its activities as a social club."

Because its activities must consist solely of holding title to property and collecting income therefrom, a title holding corporation generally cannot have unrelated business taxable income. However, Reg. 1.501(c)(2)-1(a) provides certain exceptions. Further, as noted above, the regulation has not been updated to reflect the liberalization in the rule for otherwise disqualifying unrelated business income, incidentally derived, in the second sentence of IRC 501(c)(2). These provisions, however, refer only to the effect on the title holding corporation's exemption. They do not affect the taxability of the income in question. If a title holding corporation has unrelated business income from sources other those described below, it does not qualify for exemption under IRC 501(c)(2).

The first exception is for income taxable solely because of IRC 512(a)(3)(C). This section describes title holding corporations whose exempt parents are described in IRC 501(c)(7), (c)(9), (c)(17), or (c)(20) and are subject to the special rules of IRC 512(a)(3), which treat all non-member income as taxable. [Note: IRC 501(c)(20) has expired. However, IRC 512(a)(3) has not been amended to remove the reference to IRC 501(c)(20).] Such a title holding corporation is therefore taxable on income (such as investment income) it receives from non-member sources. Absent the exception in Reg. 1.501(c)(2)-1(a), such a title holding corporation could never qualify for exemption. However, if the title holding corporation's gross receipts, combined with a 501(c)(7) parent's other non-member gross receipts, exceed the 35% limit, the parent will no longer qualify for exemption.

The second exception is for debt-financed income taxable solely because of IRC 514. Such income, while still taxable, will not cause the loss of the title holding corporation's exemption. Note that indebtedness owned by the title holding corporation to its exempt parent is not acquisition indebtedness for purposes of IRC 514 (see Rev. Rul. 77-72, 1977-1 C.B. 157). However, the exclusion from acquisition indebtedness set forth in IRC 514(c)(9) does not apply to IRC 501(c)(2) organizations even if

the 501(c)(2)'s parent is a qualified organization for purposes of IRC 514(c)(9). See the discussion in the second part of this article with respect to IRC 501(c)(25) for further details.

The third exception is for investment income taxed solely because of IRC 512(b)(3)(B)(ii). This section pertains to income from leases where the amount of the rent depends on the net income or profits from the leased property. Note that a lease based on a fixed percentage of gross receipts or sales does not result in taxable income.

The fourth exception is for investment income taxed solely by reason of IRC 512(b)(3). This section pertains to interest, annuities, royalties, and rents received from controlled entities.

The fifth category of exceptions deals with rents received from personal property leased with real property. IRC 512(b)(3)(A)(ii) excludes from the definition of unrelated business income rents from personal property leased with real property if the amount of the rent attributable to the personal property is incidental compared to the total rent received. "Incidental" here means 10% or less of the total rent. If the rent allocated to the personal property exceeds 10% of the total, then it is taxable as unrelated business income. A title holding corporation can receive this type of unrelated business income without jeopardizing its exemption.

Similarly, IRC 512(b)(3)(B)(i) provides that if personal property is leased in connection with real property and more than 50% of the rent is attributable to the personal property, all the rental income (not just the portion attributable to personal property) is taxable as unrelated business income. A title holding corporation can also receive this type of unrelated business income without jeopardizing its exemption.

A final permissible form of unrelated business income for title holding corporations was established by the amendment of IRC 501(c)(2) in 1993 by the Omnibus Budget Reconciliation Act (OBRA). For tax years beginning on or after January 1, 1994, a title holding corporation may receive up to 10% of its gross income from unrelated business income incidentally derived from the holding of real property without jeopardizing its exempt status. Examples of the type of income referred to include income from vending machines, laundry facilities, and parking facilities. This income remains taxable, but will not result in the loss of exemption. See the second sentence of IRC 501(c)(2) and the section to which it refers, IRC 501(c)(25)(G), added by P.L. 103-66, section 13146(b).

The rulings regarding permissible unrelated business income are more complex when a title holding corporation owns an interest in a partnership. In GCM 39597 (June 17, 1986), the Service considered the exempt status of a title holding corporation whose sole property consisted of a limited partnership interest in an investment partnership. In the year under consideration, the investment partnership received approximately 3% of its income from activities other than trading for its own account. The GCM concluded that each of these activities was an unrelated trade or business, under the general definition of the term, with respect to the title holding corporation. None of the income flowing from these activities to the title holding corporation was unrelated business income described in Reg. 1.501(c)(2)-1(a). The GCM declined to allow a de minimis exception, and exemption under IRC 501(c)(2) was precluded. This holding would not change as a result of the OBRA amendment of IRC 501(c)(2) because the income in question here is not incidental to the rental of real property.

GCM 39597 goes on to say that absent the prohibited unrelated business income, the title holding corporation would qualify for exemption. Though IRC 512(c) uses the partnership's activity to determine the character of income at the partner level, it does not impute the partnership's activity to the individual partners. In the case of a limited partner who has no management role in the partnership and whose status is solely that of an investor, exempt status under IRC 501(c)(2) is appropriate.

6. DISTRIBUTIONS DEMANDED

Reg. 1.501(c) (2)-1(b) states that a corporation described in IRC 501(c)(2) cannot accumulate income and retain exemption, but must turn over its entire income, less expenses, to an organization exempt under section 501(a). The timing of this distribution is not defined in the Code or regulations. As a practical matter, it would seem reasonable to allow the title holding corporation until the end of the succeeding taxable year to make the distribution. Such a rule of thumb would provide ample time for normal accounting and other administrative procedures by the title holding corporation. The form of the distribution is not important, but payment must actually be made, not merely accrued. Allowing the parent rent free use of the facilities is also a permissible form of distribution.

In computing the amount required to be distributed, the title holding corporation may deduct operating expenses that would be deductible by a taxable corporation. This includes a reasonable allowance for depreciation as discussed in Rev. Rul. 66-102, 1966-1 C.B. 133 and payments to retire indebtedness as discussed in Rev. Rul. 67-104, 1967-1 C. B. 120.

7. HOW NOT TO STRUCTURE A TITLE HOLDING CORPORATION

M Realty Corporation's articles of incorporation stated that the organization was formed to "take, buy, purchase, exchange, hire, lease or otherwise acquire real estate and property, either improved or unimproved, and any interest or right therein, and to own hold, control, maintain, manage and develop the same." The shares of stock in M were held by three organizations: a church, an association and a community center. The community center was organized before 1969. The association was exempt under IRC 501(c)(4). Neither the church nor the community center had applied for or received recognition of exempt status. No information was provided as to any relationships among the three parent organizations.

The property held by M consisted of real property and investments in stocks and bonds. The primary source of income consisted of the rental of real property. The property was 100% occupied and rented by commercial and residential tenants unrelated to M or M's parents.

For the three years for which financial information was provided in M's application for exemption, M had net income of approximately $100,000, $230,000, and $210,000. In each year, M paid approximately $5,000 to each of its parent organizations. These distributions were characterized as charitable contributions. These distributions amounted to 1%, 6% and 7% of M's net income for those years.

First, in analyzing this case, M's articles of incorporation provided, in part, that it will manage and develop property. These purposes are not limited to holding title to property, collecting income therefrom and turning over the net income to a qualified shareholder. M does not meet the organizational requirements of IRC 501(c)(2) because it was incorporated with broad powers and business purposes far beyond the scope necessary to a title holding company. Compare the language to that used in Rev. Rul. 58-566, discussed above.

M failed to turn over its income less expenses to organizations exempt under IRC 501(a). The financial information submitted indicated that M distributed only $5,000 to each shareholder for each year in question. These amounts were not sufficient so as to be classified as income distributions. Moreover, M had substantial accumulated retained earnings of $2,700,000. These accumulated earnings demonstrate the non-distribution of net earnings from operations in prior years.

It appears that the parent organizations in M's case may be related, although the point is not certain. However, M's real property is not used by the parent organizations in their exempt activities, and M also holds stocks and bonds. Thus, M does not fall within either of the narrow exceptions to the rule against multiple parents discussed in GCM 37351, above.

Finally, two of M's three parents, the church and the pre- 1969 community center, do not have favorable ruling or determination letters. While they are excepted from the filing requirements imposed by IRC 508, it would still be necessary for M to provide enough information to establish that they are described in IRC 501(c)(3) before M could receive a favorable ruling under IRC 501(c)(2).

PART II – IRC 501(c)(25)

IRC 501(c)(25), subparagraphs (A) through (D), was enacted in the Tax Reform Act of 1986 by P. L. 99-514, section 1603, and was modified by the Technical and Miscellaneous Revenue Act of 1988, P. L. 100-647, section 1016(a), modifying IRC 501(c)(25)(A) and (D) and adding IRC 501(c)(25)(E) and (F). Finally, IRC 501(c)(25) was amended last in 1993 in the Omnibus Budget Reconciliation Act, P. L. 103-66, section 13146, which added IRC 501(c)(25)(G).

In enacting IRC 501(c)(25), Congress allowed certain pension trusts, governmental entities and IRC 501(c)(3) organizations wider latitude to pool their resources in their real property investments than permitted for IRC 501(c)(2) title holding companies. Even though the purpose of IRC 501(c)(25) was to recognize title holding companies with multiple parents as exempt from federal tax, the vast majority of IRC 501(c)(25) applicants have a single parent. Although no regulations have been issued under this Code section, the Service has published Notice 87-18, 1987-1 C.B. 455 and Notice 88- 121, 1988-2 C.B. 457 to provide guidance in this area. Notice 87-18 essentially requires that most of the statutory requirements be included in the title holding company's organizing document. Notice 88-121 clarified permissible holdings and unrelated business income issues. The provisions of both Notices will be discussed in detail in the appropriate sections of this article.

1. ORGANIZATIONAL OBLIGATIONS

IRC 501(c)(25)(A) describes multiple-parent title holding companies that are either corporations or trusts (unlike IRC 501(c)(2) title holding companies, which may not be ordinary trusts) that have no more than 35 shareholders or beneficiaries, have only one class of stock or beneficial interest, and are organized for the exclusive purposes of acquiring, holding title to, and collecting income from, real property, and remitting the entire amount of income from such property (less expenses) to one or more organizations described in section 501(c)(25)(C) which are shareholders or beneficiaries of title holding companies. Notice 87-18 requires that language satisfying these requirements be included in the title holding company's organizing document. Although an IRC 501(c)(25) title holding company may be a trust, such entities are rare. In the remainder of this article we will refer to corporations, but keep in mind that trusts are included as well.

Many IRC 501(c)(25) applicants are formed under general corporation laws and are not nonprofit corporations. In fact, given the language in the statute and the two notices dealing with "shareholders," it would seem logical that such organizations would generally be for-profit corporations. However, as long as the organizational requirements are met, it does not matter what type of corporation is used. For non-stock corporations the term "member" is used and is considered synonymous with "shareholder." A section 501(c)(25) organization may be organized as a nonstock corporation if its articles of incorporation or bylaws provide members with the same rights as required by Notice 87-18.

If state law prevents a corporation from including the required language in its articles of incorporation, the corporation must include such language in its by-laws. Such a state law restriction is the ONLY permissible basis for not including the required language in the articles. See Exhibit 1 for sample articles of incorporation that meet the requirements of IRC 501(c)(25).

IRC 501(c)(25)(B) provides that a title holding company need not be organized by one or more organizations described in IRC 501(c)(25)(C). That is, as long as the SHAREHOLDERS are described in IRC 501(c)(25)(C), it does not matter who organized or incorporated the title holding company. In

fact, most 501(c)(25) title holding companies are organized by real estate investment management firms as Delaware business corporations.

IRC 501(c)(25)(D) provides that an organization shall not be treated as a title holding company described in IRC 501(c)(25)(A) unless it permits its shareholders or beneficiaries (i) to dismiss its investment adviser, and (ii) to terminate their interest in the organization by selling or exchanging their stock in the title holding company to any organization described in section 501(c)(25)(C) so long as the sale or exchange does not increase the number of shareholders or beneficiaries in such title holding company above 35, or by having their stock or interest redeemed by the title holding company after the shareholder or beneficiary has provided 90 days notice to the title holding company. Again, Notice 87-18 requires that these provisions be included in the title holding company's organizing document.

2. PERMITTED PARENTS

Congress capped the number of shareholders or beneficiaries of an IRC 501(c)(25) title holding company at 35. The committee hearings reflect that the reason for the cap was to ensure that the group of owners is sufficiently small to actually control the title holding company rather than allowing the investment advisor to control the title holding company.

IRC 501(c)(25)(C) provides that all shareholders of an exempt title holding company must be (i) a qualified pension, profit sharing, or stock bonus plan that meets the requirements of section 401(a); (ii) a governmental plan (within the meaning of section 414(d); (iii) the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing; or (iv) any organization described in IRC 501(c)(3). Each of these is described in more detail below. In contrast to IRC 501(c)(2), most types of 501(c) organizations are NOT eligible shareholders for a 501(c)(25) organization.

A. Pension Plans

An applicant organization seeking exemption under IRC 501(c)(25) may have as a shareholder a qualified pension, profit sharing, or stock bonus plan within the meaning of IRC 401(a) of the Code and exempt under IRC 501(a). To establish that its shareholder is described in IRC 501(c)(25)(C)(i), the applicant should submit a copy of the shareholder's determination letter. Two types of entities frequently encountered in this area which require some additional explanation are master trusts and group trusts.

A master trust is established for the purpose of investing and administering the assets of its constituent plans, which may be pension plans described in IRC 401(a). A master trust is not itself a pension plan and therefore will not have a determination letter from the Service. Thus, it would appear that a master trust is not a permissible shareholder under IRC 501(c)(25). However, if each of a master trust's constituent plans has a determination letter establishing that it is described in IRC 401(a) we can look through to such letters to establish that the master trust is an entity described in IRC 501(c)(25)(C)(i).

A master trust must be the trust for each constituent plan. There may not be any intervening trusts between the plans and the master trust. We must obtain a copy of the master trust's trust document to establish that the master trust is the trust for each constituent plan. The trust indenture will identify each of the plans covered by the master trust. Also, a copy of the determination letter issued to each of the constituent plans should be submitted. We must also get a statement from the applicant organization that the master trust's constituent plans have no intervening trusts, and do not contain provisions for individual retirement accounts (IRAs). IRAs are exempt pursuant to IRC 408(c), not IRC 401(a), and thus are not permitted parents.

The following language is included in all exemption letters issued to section 501(c)(25) applicant organizations that have master trusts as their sole shareholder:

> More specifically, this ruling is based on your representation that the constituent Plans are named in the trust indenture establishing the Master Trust, which is your sole shareholder, and that all the constituent Plans are described in section 401(a) of the Internal Revenue Code and are exempt under section 501(a) of the Code. Furthermore, this ruling is based on your representations that the Plans have no intervening trusts, and do not contain provisions for individual retirement accounts. However, this letter should not be construed as a ruling on the status of the Plans and the Master Trust under sections 401(a) and 501(a) of the Code.

In some cases, an applicant organization may have a group trust, rather than a master trust, as its shareholder. There is a significant difference in the operations of a group trust and a master trust. A master trust is the trust for each of its constituent plans, while there are intervening trusts between the group trust and its constituent plans.

A group trust is specifically described in Rev. Rul. 81- 100, 1981-1 CB 326. Because the Employee Plans Division determines whether a trust is a group trust within the meaning of Rev. Rul 81- 100, the applicant organization must furnish a letter from the Service verifying that its shareholder is a group trust. If the group trust does not have such a ruling letter, the applicant organization should be afforded sufficient time for the group trust to apply for and receive such a ruling.

B. Governmental Plan

An organization may have an IRC 414(d) governmental plan as its shareholder. An IRC 414(d) governmental plan is a plan established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing. The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed from contributions required under the Act, and any plan of an international organization that is exempt from taxation by reason of the International Organizations Immunity Act.

The applicant organization should be requested to furnish a copy of the letter issued to its shareholder recognizing it as a governmental plan within the meaning of IRC 414(d). However, many governmental plans do not request or receive determination letters. These governmental plans are usually created by state or local law. Even though an applicant cannot furnish a determination letter, the applicant may be able to establish that its shareholder is a governmental entity within the meaning of IRC 501(c)(25)(C)(iii) by furnishing a copy of the statute creating the retirement plan as discussed more fully below.

C. Governmental Entities

A governmental entity within the meaning of IRC 501(c)(25)(C)(iii) may be a qualified shareholder of an IRC 501(c)(25) title holding company. The term governmental entity includes the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing. The

term also includes a corporation organized under an Act of Congress and exempt under IRC 501(c)(1) and entities that have a ruling recognizing them as governmental entities within the meaning of IRC 115. Hospital boards, boards of regents, and retirement plans of states, cities, towns, and counties may be more difficult to verify as being agencies and instrumentalities of governmental entities. In such cases, we request copies of the statute creating the entity to see if the statute establishes it as a governmental agency or entity.

D. IRC 501(c)(3) Organizations

An organization seeking exemption under IRC 501(c)(25) may have as its shareholder an organization described in IRC 501(c)(3). Note that unlike IRC 501(c)(2), no other type of 501(c) organization is a permissible parent. A copy of the determination letter issued to the applicant's shareholder must be submitted, or the shareholder sufficiently identified so the Service can determine its exempt status under IRC 501(c)(3).

Organizations formed before 1969 and churches are not subject to the application requirements of IRC 508 and may not have ever applied for and received a determination letter. As discussed above in connection with IRC 501(c)(2) applications, sufficient information must be obtained to establish that the shareholders would qualify for exemption if they applied.

However, if an organization is currently seeking exemption under IRC 501(c)(3), and is simultaneously creating an IRC 501(c)(25) title holding company, there may be operational problems with respect to both organizations. Careful consideration should be given to exemption applications covering this type of situation. See Exhibit 2.

3. REQUIRED RELATIONSHIP

As discussed in the first half of this article, IRC 501(c)(2) does not explicitly state the relationship required between a title holding company and its parent, although Service position has long been that some element of control of the title holding company by its parent is necessary. In contrast, IRC 501(c)(25) explicitly requires control by the organizations to which income is turned over.

4. PERMISSIBLE PROPERTY AND ALLOWABLE ACTIVITIES

With a few exceptions, discussed below, IRC 501(c)(25) organizations may own only real property. Congress also narrowed the definition of "real property" for IRC 501(c)(25) purposes by excluding any interest as a tenant in common (or similar interest), or any indirect interest. Thus, an IRC 501(c)(25) title holding company must own its real property solely and directly, and not through an interest in a partnership, trust, or corporation. Except as discussed below in connection with qualified subsidiaries, it may not own stock in other corporations.

Nothing in the statute or either of the Notices requires a title holding company to use a property management firm to manage its real estate holdings, although it is permissible to do so. By analogy to Rev. Rul. 69-381, discussed in the first half of this article, the use of the language in the statute regarding collecting income and turning over income, less expenses, implies that it is permissible for the title holding company itself to collect the income and pay the expenses, including those expenses for normal maintenance of the building and grounds.

IRC 501(c)(25)(F) provides that for purposes of subparagraph (A), the term "real property" includes any personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property (determined under the rules of section 856(d)(1)) for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such leased property. This provision permits, for example, the lease of office furniture as part of a lease for office space.

Notice 88-121 clarifies that an IRC 501(c)(25) organization may not be organized for the purpose of holding interests in partnerships or real estate investment trusts or for the purpose of making mortgage loans. However, an IRC 501(c)(25) organization may acquire options to purchase real estate, provided the options are purchased with the intent to purchase particular real estate and not for the purpose of option trading.

Notice 88-121 also provides that an IRC 501(c)(25) organization may hold reasonable cash reserves sufficient to meet its operational needs. Reserves are considered reasonable if initial subscriptions are held for less than one year before investment in real estate. The reserves must be held in cash, or in short term investments such as certificates of deposit, bankers' acceptances, interest-bearing savings accounts, commercial paper, government obligations, and shares in money market funds. Investments will not be considered short term if the period to maturity exceeds 91 days.

A. Qualified Subsidiaries

As noted above, 501(c)(25) title holding companies generally may not own stock, as stock is not real property. The sole exception to this rule is IRC 501(c)(25)(E), which permits a title holding company to own stock in a qualified subsidiary. As originally enacted, IRC 501(c)(25) included 501(c)(25) title holding companies in the category of permissible parents for other 501(c)(25) organizations. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) eliminated this provision and replaced it with that permitting qualified subsidiaries.

IRC 501(c)(25)(E)(i) provides that a corporation that is a qualified subsidiary is not treated as a separate corporation for tax purposes. All assets, liabilities, and items of income, deduction, and credit of a qualified subsidiary are treated as assets, liabilities, etc., of the IRC 501(c)(25) parent. As a qualified subsidiary is not treated as a separate entity for federal tax purposes, it does not have its own employer identification number. A qualified subsidiary does not file a separate Form 990 or other federal tax or information return. Because a qualified subsidiary is not treated as a separate entity for tax purposes, the Service does not issue a ruling to a qualified subsidiary recognizing it as such. However, to meet the requirements of some state tax authorities that a qualified subsidiary have its own exemption letter to qualify for exemption from state tax, the Service will issue a ruling to the IRC 501(c)(25) parent that its subsidiaries are qualified subsidiaries under IRC 501(c)(25)(E). See Exhibit 3.

IRC 501(c)(25)(E)(ii) provides that the term "qualified subsidiary" means any corporation if, at all times during the period of its existence, the IRC 501(c)(25) parent held 100 percent of its stock. Thus, an IRC 501(c)(25) parent cannot acquire a pre-existing corporation from the pre-existing corporation's shareholder, unless that shareholder is also an IRC 501(c)(25) organization. A qualified subsidiary must be a subsidiary of a 501(c)(25) organization, not a direct subsidiary of a pension plan or other permissible 501(c)(25) shareholder.

An IRC 501(c)(25) parent may have more than one qualified subsidiary. The statute contains no express limit on the number of qualified subsidiaries a parent may own directly.

A qualified subsidiary must comply with all rules of IRC 501(c)(25) for the parent to retain exemption. The activities of the qualified subsidiary are considered along with the other activities of the parent (and any other qualified subsidiaries). If, for example, a qualified subsidiary received unrelated business taxable income from parking, and such income was incidentally derived from its holding of real property, but did not exceed 10% of the combined gross income of the parent and all qualified subsidiaries, then the parent would retain its exemption along with its qualified subsidiaries.

If the parent transfers any qualified subsidiary stock to another person, the subsidiary is disqualified. If the parent transferred less than all the stock it held in the qualified subsidiary, the parent would then be holding an impermissible interest in personal property and would no longer meet the requirements for

exemption under IRC 501(c)(25). Also, if a qualified subsidiary issued stock to anyone other than its parent, the qualified subsidiary would be disqualified. This would also result in the parent's loss of exemption, as the parent would own stock, an impermissible holding for a 501(c)(25) title holding company.

If a qualified subsidiary conducted an unrelated trade or business, that was not incidental to its holding of real property, the activity would not result in its disqualification, but would cause the parent's loss of exemption, as well as the loss of exemption of all the parent's other qualified subsidiaries (unless the requirements of IRC 501(c)(25)(G)(ii) were satisfied).

IRC 501(c)(25)(E)(iii) provides that if a corporation which was a "qualified subsidiary" ceases to meet the requirements of IRC 501(c)(25)(E)(ii), it is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from its IRC 501(c)(25) parent immediately before the date it ceased to be a "qualified subsidiary" in exchange for its stock. When a qualified subsidiary becomes disqualified, the rules set out in IRC 337(d) should be considered, along with the rules governing corporate reorganizations set out in Part III of subchapter C, IRC 351 et seq.

B. Qualified Subsidiaries -- Example

X is a state retirement board, and is a permissible parent under IRC 501(c)(25)(C). X is the sole shareholder of several corporations, S1 through S5, each of which owns a single piece of real property. X requests a ruling that S1, S2, S3, S4, and S5 are qualified subsidiaries.

The corporations (S1 through S5) cannot be qualified subsidiaries because X is not itself a 501(c)(25) organization. As X now owns their stock, they can never comply with the requirement that at all times their stock has been owned by a 501(c)(25) organization. S1 through S5 may, however, be able to qualify for exemption under IRC 501(c)(25) if they otherwise meet the requirements of the statute.

C. Unrelated Business Income

Generally, the receipt of unrelated business income by an IRC 501(c)(25) title holding company will subject it to loss of exempt status because a title holding company cannot be exempt from taxation if it engages in any business other than that of holding title to real property and collecting income therefrom. Income derived from a business operation or the business of acquiring, improving, and selling real property or trading options, is income from unrelated trade or business and will result in the loss of exempt status. The exceptions to this general rule are even more limited than those discussed in the first half of this article with respect to IRC 501(c)(2).

As discussed above, IRC 501(c)(25)(F) treats as real property a limited amount of personal property that is leased with real property. For example, office furniture could be leased with office space. This exception applies only so long as the rent attributable to the personal property does not exceed 15% of the total rent. However, the definition of real property contained in IRC 501(c)(25)(F) does not apply for purposes of other Code sections. Consequently, income amounts attributable to personal property that are acceptable for purposes of IRC 501(c)(25)(A) and (F) could result in unrelated business taxable income under the provisions of IRC 512(b)(3)(A)(ii), or under the provisions of IRC 512(b)(3)(B)(ii).

OBRA amended IRC 501(c)(2) and IRC 501(c)(25) through the enactment of IRC 501(c)(25)(G). IRC 501(c)(25)(G) allows IRC 501(c)(2) and IRC 501(c)(25) organizations to receive unrelated business income of up to 10 percent of their gross income, provided that the unrelated business income is incidentally derived from the holding of real property. Examples of incidentally derived income are parking revenue and income from vending machines. Income from manufacturing, for example, would not be considered incidental to the holding of real property.

IRC 501(c)(25)(G)(i) is not an exclusion from unrelated business income for title holding companies, but is a test in determining whether exemption will be jeopardized. Title holding companies receiving incidentally derived unrelated business income must pay unrelated business income tax on that income.

IRC 501(c)(25)(G)(ii) provides that this limited exception does not apply if the amount of gross income received exceeds 10 percent of the organization's gross income for the taxable year, unless the organization establishes to the satisfaction of the of the Secretary of the Treasury that the excess UBI was inadvertent and reasonable steps are being taken to correct the circumstances giving rise to the excess unrelated business income.

D. IRC 514 -- Special Rules

IRC 514(c)(9) provides that, for certain organizations, acquisition indebtedness does not include indebtedness incurred in acquiring or improving certain real property. As noted in the first section of this article, this special rule does not apply to IRC 501(c)(2) title holding companies even if the parent would receive the benefit of this rule if it held the property directly.

To the extent shareholders of an IRC 501(c)(25) title holding company are "qualified organizations" for purposes of IRC 514(c)(9), the title holding company will not be considered to have acquisition indebtedness and income from the property will not be taxable. "Qualified organizations" are schools described in IRC 170(b)(1)(A)(ii), their affiliated IRC 509(a)(3) supporting organizations, and qualified trusts under IRC 401. This difference in the treatment of acquisition indebtedness is probably the most significant reason for the existence of IRC 501(c)(25) title holding companies with single parents.

IRC 514(c)(9)(F) contains rather complicated rules for allocating income and expenses in the case of an IRC 501(c)(25) title holding company with multiple parents, some of whom are qualified organizations. However, since title holding companies with multiple parents are quite rare, implementation of these rules will rarely be necessary.

5. DISTRIBUTIONS DEMANDED

The language of IRC 501(c)(25) with respect to "turning over income" is virtually identical to that of IRC 501(c)(2). Presumably, similar rules apply with respect to allowable deductions and the timing of distributions.

EXHIBIT 1
Articles of Incorporation
XYZ Corporation

ARTICLE I

The name of the corporation is the XYZ Corporation

ARTICLE II

This Corporation is organized under the General Corporation Law of the State of Delaware. The corporation shall have perpetual duration and shall have only one class of stock.

ARTICLE III

The Corporation is organized for the exclusive purpose of acquiring, holding title to, and collecting income from real property, and remitting the entire amount of income from such property (less expenses) to one or more organizations described in section 501(c)(25)(C) of the Internal Revenue Code.

ARTICLE IV

The Corporation shall have no more than 35 shareholders.

ARTICLE V

The Corporation's shareholders shall have the right to dismiss the investment advisor.

ARTICLE VI

The shareholder shall have the right to terminate its interest in the corporation by either or both of the following alternatives as determined by the corporation:

(A) by selling or exchanging its stock in the Corporation to any organization described in section 501(c)(25)(C) so long as the sale or exchange does not increase the number of the Corporation's shareholders above 35, or

(II) by having its stock redeemed by the Corporation after the shareholder has provided 90 days notice to the Corporation.

ARTICLE VII

The Corporation shall be governed by a Board of Directors. The exact number of Directors and their method of selection is set out in the bylaws of the Corporation.

ARTICLE VIII

The Articles of Incorporation may be amended by an affirmative vote of Directors.

EXHIBIT 2

PROBLEM

U is a commercial real estate management company. The owners of U have learned that many tax-exempt organizations are unwilling to accept donations of real property because of the practical difficulties in managing or selling such property. The owners of U have therefore created B to accept donations of real property on behalf of various unrelated charities. The owners of U are B's officers and directors. Individual donors will donate real property to B for the benefit of a named charity. The charity will direct B to either sell the property, or to hold it. If the property is sold, the proceeds-, net of any commissions and other fees, will be turned over to the named charity. B has applied for exemption under IRC 501(c)(3).

B has also established Y, a title holding company. It has the same officers and directors as B. Y's sole shareholder will be B. When the unrelated charities wish to retain real property (rather than sell it immediately), it will be transferred to Y. Y will hold the property under a contract with the unrelated charity, collect the income from it, and turn the net income over to B for distribution to the charities. U will provide property management and other services to both B and Y at normal commercial rates. Y has applied for exemption under lRC501(c)(25).

What issues do you see with respect to both B and Y?

DISCUSSION

B's sole activity is providing property management and sales services to unrelated exempt organizations for a fee. Providing such commercial services does not further an exempt purpose, unless the fee charged is substantially below B's costs. Since U is charging normal commercial rates for its services, this test is not met. Furthermore, there is substantial private benefit to U in the form of fees and commissions for its services.

Even if B qualified for exemption under IRC 501 (c)(3), it is unlikely that Y is described in IRC 501(c)(25). First, it is not clear that Y actually holds title to real property. Y's "ownership" of the property is limited by the terms of the contracts with the unrelated charities. For example, Y cannot sell the property absent permission of the charity. Second, the statute clearly requires that Y's shareholders and the recipients of its income be the same organizations. In this case, the ultimate recipients of the income are not shareholders. Although Y's income is passed through B on its way to the ultimate charitable recipients, B has no legal right to keep the income from the property. Finally, it appears that Y's contractual relationships may be a means of avoiding the 35 shareholder limit of IRC 501 (c)(25), since there is no limit on the number of charities on whose behalf Y can hold property.

EXHIBIT 3

Dear Applicant:

This letter is in reply to your request for a ruling concerning the status, for federal tax purposes, of your qualified subsidiary, [full name of subsidiary].

Your exemption as a title-holding corporation under section 501(c)(25) of the Internal Revenue Code was recognized by our exemption letter to you dated [date of exemption letter].

Your qualified subsidiary was formed by you for the purpose of holding title to real property. The information submitted shows that 100 percent of the stock of your subsidiary has been held by you at all times during its existence.

Section 501(c)(25)(A) of the Code provides for the exemption from federal income tax of title-holding corporations or trusts that hold title to real property and otherwise meet the requirements of section 501(c)(25).

Section 501(c)(25)(E) of the Code provides that a corporation may be a qualified subsidiary of an exempt tile-holding organization if 100 percent of its stock is held, at all times during such corporation's existence, by an exempt title-holding organization. The Code further provides that the qualified subsidiary will not be treated as a separate corporation for federal tax purposes. In addition, all of the qualified subsidiary's assets, liabilities, and items of income, deduction, and credit will be treated as belonging to the exempt parent title-holding organization.

Based upon the information provided, we rule that the above-named subsidiary is your qualified subsidiary corporation as described in section 501(c)(25)(E) of the Code. Therefore, you and your qualified subsidiary shall be treated, for federal tax purposes, as a single entity as long as you and your qualified subsidiary continue to meet all of the requirements of section 501(c)(25).

Your activities and those of your qualified subsidiary corporation will be considered in the aggregate to determine whether you continue to qualify for exempt status. Consequently, any activity conducted by a qualified subsidiary corporation that is not permitted under section 501(c)(25) may cause you to lose your exempt status.

Your qualified subsidiary corporation is not required to file federal tax and information returns that are generally required under federal tax law since it is treated as part of its exempt parent title-holding organization.

As the exempt parent title-holding organization, you are required to file all federal returns, including Form 990, Return of Organization Exempt From Income Tax, required by section 6033 of the Code, using your Employer Identification Number. The Form 990 must include financial information applicable to your qualified subsidiary corporation. The information pertaining to your qualified subsidiary corporation should not be listed separately, but should be aggregated with the information applicable to you. Therefore, you and your qualified subsidiary corporation must be on the same annual

accounting period. Form 990 should be filed with the Ogden Service Center, Ogden, UT 84201-0027.

When Form 990, Return of Organization Exempt from Income Tax is filed, please provide the information listed below with your return:

1. The name, address, and employer identification number, if any, of each qualified subsidiary.
2. A statement that you have held 100 percent of the stock of each named qualified subsidiary at all times during the subsidiary's existence.
3. The name and address of any previously qualified subsidiary and an explanation as to why the subsidiary is no longer a qualified subsidiary.
4. A statement describing any changes during the tax year in the purposes, character, or method of operation of each qualified subsidiary.
5. Please use the employer identification number indicated in the heading of this letter on all returns you file and in all correspondence with the Internal Revenue Service. Your qualified subsidiaries should not apply for their own employer identification number. Because this letter could help resolve any questions about your exempt status, you should keep it in your permanent records. If you have any questions about this letter, or about filing requirements, excise, employment, or other federal taxes, please contact the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office at 877-829-5500 (a toll free number) or send correspondence to Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

B. LIMITED LIABILITY COMPANIES AS EXEMPT ORGANIZATIONS -- UPDATE - by Richard A. McCray and Ward L. Thomas

1. INTRODUCTION

This article updates last year's article at 2000 CPE 111, which discussed the state laws governing limited liability companies ("LLCs"), federal tax treatment generally, and issues regarding their use as exempt organizations (focusing on IRC 501(c)(3)). The Service has developed an approach for dealing with such LLCs. This article discusses recent developments in the area and issues still pending with respect to LLCs, again with the focus on IRC 501(c)(3).

2. DISREGARDED ENTITIES

A. Ann. 99-102

The question was posed in last year's article whether an LLC can be exempt as a disregarded part of an exempt organization that is the sole owner of the LLC. The Service has determined that it can.

Ann. 99-102, 1999-43 I.R.B. 545, establishes that an LLC wholly owned by a single exempt organization (exempt under IRC 501(a)) may be disregarded as an entity separate from its owner. Under Reg. 301.7701-3(b)(1), an eligible entity (which includes most LLCs) with a single owner is disregarded unless it elects otherwise. There are two ways for the eligible entity to elect separate entity treatment: by filing for separate entity treatment on Form 8832 (Reg. 301.7701-3(c)(1)(i)), or by claiming exemption as an entity separate from its owner, as by filing a separate Form 1023 or Form 990 (Reg. 301.7701-3(c)(1)(v)(A)). In the latter case, the eligible entity is treated as having made the election for the period it claims exemption or is determined to be exempt.

Ann. 99-102 requires the exempt owner of a disregarded LLC to treat the operations and finances of the LLC as its own for tax and information reporting purposes. In addition, the new Form 990 (Part IX) solicits information relating specifically to disregarded entities.

B. IRC 508

The notice requirements under IRC 508 apply to a disregarded entity in the same manner as to a subordinate organization in a group exemption. See Situation 3 of Rev. Rul. 90- 100, 1990-2 C.B. 156.

C. Organizational Test

The question was posed in last year's article whether a disregarded entity's articles of organization must satisfy the 501(c)(3) organizational test. The Service currently does not require that the articles independently satisfy the test: because the entity is treated as an activity of the owner, it is the owner's articles that matter. However, nothing in the disregarded entity's articles should prohibit the entity from operating exclusively for exempt purposes. For instance, a provision allowing a disregarded LLC to operate "for all purposes for which LLCs may be operated" would be permissible. A provision that "the remaining assets upon dissolution are to be distributed to the members of the LLC" would be permissible, because the sole member is qualified under IRC 501(c)(3). Where the disregarded LLC's articles do not satisfy the 501(c)(3) organizational test, the examining agent or determination specialist should closely scrutinize the past and planned activities of the LLC to ensure that the entire entity (including the disregarded entity) complies with the 501(c)(3) operational test.

D. Charitable Deduction

Ann. 99-102 clearly allows the disregarded entity to be treated as part of its exempt owner for purposes of subchapter F (IRC 501 et seq.), Chapter 42, and information and UBIT reporting purposes. However, the Service is considering whether the same treatment applies for purposes of IRC 170. If not,

then a contribution to a disregarded entity would not be deductible as a charitable contribution unless the disregarded entity either qualified in its own right under IRC 170(c), or it qualified as an agent of the exempt owner under the facts and circumstances. Guidance on this issue will be forthcoming in the near future.

E. Employment Taxes

Another guidance project of the Service involves employment taxes. In Notice 99-6, 1999-3 I.R.B. 12, the Service solicited public comment regarding issues related to employment tax reporting and payment by disregarded entities. Currently, disregarded entities are still allowed to choose between regarded or disregarded status for employment tax purposes.

F. Disregarded as Entity but Not as Activity

Where an applicant for recognition of exemption indicates that it is or intends to be the sole owner of a disregarded LLC, the governing documents and information regarding the LLC's activities and finances should be obtained and reviewed. The LLC may be disregarded as a separate entity, but should not be disregarded as an activity. Special care should be taken to insure that disregarded LLCs are not used as a device to thwart the various rules governing exempt organizations. A disregarded LLC's operations may give rise to exemption problems, UBIT problems, or excise tax problems for the sole exempt owner.

3. REGARDED ENTITIES (ASSOCIATIONS)

A. Partnership vs. Association Status

One confusing concept is determining when an LLC (or other eligible entity) is treated as a partnership. The longstanding Service position is that a partnership cannot qualify under IRC 501(c)(3). However, an eligible entity (which may include an LLC or a partnership) that claims exemption as a separate entity is treated as an association, rather than as a partnership or disregarded entity, during the period in which it claims exemption or is determined to be exempt (Reg. 301.7701-3(c)(1)(v)(A)).

B. 501(c)(3) Exemption for LLCs--12 Conditions

Last year's article posed the question whether an LLC can qualify for exemption under IRC 501(c)(3) (other than as a disregarded entity with a sole exempt organization owner). The Service has determined that it can, under certain conditions.

The Service will recognize the 501(c)(3) exemption of an LLC that otherwise qualifies for exemption if it satisfies each of the 12 conditions below. The conditions are designed to ensure that the organization is organized and will be operated exclusively for exempt purposes and to preclude inurement of net earnings to private shareholders or individuals.

1. The organizational documents must include a specific statement limiting the LLC's activities to one or more exempt purposes.

This requirement may be satisfied by standard purposes and activities clauses that satisfy the 501(c)(3) organizational test, such as "The organization is organized exclusively for exempt purposes under section 501(c)(3) of the Internal Revenue Code," and "The organization may not carry on activities not permitted to be carried on by an organization described in section 501(c)(3)." Taxpayers may not rely upon the cy pres doctrine to meet this requirement for LLCs.

2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.

3. The organizational language must require that the LLC's members be section 501(c)(3) organizations or governmental units or wholly owned instrumentalities of a state or political subdivision thereof ("governmental units or instrumentalities").

4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a section 501(c)(3) organization or governmental unit or instrumentality.

Because state laws generally provide LLC members with ownership rights in the assets of the LLC, the Service is concerned that allowing non-exempt members would result in potential inurement problems. Thus, the LLC cannot have private shareholders or individuals as members, and its organizing documents must state a purpose to further the members' charitable purposes. It should be noted, however, that the presence of solely charitable members does not ensure that the organization will be operated exclusively for charitable purposes. See, e.g., Rev. Rul. 72-369, 1972-2 C.B. 245 (organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations not exempt under IRC 501(c)(3)); compare Rev. Rul. 71-529, 1971-2 C.B. 234 (organization controlled by a group of unrelated 501(c)(3) organizations and providing investment management services for a charge substantially below cost solely to that group qualifies under IRC 501(c)(3)).

5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether directly or indirectly) any nonmember other than a section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value.

This provision helps ensure that the LLC and its assets are devoted exclusively to charitable purposes and that any dealings with private interests are at arm's length. Grants for exempt purposes to individuals or noncharitable organizations (as described in Rev. Rul. 68-489, 1968-2 C.B. 210) would also be permitted.

6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.

This requirement may be satisfied by a standard dissolution clause that satisfies the 501(c)(3) organizational test, such as "Upon dissolution, all assets remaining after the payment of liabilities shall be distributed exclusively to exempt organizations or for exempt purposes under section 501(c)(3) of the Internal Revenue Code." Taxpayers may not rely upon the cy pres doctrine to meet this requirement for LLCs.

7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with section 501(c)(3).

8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.

The idea here is that the LLC, like any other charitable organization, should intend to operate as a charity for its entire life and not flip between exempt and nonexempt status.

9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in section 501(c)(3) or governmental units or instrumentalities.

Such distribution would be inurement, unless the distribution is to a member other than in its capacity as a member, as where the member is the creditor on a loan to the LLC.

10. The organizational language must contain an acceptable contingency plan in the event one or more members ceases at any time to be an organization described in section 501(c)(3) or a governmental unit or instrumentality.

Forfeiture of the nonexempt member's interest is acceptable. A forced sale of the nonexempt organization's interest to another section 501(c)(3) organization or governmental unit or instrumentality would also be acceptable. The plan cannot involve a distribution of the LLC's assets to the nonexempt member, and should ensure that the nonexempt member's rights in the LLC are fully terminated within a reasonable time, e.g., 90 days from the date that a member's exemption is revoked.

11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.

12. The LLC must represent that all its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

Some states (California, Indiana, Iowa, Maryland, Minnesota, New York, North Dakota, Rhode Island, Texas, Utah, and Virginia) and the District of Columbia appear to require that an LLC be formed for a business purpose. In such states, it is questionable whether an LLC may be formed as a 501(c)(3) charitable organization. For the time being, however, absent state case law to the contrary, the Service is willing to recognize exemption based on the LLC's representation that its charitable status is permitted under state law, and that the provisions set forth above are enforceable.

C. Organizing Documents

The question arises as to which organizing document must meet the conditions set forth above. Unfortunately, state laws lack uniformity in determining whether the articles of organization (referred to in some states as the certificate of organization or certificate of formation--to confuse matters more, some states use the latter terms to refer to a document issued by the state when the state approves the articles of organization upon submission) or the operating agreement (referred to in some states as the regulations) controls in the event of a conflict. In some states, the articles of organization are the controlling document. In other states, it appears that the articles of organization control as to third parties, and the operating agreement controls as to members. For administrative convenience, the Service will require that both the articles of organization and the operating agreement separately comply with the 11 conditions above (the 12th condition is met in a separate written statement from the organization).

Most states expressly allow provisions to be included in the articles of organization that are not inconsistent with law, at least if the provisions are permitted to be included in the operating agreement. A few states (Arkansas, Colorado, Idaho, Oklahoma, and Wisconsin) appear to prohibit the inclusion of any information in the articles of organization other than certain specified items (e.g., name, address, whether the organization is managed by the members)-- in these states, the 11 provisions set forth above

may be included in the operating agreement only, so long as there are no conflicting provisions in the articles of organization.

D. National Office Involvement

Cincinnati and Area Offices may recognize the 501(c)(3) exemption of LLCs that meet the 12 conditions set forth above and otherwise qualify for exemption. Where the LLC is unwilling or claims it is unable to comply with all conditions, or where it is questionable whether the organization's governing documents, as amended, comply with all conditions (e.g., where terms are ambiguous or appear to conflict with one another), the case should be referred to EO Technical.

E. Other Exempt Organizations

An LLC that meets each of the 12 conditions above would also qualify for 501(c)(4) status if it otherwise met the requirements of that section. A 501(c)(4) case should be coordinated with EO Technical if the 12 conditions are not met.

The Service has yet to establish its position on whether and under what circumstances LLCs may qualify for exemption under other Code sections. Such issues should continue to be coordinated with EO Technical.

4. SUMMARY

The Service now recognizes the exempt status of disregarded entity LLCs owned by a sole exempt owner. It also recognizes the separate 501(c)(3) exemption of LLCs that represent that such status is permitted of LLCs under state law, and whose articles of organization and operating agreement comply with 11 other conditions.

C. EXEMPTION OF CANADIAN CHARITIES UNDER THE UNITED STATES-CANADA INCOME TAX TREATY - by Michael Seto and Mary Jo Salins

1. INTRODUCTION

Notice 99-47, 1999-36 I.R.B. 391 (Notice 99-47), provides guidance on the treatment of Canadian charities seeking exemption from federal income tax under the United States -- Canada Income Tax Treaty (Treaty) and section 501(c)(3) of the Internal Revenue Code (Code). This article will review the provisions of the Treaty and Notice 99-47 governing the treatment of exempt organizations. This article will also provide general information and guidance on the treatment of Canadian charities seeking exempt status in the United States. Finally, this article will briefly discuss the oversight of Canadian charities by the Canada Customs and Revenue Agency, formerly Revenue Canada, and the types of data available from that agency.

2. BACKGROUND

A. General Rules Concerning Exemption of Foreign Charities

A foreign charity may qualify for recognition of exemption under IRC 501(c)(3) as formation outside the U.S. does not bar exemption under IRC 501(c)(3). See Rev. Rul. 66-177, 1966-1 C.B. 132. Like U.S. domestic charities seeking exemption under IRC 501(c)(3), a foreign charity must comply with all the requirements of IRC 501(c)(3) and the requirements of IRC 508, including the notification requirement of section 508(a).

A foreign charity may be a non-private foundation under IRC 509(a)(1), (2), or (3) or a private foundation. The same rules used to classify a domestic organization apply to a foreign charity. If a foreign private foundation receives 85 percent of its support (other than gross investment income) from sources outside the United States, the requirements of IRC 507 and IRC 508 and Subchapter A of Chapter 42 (the private foundation rules) are not applicable to that foreign private foundation. See IRC 4948(b) and Regs. 53.4948-1(b).

Contributions to a foreign charity exempt under IRC 501(c)(3) are not tax deductible under IRC 170(c). Specifically, IRC 170(c)(2)(A) provides that a contributor may take a charitable tax deduction on a donation under this code section provided that the exempt organization was created or organized in the United States or any possession of the United States. For a detailed discussion of foreign charities or foreign activities of domestic charities and the statutory structure concerning the aforementioned, please see 1992 CPE, Topic K, Foreign Activities of Domestic Charities and Foreign Charities, p. 220.

B. Exceptions to General Rules For Exemption of Foreign Charities
When Tax Treaties are in Effect

The usual rules governing the recognition of exemption of foreign charities may not apply if an income tax treaty exists between the United States and another country. The United States has bilateral income tax treaties with many countries designed to help taxpayers avoid double taxation by the United States and the foreign country on the same income, to assist each country in administration of taxes, and to prevent tax evasion. An example of double taxation would be pension income received by a U.S. citizen residing in foreign country A, which may be subject to taxes imposed by both A and the United States, the former being the country of residency and the latter the country of citizenship. The United States may provide relief from such double taxation under a tax treaty by providing credits on taxes paid to A or vice versa.

Tax treaties usually deal with the tax treatment of income, estates, gifts and pensions, but some also contain provisions that govern the tax treatment of certain types of exempt organizations. An example of an income tax treaty containing such provisions is the United States -- Canada Income Tax Treaty, a provision contained which specifically governs the treatment of Canadian charities seeking exemption from federal income tax and the deductibility of contributions made to Canadian charities. The Treaty also governs U.S. charities seeking tax exemption under Canadian laws, which is not the focus of this Article.

C. General Rules Concerning the Relationship Between Tax Treaties and Tax Code

A provision of a tax treaty is treated in the same way as with a provision of the Tax Code. See IRC 7852(d) and IRC 894(a). If there is a conflict between a treaty provision and the Code, the provision adopted later generally takes precedence over the other provision. See Reid v. Covert, 354 U.S. 1 (1956). Thus, if the U.S. has a tax treaty with a foreign country where a foreign charity is involved, the terms of the treaty in such a situation may govern the treatment of that foreign charity, not IRC 501(c)(3) and other applicable code sections. It is important that a determination be made whether the provisions in the treaty or the Code govern the treatment of that foreign charity. It also important to ascertain whether the Service provided guidance via notice, revenue procedure or revenue ruling on this particular treaty.

3. THE UNITED STATES -- CANADA INCOME TAX TREATY

This section of the article will describe some of the terms used in the Treaty, provide background information on the Treaty and describe the specific provision of the Treaty that deals with exempt organizations. It will also discuss Notice 99-47, which describes the procedures which Canadian charities must follow in order to be recognized as exempt from U.S. income tax by the Service.

A. Descriptive Treaty Terminology

It is important to know certain terminology used in the Treaty to understand the overall treatment of Canadian (and U.S.) charities. These terms include the following:

- o Contracting states -- This term is used in the Treaty to describe the United States and Canada, the parties that entered into a "contract" (i.e., the Treaty);
- o Protocols -- On occasion a treaty is amended to reflect the need of the contracting states. An amendment to a treaty is known as a protocol;
- o Competent Authority -- the person designated by each respective country to handle communications and negotiations of treaty matters between the contracting states;
- o Canada Customs and Revenue Authority -- the organization so designated by Canada as the Competent Authority;
- o Director, International, Large and Midsize Business Division, Internal Revenue Service – the office designated by the United States as the Competent Authority.

B. Background

The current United States and Canada Income Tax Treaty was signed in 1980 and generally became effective on August 16, 1984, with the exchange of instruments of ratification between the two countries. As mentioned previously, the Treaty between the United States and Canada contains a

provision that governs the treatment of U.S. or Canadian organizations seeking tax exemption in the other country. This provision is Article XXI of the Treaty.

Article XXI contains six paragraphs, dealing with the types of organizations that qualify for tax exemption; the types of income that qualify for tax exemption; the availability of deductions to U.S. donors of Canadian charities; and the availability of deductions to Canadian donors of U.S. charities.

The Treaty, however, does not specifically set out any procedures which a Canadian or U.S. organization may follow to obtain tax exemption in the other country. In the United States, a Canadian organization would have to follow the procedures prescribed in Rev. Proc. 59-31, 1959-2 C.B. 949, which was promulgated under the revised U.S. -- Canada Tax Convention of 1941 (Tax Convention). The Tax Convention was terminated with the ratification of the Treaty in 1984.

When the Treaty was signed, a letter or diplomatic note dated September 26, 1980 was exchanged between the representatives of the United States and Canada. It states that the Competent Authority of each contracting state will review the procedures and requirements for organizations of the other country to establish tax exemption under Article XXI of the Treaty. Once the Competent Authorities of both countries determine that the other country's procedures and requirements are comparable to their own, each Competent Authority will accept certification by the other that such an organization is an exempt organization under Article XXI. The purpose is to avoid filing of duplicate exemption applications and redundant reviews. For example, if a U.S. organization establishes tax exemption pursuant to U.S. procedures and requirements, Canada will accept such determination and recognize that organization as an exempt organization in Canada under the Treaty. The practical effect is that an organization will not have to qualify for tax exemption in both countries.

The Service announced in Notice 99-47 that the Competent Authorities of both countries reached an agreement to implement Article XXI as contemplated by the September 26, 1980 diplomatic note. Specifically, the provisions of Notice 99-47 govern the treatment of Canadian charities seeking exempt status in the United States. The Notice in effect supersedes the rules and procedures described in Rev. Proc. 59-31. (Notice 99-47 is reproduced in the appendix of this article).

C. Tax Exemption of Canadian Charities under Article XXI

Paragraph 1 of Article XXI provides for the exemption from tax organizations that are religious, scientific, literary, educational, or charitable. Note that amateur athletic organizations and testing for public safety organizations, which are described in IRC 501(c)(3), are not listed among the types of organizations eligible for exemption under the Treaty.

The income of these organizations is exempt from tax of a contracting state to the extent that it is exempt from taxation in the other contracting state where it is a resident. For example, if a charity is a religious, scientific, literary, educational or charitable organization within the meaning of Article XXI, and resides in Canada, the U.S. source income it receives is exempt from U.S. income tax to the extent that the charity is exempt from Canadian income tax. This rule is the same for recognized United States charities regarding exemption from Canadian income tax.

Another type of organization exempt under the Treaty is a fund, company or organization that is operated exclusively to administer or provide pensions, retirement or employee benefits. See Article XXI, paragraph 2. These organizations are exempt from income and withholding taxes.

D. Canadian Private Foundations

Under the Treaty, there is a special provision concerning a Canadian charity that is a private foundation. If the Canadian private foundation receives "substantially all" (85 percent or more) of its financial support from persons who are non-U.S. citizens or residents, it is exempt from excise taxes

imposed on private foundations by the United States. See Article XXI, paragraph 4. This excise tax exemption also includes taxes imposed by section 4948(a). See Reg. 53.4948-1(a)(3). (This exemption from taxes imposed by section 4948(a) was also described in Rev. Rul. 74-183, 1974-1 C.B. 328, which was promulgated pursuant to the Tax Convention. Rev. Rul. 74-183 in effect became obsolete with the termination of the Tax Convention.)

E. Unrelated Business Income

An exempt organization's income from an unrelated trade or business is not exempt from taxation under the Treaty. Income derived from a related person that is not an exempt organization is also not exempt from taxation. An example is an exempt organization that owns a subsidiary that carries on a business: income derived therefrom would not be exempt from taxation under the Treaty. See Article XXI, paragraph 3.

4. NOTICE 99-47: QUALIFICATIONS FOR AUTOMATIC RECOGNITION EXEMPTION OF CANADIAN CHARITIES

As described in the Notice, the Service will automatically recognize a Canadian charity as exempt from U.S. income tax if the following requirements are satisfied:

- o the organization is organized under the laws of Canada;
- o the organization is a religious, scientific, literary, educational or charitable organization;
- o the organization has been recognized by Canada as a registered Canadian charity.

Similarly, Canada will automatically recognize the tax- exempt status of a U.S. charity if:

- o the organization is organized under laws of the United States;
- o the organization is a religious, scientific, literary, educational or charitable organization;
- o the organization has been recognized by the Service as exempt under IRC 501(c)(3).

Once a Canadian registered charity is recognized as exempt, the recognition of exemption remains in effect until Canada withdraws its registration or the Service determines that that Canadian registered charity fails to satisfy the requirements for exempt status under IRC 501(c)(3) and the rules and regulations thereunder.

A. Private Foundation Classification and Canadian Registered Charities

Because Canada's and the United States' provisions for "private foundations" are not comparable, Notice 99-47 provides that a Canadian registered charity presumed to be a private foundation under IRC 509(a). The deduction limitation of 30 percent (rather than the 50 percent for public charities) under IRC 170(b) will apply to U.S. donors on their Canadian source income. To rebut this presumption, the Canadian Charity may submit to the Service the proper financial information needed to determine the appropriate foundation classification.

B. Publication 78, Cumulative List of Organizations

A major benefit for submitting the financial information for foundation classification purposes is that a Canadian registered charity will be listed in Publication 78, Cumulative List of Organizations, even if the charity is determined to be a private foundation.

As a practical matter, many U.S. donors would be reluctant to contribute to Canadian registered charities without assurance from the Service that contributions are charitable contributions for U.S. income tax purposes. The limited deductibility, generally to the extent of the donor's Canadian source income, is discussed below. The Notice specifically requires that a donor claiming a charitable contribution made to a Canadian charity be required to show that the organization is in fact a Canadian registered charity. Hence, another benefit for submitting the financial information (and be listed in Publication 78) is the assurance to the donors that their contributions are charitable contributions under IRC 170.

C. Effect on IRC 508 Notification Requirement

IRC 508(a) and the regulations thereunder provide that the Service will not recognize an organization as exempt under IRC 501(c)(3) if the organization does not give notice with the Service. Given the fact that Notice 99-47 provides for the automatic recognition of exemption, made pursuant to the Treaty and enacted after the passage of IRC 508, the Treaty overrules the notice requirement of IRC 508. Thus, IRC 508 does not apply.

D. Filing and Disclosure Requirements Applicable to Canadian Registered Charities

All exempt organizations and private foundations, with some exceptions, must file annual information returns that include Form 990, Return of Organizations Exempt From Income Tax or Form 990- PF, Return of Private Foundation. See IRC 6033(a). Although Canadian registered charities need not file Forms 1023 with the Service to be recognized as exempt from U.S. income tax, they are not exempt under the Treaty or Notice from filing annual information returns. Rather, exceptions to the filing requirement are described by IRC 6033(a) and the regulations thereunder.

Under Rev. Proc. 94-17, 1994-1 C.B. 579, a Canadian registered charity (other than a private foundation), similar to the relief offered any foreign organization (other than a private foundation), is relieved from filing the Form 990 for any year in which it has gross receipts of $25,000 or less from United States source income and has no significant activity in the United States.

Canadian registered charities must also make available their annual information returns for public inspection as prescribed under IRC 6104. Neither the Treaty nor Notice exempt Canadian registered charities from this disclosure requirement (since a Canadian registered charity does not file a Form 1023 for U.S. exemption purposes, there is no public inspection of said form). For detailed discussions of filing requirements of exempt organizations, please see 1997 CPE, Topic B, Publicity and Disclosure of Form 990, and 2000 CPE, Topic O, Update: The Final Regulations on the Disclosure Requirements for Annual Information Returns and Applications for Exemptions.

E. Additional Disclosure Requirement -- IRC 6114

Specifically, IRC 6114 provides that if a taxpayer takes advantage of the benefits provided under a treaty and such treaty overrules or modifies a provision of the Code, that taxpayer must disclose such position to the Service.

As discussed above, a Canadian registered charity is automatically recognized by the Service to be exempt without filing a Form 1023 exemption application. Nevertheless, a Canadian registered charity must disclose to the Service that it is exempt from U.S. income tax. Disclosure is done by filing Form 8833 along with the information return required under IRC 6033. If a Canadian registered charity is exempt from filing an information return under IRC 6033, it needs only to file Form 8833.

This notice requirement is also applicable to individual U.S. contributors of Canadian registered charities seeking to claim charitable deductions. See Notice 99-47.

5. Limited Deductibility of Contributions Under the Treaty and Notice

Contributions made by a U.S. citizen or resident to a Canadian registered charity are treated as charitable contributions for purposes of IRC 170(c). See Article XXI, paragraph 5 and Notice 99-47. However, the charitable tax deduction is subject to two restrictions. First, a U.S. donor may use the deduction only against its Canadian source income. Second, the deduction is subject to the percentage limitations described in IRC 170(b). The percentage limitations permit a U.S. donor that made charitable contributions to a Canadian registered charity classified as a private foundation to deduct up to 30 percent of the donor's income derived from Canada. Any excess may be carried over and deducted in subsequent taxable years. This percentage amount is raised to 50 percent if the Canadian registered charity is classified as a non-private foundation under IRC 509(a)(1) or IRC 509(a)(2). (The percentage limitation does not apply where the Canadian registered charity is a Canadian college or university at which the donor, or a member of the donor's family, is or was enrolled (see Article XXI, paragraph 5)).

This deduction rule mirrors the rule that governs contributions made by a Canadian citizen or resident to a U.S. charity. See paragraph 6, Article XXI. Also, a U.S. donor may have to file the Form 8033 along with his or her income tax return if that person claims a charitable contribution deduction. See Notice 99-47.

6. CHARITIES REGULATIONS IN CANADA

The income of charities residing or carrying on business in Canada is exempt from Canadian tax under section 149 of the Income Tax Act (ITA). Under the ITA there are two types of charities. These are charitable organizations and charitable foundations.

A charitable organization is one in which all of the resources are devoted to charitable activities carried on by the organization itself, though it may also fund other registered charities and carry on a related business.

A charitable foundation is organized and operated exclusively for charitable purposes, and are either public or private. Canadian provisions, however, are not similar to the IRC definition of private foundation. A public foundation generally funds other registered charities and may carry on a related business. A private foundation is defined as a charitable organization that is not a public foundation. Accordingly, a private foundation is one in which either (a) more than 50 percent of the directors, trustees, officers, or similar officials do not deal with each other at arm's length; or (b) more than 50 percent of the capital contributed to the foundation has been contributed by one person or member of a group that does not deal with the foundation at arm's length.

In addition to the general rules described above, there are also stricter income tax rules placed on foundations (and private foundations in particular) dealing with disbursement quotas, transfers of property tax, gifts of non-qualifying property, and the registration revocation tax.

Tax relief is available under the ITA for donations to charities, which include: registered charities; registered Canadian amateur athletic associations; housing corporations resident in Canada and exempt from tax under the ITA; Canadian municipalities; the United Nations or an agency thereof; universities outside Canada the student bodies of which ordinarily include students from Canada; charitable organizations outside Canada to which Her Majesty in Right of Canada has made a gift during an individual's taxation year or the 12 months immediately preceding the taxation year, or Her Majesty in Right of Canada or a province. Excess credits for charitable contributions may be carried over for 5 years under the ITA.

The Canada Customs and Revenue Agency (CCRA), formerly, Revenue Canada, is the Canadian government agency responsible for promoting and enforcing compliance with Canada's tax, trade, and border legislation and regulations. The Charities Division of the CCRA reviews applications from

organizations or groups that want to register as a charity, gives technical advice on operating a charity, and handles audit and compliance activities.

It is responsible for the development and publication of forms, interpretation bulletins, information circulars, brochures and guides, newsletters and draft publications related to charities in order to educate the public regarding their rights and obligations. It also maintains a list of registered Canadian charities, which can be searched online, calling the Charities Division toll-free with bilingual service at 1-800-267-2384 (English) or 1-888-892-5667 (bilingual), or writing to the Charities Division; Canada Customs and Revenue Agency; Ottawa, ON K1A 0L5.

Similar to Notice 99-47 published by the IRS, CCRA has also included guidance on the implementation of Article XXI of the Canada-U.S. income tax treaty, through publication of an information circular, interpretation bulletin, and a registered charities newsletter. For further information concerning tax information provided by CCRA, see its websites: www.ccra-adrc.ca./menu-e.html or www.ccra-adrc.gc.ca/tax/charities/menu-e.html.

7. CONCLUSION

The purpose of Notice 99-47 is to facilitate the exemption application process of charities in one country that is seeking exemption in the other country. It is designed to remove unnecessary duplication of exemption procedures while ensuring that exempt organizations residing in the other country are in compliance with all the rules and regulations therein. The Service is revising the IRM to reflect the changes made by Notice 99-47.

APPENDIX

Notice 99-47

Guidance Relating to Article XXI
of the United States-Canada Income Tax Convention

1999-36 I.R.B. 344; Notice 99-47

September 7, 1999

PURPOSE

This notice provides guidance concerning a competent authority agreement between the United States and Canada that implements Article XXI (Exempt Organizations) of the United States- Canada Income Tax Convention (Treaty).

BACKGROUND

Article XXI of the Treaty generally provides for deduction of cross-border charitable contributions, and reciprocal recognition of exemption for religious, scientific, literary, educational, or charitable organizations. Diplomatic notes that accompany the Treaty provide that the competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting State to establish its status as a religious, scientific, literary, educational, or charitable organization entitled to exemption under paragraph 1 of Article XXI, or as an eligible recipient of the charitable contributions referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. The diplomatic notes also provide that if a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the other administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under

paragraphs 1, 5 and 6 of Article XXI.

SCOPE OF TREATY RELIEF

The U.S. and Canadian Competent Authorities, pursuant to Article XXVI (Mutual Agreement Procedure) of the Treaty, have entered into a mutual agreement that implements Article XXI as contemplated by the diplomatic notes. Under the terms of the agreement, recognized religious, scientific, literary, educational, or charitable organizations that are organized under the laws of either the U.S. or Canada will automatically receive recognition of exemption without application in the other country. U.S. organizations must be recognized as exempt under section 501(c)(3) of the Code in order to qualify for this treatment. Similarly, Revenue Canada must recognize Canadian organizations as Canadian registered charities.

Moreover, recognized charitable organizations resident in one country will be eligible to receive deductible charitable contributions from residents of the other country. However, in the case of a contribution (or contributions) by a resident or citizen of the United States (other than a contribution to a college or university at which the citizen or resident or a member of his family is or was enrolled), U.S. law requires that the amount of deductions in the aggregate for a taxable year may not exceed a certain percentage of the donor's Canadian source income. Any excess contribution that is not deductible as a result of this limitation may be carried over and deducted in subsequent taxable years, subject to the same limitations.

Furthermore, the U.S. will presume, in the absence of receiving certain financial information, that all Canadian registered charities are private foundations. Accordingly, if a Canadian registered charity does not provide the U.S. with the financial information needed to determine its foundation classification, the organization will be presumed to be a private foundation under U.S. law, the donor's deductible contributions will be limited to 30 percent of the donor's Canadian source income, and the organization will not have the benefit of being listed in Publication 78, Cumulative List of Organizations. Moreover, although the Canadian registered charity will not be required to apply for exemption, a donor claiming a charitable contribution deduction will be required to show that the organization is a Canadian registered charity.

Alternatively, if a Canadian registered charity provides the U.S. with the information needed to determine its foundation classification, aside from automatic recognition of exemption, the organization will be listed in Publication 78, as a foreign organization, and will be eligible to receive contributions deductible up to 50 percent of the donor's Canadian source income, assuming it is determined not to be a private foundation. If the Canadian registered charity submits information that establishes that it is a private foundation, it will nevertheless be listed in Publication 78, but deductible contributions will be limited to 30 percent of the donor's Canadian source income.

Under the agreement, recognition of exemption by the U.S. of a Canadian registered charity will remain in effect until the U.S. determines that the organization fails to satisfy the requirements for exempt status under U.S. law. Further, Canadian organizations will be required to file the applicable Form 990, Return of Organizations Exempt From Income Tax, or Form 990-PF, Return of Private Foundation, unless they receive less than $ 25,000 of U.S. source income.

DISCLOSURE REQUIREMENT

Section 6114(a) of the Code requires that taxpayers taking the position that a U.S. treaty overrules a general U.S. tax principle or law must disclose such position on a return of tax or, if no return of tax is required to be filed, as the Internal Revenue Service may prescribe. Accordingly, taxpayers claiming exemption or charitable contribution deductions pursuant to this agreement must disclose this position on their income tax return for the year in which the charitable contribution deduction or claim for

exemption is made. Taxpayers may use Form 8833 for this purpose, or they may attach to their return a separate statement indicating that they are claiming exemption or a charitable contribution deduction pursuant to Article XXI of the Treaty. Taxpayers may make reference to this Notice 99-47 in their disclosure statement.

DRAFTING INFORMATION

The principal author of this notice is Patrick Kevin Orzel of the Office of Assistant Commissioner (International). For further information regarding this notice, contact Mr. Orzel at (202) 874- 1550 (not a toll-free number).

D. UPDATE ON HEALTH CARE - by Lawrence M. Brauer and Roderick H. Darling

1. INTRODUCTION

In the past year, no major revenue rulings have been issued in the areas of unrelated business income, health maintenance organizations and IRC 4958 (intermediate sanctions). Nevertheless, we have considered several fact situations that illustrate the application of some of the rules affecting these areas.

2. UNRELATED BUSINESS INCOME

A. Convenience of the Patient Exception

IRC 513(a)(2) provides that an unrelated trade or business does not include any trade or business which is carried on by an IRC 501(c)(3) organization or by certain state colleges and universities primarily for the convenience of its members, students, patients, officers, or employees.

This exception was considered in PLR 200016023 (1/21/00). In this private letter ruling, the issue was whether the rental income one hospital received from another hospital was unrelated business income under IRC 513(a) or debt-financed income under IRC 514(a).

University Hospital was a large tax-exempt teaching hospital located in a large urban area. For many years, University Hospital had teaching relationships with several other hospitals in the same city (the University Hospital Teaching System). One of the hospitals in the University Hospital Teaching System was Specialty Hospital, a large, independent, IRC 501(c)(3) urban hospital devoted to the treatment of certain disorders.

General Hospital, a large, tax-exempt, acute care and teaching hospital located immediately adjacent to Specialty Hospital, was also part of the University Hospital Teaching System. Rehab Hospital, an IRC 501(c)(3) rehabilitation hospital, was also part of University Hospital's Teaching System. Rehab Hospital and General Hospital have the same corporate member. University Hospital, Specialty Hospital and General Hospital are structurally unrelated to each other.

Due to advances in medical technology, Specialty Hospital improved its ability to provide health care services on an outpatient basis. As a result, Specialty Hospital developed excess inpatient capacity in its main facility. Specialty Hospital sought to use this excess capacity in a manner that would further its charitable purpose of providing health care to the community, consistent with its position as a participant in the University Hospital Teaching System.

As a result, Specialty Hospital leased this excess capacity to Rehab Hospital at fair market value. Rehab Hospital used the leased space (the Rehab Hospital Unit) as a 15-bed inpatient unit of a rehabilitation or long-term care hospital providing post-acute medical care or rehabilitation services. The Rehab Hospital Unit was operated as a separate unit of Rehab Hospital under Rehab Hospital's hospital license, and persons treated at the Rehab Hospital Unit were admitted as Rehab Hospital patients. Although the patients of Specialty Hospital transferred to Rehab Hospital would be admitted to the Rehab Hospital Unit, no beds were set aside in advance for Specialty Hospital's patients and Specialty Hospital's patients did not receive any preference in admission.

Because the Rehab Hospital Unit was located within Specialty Hospital's facility, the number of patients Specialty Hospital discharged to Rehab Hospital could increase, since the proximity and convenience of the Rehab Hospital Unit for Specialty Hospital's physicians would facilitate the continuity of care of Specialty Hospital's patients. Specialty Hospital's patients, who would otherwise have remained at Specialty Hospital for longer periods, would instead be discharged from Specialty

Hospital to Rehab Hospital's Unit. This transfer from the sick bed environment of an inpatient unit to a continuing care, rehabilitation unit is desirable for patient care and is encouraged by health care insurers. In essence, the location of the Rehab Hospital Unit within Specialty Hospital's facility would serve in part as Specialty Hospital's rehabilitation facility, relieving Specialty Hospital of the need to fund and operate its own rehabilitation facility. In addition, patients discharged from General Hospital to the Rehab Hospital Unit would also benefit from the rehabilitation services located in the adjacent Specialty Hospital.

By Specialty Hospital leasing unused excess inpatient capacity to Rehab Hospital to provide post-acute medical care or rehabilitation services, Specialty Hospital used this otherwise dormant space to further its charitable purpose of providing health care to the community. By Specialty Hospital providing a convenient rehabilitation facility to which its patients may be discharged as needed, Specialty Hospital furthered its charitable purpose without the need to fund and operate its own rehabilitation facility. Therefore, to the extent that this leased space was used for treating Specialty Hospital's own patients, leasing the space to Rehab Hospital was not an unrelated trade or business activity because the space was used for the convenience of Specialty Hospital's patients.

Based on these facts, the Service ruled that Specialty Hospital's leasing activity was not an unrelated trade or business under IRC 513(a) or an activity utilizing debt-financed property under IRC 514(a).

B. Substantially Related

IRC 513(a) provides that the conduct by a tax-exempt organization of a trade or business which is not substantially related to the organization's exercise or performance of its tax- exempt purpose is an unrelated trade or business. This principle was considered in PLR 9837031 (6/15/98) in the context of a large integrated health care delivery system.

This private letter ruling involved a large integrated health care delivery system (System). The members of System included a parent organization (Parent), a hospital (Hospital), a teaching hospital (Medical Center), and a clinic (Clinic), all of which were tax-exempt under IRC 501(c)(3). The System also included a health maintenance organization (HMO), which was tax-exempt under IRC 501(c)(4).

HMO contracted with Clinic for Clinic to provide physician services to HMO's enrollees in return for the payment of capitated fees. Clinic employed staff physicians and contracted with independent physicians. Clinic paid its employed physicians a salary plus incentives, paid its contracted primary care physicians capitated fees and paid its contracted specialists fees-for-service.

On these facts, the Service ruled that the capitated payments Clinic received from HMO for the provision of physician services to HMO's enrollees, whether performed by Clinic's employed or contracted physicians, were not unrelated business income to Clinic. Clinic's exempt purposes included the provision of heath care services to the community. The provision of health care services by Clinic's employed and contracted physicians to HMO's enrollees, in return for the receipt of fees from HMO, was substantially related to Clinic's exempt purposes.

This private letter ruling considered the substantially related principle in another context, involving the provision of various ancillary health care services. In this private letter ruling, Hospital, Medical Center and Clinic, as part of their overall provision of health care services to the community, each provided certain ancillary health care services, including:

(1) Radiology services, such as magnetic resonance imaging (MRI),

(2) Respiratory, speech and physical therapy,

(3) Occupational and industrial medicine,

(4) Home health and hospice services, and

(5) Case management services.

Hospital, Medical Center and Clinic provided these ancillary health care services through their professional health care employees, consisting of registered nurses, medical technicians and skilled therapists. They provided these ancillary health care services in three different settings:

(1) On Hospital's and Medical Center's respective hospital campuses to patients of Hospital, Medical Center and to patients of other medical institutions in the System,

(2) On Hospital's and Medical Center's respective hospital campuses to persons who were not patients of Hospital, Medical Center, Clinic or of any other medical institution in the System, and

(3) At locations away from Hospital and Medical Center's campus at medical institutions that were not part of the System, or at employer locations.

On these facts, the Service concluded that the provision of professional ancillary health care services by the professional health care employees of Hospital, Medical Center and Clinic furthered their respective exempt purposes, even though some of the patients who received these services were registered at non-System medical institutions and even though some of the health care services were performed at non-System medical institutions or at employer locations. Therefore, the Service ruled that the provision of these services was substantially related to Hospital's, Medical Center's and Clinic's exempt purposes.

C. Laboratory Testing Services

An issue that frequently arises in the health care context is whether the performance of laboratory testing services by a hospital is an unrelated business activity. The key element in analyzing this issue is the convenience of the patient exception in IRC 513(a)(2), previously discussed. Two significant revenue rulings in this area are Rev. Rul. 68-376, 1968-2 C.B. 246, and Rev. Rul. 85- 110, 1985-2 C.B. 166. Rev. Rul. 68-376 described six factual situations where it was determined whether a person was a patient of the hospital for purposes of IRC 513(a)(2). Rev. Rul. 85-110 concluded that the hospital's performance of diagnostic laboratory testing on specimens received from the private office patients of a hospital's staff physicians and from patients of a medical clinic that was unrelated to the hospital was an unrelated trade or business because there was no substantial causal relationship between the achievement of the hospital's tax-exempt purpose and the provision of diagnostic laboratory testing services to non-patients of the hospital. This revenue ruling also concluded that the hospital's provision of diagnostic laboratory testing services on specimens from persons who are not the hospital's patients is not an activity carried on primarily for the convenience of its patients under IRC 513(a)(2).

The most significant case in this area is St. Luke's Hospital of Kansas City. v. United States, 494 F.Supp. 85 (W.D. Mo. 1980) (St. Luke's). In this case, the District Court held that the performance of diagnostic laboratory testing services by an IRC 501(c)(3) teaching hospital on specimens obtained from individuals who were not patients of the hospital, which were needed for the conduct of the hospital's teaching activities, was not an unrelated trade or business activity where the testing services contributed importantly and substantially to the hospital's teaching program. (In Rev. Rul. 85-109, 1985-2 C.B. 165, the Service announced that it would follow this part of the St. Luke's decision.)

Treas. Reg. 1.513-1(d)(3) provides that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities have to be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, an important fact in St. Luke's and in Rev. Rul. 85-109 was that the diagnostic laboratory testing program was relatively small in size compared to the other activities of the pathology department, and business was not actively solicited through advertising or otherwise.

Several private letter rulings have considered whether a hospital's performance of laboratory testing services was an unrelated trade or business.

In PLR 9837031, Hospital, Medical Center and Clinic performed laboratory testing services on specimens obtained from the following six sources:

(1) Specimens from Hospital's and Medical Center's inpatients.

(2) Specimens sent to the laboratory by Clinic's non-employee contracted physicians, in connection with physician services they provided to HMO enrollees.

(3) Specimens sent to the laboratory by Clinic's employee physicians.

(4) Specimens from the private patients of Clinic's non-employee contracted physicians, in connection with physician services they provided to these patients who were not HMO enrollees.

(5) Specimens from the private patients of Clinic's non-employee contracted physicians who were members of Medical Center's medical staff, in connection with physician services they provided to these patients.

(6) Specimens from the private patients of physicians who were not affiliated with System, in connection with physician services they provided to these patients.

The specimens from sources (4), (5) and (6) were obtained by the laboratory in two ways. Under the more common method, individuals presented themselves at Hospital, Medical Center or Clinic to have the specimens obtained in person (such as by drawing blood, collecting a urine sample, or taking a culture or tissue sample). Under the less common method, physicians obtained specimens from their patients at locations other than Hospital, Medical Center or Clinic, such as the physicians' private offices, and the physicians sent the specimens to Hospital, Medical Center or Clinic to perform the laboratory services at that facility.

Source (1). In PLR 9837031, the Service ruled that the laboratory services performed on specimens obtained from Hospital's and Medical Center's inpatients were performed within the rationale of Rev. Rul. 68-376, 1968-2 C.B. 246. Therefore, the income earned by Hospital, Medical Center and Clinic from performing these laboratory testing services was not income from an unrelated trade or business.

Source (2). PLR 200025059 (3/22/00) involved the same facts as in PLR 9837031. In addition to providing health care to the community, Hospital, Medical Center and Clinic also provided education to medical professionals. Specifically, Hospital and Medical Center engaged in a number of continuing education, residency and fellowship programs and operated a school that trained medical technologists. Hospital also engaged in significant medical education and research activities. In addition, Clinic conducted research and educational activities with Hospital, and Clinic conducted continuing medical education programs in conjunction with Hospital, Medical Center and HMO.

The collection of specimens from all sources, including from Clinic's non-employee contracted physicians, was instrumental to the educational components of Hospital, Medical Center and Clinic in training medical students, interns and residents of Hospital's medical education programs. Hospital's and Medical Center's residency and fellowship programs in certain medical specialties as well as the school for medical technologists rely on the collection and testing of these specimens. The greater number of specimens, the greater number of tests the students are able to perform and the more likely they are to encounter a greater number of cultures that test positive, often providing a more beneficial learning experience. Because Clinic's non-employee contracted physicians typically treated patients who resided throughout a relatively broad geographic area, the collected specimens generally included a wide sampling of disease strains, a situation that would not be possible without these physicians providing the specimens.

Based on St. Luke's and Rev. Rul. 85-109, PLR 200025059 concluded that the testing of specimens sent to Hospital's Medical Center's and Clinic's laboratories by Clinic's non-employee contracted physicians, in connection with physician services they provided to HMO enrollees, contributed importantly to the educational purposes of Hospital, Medical Center and Clinic because the testing of specimens was utilized in the education of medical students, residents and interns. Therefore, the income earned by Hospital, Medical Center and Clinic from performing these laboratory testing services was not income from an unrelated trade or business.

Source (3). In PLR 9837031, the Service ruled that the income earned by Hospital, Medical Center and Clinic from the performance of laboratory testing services on specimens obtained by physicians employed by Clinic was derived from activities undertaken for the convenience of Clinic's employee-physicians, within the meaning of IRC 513(a)(2). Therefore, the income earned by Hospital, Medical Center and Clinic from performing these laboratory testing services was not income from an unrelated trade or business.

Sources (4), (5) and (6). In PLR 9837031, the Service ruled that when an individual presented oneself in person at the laboratory site of the Hospital, Medical Center or Clinic to provide a specimen, the individual is considered to be a patient of that particular facility, even though the individual is also the patient of a physician in private practice who is not employed or contracted by the Hospital, Medical Center or Clinic. Therefore, the income earned by Hospital, Medical Center and Clinic from performing these laboratory testing services was not income from an unrelated trade or business.

Although not part of the private letter ruling, where the Hospital, Medical Center and Clinic performed laboratory services on specimens sent to the laboratory by non-employee or non-contracted private physicians who obtained specimens at sites other than the Hospital, Medical Center or Clinic, such as the physicians' private offices, the Hospital, Medical Center and Clinic correctly treated this activity as an unrelated trade or business.

The performance of laboratory testing services was also the subject of PLR 9851054 (9/25/98), but under a different set of circumstances. In this private letter ruling, four unrelated IRC 501(c)(3) hospitals were the members of L, an IRC 501(c)(3) organization, and L was the sole member of R, also an IRC 501(c)(3) hospital. (These five hospitals are collectively referred to as the Patron Hospitals.) In order to provide laboratory services for their respective patients, the Patron Hospitals consolidated their laboratory operations by forming S, a stock corporation that was recognized as tax-exempt under IRC 501(e). The laboratory services consisted of analyzing and testing certain specimens obtained from the human body. S derived its income from performing laboratory services for Patron Hospitals' patients who presented themselves at the Patron Hospitals' draw sites.

Three of the Patron Hospitals formed a limited liability company (LLC). (These three hospitals are collectively referred to as the LLC Hospitals.) LLC derived its income from performing laboratory

services for individuals who did not present themselves at the draw sites.

The laboratory operations for both S and LLC were conducted at a centralized laboratory which was owned by S and LLC as tenants-in-common (the Central Lab). Under an Allocation Agreement between S and LLC, all personnel required to operate the Central Lab were employed by LLC. A wholly-owned for-profit subsidiary of one of the Patron Hospitals (Management Company) managed the Central Lab's operations in return for a fixed monthly management fee. Management Company paid the Central Lab's payroll costs from an LLC payroll account that was funded by Central Lab's revenues. In addition, Management Company paid Central Lab's operating expenses from Central Lab's revenues.

The Patron Hospitals obtained specimens at various draw sites, located at the Patron Hospitals and at places owned or leased by a Patron Hospital. The personnel at these draw sites were employed by a respective Patron Hospital and consisted of phlebotomists and medically-trained support staff. The personnel at these draw sites drew and collected specimens and forwarded them to the Central Lab for analysis and testing. The Central Lab's employees performed the appropriate analysis and testing on these specimens using the Central Lab's facilities. Under the Allocation Agreement, the Central Lab's revenue from specimens received from the Patron Hospital draw sites was specifically identified and tracked to S.

Specimens drawn and collected at other than the Patron Hospital draw sites were done by persons who were not Patron Hospital employees, who forwarded the specimens to the Central Lab for analysis and testing. The Central Lab's employees performed the appropriate analysis and testing on these specimens using the Central Lab's facilities. Under the Allocation Agreement, the Central Lab's revenue from specimens received from these other draw sites was specifically identified and tracked to LLC.

Under the Allocation Agreement, the Central Lab's expenses, including payroll costs, operating expenses and management fees, were allocated to S and LLC based on their respective percentages of the number of specimens received from the Patron Hospital draw sites and from the other draw sites.

In this private letter ruling, the Service ruled that the net income S earned from the Central Lab performing analysis and testing services on specimens obtained at the Patron Hospital draw sites by Patron Hospital professional medical employees was not unrelated business income. Persons from whom specimens were drawn or collected at Patron Hospital facilities by Patron Hospital employees were considered patients of a Patron Hospital because the specimens were obtained at a Patron Hospital facility under the direction and supervision of medical professionals employed by a Patron Hospital. As a result, the Central Lab was performing analysis and testing of these patients' specimens primarily for their convenience, within the meaning of IRC 513(a)(2).

Although not discussed in the private letter ruling, the net income LLC earned from the Central Lab performing analysis and testing services on specimens obtained at the other draw sites by persons who were not Patron Hospital employees was unrelated business income.

D. Smoking Cessation Program

Treas. Reg. 1.513-1(d)(2) provides that a trade or business is substantially related to tax-exempt purposes only where the conduct of the business activities has a substantial causal relationship to the achievement of tax-exempt purposes. This regulation also states that for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Treas. Reg. 1.501(c)(3)-1(d)(1)(i) provides that education is a tax- exempt purpose under IRC 501(c)(3). In addition, Treas. Reg. 1.501(c)(4)-1(a) provides that promoting social welfare is a tax- exempt purpose under IRC 501(c)(4).

In PLR 9837031, HMO had been a leader in the use of tobacco cessation patient care in the managed care setting. HMO's research helped to demonstrate conclusively that a nurse-led program in counseling and nicotine replacement therapy was safe and effective. This led to the establishment of a tobacco cessation and prevention program for System, which resulted in a successful smoking cessation rate after the first year.

The success of the tobacco cessation and prevention program was due to the involvement of the nurses trained in the individual assessment of patient motivation. These nurses, who were generally Clinic's employees, provided counseling to patients to overcome barriers in discontinuing the use of tobacco. The nurses were trained in the indications and contraindications to the use of nicotine replacement therapy. When necessary, physicians also assisted in prescribing the nicotine replacement therapy. The nurses followed up with patients for four to six weeks, providing face-to- face visits every two weeks. When the nicotine replacement therapy was provided under the direction of a trained nurse, HMO's pharmacy benefit covered its cost. Additional follow-up was provided for up to one year, including the performance of an exit carbon monoxide breath test to gauge success. The involvement of nurses in the ongoing counseling and support of the patients' activities was unique in the field of smoking cessation programs.

Clinic and HMO planned to build on the success of their initial research by expanding the availability of their tobacco cessation and prevention program. HMO would provide experienced, certified tobacco cessation counselors to train nurses in organizations outside System to use the same approach that has proven successful at HMO. The initial training program would last one day and would include a training manual and a written certification examination developed and tested in System. A follow-up visit would be made to the organization by HMO's personnel to assist with program development and to complete the certification process for counselors. Clinic and HMO would continue to sponsor the shared data base using Clinic's initial research to assist with quality assurance and to track the success of the program.

Clinic and HMO provided the tobacco cessation and prevention program outside of System to other managed care organizations and to insurance companies, employers and to other providers in a manner that would effectively replicate the program. Clinic and HMO charged fees at a level that would encourage broad- based nationwide participation by these entities.

In this private letter ruling, the Service concluded that under these circumstances, Clinic's and HMO's provision of tobacco cessation and prevention services furthered Clinic's educational purposes and HMO's social welfare purposes by providing affordable training, seminars and program material necessary to instruct or train individuals for the purpose of improving their capabilities. Therefore, the Service ruled that the income Clinic and HMO earned from providing these services was not unrelated business income.

E. UBIT Cost Allocation Method

Treas. Reg. 1.512(a)-1 provides that unrelated business taxable income is the gross income derived from any unrelated trade or business regularly carried on, less allowable deductions directly connected with the carrying on of such trade or business, subject to certain modifications.

In the request for ruling, which eventually was issued as PLR 9837031, the taxpayer requested a ruling that the particular cost allocation method Hospital, Medical Center and Clinic used in accounting for the provision of laboratory testing services (discussed above) and ancillary health care services (also discussed above) that produce unrelated business income was reasonable under Treas. Reg. 1.512(a)-1.

The predecessor of section 8.01 of Rev. Proc. 2000-4, 2000 I.R.B. 115, 128, states:

The Service ordinarily will not issue a letter ruling or

> determination letter in certain areas because of the factual nature of the problem involved or because of other reasons. The Service may decline to issue a ruling or a determination letter when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts or circumstances of a particular case.

Due to the inherently factual nature of the question presented, the Service declined to issue this requested ruling, based on the predecessor of section 8.01 of Rev. Proc. 2000-4.

3. HEALTH MAINTENANCE ORGANIZATION (HMOS)

A. IRC 501(m)

IRC 501(m)(1) provides that an organization that may otherwise qualify for exemption under IRC 501(c)(3) or IRC 501(c)(4) may be tax-exempt only if no substantial part of its activities consists of providing commercial-type insurance. IRC 501(m)(2) provides that if an organization satisfies IRC 501(m)(1), any activity of the organization consisting of providing commercial-type insurance is treated as an unrelated trade or business that is subject to tax under subchapter L of the Code as an insurance company, rather than under IRC 511.

In PLR 200033046 (4/27/00), a technical advice memorandum (TAM), the Service considered whether an IRC 501(c)(4) health maintenance organization (HMO) with a point-of-service program provided commercial-type insurance within the meaning of IRC 501(m)(1). In this TAM, HMO arranged, on a prepaid basis, for the provision of comprehensive preventive and therapeutic health care services to its enrollees. HMO's enrollees consisted of individuals and employer groups. HMO obtained the health care services for its enrollees by contracting with a network of independent physicians and with hospitals within designated service areas.

HMO offered its enrollees a choice of two plans when choosing their benefits:

> Under Plan A, an enrollee could obtain health care services only from a network primary care physician or from a network specialist following prior authorization by the network primary care provider. In the event of an emergency, however, an enrollee could obtain health care services from a network or non-network specialist without prior authorization from a network primary care physician.
>
> Plan B was a point-of-service (POS) program under which an enrollee could utilize a network or a non-network physician whom the enrollee chose. The POS program was administered by Y, a non-exempt affiliate of HMO. In the event of an emergency, an enrollee could obtain health care services from a network or non-network specialist without prior authorization from a primary care physician.

Based on the number of enrollees, Plan A was HMO's predominant plan and Plan B was insignificant.

HMO compensated its contracted primary care physicians for medical services based on the type of plan that the enrollee selected. HMO paid a network primary care physician who treated a Plan A enrollee on a capitated fee basis. HMO paid a network primary care physician who treated a Plan B enrollee 70 percent of the predetermined network fee-for-service charges. HMO paid non-network

primary care physicians who treated Plan B enrollees 100 percent of their standard charges, a portion of which was paid by the enrollees as a co-payment. Thus, a network primary care physician who provided medical services to a Plan A enrollee was paid a different fee for providing the identical medical services to a Plan B enrollee. HMO did not withhold any amounts from the payments it made to any of the physicians.

Under this TAM, HMO's cost of arranging primary health care services for each Plan A enrollee was fixed regardless of the extent of primary care services the primary care physician provided to the Plan A enrollee. In other words, HMO's cost of arranging primary medical care services for each Plan A enrollee did not vary based on the extent of primary care services a network physician provided to the Plan A enrollee. Therefore, HMO shifted to its network primary care physicians a substantial portion of its risk of loss associated with arranging primary health care services for its Plan A enrollees, and HMO retained only a normal business risk. See Rev. Rul. 68-27, 1968-1 C.B. 315. As a result, HMO's activities with respect to its Plan A enrollees did not consist of providing commercial-type insurance within the meaning of IRC 501(m)(1).

On the other hand, HMO's cost of arranging primary health care services for each Plan B enrollee was not fixed, but varied based on the extent of primary care services the primary care physician provided to the Plan B enrollee. Since HMO paid primary care physicians who treated Plan B enrollees on a fee-for-service basis, HMO bore the risk of loss associated with the cost of providing additional primary care services a Plan B enrollee may require. Therefore, HMO retained rather than shifted to these primary care physicians its risk of loss associated with arranging primary health care services for its Plan B enrollees. As a result, HMO's activities with respect to its Plan B enrollees consisted of providing commercial-type insurance within the meaning of IRC 501(m)(1).

Since HMO's activities of providing commercial-type insurance for its Plan B enrollees was not substantial in relation to its total activities, under IRC 501(m)(1), these activities would not affect HMO's exemption. However, under IRC 501(m)(2), the net income HMO earned from providing commercial-type insurance for its Plan B enrollees would be subject to unrelated business income tax, but HMO's liability for unrelated business income tax would be calculated under subchapter L of the Code, rather than under IRC 511.

The conclusions in this TAM are consistent with the guidelines for examiners included in 7.8.1 IRM, Exempt Organizations Examinations Guidelines Handbook, Chapter 27, Health Maintenance Organizations.

B. Medicaid-Only HMOs

The article at 1999 CPE 67 discussed whether HMOs that arrange for the provision of health care services exclusively to Medicaid beneficiaries qualify for exemption under IRC 501(c)(3). As stated in that article, a Medicaid-only HMO that qualifies for exemption under IRC 501(c)(3) must also satisfy the requirements of IRC 501(m)(1).

In examining HMOs, examiners should first determine whether the HMO meets the examination guidelines in IRM 7.8.1, Chapter 27 for exemption under IRC 501(c)(3) or under IRC 501(c)(4). If the HMO meets these guidelines, the examiner should then consider whether the HMO also satisfies the examination guidelines for IRC 501(m).

IRM 7.8.1, Chapter 27 identifies several IRC 501(m)(1) issues that apply to HMOs that qualify for exemption under IRC 501(c)(3) or IRC 501(c)(4).

i. Physician Compensation Method

7.8.1 IRM 27.10.1 states that one factor demonstrating that an HMO's activities do not consist of

providing commercial-type insurance is that the HMO has shifted a significant portion of its risk of loss to its primary care providers. See Rev. Rul. 68-27, 1968-1 C.B. 315. An example of such risk shifting is an HMO compensating its contracted primary care providers on a capitated fee basis. Another example is an HMO compensating its contracted primary care providers on a fee-for-service basis, using the Medicaid- approved fee schedule, and withholding a substantial portion of the fees paid.

A Medicaid-only HMO that meets the IRM examination guidelines for exemption under IRC 501(c)(3) or IRC 501(c)(4), and that compensates its contracted primary care providers using the Medicaid-approved fee schedule, but does not withhold a substantial portion of the fees paid, does not satisfy the examination guidelines for IRC 501(m).

Under these circumstances, an HMO may argue that it satisfies IRC 501(m) because it has shifted a significant portion of its risk of loss under a stop-loss insurance arrangement or a deficit sharing arrangement.

ii. Stop-Loss Insurance

7.8.1 IRM 27.10.2(1) states:

> An HMO that compensates providers using a fee-for-service arrangement may obtain stop-loss insurance from an unrelated party to protect itself from a portion of the financial risk associated with operating the HMO. Whether a stop-loss insurance arrangement obtained by an HMO shifts a significant portion of the HMO's risk of loss depends on all the facts and circumstances.

To minimize its risk of loss, a Medicaid-only HMO may purchase stop-loss insurance from an unrelated insurance company. In some cases, the HMO's Medicaid agreement with the state requires that the HMO purchase stop-loss insurance. In other cases, the state itself provides the stop-loss insurance to the HMO, and may even charge the HMO a premium for this insurance in the form of a reduction in the capitated fees it pays to the HMO. Generally, under a stop-loss insurance arrangement, if the total annual medical expenses the HMO incurs on behalf of an enrollee exceed a certain amount, the insurer will absorb all or a portion of these excess expenses. In some cases, the insurer imposes a maximum on the amount it will pay, or covers only certain types of medical expenses, such as in-patient hospital care. (For example, a stop-loss arrangement may provide that if the HMO's total in-patient hospital expenses for an enrollee exceed $50,000 per year, the insurance company would absorb 80% of this excess, but would pay no more than $100,000 per enrollee per year.) In these situations, the HMO may argue that under this arrangement, it has shifted substantial risk of loss to the insurer.

Treas. Reg. 1.801-3(a)(1) states:

> The term insurance company means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

When a Medicaid HMO contracts with a state to arrange for the provision of health care services to its Medicaid beneficiary enrollees, the HMO is primarily liable to arrange and pay for the provision of these services to its enrollees, notwithstanding that the HMO has purchased stop-loss insurance. Where it has been determined that an HMO is providing health insurance for its enrollees, under Treas. Reg. 1.801-3(a)(1), its predominant activity is issuing an insurance contract to the state. The fact that the HMO has obtained an insurance contract from a third party insurer (or from the state itself) that would indemnify the HMO for a portion of the losses it might sustain in performing its Medicaid contract with

the state does not alter the fact that the HMO is primarily engaged in the business of insurance.

Even if an HMO with a stop-loss arrangement were considered to have shifted a portion of its risk of loss to an insurance company, the HMO would have to establish that the portion of the risk it shifted was substantial, within the meaning of IRC 501(m)(1), in relation to its total risk of loss, or conversely, that the portion of the risk of loss it retained was insubstantial.

iii. Deficit Sharing

7.8.1 IRM 27.10.2(2) states:

> An HMO that compensates providers using a fee-for-service arrangement may enter into an arrangement with the providers for the providers to share a portion of the HMO's operating losses. Whether a deficit sharing arrangement that an HMO has with its providers shifts a significant portion of the HMO's risk of loss depends on all the facts and circumstances.
>
> a. An HMO that has a deficit sharing arrangement with a related organization does not shift a significant portion of its risk of loss because the related organization is part of the HMO's economic family. See Rev. Rul. 77-316, 1977-2 C.B. 53; Rev. Rul. 78-338, 1978-2 C.B. 107.

The economic family concept was also applied in a case involving the deductibility of premiums paid to a foreign captive insurance company. In Malone & Hyde, Inc. and Subsidiaries v. Commissioner, 62 F.3d 835 (6th Cir. 1995), the court of appeals held the contractual arrangement between a parent corporation and its foreign subsidiary was not insurance where no shifting of the economic risk of loss had occurred.

When an integrated health care delivery system forms an HMO, and when a group of hospitals which are structurally unrelated to each other form an HMO, the member hospitals are usually the HMO's principal, if not exclusive, providers of inpatient and outpatient hospital services to the HMO's enrollees. Under a deficit sharing arrangement between the member hospitals and the HMO, the member hospitals agree to bear a portion of the HMO's operating losses. If an HMO enters into a deficit sharing arrangement with member hospitals that are structurally related to each other, the HMO does not shift a substantial portion of its risk of loss because it has not shifted its risk of loss outside its economic family. On the other hand, if an HMO enters into a deficit sharing arrangement with member hospitals that are not structurally related to each other, and the hospitals are jointly and severally liable for all of the HMO's operating losses, not just the losses attributable to services the HMO performed for the patients of the particular hospital, an argument can be made that the HMO has shifted a substantial portion of its risk of loss to these unrelated hospitals.

iv. Commercial-Type Insurance

HMOs that qualify for exemption under either IRC 501(c)(3) or IRC 501(c)(4) but which fail to satisfy the IRM examination guidelines in Chapter 27 may argue that although they may provide insurance, they do not provide commercial-type insurance within the meaning of IRC 501(m)(1).

In Paratransit Insurance Corporation v. Commissioner, 102 T.C. 745 (1994) and in Florida Hospital Trust Fund, et al. v. Commissioner, 103 T.C. 140 (1994), aff'd on other grounds, 71 F.3d 808, 812 (11th Cir. 1996), the Tax Court held that commercial insurance is insurance that is generally available commercially. Paratransit states that to be commercial-type insurance, the insurance does not have to be generally available to the public.

Medicaid-only HMOs may argue that even if they are considered as providing insurance, this insurance is not commercial- type insurance, within the meaning of IRC 501(m). They may argue that health insurance to Medicaid beneficiaries is not generally available commercially because virtually no insurance companies in the community offer health insurance solely to a Medicaid population, and if they do, it is generally not affordable.

This argument assumes that the Medicaid beneficiaries are the purchasers of health care insurance, rather than the state. Although a Medicaid beneficiary may select a particular provider from among a panel of providers to be his or her primary care provider, he or she does not purchase the insurance or pay for the insurance. Instead, the state solicits bids from health care organizations to arrange for the provision of health care services to Medicaid beneficiaries in selected areas of the state. The state contracts with the organization and compensates the organization, usually on a capitated fee basis. Usually, there are a number of health care insurance companies, integrated health care systems or other health care consortiums that may offer to sell these health care insurance services to the state, even though this health care insurance is not available for purchase by the individual Medicaid beneficiaries themselves. Thus, if the health care services these organizations provide is considered as insurance, it is generally available commercially to the purchaser of the insurance. On this basis, under Paratransit and Florida Hospital Trust Fund, if the health care services offered by a Medicaid-only HMO are treated as insurance, this insurance would be commercial-type insurance within the meaning of IRC 501(m)(1).

4. SECTION 4958 (INTERMEDIATE SANCTIONS)

A. Pending Litigation

A group of cases, collectively referred to as the Sta-Home Health Agency cases, are currently pending in the U.S. Tax Court. These cases involve eleven separate petitions./1/ In these cases, the Service imposed excise taxes under IRC 4958 on disqualified persons and organization managers and revoked the exemption of three IRC 501(c)(3) organizations.

In the late 1970's, Mr. Vic Caracci and his wife formed three non-profit corporations to perform home health care services for homebound patients in central Mississippi. The Service recognized these organizations as tax-exempt under IRC 501(c)(3).

Mr. and Mrs. Caracci's children later became involved in operating these organizations. Mrs. Caracci, a son and daughter, were each a member of the board of directors and a principal officer of each organization.

On October 1, 1995, the Board of Directors of each of the three organizations caused the organizations to transfer their assets and liabilities to three Subchapter S Corporations. Collectively, the Caraccis owned all of the voting stock of the S Corporations. The S Corporations continued the home health care activities of the former organizations. The organizations received no consideration from the S Corporations for the transfer of their assets other than the assumption of their liabilities.

The appraiser for the Caraccis determined that as October 1, 1995, each organization's liabilities exceeded the fair market value of its assets, so that the value of the net assets of each organization was less than zero. The Service, on the other hand, determined that the fair market value of each organization's assets substantially exceeded its liabilities, so that the value of the net assets of each organization was significantly more than zero.

The Service contended that each of the Caraccis, directly or indirectly, was a disqualified person within the meaning of IRC 4958(f)(1)(A) and IRC 4958(f)(1)(B). The Service contended that the transfers by the organizations of their net assets to the S Corporations were for less than adequate consideration because the liabilities assumed were substantially more than the value of the assets transferred. Since each of the Caraccis was a shareholder of each of the S Corporations, the increase in

the value of their shares that resulted from the transfers was an excess benefit transaction between each organization and each of the Caraccis within the meaning of IRC 4958(c)(1).

The Service also contended that each of the S Corporations was indirectly a disqualified person within the meaning of IRC 4958(f)(1)(C). Since the transfers by the organizations of their net assets to the S Corporations were for less than adequate consideration, the additional economic benefit the S Corporations received was an excess benefit transaction between the organizations and the S Corporations within the meaning of IRC 4958(c)(1).

As a result, the Service asserted that, under IRC 4958(a)(1), the 25 percent first tier excise tax applied to each of the excess benefit transactions. Thus, each of the Caraccis and each of the S Corporations were jointly and severally liable for the 25 percent first tier excise tax based on the amount of excess benefit they each received.

As of the date the statutory notices were issued, none of the excess benefit transactions had been corrected within the meaning of IRC 4958(f)(6). Therefore, under IRC 4958(b), the Service asserted that the 200 percent second tier excise tax also applied to each of the excess benefit transactions. Thus, each of the Caraccis and each of the S Corporations were jointly and severally liable for this excise tax also.

In addition, the Service contended that Mrs. Caracci, a son and daughter were each an organization manager within the meaning of IRC 4958(f)(2). The Service also contended that each individual participated in each excess benefit transaction knowing that each was an excess benefit transaction, and that each individual's participation was willful and not due to reasonable cause within the meaning of IRC 4958(a)(2). As a result, the Service asserted that, under IRC 4958(a)(2), the 10 percent excise tax applied to the participation by each organization manager in each excess benefit transaction. Thus, each of these individuals was jointly and severally liable for this excise tax, but not to exceed $10,000 for each act of participation by each individual.

In the statutory notices of deficiency, the Service asserted that when the organizations transferred their net assets to the S Corporations for less than adequate consideration, this was a substantial activity that was not in furtherance of an exempt purpose and therefore violated the operational test of Treas. Reg. 1.501(c)(3)-1(c)(1).

The Service also asserted that these transfers indirectly enriched each of the Caraccis by increasing the value of their stock in each of the S Corporations. As a result, the organizations conferred private inurement on each of the Caraccis, in violation of the proscription against private inurement in Treas. Reg. 1.501(c)(3)-1(c)(3) and in violation of the proscription against impermissible private benefit in Treas. Reg. 1.501(c)(3)-1(d)(1)(ii). Furthermore, by impermissibly benefiting private interests, the tax-exempt organizations no longer promoted health in a charitable manner by benefiting the community.

For these reasons, the Service revoked the IRC 501(c)(3) exemption of each of the three organizations.

B. Internal Revenue Manual

On November 4, 1999, Chapter 28 (Taxes on Excess Benefit Transactions) was added to 7.8.1 Internal Revenue Manual (IRM), the Exempt Organizations Guidelines Handbook. This chapter discusses several procedural aspects involving the application of IRC 4958, including:

i. When excess benefit transactions occur,

ii. The period of limitations for IRC 4958 excise taxes,

iii. Whether excess benefit transactions have been corrected, and

iv. When IRC 4958 excise taxes should be abated.

Chapter 28 also includes guidelines on completing Form 872 (Consent to Extend the Time to Assess Tax) for purposes of extending the period of assessment for IRC 4958 excise taxes.

In addition, Chapter 28 includes the reminder that Exempt Organizations Area Managers are required to request technical advice in all cases in which an excise tax under IRC 4958 is being proposed and in all IRC 4958 cases being considered for resolution by a closing agreement.

Examining agents are encouraged to use these guidelines in connection with all matters involving IRC 4958.

FOOTNOTE

/1/ Docket Nos. 14711-99X, 17333-99, 17334-99, 17335-99, 17336- 99X, 17337-99, 17338-99, 17339-99X, 17340-99, 17341-99, and 17342-99.

END OF FOOTNOTE

E. COLLEGE HOUSING - by Debra Cowen, Debra Kawecki and Gerry Sack

1. INTRODUCTION

Recently, the Service has received a number of applications and ruling requests from organizations that want to provide up-to-date student housing facilities on or near college campuses. The organizations plan to construct or purchase, own, and operate the dormitories or apartment facilities. The projects will be financed through the issuance of tax-exempt bonds. Although each applicant's proposal is different and must be considered on its merits, there are a number of common threads that raise concerns. This article addresses those concerns.

2. COMMON FACT PATTERN

Although no two organizations or transactions are identical, it is helpful to discuss exempt organization issues in context. The following example is representative:

X is organized and operated to provide reasonably priced student housing for colleges and universities that lack adequate student housing and is considering projects at several colleges across the country. X plans to construct, renovate, own, and operate the student housing facilities and may also provide additional services such as cafeteria facilities. X represents that any project will be built in response to the college's decision that it needs additional student housing and will be compatible with the college phone system and Internet technology allowing a direct link to the campus network. X plans to finance the facility through the issuance of tax-exempt bonds.

X may lease land for the facility at a nominal fee from the college, or may purchase property adjacent to or near the campus. X plans to develop and operate the student housing in conjunction with the respective colleges. The charges to students are to be sufficient to pay the operating expenses of the facility and retire debt. Once the facility is built, X will contract with a third-party management company to manage the facility. X will retain an administrative fee for its development, financing, and oversight. At the end of the lease term or on payment of the bonds in full, X plans to transfer ownership of the facility to the college.

Upon completion of the purchase or construction, the facility will be made available to students consistent with the guidelines and policies of the college. Vacant apartments may also be made available to faculty and staff. When the college is not in session, rooms may be made available to participants in college- sponsored interim programs, participants in non-college sponsored educational activities near campus, and students from other colleges studying or pursuing internships in the area, as well as to the general public. X plans to look for similar opportunities at other educational institutions across the country. Where new construction is not needed, X will either lease or acquire existing facilities for renovation and operation. Depending on the needs of the institution, X will also develop, own and operate student food service facilities in conjunction with the student housing facility. Both construction and renovation will be financed by tax exempt bonds.

3. CURRENT LAW

A. SERVING A CHARITABLE CLASS

Providing housing for students, absent special facts and circumstances, is a trade or business that is not charitable. An organization providing student housing may, however, qualify for exemption under IRC 501(c)(3) if certain facts and circumstances are present. It may qualify for exemption by serving a class of students recognized as a charitable class. For example, Rev. Rul. 64-274, 1964-2 C.B. 141, describes an organization that provides free housing, scholarships, and books, to students who could not otherwise attend college because of a lack of funds. The Service ruled that this organization was exempt because it was advancing education by relieving the poverty of the students. It was serving a charitable

class. Similarly, the Service recognized an organization making low- interest, unsecured loans for educational purposes to students needing financial assistance as exempt under IRC 501(c)(3) in Rev. Rul. 63-220, 1963-2 C.B. 208.

B. COLLEGE AND COMMUNITY CONTROL

The organizations described in Rev. Ruls. 67-217, 1967-2 C.B. 181, and 76-336, 1976-2 C.B. 143, rely for exemption primarily on the element of control by or on behalf of an exempt organization.

The organization described in Rev. Rul. 67-217, was formed to provide housing and food service exclusively for students and faculty at a specific university, which lacked adequate facilities. The facility was constructed near the university and was managed by a commercial firm in accordance with the university's rules. The facility was made available to students at rates comparable to those charged by the university for similar facilities. Support services were provided to supplement university activities. Income came from rents and food service charges and funds were expended for operating expenses and debt retirement. Any surplus was donated to the university. The university had an option to purchase the facility at any time for an amount equal to the outstanding indebtedness.

The organization described in Rev. Rul. 76-336, 1976-2 C.B. 143, was formed by community leaders to provide housing for students of a particular college in response to studies by staff members of the college showing that the college lacked suitable housing to meet the need. The college itself provided no housing because it was financially unable to do so. Many students, however, lived so far away that daily commuting was unreasonable. The housing facility was built adjacent to the college campus and available to students first-come, first-served. The college and the organization consulted and cooperated to ensure the needs of the college and its students were served by the operation of the housing facility. Income came from rentals and contributions. Disbursements were for operating expenses and debt retirement. Under these circumstances, the Service determined that the organization was advancing education by assisting the college, which was unable to provide adequate student housing, to fulfill its educational purposes, and aiding the students to attain an education.

In Rev. Rul. 67-217, the college clearly controlled the activities of the organization. In the later revenue ruling, the tie was to both the community and the college. In the example above, X can not rely on either of these revenue rulings. Because X's purpose is to provide financing and housing services to a number of colleges and universities, it can not be controlled by any one educational institution or by any one community. Also, it will not restrict its services to a charitable class of students.

Although GCMs are not precedential, they contain a more detailed discussion of the facts and analysis applied in a particular situation than a published revenue ruling. GCM 36493 considers the organization described in Rev. Rul. 76-336 and is helpful to a discussion of the key factors to consider in analyzing whether an organization providing student housing is operated in a manner consistent with exemption under section 501(c)(3).

A fact that weighed heavily in the analysis of Rev. Rul. 76-336 was that the organization was created by community leaders after studies made by the President of the College and the community leaders showed insufficient affordable student housing. The organization was not controlled by the developers but by the community on behalf of the college. The college and the organization consulted and cooperated to serve the housing needs of the students.

The organization described in Rev. Rul. 76-336 also operated below cost. The housing site was provided by the city at a fraction of its market value and the city made substantial contributions of equipment and services. The housing was not bond- financed. The costs not covered by the affordable rents were offset by contributions from both individuals and the community. There is no GCM elaborating on the facts stated in Rev. Rul. 67-217. However, a close reading reveals ongoing

cooperation between the university and the organization regarding both the need for the facility and the operation of the facility so as to serve the needs of the university. The ruling indicates that the facility was made available to students at the same price as other university housing. The ruling is silent, however, whether the organization operated below cost by reducing its charges to students through the use of contributions or university subsidies.

The essential facts and circumstances in both Rev. Rul. 67-217 and 76-336 - community control, college involvement, and below cost operation - are significantly absent in the Common Fact Pattern. X, as noted above, is not controlled by any one exempt organization and, although it offers discounted administrative services, does not operate below cost. The facts that services are provided at cost and solely for exempt organizations are not sufficient to characterize the activity as charitable. Rev. Rul. 72-369, 1972-2 C.B. 245, discussed further in subsection D, denied exemption to an organization similar to X that provided consulting and management services to unrelated exempt organizations.

C. FEEDER PROVISIONS

IRC 502 is a good starting point for analyzing whether an organization engaged in a commercial type activity qualifies for exemption under IRC 501(c)(3). IRC 502 sets forth the general rule that an organization operated for the primary purpose of carrying on a trade or business for profit cannot establish exemption on the ground that all of its profits are payable to one or more exempt organizations. A subsidiary organization may be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, but an organization that provides services to organizations other than its parent (or its parent's subsidiaries) is engaged in a trade or business that would be considered an unrelated trade or business if conducted directly by the parent and will not qualify for exemption.

The example in the regulations is an organization furnishing electric power. The organization will be tax-exempt as long as it is operated for the sole purpose of furnishing electricity to its parent because its activities are integral to the operation of its parent. If, however, the organization is operated primarily to furnish electric power to consumers other than its parent, it will not qualify for exemption because it is engaged in a business that would be an unrelated trade or business if regularly carried on by the parent.

As an example of the operation of IRC 502, consider the organizations described in Rev. Ruls. 54-305, 1954-2 C.B. 127 and 69-528, 1969-2 C.B. 127. Rev. Rul. 54-305 involves a purchasing agency formed by unrelated exempt hospitals to reduce hospital costs. It was denied exemption under IRC 501(c)(3). The agency was formed to purchase supplies and perform related services for several otherwise unrelated charitable organizations. The Service determined that these activities were not per se charitable but were business activities of the kind ordinarily carried on for profit. Because the activities would have been unrelated activities if carried on by any one of the tax-exempt organizations served, exemption was precluded by IRC 502.

In Rev. Rul. 69-528, investment services provided to unrelated entities were also considered ordinary commercial services that would be unrelated trade or business if carried on by any of the tax-exempt members of the organization. The malpractice insurance trust described in Rev. Rul. 78-41, 1978-1 C.B. 148, on the other hand, was able to establish exemption because it was considered an integral part of its parent hospital. The activities of the trust were ordinary insurance services available in the commercial marketplace. Because the services were offered solely to the hospital that created it, exemption was not precluded by IRC 502.

Congress has legislated two exceptions to IRC 502 to accommodate cooperative organizations whose purposes are to provide certain support services at cost to unrelated exempt members. IRC 501(e) provides exemption for hospital service corporations performing specific enumerated services on a cooperative basis for its members that are tax-exempt hospitals. IRC 501(f) provides exemption to

cooperative service organizations, organized and controlled by schools and certain state and municipal colleges and universities, for the collective investment of their funds in stocks and securities. A thorough discussion of IRC 501(e) and 501(f) is outside the scope of this article. (For further discussion of these sections see Cooperative Hospital Service Organizations, 1979 CPE 268, 1980 CPE 77, 1981 CPE 29, 1982 CPE 3, and 1999 CPE 86, Feeder Organizations, 1983 CPE 83, and Cooperative Service Organizations, 1986 CPE 80.) These exceptions, however, are clear and unambiguous. Both sections have been strictly construed. Although the organizations described in Rev. Ruls. 54-305 and 69-528 may now qualify for exemption under these legislative exceptions, the rationale on which the rulings were based remains valid.

D. INTEGRAL PART AND/OR SUBSTANTIALLY BELOW COST

An organization may avoid IRC 502 by providing essential services to a related entity as discussed in subsection C, or by providing services at substantially below cost. The Service first published this position in Rev. Rul. 71-529, 1971-2 C.B. 234. This ruling describes an organization assisting unrelated educational organizations manage endowment and investment funds in a manner similar to Rev. Rul. 69-528. However, this organization's operating expenses were paid by grants from independent non-member charitable organizations. The member organizations paid only a nominal fee for the services. The revenue ruling states that fees represented less than 15 percent of the total costs of operation. The ruling concludes that the organization qualifies for exemption because it is performing an essential function for exempt organizations, and that by performing this function for a charge substantially below cost it is performing a charitable activity. The importance of the donative element was affirmed in Rev. Rul. 72-369, 1972-2 C.B. 245, which describes an organization formed to improve exempt organizations' charitable programs by providing managerial and consulting services. The services were offered at cost. The Service ruled that this organization did not qualify for exemption because providing administrative services on a regular basis for a fee is a trade or business ordinarily carried on for profit. Without the donative element of below-cost operation, the organization lacked a charitable purpose. This ruling is a reaffirmation of the longstanding general rule stated in IRC 502.

Courts have upheld the position taken by the Service in the above revenue rulings. Unless a court views the services provided by the organization as essential and the class of recipients as related, it has not found the integral part test satisfied.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the Court held that an organization providing consulting services to non-profit organizations at not less than the organization's cost was not operated exclusively for exempt purposes. The consulting services were directed at basic and applied research for the organization's non-profit clients. In sustaining the Service's determination that the organization was operated for a substantial non-exempt commercial purpose, the Court found that petitioner's sole activity, selling consulting services to exempt and other non-profit organizations, was the conduct of a business which ordinarily is conducted by commercial ventures for profit. The organization's only role was that of a conduit linking individual researchers with the interested organizations seeking a substitute to full-time staffing, a role not inherently charitable, educational, or scientific.

In Chart, Inc. v. U.S.A, 491 F. Supp. 10 (Dist. D.C. 1979), rev'd 652 F.2d 195 (D.C. Cir. 1981), the plaintiff provided shared electronic data processing to tax-exempt, non-profit member hospitals. The organization was held exempt because the services were found to be an integral part of the hospitals' activities and were highly specialized services for which there was no commercial counterpart.

In Council for Bibliographic and Information Technologies v. Commissioner, 1992 T.C. Memo 364 (1992), the petitioner was an outgrowth of an existing organization, Ohionet, which was exempt under IRC 501(c)(3). One project of Ohionet was TLM. Ohionet was controlled by its members who were IRC

501(c)(3) organizations. Ohionet asked those members using TLM to form a new organization to use TLM. The Court described TLM as follows:

> TLM is an on-site computerized library system. TLM uses a computer that is owned and operated by petitioner's members. TLM is a transaction system which a library and its patrons may use for its circulation and cataloging. Users of TLM include terminal operators who charge or discharge books at circulation desks, technical processing staff members who label materials and create inventory records, acquisition staff members who prepare orders, and patrons or reference libraries who conduct on-line searches.

The following paragraph provides a summation of the Court's analysis.

> In our opinion, petitioners activities . . . are necessary and indispensable to the operations of petitioner's members. In order for a library to function, materials must be ordered, added to the catalogue system, shelved, located by patrons or staff, checked out, checked in, reshelved, and eventually removed from the catalogue system. Such activities are the essence of running a library. Accordingly, since we conclude that petitioner's activities bear a close and intimate relationship to the functioning of its tax exempt members, we hold that the petitioner is entitled to tax exemption as an educational institution under section 501(c)(3).

In Nonprofits' Inc. Alliance v. United States, 38 Fed. Cl. 288, (1994), the plaintiff was a group self-insurance risk pool with members consisting entirely of IRC 501(c)(3) organizations whose dues to the organization were fully paid up. The plaintiff, which qualified as tax-exempt under California law, maintained that by providing insurance at stable prices, it "directly advances the charitable purposes of nonprofit organizations . . . " Plaintiff conducted four basic activities: 1) providing liability insurance, 2) developing educational material and presentations, 3) providing loss control, and 4) serving as a resource for insurance-related questions. Although plaintiff admitted that its services were similar to those provided by commercial entities, it claimed to be providing services at substantially below cost. It also claimed that its additional services, such as education and risk management distinguished it from a commercial insurance company. The plaintiff argued that it was providing services similar to those in Council for Bibliographic and Information Technologies, supra, and could rely on the shared hospital services cases as the Court had applied them to non-hospital situations. The court, however, determined that the services were not essential and that the members were not related so the integral part test was not satisfied.

4. DISCUSSION

These precedents supply a framework for analyzing the Common Fact Pattern. X was not created in response to a student housing deficiency substantiated by the community and a specific college prior to its founding. It was not created by leaders of the community in which the housing units will be located, nor in conjunction with the colleges on whose campuses the units will be located. X is an independent organization that plans to canvas the country looking for opportunities to create and finance additional student housing. There is no evidence that members of the local community or directors of the college will have significant involvement, contribute to, or otherwise participate in the operations of X. X's role in the student housing projects is that of a developer. Its role is to market and design the projects and to

act as a vehicle for financing the projects through the issuance of tax- exempt bonds. Its projects are designed to be self-supporting.

Although Congress has shown a willingness to consider special legislation for certain kinds of organizations [IRC 501(e) and 501(f)] providing specific commercial services to a particular sector of the Exempt Organizations community, X does not fit either of these exceptions. X is providing commercial development services with respect to the issuance of bond financing to unrelated exempt organizations for a fee. This is an activity normally conducted on a commercial basis and would be considered an unrelated trade or business if conducted by one exempt organization for other unrelated exempt organizations.

X is outside the scope of IRC 502 because it is not directly controlled by an exempt organization. However, the general rule in that section still applies. X cannot establish exemption on the grounds that all its profits are devoted to charitable purposes. X cannot establish that its operations benefit a charitable class. Nor can X demonstrate that it is operated for the exempt purpose of advancing education by assisting a particular college in fulfilling its educational purposes. X may establish exempt status by demonstrating that it is providing essential services to a related group of organizations or it may establish that its commercial type services are offered to exempt organizations substantially below cost.

Under the facts and circumstances described in the Common Fact Pattern, it is unlikely that X can establish exemption as providing essential services or providing services at substantially below cost. X provides normal commercial services. These services are very similar to those provided by the organization in Nonprofit Inc. Alliance, supra. The entities that X will provide these services to are not related in any way. It is also highly unlikely that X is providing its services at substantially below cost. The Service and the courts have treated substantially below cost as 15% of cost with the rest of the organization's expenses made up from contributions. This is a very difficult test for an organization to meet. On the basis of this analysis, it is clear that an organization performing activities similar to those performed by X would not qualify for exemption under IRC 501(c)(3).

5. OTHER ISSUES

If an organization providing college housing in a manner similar to the organization described in Rev. Ruls. 67-217 and 76-336 is able to establish an exempt purpose, it is still necessary to examine its operations to assure they do not result in private benefit. The nature of the comprehensive service agreements between the developer and management company require detailed review. The organization must establish that it firmly controls the activities of the contracted companies, that the contracts were negotiated at arm's length, and that the terms of the contracts do not unfairly favor the contractors. These issues were addressed last year in Charter Schools (see the 2000 EO CPE Text, Topic J) but also apply in this context. Organizations issuing tax exempt bonds should also be aware of the inurement issues discussed in Identifying Abusive Transactions Involving Section 501(c)(3) Organizations and Tax-Exempt Bonds (see the 1999 EO CPE Text, Topic H).

Unrelated business income tax issues may also arise because of the very nature of college housing. Most students remain on campus for only 9 months. If space in the facility is made available during the summer or other interim periods, consideration must be given to whether that use is related to the organizations' exempt purposes (as opposed to the college's much broader exempt purposes) or is taxable as unrelated business income under IRC 511. Organizations should be aware that the housing organization cannot take advantage of the very broad mission of a college or university. One must keep in mind the limited exempt purpose of these organizations when making this determination. In this regard, it is likely that any rental activity other than to students enrolled in programs of the particular college being served will be considered unrelated to the organizations' exempt purposes and subject to tax.

F. TRUST PRIMER - by ELISE LIN, RON SHOEMAKER AND DEBRA KAWECKI

INTRODUCTION

The trust instrument can be a pretty powerful piece of paper. The trust form has always been considered as one of the foremost developments in the common law because of its flexibility. This flexibility allows the trust instrument to serve a number of tax planning purposes. With a little planning, a trust can create a current charitable tax deduction, avoid capital gains tax on the sale of appreciated assets, and significantly lower estate tax. For this reason, trusts are a common estate planning tool.

The Code recognizes this and provides several provisions designed specifically for estate planning. The Code frequently permits trusts with charitable interests to achieve legitimate estate planning goals. However, planners with a variety of tax objectives have used trusts to generate tax-free savings in conjunction with compensation arrangements, pension planning, and education savings. Because uses are not always appropriate, Congress and the Service have occasionally had to step in when tax planning borders on tax evasion. In many of these situations charitable objectives are decidedly subordinate to the desire to avoid capital gains tax or to control an asset into succeeding generations.

Financial advisors function in a highly competitive market. Thus, it is not surprising that some plans may promise more tax savings than they should. To effectively deal with these abusive, often highly-promoted situations, the Service is expanding its abusive trust program so that local units will be in place to coordinate the use of IRC 6700 penalties for abusive trust promotions at the local level. The 1999 CPE, Topic M; discusses using the IRC 6700 tax shelter promotion penalty when promoters market plans that misuse the IRC 170 charitable contribution deduction.

This article describes how IRC 4947 applies the Chapter 42 private foundation excise taxes to trusts that take advantage of charitable deductions. IRC 4947 controls the application of the private foundation excise tax rules contained in Chapter 42 of the Code to both nonexempt charitable trusts and trusts with both charitable and noncharitable interests, entities that can be complex. This article starts with basic trust concepts and then discusses charitable remainder trusts and charitable lead trusts. It also describes emerging IRC 4947 trust issues.

PART I -- BASIC TRUST PRINCIPLES

1. OVERVIEW

In the simplest terms, a trust is a three-party arrangement in which the founder of the trust (commonly known as the donor, grantor, or settlor) transfers legal title of the trust property (a res) to a trustee (a fiduciary with respect to the property) to hold and to manage for a third party (the trust's beneficiary) in accord with the grantor's intent. The beneficiary holds beneficial title to the property. A trust can be created either during the grantor's lifetime or at his or her death by an instrument such as a will that takes effect at death.

Some essential trust terms are:

GRANTOR -- The grantor is also known as the trustor, settlor, or founder. The grantor is the person who transfers the trust property to the trustee.

TRUST PROPERTY -- A trust must have some assets, even if only one dollar. Trust property includes assets like cash, securities, real property, tangible personal property, and life insurance policies. The assets can be either transferred during life of the

grantor ("inter vivos") or at his or her death ("testamentary"). The trust property is also referred to as the corpus, principal, estate or trust res.

TRUSTEE -- The trustee is the individual or entity responsible for holding and managing the trust property for the benefit of the beneficiary. Trustees can be a corporate fiduciary or any competent individual who is not a minor. The trustee holds the legal title to the trust property. As such, the trustee has a fiduciary duty to the beneficiaries with respect to the trust property. In the event of a breach of fiduciary duty, a trustee may be held personally liable. Such breaches include failing to pay out distributions or misappropriation.

BENEFICIARY -- The beneficiary is the individual or entity who will receive the benefits of the trust property. The beneficiary holds the beneficial title to the trust property. The trust document must clearly identify the beneficiary or beneficiaries.

2. PURPOSE OF THE TRUST

Every trust must have a legal purpose. The purpose is distinct from the grantor's motives or objectives in establishing a trust. For example, a trust can benefit a specific beneficiary and achieve tax benefits for the grantor. Benefiting the beneficiary is the trust's purpose. Achieving certain tax objectives might be the primary motive of the donor, but it is not the purpose of the trust.

Trusts can provide advantages for estate, financial, personal or business purposes, including:

1. Giving a beneficiary the benefit of property, such as the income generated by property, with the property going to a successor beneficiary upon a contingency such as the initial beneficiary's death;

2. Enabling the grantor to delay payments of assets to beneficiaries until after they reach the age of majority. A trust can provide partial distributions to a beneficiary and delay the ultimate distribution to the beneficiary to an age well beyond majority;

3. Protecting a beneficiary "from himself." These trusts, commonly called "spendthrift trusts", give the trustee the power to withhold payments to the beneficiary in case the beneficiary has legal judgments or claims against him or her. The beneficiary's creditors generally cannot reach assets in the trust.

3. TAX LAW CONCEPTS

A. SIMPLE TRUST

A simple trust must distribute all its income currently. Generally, it cannot accumulate income, distribute out of corpus, or pay money for charitable purposes. If a trust distributes corpus during a year,

as in the year it terminates, the trust becomes a complex trust for that year. Whether a trust is simple or complex determines the amount of the personal exemption ($300 for simple trusts and $100 for complex trusts), that applies in calculating the tax owed.

B. COMPLEX TRUST

A complex trust is any trust that does not meet the requirements for a simple trust. Complex trusts may accumulate income, distribute amounts other than current income and, make deductible payments for charitable purposes under section 642(c) of the Code.

C. GRANTOR TRUST

A grantor trust is a trust over which the grantor has retained certain interests or control. The grantor trust rules in IRC 671-678 are anti-abuse rules. They prevent the grantor from taking tax advantages from assets that have not left his or her control. The anti-abuse rules treat the grantor as owner of all or a portion of the trust. The grantor is subject to tax on trust income so treated even if he or she does not actually receive the income.

D. REVOCABLE TRUST

If the grantor retains the ability to revoke the trust and revest the trust assets in the grantor, the trust is revocable and the income is taxable to the grantor under the grantor trust rules. Assets in a revocable trust are included in the grantor's gross estate for federal estate tax purposes.

Revocable trusts also called living trusts, are one of the more frequently misunderstood trust concepts. They are used primarily as a will substitute. Assets in trust avoid the cost, time, expense, and publicity of probate.

Because a revocable trust may be a will substitute, it may provide for direct gifts to charity as well as establishing a split interest trust, a charitable remainder trust, or a charitable lead trust. For example, a revocable trust may establish a charitable remainder trust upon the grantor's death to benefit a surviving spouse or child. The noncharitable beneficiary can receive an income payment for life, or for a term of years. The remainder will pass to charity at the death of the noncharitable income recipient or the end of the term.

Similarly, a grantor may use a will or a revocable trust to establish a charitable lead trust, with an interest for charity during a term of years or for the life of certain individuals, and the remainder to the grantor's spouse, child or other heir.

E. IRREVOCABLE TRUST

An irrevocable trust is one that, by its terms, cannot be revoked.

PART II -- IRC 4947

The Tax Reform Act of 1969 imposed a new tax plan on charitable organizations and charitable giving. Congress was responding to abuses, particularly from charities controlled by limited (typically family) interests. The most significant changes are the distinction between public charities and private foundations, and the excise taxes in Chapter 42 of the Code that apply to restrict the activities of private foundations. The provisions of Chapter 42 are anti-abuse rules designed to insure private foundations operate to achieve charitable purposes rather than benefit the limited interests that control them.

Private foundations are not the only narrowly controlled entities that enjoy tax advantages available for charitable giving. Trusts with only charitable beneficiaries and trusts with both charitable and noncharitable beneficiaries enjoy the benefit of tax deductible contributions. These trusts are also subject to the same abuses that led to the imposition of Chapter 42 on private foundations. The benefits sought by the private foundation reforms of the Tax Reform Act of 1969 would have been substantially

undercut if charitable and split interest trusts were not also subject to the anti-abuse rules.

IRC 4947 subjects trusts with charitable interests to some or all of the Chapter 42 excise taxes. It is a "loophole" closer. Without it, narrowly controlled foundations could achieve most of the benefits of tax exempt status without the safeguards created by the Chapter 42 excise taxes. In calculating the taxable income of a trust, an unlimited charitable deduction is available. Thus a charitable trust not exempt under section 501(c)(3) would not pay tax or pay very little tax after deducting its charitable contribution.

IRC 4947(a)(1) provides that nonexempt charitable trusts will be subject to all Chapter 42 excise taxes. A nonexempt charitable trust has assets held in trust for charitable beneficiaries only. There are no noncharitable interests. A nonexempt charitable trust can be created during the life of the grantor or to take effect at the grantor's death. The trustee may see no benefit in applying for exemption under section 501(c)(3) but because of IRC 4947, the trust is subject to Chapter 42. A split interest trust described in IRC 4947(a)(2) has both charitable and noncharitable interests. In a charitable remainder trust, noncharitable interests terminate when the person or persons holding the life interest dies or when the specified term of years in completed. After a reasonable period of settlement, these trusts if they continue in existence rather than terminate are no longer split-interest trusts. They have metamorphosed into nonexempt charitable trusts now subject to all of Chapter 42.

A charitable lead trust is also subject to IRC 4947. Unlike charitable remainder trusts, the charitable lead trust pays the charity a stream of payments with the remainder going to individual beneficiaries. In certain tax planning situations, the lead trust can provide advantages to the grantor.

1. IRC 4947 (A)(1) TRUSTS

The nonexempt charitable trust is subject to all Chapter 42 private foundation provisions as well as IRC 507 through IRC 509. The split-interest trust is never subject to IRC 4940 and IRC 4942 and only rarely to IRC 4943 and IRC 4944. The statute reads that a nonexempt charitable trust will be treated as an organization described in IRC 501(c)(3), thus subjecting it to all of Chapter 42. While treated as if it were described in IRC 501(c)(3) for certain purposes, the nonexempt charitable trust is not actually tax exempt by virtue of IRC 501(c)(3).

A nonexempt charitable trust is subject to the rules of IRC 4947(a)(1) if it:

(1) Is a trust which is not exempt from taxation under section 501(a), and

(2) All of the unexpired interests are devoted to one or more exempt purposes described in IRC 170(c)(2)(B), and for which a charitable deduction was allowed under an income tax, estate tax, or gift tax provision. Reg. 53.4947-1(b)(1).

This is a complicated way of saying that IRC 4947(a)(1) applies to trusts with only charitable beneficiaries and the grantor or the grantor's estate took a charitable deduction. Often, nonexempt charitable trusts apply to the Service for a ruling on public charity status, usually under IRC 509(a)(3). Care needs to be taken to determine that the trust's assets are devoted solely to purpose described in IRC 170(c)(2)(B). For example, if a trust were paying out part of its income for political purposes it would not meet the definition of IRC 4947(a)(1) and could not receive a favorable ruling under IRC 509(a)(3). Of course, contributions to the trust should not have been deductible under IRC 170 but the public charity ruling may be the first time the Service sees the trust instrument.

2. IRC 4947(A)(2)

Split-interest trusts are a common income and estate planning tool to reduce taxes for persons who are also charitably inclined. There are a number of different types of split interest trusts. Charitable remainder trusts, charitable lead trusts and pooled income funds.

Split-interest trusts are often promoted by charities with the charity serving as the trustee. This is not required. For charitable remainder trusts and charitable lead trusts, there is no requirement that the named charity even know of its impending gift. A charity does not have to be specifically named as the remainderman at the time the charitable remainder trust is created. The remainderman can be described by class (such as any organization exempt under section 501(c)(3) of the Code). The specific remainderman may be chosen at a later date by a trustee, with the specific power to choose the remainder beneficiary. A private foundation controlled by the grantor's family can be the remainder beneficiary. This may effect the size or timing of the grantor's charitable deduction.

Charitable remainder trusts have been discussed in a number of recent EO CPE Texts. See FY 2000 CPE Text, Topic P, paragraph 3.B. (page 226); FY 1999 EO CPE Text, Topic P, paragraphs 3.B. (page 319), 6. (page 331), and 7. (page 333).

A charitable remainder trust is generally exempt from tax under IRC 664 of Subchapter J, not under 501(a). Exemption under section 501(c)(3) would not be appropriate because of the private interest present in each split interest trust.

3. CHARITABLE REMAINDER TRUSTS, IRC 664

A. IN GENERAL

Like Chapter 42, IRC 664 and related provisions (IRC 170(f), 2055(e), and 2522(c)) were enacted as a part of the Tax Reform of 1969. See section 201(a), (d), and (e) of the Act.

B. CURRENT BENEFICIARY AND REMAINDER BENEFICIARY

A charitable remainder trust consists of two distinct components:

(1) A private interest in the form of a right to a stream of payments from the trust for life or a term certain (not in excess of 20 years). A charity may be the recipient of part of the annuity or unitrust amount so long as there is at least part of the amount going to a noncharitable beneficiary each year. For simplicity, the recipient of the annuity or unitrust amount is referred to as the noncharitable beneficiary and,

(2) A charitable interest in the assets remaining in the trust payable to an organization(s) described in IRC 170(c) at the expiration of the preceding non-charitable interest. A charitable remainder trust is irrevocable.

C. TWO TYPES OF CHARITABLE REMAINDER TRUSTS

The charitable remainder trust takes two forms; (i) the charitable remainder annuity trust (CRAT) and (ii) the charitable remainder unitrust ("CRUT"). IRC 664(d)(1) and 664(d)(2) and (d)(3), respectively. The primary distinction between the CRUT and the CRAT is the manner used to determine the amount of the payment to the noncharitable beneficiary.

D. CHARITABLE REMAINDER ANNUITY TRUST

A charitable remainder annuity trust pays a specific amount of money to the noncharitable beneficiary every year. The annuity can be either a stated dollar amount or a fixed percentage of the fair market value of the assets on the date contributed to the trusts. The annuity may not be less than 5 percent. For transfers after June 18, 1997, the annuity may not be greater than 50 percent of the fair market value of trust assets as of the date of the transfer of assets to the trust. See IRC 664(d)(1).

The payout does not vary and it does not matter how much income is earned by the trust during the year. If assets held by the trust are producing substantial gains, the noncharitable beneficiary will not benefit. If income is insufficient to support the payout the difference is made up from the principal of the trust. Because the annuity is fixed, the noncharitable recipient receives no benefit from any appreciation in trust assets from year to year. The amount that will actually pass to the charity cannot be determined until the expiration of the noncharitable interest. However, the present value of the remainder interest is determined at the time of the contribution using actuarial tables. If the assets have been appreciating, the charity will benefit. If the corpus has been invaded to pay the annuity to the noncharitable beneficiary, there may be little left for the charity.

E. CHARITABLE REMAINDER UNITRUST

The charitable remainder unitrust pays a fixed percentage (of not less than 5 percent) of the net fair market value of its assets valued annually and for transfers after June 18, 1997, not more than 50 percent. The unitrust payout will be different each year because the payout is based on an annual valuation. IRC 664(d)(2). If the value of the unitrust assets increases, the payout to the noncharitable beneficiary will increase. The advantage of the unitrust over the annuity trust to the noncharitable beneficiary is that the unitrust serves as a hedge against inflation.

As with the annuity trust, the amount the charity will actually receive can not be determined until the noncharitable interest terminates.

F. NICRUTs AND NIMCRUTs

Two varieties of CRUTS are permitted under the Code. They can be used to avoid the invasion of corpus when the trust's income is not sufficient to make the unitrust payment. Both the NICRUT and the NIMCRUT permit the trustee to pay the lesser of the fixed percentage or the trust's actual income. NIMCRUT stands for net income with make-up charitable remainder unitrust. This type of trust pays to the noncharitable beneficiary the lesser of:

(1) The fixed percentage (not less than 5 percent nor more than 50 percent) of net fair market value of assets of the trust valued annually (the same as the CRUT) or

(2) The amount of the actual trust accounting income (not tax income) for the year. IRC 664(d)(3).

If the trust income is less than the fixed percentage amount for any given year, a shortfall is created because the beneficiary is getting less than the fixed percentage amount. The amount of shortfall may be "made up" in a later year.

Trust A has a unitrust payout of 5%. In year 1 through 4, the trust has no net income and the unitrust payout is $0.00. In year 5 the trust earns 8%. The extra 3% can be used to make-up the short fall.

The make-up must come from extra trust accounting income, not from principal. The NICRUT is the same as the NIMCRUT except there is no make-up provision

The NIMCRUT is commonly used when the donor wants to place property that does not produce regular income and is not readily marketable into a charitable remainder unitrust. Grantors often use a NIMCRUT to hold real estate and stock or other interests in a closely held business. If the grantor were to donate only unimproved real estate to a regular unitrust, the trust would earn no income and part or all of the real estate would need to be sold in order to make the fixed payment to the noncharitable recipient. This would probably not achieve the grantor's goal, which most likely was to hold the property in trust while it appreciated. By using a NIMCRUT, the payment to the income beneficiary is $0.00, the lesser of the unitrust percentage amount or the trust accounting income. An expensive and, perhaps, fruitless effort to sell part of the trust property is avoided. In this scenario, either a NICRUT or a NIMCRUT will do.

The NIMCRUT will be used by grantors who wish to have small current income payments and larger payments in the future.

> Grantor is 50 years old and is contemplating retiring in 10 years. He owns a parcel of appreciating real estate. He is in a high tax bracket and does not currently need any income. He places the property in a NIMCRUT. It makes no current payment to him, as it has no income. This continues for 10 years. In year ten he retires and the trustee sells the property. The settlement is used to invest in income producing assets. The trust now pays him the unitrust percentage, which is 7%. The trust is making 11%. The makeup provision of the NIMCRUT can now be used to pay him additional payments to make up the payments that were not received in the earlier years. He now has additional retirement income at a time when he may be in a lower tax bracket.

G. FLIP UNITRUST

An other variety of unitrust is called the "flip" trust. This trust starts out as either a NICRUT or a NIMCRUT. On the occurrence of a specific event set forth in the trust document, it "flips" or converts automatically to a straight fixed percentage unitrust.

> A and B, husband and wife, want to be able to help fund the college expenses of their granddaughter, C. C is 10 years old. A and B own property that is currently appreciating without producing income. They are advised to set up a flip unitrust. The unitrust amount is set at 10%. For the first 8 years the trust will be a NIMCRUT. C is the beneficiary but she receives no income during the 8 year NIMCRUT period. The triggering event to flip the trust is C's 18th birthday. The property has significantly appreciated in value. It is sold and the proceeds are invested in income producing assets.

Any trust accounting income received during the year of C's 18th birthday that exceeds the 10% unitrust amount may be paid to C under the IRC 664(d)(3)(B) make-up provisions upon the flip to a standard fixed percentage unitrust, any unpaid makeup amount is forfeited. The trust assets have greatly appreciated in value so that the 10% received by C should be sufficient to fund her college expenses. Even if the trust income is not sufficient, because the trust in now a regular CRUT, corpus can be invaded to pay the unitrust amount. A and B will get a charitable deduction based on the present value of the remainder interest upon setting up the trust, but, the present value of C's unitrust interest will be

subject to gift and generation skipping transfer tax. They will not have to pay capital gains on the sale of the property. Income from the trust will be taxed at C's lower tax rate. The property will be removed from A and B's estate, lowering their estate tax.

Reg. 1.664-3(a)(1)(i)(c) provides the authority for the flip provision. Specifically, that regulation permits the net income method for a unitrust for an initial period and then fixed percentage amount for the remaining period of the trust only if the governing instrument provides for certain conditions. These conditions include the requirement that the change in unitrust payment method is triggered on a specific date or by a single event whose occurrence is not discretionary with, or in the control of, the trustees or any other persons. Reg. 1.664-3(a)(1)(i)(d) provides that the sale of unmarketable assets, or the marriage, divorce, death, or birth of a child are permissible triggering events because they are not considered to be discretionary with any person. This list is not all inclusive.

There are provisions in the regulations for the effective date of the "flip" provision that are complex and beyond the scope of the article. But, the reformation of a trust to add a flip provision could result in a self-dealing transaction under IRC 4941 in the absence of authority to the contrary. The issue of self-dealing under IRC 4941 was discussed in the FY 1999 EO CPE Text, Topic P, pages 333-335. It is clear that a "flip" qualifying under the requirements of the IRC 664 regulations will not constitute an act of self- dealing, including trust document reformations occurring under the effective date provisions of Reg. 1.664-3(a)(1)(i)(f).

For example, under Reg. 1.664-3(a)(1)(i)(f)(3), if a unitrust without a flip provision in its governing instrument begins legal proceedings to reform the governing instrument to add a flip provision by a certain date, it will not commit an act of self- dealing under IRC 4941 or fail to qualify as a valid IRC 664 trust. The deadline for starting the reformation proceeding, or for amending the trust if permitted, is June 30, 2000. Of course, if the governing instrument is not reformed according to the regulations, an act of self-dealing may have occurred. For additional information on the issue of the flip provision and self-dealing in the context of governing instrument reformations, see the FY 2000 CPE Text, Topic P, pages 226-229.

H. CRUT AND CRAT CREATIVITY

Not all CRUTS and CRATS look alike. The Grantor has a number of options in drafting the trust agreement to meet special needs.

(1) Upon the creation of a charitable remainder trust the trust instrument can reserve a power for the noncharitable beneficiary to appoint by will the charitable remaindermen. Rev. Rul. 76-7, 1976-1 C.B. 179.

(2) Upon the creation of an inter-vivos charitable remainder trust, the grantor may reserve a power to substitute another charity as the remainderman in place of the charity named in the trust document. Rev. Rul. 76-8, 1976-1 C.B. 179.

(3) The charitable remainder interest need not be named in the trust document and the trustee may be vested with the power to name the charitable recipient of the remainder interest. However, all charitable remainder trusts must provide that the trustee will transfer the remainder to a qualified charitable organization if the named organization is not qualified at the time payments are to be made to it. Regs. 1.644-2(a)(6)(iv) and 1.644-3(a)(6)(iv)

NOTE: Contrast these rules with the more restrictive rules applied to IRC 501(c)(3) exempt organizations for designating charitable recipients subsequent to the date of the gift. Consider; (a) the material restriction or condition requirement of the community trust regulations and Regs. 1.507-2(a)(8); (b) the limited rights under IRC 170(b)(1)(E)(iii) for pooled common funds; and (c) the limits for naming charitable recipients under the organizational test for supporting organizations. See Rev. Rul. 79-197, 1979-1 C.B. 204.

(4) The donor may be named as trustee or retain the power to substitute himself as trustee. Rev. Rul. 77-285, 1977-2 C.B. 213. However, only an independent trustee may have the power to allocate the annuity or unitrust amount among the various named recipients. Rev. Rul. 77-73, 1977-1 C.B. 175. The donor may not retain the power to name himself as trustee when the trustee has the power to allocate the annuity or unitrust amount among the various named recipients. Rev. Rul. 77-285.

(5) The noncharitable interest is payable to "persons". The term "persons" is defined to include a trust, estate, partnership, association, company, or corporation (See IRC 7701(a)). If the income recipient is not an individual (or combination of individual and charity) the term of the trust must be a term of years, not more than 20 years.

(6) Payment of the annuity or unitrust amount may be made to the guardian of a minor. The payment of a portion of the annuity or unitrust amount may be made to an IRC 170(c) charitable recipient. Regs. 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i). The trust document may also provide the trustee with the discretion to distribute a portion of the annuity or unitrust amount to a charitable recipient. In all cases there must be at least one noncharitable recipient of the annuity or unitrust amount. IRC 664(d)(1) and (2).

(7) It is not uncommon that the annuity or unitrust payment is payable, in succession, to the grantor and the grantor's spouse for life. The grantor may reserve the right to revoke, by a direction in the last will and testament, his or her spouse's income right in the trust. Rev. Rul. 74-149, 1974-1 C.B. 157. The reservation of a power of revocation by the grantor-spouse is also not uncommon.

(8) Charitable remainder trusts are funded with many different types of assets. It is a common practice to fund the trusts with appreciated assets. As discussed above, the sale of appreciated assets by the trust is not taxable with respect to the trust.

(9) An inter vivos charitable remainder unitrust, created during the life of the grantor, may receive additions to the trust assets by transfers of property made during the grantor's life or at his death by a provision in his will. Rev. Rul. 74-149. Additional property contributions may not be made to a charitable remainder annuity trust. Regs. 1.664-2(b).

(10) Charitable remainder trusts are commonly established during the grantor's lifetime under a trust document. More infrequently, charitable remainder trusts are established at death under a provision of the decedent's last will and testament. A revocable trust can also be used, which creates a charitable remainder trust at death. The Service has published, in several revenue procedures, sample documents of provisions that meet the requirements of IRC 664 and the regulations.

(11) The trust may satisfy the annuity or unitrust amount by making a distribution of property rather than cash. A property distribution to satisfy the annual payout requirement is treated as a sale or exchange by the trust. Regs. 1.664-1(d)(5).

4. TAX BENEFITS OF CHARITABLE REMAINDER TRUSTS

A number of tax benefits are associated with charitable remainder trusts:

(1) The donor of a lifetime gift generally receives a current income tax deduction under IRC 170 even though the trust principal may not be distributed to charity for many years.

(2) The trust is generally exempt from tax on the income earned by the trust.

(3) The grantor has a choice.

a. Sell the property first, pay the tax and put cash in trust.

b. Place the asset in trust and have the trust sell it without paying tax.

If the grantor transfers appreciated property to a CRUT (CRATS don't work as well), a subsequent sale of the property by the trust will usually not be taxable to the trust. Thus, a tax-free sale by the trust increases corpus, which increases the income available to the recipient of the unitrust amount.

Although the trust is generally exempt on the income it earns under IRC 664(c), the annuity or unitrust payments distributed to the noncharitable recipient may be taxable to the recipient. The distributions are characterized as ordinary income, capital gain income, other income, or as a distribution of trust principal under ordering rules for establishing priorities under IRC 664(b). Thus, the noncharitable recipient is taxed on amounts received from the trust to the extent that the trust has current or previously undistributed ordinary or capital gain income.

5. CHARITABLE LEAD TRUST

A charitable lead trust (CLT) pays the charity first. It is defined in IRC 170(f)(2)(B). IRC 4947(a)(2) applies to a charitable lead trust. There is an annuity version and a unitrust version. The charitable lead trust is a split-interest trust that is the reverse of the charitable remainder trust. In the charitable lead trust, the charitable payment is a guaranteed annuity or fixed percentage of fair market value of trust property, valued annually, payable to charity for a term of years or for the life or lives of specified individuals. Charity comes first. The remainder interest in the trust is paid to private interests, often the grantor or the grantor's heirs.

A CLT can be either a grantor trust or a complex trust.

(1) Non-grantor CLT. The income from this trust is taxed to the trust not the grantor. The grantor does not get an income tax charitable deduction for the transfer to the trust. The trust is entitled to a charitable deduction for any amount of gross income paid to a charity during the year. This trust is mostly used to avoid transfer taxes.

(2) Grantor CLT. The income from the trust is taxed to the grantor but the grantor gets an income tax charitable deduction for the present value of the annuity or unitrust interest at the time the assets are transferred. This must be an inter vivos trust because the income has to be taxed to the grantor.

The reason CRATS are not preferred over CRUTS is that an annuity, being fixed, benefits the charitable remainderman because the income beneficiary does not share in the appreciation of the trusts assets. In lead trusts, charitable lead annuity trusts are usually preferred rather than charitable lead unitrusts. The grantor wants to benefit the remainderman because the remainderman is the grantor or the grantor's designee. A charitable lead annuity trust pays out a uniform payment to the charity. Any appreciation remains in the trust to benefit the remainderman.

6. POOLED INCOME FUND

A pooled income fund is established and maintained by a public charity, that

(1) Pays income to the grantor or an individual beneficiary named by the grantor; and

(2) Passes the remainder interest to charity.

The grantor contributes property to a commingled fund established and maintained by a charitable organization. Income earned by the fund is paid out yearly to each donor or other named beneficiary in proportion to the assets contributed. On the death of the donor or other named income beneficiary, a portion of the assets attributable to the income interest is severed from the fund and transferred to the charity.

There are a number of important differences between a charitable remainder trust and a pooled income fund.

(1) For the pooled income fund, the income beneficiary receives his full proportionate share of all trust accounting income earned by the pooled fund.

(2) There is no predetermined annuity or fixed percentage payment amount.

(3) Because the payment is based on income, there is never any invasion of corpus. If the fund earns no income, it makes no payment for the year.

(4) The pooled income fund is managed by the exempt organization (usually with the assistance of a professional investment company). A CRT can be trusteed or managed by virtually anyone, including the grantor.

(5) From the grantor's perspective, a CRT is much more flexible but a PIF has the advantage of simplicity.

7. 4947(A)(1) AND (A)(2) THE PRIVATE FOUNDATION ISSUES

All the split-interest trusts identified above are subject to IRC 4947(a)(2). Under IRC 4947(a)(2), a split interest trust is subject to IRC 507, IRC 508(e), IRC 4941, IRC 4945, and, in some cases, IRC 4943 and IRC 4944.

IRC 4947(b)(3) provides rules for excluding a split- interest trust from IRC 4943 and IRC 4944. IRC 4943 and 4944 do not apply to most split-interest trusts because of this exclusion. The calculations called for in IRC 4947(b)(3) must be made to determine if IRC 4943 and 4944 will or will not apply.

Part III -- UBI

A charitable remainder trust that realizes any amount of unrelated business income, as defined in IRC 512, is taxed as a complex trust for that year. Regs. 1.664-1(c). Typically, IRC 514 creates the problem, as a trust has debt financed income if it takes property subject to a mortgage. There are two exceptions.

(1) A trust will not have UBI for a period of ten years following a gift as long as it does not assume the debt.

(2) An inter vivos trust will not have UBI for a period of 10 years following a gift as long as the debt was placed on the property for more than 5 years from the making of the gift and the debt is not assumed.

Many situations, such as borrowing on an insurance policy, or receiving income from a working gas and oil interest, create UBI. Because unrelated debt financed income can arise after the creation of the trust, a trustee without a tax background may not be aware of these complex rules.

The treatment of unrelated business taxable income to a charitable remainder trust was the subject of recent Court of Appeals opinion. The trust received unrelated taxable income through no action of its own. Leila G. Newhall Unitrust v. Commissioner, 105 F.3d 482 (9th Cir. 1997) concerns the treatment of a charitable remainder unitrust trust which received unrelated business taxable income. The trust was a shareholder in a publicly traded company. In 1983 the company underwent a partial liquidation and transferred certain of its assets to two newly formed publicly traded limited partnerships. The trust received interests in the two limited partnerships. There was an additional transfer of publicly traded partnership interest when the company completely liquidated. IRC 512(c) requires that partnership income be included in unrelated business taxable income ("UBTI") if the conduct of the partnership's business directly by the organization would have resulted in UBTI. IRC 664(c) provides that a charitable remainder antirust shall be exempt from tax unless that trust has UBTI. Sec. 1.664-1(c), Income Tax Regs., states that a charitable remainder unitrust that receives UBTI is taxable on all of its income. The

Court concluded that the trust had partnership income that was subject to unrelated business income tax and thus it was taxable as a complex trust on all of its income and not merely to the extent of UBTI.

Part IV -- Estate Administration

1. AN EXCEPTION TO SELF-DEALING

IRC 4941, which provides that any sale, exchange or leasing of property between a private foundation and a disqualified person is an act of self-dealing, could make it vary difficult to administer an estate.

For example, an individual's will or trust may establish several trusts to be administered after the grantor's death. The testator may have specified the assets to be used to fund each bequest but the choices may not be appropriate to achieve the testator's intent. Or the testator may not make any specific bequest, giving the residue of his or her estate to charity after the specific bequests.

Testator A bequeathed $100,000 to his wife and a piece of unimproved real estate of equivalent value to private foundation Z, of which A was the creator and manager. In keeping with state law and to meet the needs of the private foundation and the spouse, the executor exercises his power and distributes the $100,000 cash to the foundation and the real estate to A's wife.

The spouse and the private foundation are both pleased with the outcome, but has an indirect act of self-dealing occurred? The regulations under IRC 4941 specifically provide an exception to the general rules on self-dealing to ease estate administration.

> The term "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property . . . held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if --

This exception applies if certain specific conditions are met. The purpose of the exception is to allow flexibility to shift assets during administration of the estate to facilitate the carrying out of the decedent's intent provided in the will or revocable trust instrument. One important condition for the application of this exception is that exchanges of assets must be at equal fair market values. Reg. 53.4941(d)-1(b)(3)(iv). The other requirements for qualifying for the estate administration, found generally in Reg. 53.4949-1(b)(3)(i) through (v), are as follows:

> (i) The administrator or executor of an estate or trustee of a revocable trust either, possesses a power of sale with respect to the property, has the power to reallocate the property to another beneficiary, or is required to sell the property under the terms of any option subject to which the property was acquired;
>
> (ii) Such transaction is approved by the probate court having jurisdiction over the estate (or trust);
>
> (iii) Such transaction occurs before the estate is considered terminated for federal income tax purposes;
>
> (iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option

subject to which the property was acquired by the estate or trust.

(v) With respect to transactions occurring after April 16, 1973, the transaction either:

(a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(b) Results in the foundation receiving an assets related to the active a carrying out of its exempt purposes, or

(c) Is required under the terms of any option, which is binding on the estate (or trust).

2. A CLARIFYING POINT

Reg. 53.4941(d)-1(b)(3) can be confusing because it refers to a "revocable trust". In reading this paragraph, treat the term "revocable trust" as a trust that has become irrevocable upon the testator's death. Because trusts and estates have a period of existence during which the testator's affairs are wrapped up, the subject of the termination of revocable trusts as well as split- interest trusts under IRC 4947 is discussed in detail in the following section.

3. AN ACT OF SELF-DEALING

The following situation constitutes an act of self- dealing, because the estate administration exception does not apply.

(1) A revocable trust is winding up its affairs during a reasonable period of settlement.

(2) It purchases property for less than fair market value from a private foundation.

(3) The trust is a disqualified person to the foundation under IRC 4946.

The exception is not available because of the below market rate sale.

4. ROCKEFELLER V. U.S., CONSTITUTIONALITY CONFIRMED

The possibility of self-dealing and the estate administration exception was pivotal in Rockefeller v. United States, 718 F.2d 290 (8th Cir. 1983), cert. den. 466 U.S. 962 (1984), in which the court considered a case where the Service imposed a self- dealing penalty on an executor. On February 22, 1973, Winthrop Rockefeller died. Pursuant to the terms of his Last Will and Testament, dated November 14, 1972, he left the residue of his estate to a charitable trust created under his Will. The Will contemplated that property known as Winrock Farms would constitute a substantial part of the residue and would compose a substantial part of the trust.

On September 30, 1975, plaintiff, the son of Winthrop Rockefeller, and the executor of the estate of Winthrop Rockefeller, executed an agreement with the executor of Winthrop Rockefeller's estate to purchase all the stock of Winrock Farms. The plaintiff and the estate obtained an independent appraisal of the fair market value of the Winrock Farms' stock, and petitioned the Probate Court of Conway County, Arkansas, the probate court with jurisdiction over the estate for approval of the sale. The Probate Court entered an order approving the sale at the appraised fair market value, and plaintiff purchased the stock at that value on December 19, 1975.

After auditing the estate's 1975 tax return, the Internal Revenue Service issued a report proposing certain adjustments in the estate's tax return. The proposed adjustments were based on certain findings of fact, one of which was that the sale of the stock to the plaintiff was not at fair market value. The Commissioner relied on the definition of self dealing in Section 4941(d)(1), which includes indirect sales between a disqualified person and a private foundation, and failure to meet the requirements of Reg. Section 53.4941(d)-1(b)(3). The plaintiff argued that IRC 4941 was unconstitutional and that even if the statute was constitutional, the regulation is unconstitutional. The Court upheld the Service, holding both the Code section and the estate administration regulation constitutional.

5. ESTATE OF REIS, GIVES A BROAD READING TO 4941

Estate of Bernard J. Reis v. Commissioner, 87 T.C. 1016 (1986) was an important win for the Service. Mark Rothko was a well- known American abstract expressionist painter who died in 1970. Bernard J. Reis, was one of the executors of his estate. Reis also was one of the directors of the Mark Rothko Foundation. In his will, after making certain specific bequests to family members, Mark Rothko bequeathed all his remaining property to the foundation.

Reis also was an officer and employee of the Marlborough Gallery, Inc. In May of 1970, shortly after Rothko's death, the executors of the estate, including Reis, entered into contracts on behalf of the estate with the gallery. The agreement provided that Rothko's paintings, which comprised the bulk of the estate's assets could be sold only by the gallery or its affiliated corporations throughout the world. The contracts were to last 12 years, and the gallery was to receive a commission of 50 percent of the proceeds from the sale of each painting.

The Service argued that because the foundation was a beneficiary under Mark Rothko's will, it had a vested beneficial interest in the property of the estate. The Service maintained that Reis' acts with respect to the property of the estate simultaneously and adversely affected the foundation's beneficial interest and constituted an indirect use of foundation assets by or for the benefit of Reis. The Service cited section 53.4941(d)-1(b)(3) of the regulations, as authority for the general proposition that acts of self-dealing with respect to property of an estate also will be regarded as acts of self-dealing with respect to assets of a private foundation that has a beneficial interest in the property of the estate.

The court agreed, explaining:

> In summary, regardless of whether the foundation is considered to have had a vested or merely an expectancy interest under New York law in the property of the Mark Rothko Estate, under section 4941 and the relevant Treasury regulations, the expectancy interest the foundation had in the estate is treated as an asset of the foundation, and transactions affecting property of the estate are treated as affecting assets of the foundation. Such transactions are excepted from the definition of acts of self-dealing under section 4941 only if they qualify for the exception described in section 53.4941(d)-1(b)(3), Excise Tax Regs., or under one of the other available exceptions (e.g., the exception for transactions which provide only incidental benefits to disqualified persons).

PART V -- TERMINATION OF AN ESTATE ISSUES FOR TRUSTS AND ESTATES

The termination issue is important. The date of termination controls when the provisions of IRC 4947 apply. The nature of the beneficiaries determines whether IRC 4947(a)(1) or IRC 4947(a)(2) applies.

1. 4947(a)(1)

Reg. 53.4947-1(b)(2)(ii) concerns the application of IRC 4947(a)(1). IRC 4947(a)(1) will apply when:

(1) An estate distributes all its net assets to charitable beneficiaries, and

(2) Is considered terminated for federal income tax purposes under Reg. 1.641(b)-3(a). The purpose of Reg. 1.641(b)-3(a) is to prevent an estate from continuing in existence for federal income tax purposes after it has completed all of its duties and avoiding the private foundation rules.

The estate will be treated as a charitable trust between the date the estate is considered terminated and the date of final distribution of all of the net assets to charity. It will be subject to 4947(a)(1) and all of the excise taxes under Chapter 42 of the Code.

2. 4947(a)(2)

Termination is also a significant issue for split-interest trusts. Regs. 53.4947-1(b)(2)(iii) permits a split-interest trust to remain subject to IRC 4947(a)(2) rather than IRC 4947(a)(1) in the following situation.

(1) A split-interest trust where the noncharitable interests have terminated, and,

(2) The charitable remainder beneficiaries are entitled to distributions of trust property.

The trust is still treated as a split-interest under IRC 4947(a)(2) until the date of final distribution of all of its net assets. If the trust is considered terminated for federal income tax purposes under Regs. 1.641(b)-3(b), then IRC 4947(a)(1) rather than IRC 4947(a)(2) shall apply. The difference between the two sections is significant. For example, IRC 4942 is applied to a charitable trust under IRC 4947(a)(1) but not to a split interest trust under IRC 4947(a)(2).

Grace periods for termination of other types of IRC 4947 trusts are also described in the regulations.

PART VI -- TRUSTS AND IRC 509(A)(3)

The only way a nonexempt charitable trust can avoid Chapter 42 is to become a public charity. The supporting organization rules of IRC 509(a)(3) offer the most likely possibility for public charity status. Split interests trust can not qualify for exemption or public charity status until all life interests terminate because they serve private interests.

Trusts applying for 509(a)(3) status usually request classification under the "operated in connection with" relationship. Applicants will be trusts created with exclusively charitable beneficiaries or split interests trusts where the payments to private parties have terminated.

Frequently, during bank mergers the surviving bank will discover that the trust department it acquired did not file for exempt status for hundreds of small trusts. It is questionable whether these bank trusteed nonexempt charitable trusts will qualify under the "operated in connection with" test. For an in depth discussion of this issue see the 1997 EO CPE Text, Topic I.

PART VII -- FILING REQUIREMENTS

1. FILING REQUIREMENTS

The returns, forms and schedules that this section refers to are the following:

Form 990, Return of Organization Exempt from Income Tax;
Schedule A (Form 990), Organization Exempt Under 501(c)(3);
Form 990-PF, Return of Private Foundation;
Form 990-T, Exempt Organization Business Income Tax Return;
Form 1041, U.S. Fiduciary Income Tax Return;
Form 1041-A, Trust Accumulation of Charitable Amounts; and
Form 5227, Split-interest Trust Information Return

2. EXEMPT CHARITABLE TRUSTS

Generally, exempt charitable trusts treated as public charities are required to file Form 990, Schedule A, and Form 990-T, if applicable. However, trusts whose annual gross receipts are not normally more than $25,000 do not have to file Form 990 and Schedule A. Exempt charitable trusts treated as private foundations are required to file Form 990-PF and 990-T, if applicable.

3. POOLED INCOME FUNDS UNDER 642(C)(5)

Pooled Income Funds ("PIF") are required to file Form 5227. However, a PIF created before May 27, 1969, is not required to filed Form 5227 provided no amounts were transferred to the PIF after that date. If the PIF has any taxable income, gross income of $600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien, the PIF must file Form 1041. In addition, if the PIF is not required to distribute currently all the income to beneficiaries, then Form 1041-A must also be filed.

4. CHARITABLE TRUSTS UNDER 642(C)(6)

This type of charitable trust is treated as a taxable private foundation that must file Form 990-PF. Form 1041 must be filed if the trust has any taxable income for the tax year, gross income of $600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien.

5. CHARITABLE REMAINDER TRUSTS UNDER 664

Charitable remainder trusts ("CRT") must file Form 5227. However, a CRT created before May 27, 1969, is not required to file 5227 provided that no amount was transferred to the trust after such date. Generally, the CRT is not subject to tax and as such, is not required to file Form 1041. However, if the CRT receives unrelated business taxable income within the meaning of section 512, the CRT is subject to tax as if it were a complex trust for such taxable year and must file Form 1041. See section 1.664-(1)(c) of the Income Tax Regulations and Leila G. Newhall Unitrust v. Commissioner, 105 F.3d 482 (9th Cir. 1997), aff'g. 104 TC 236 (1995). Furthermore, if the trust is not required to distribute all the income currently to the beneficiaries, Form 1041-A must also be filed.

6. NONEXEMPT CHARITABLE TRUSTS UNDER 4947(A)(1)

A nonexempt charitable trust must file Form 990 and Schedule A or Form 990-PF. Form 990 and Schedule A does not have to be filed if the trust does not have annual gross receipts that are normally more than $25,000. In addition, Form 1041 must also be filed if the trust has any taxable income, gross income of $600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien. However, if the trust has no taxable income, Form 990 or Form 990-PF may be used to satisfy the requirements of filing Form 1041.

7. ALL OTHER SECTION 4947(A)(2) TRUSTS TREATED AS PRIVATE FOUNDATIONS

These trusts must file Form 5227. However, trusts created before May 27, 1969, is not required to file Form 5227 provided no amounts were transferred to the trust after that date. Form 1041 must also be filed if the trust has any taxable income for the tax year, gross income of $600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien. In the event that the trust is not required to distribute currently all the income to the beneficiaries, then Form 1041-A must also be filed.

PART VIII -- CURRENT TRUST ISSUES

1. ACCELERATED TRUSTS

The FY 1996 EO CPE Text, Topic G discussed the accelerated unitrust issue described in Notice 94-78, 1994-2 C.B. 555. Notice 94- 78 describes the scheme, as asserted by certain taxpayers as follows:

> In these transactions, appreciated assets are transferred to a short-term charitable remainder unitrust that has a high percentage unitrust amount. For example, assume that capital assets with a value of $1 million and a zero basis are contributed to the trust on January 1. Assume further that the assets pay no income and that the term of the trust is two years, the unitrust amount is set at 80 percent of the fair market value of the trust assets valued annually.
>
> The unitrust amount required to be paid for the first year is $800,000, but during the first year no actual distributions are made from the trust to the donor as the recipient of the unitrust amount. At the beginning of the second year, all the assets are sold for $1 million, and the $800,000 unitrust amount for the first year is distributed to the donor between January 1 and April 15 of the second year. The unitrust amount for the second year is $160,000 (80 percent times the $200,000 net fair market value of trust assets). At the end of the second year, the trust terminates, and $40,000 is paid to the charitable organization.

Proponents of this transaction contend that the tax treatment of this example would be as follows. Because the trust had no income during the first year, the entire $800,000 unitrust amount is characterized as a distribution of corpus under section 664(b)(4).

> (Because the distribution is made before April 15, the distribution is treated as a payment of the unitrust amount for the trust's first year.)

The $160,000 unitrust amount for the second year is characterized as capital gain, on which the donor pays tax of $44,800 ($160,000 times the 28 percent tax rate for capital gains). The donor is left with net cash of $915,200 ($800,000 from the first year and $115,200 net from the second year). If the donor had sold the assets directly, the donor would have paid tax of $280,000 on the $1 million capital gain, leaving net cash of only $720,000.

The Notice asserts that the Service will challenge transactions of this type based on a laundry list of legal theories. Congress amended IRC 664(d)(2)(A) [and 664(d)(1)(A)] to address the problem of the accelerated trust by limiting the maximum amount of the unitrust payment amount to no more than 50 percent of the fair market value of trust assets.

Notwithstanding the new legislation or Notice 94-78, the real authority that led to the end of this type of accelerated trust abuse was new Reg. 1.664-3(a)(1)(g), which requires that payment generally be made by the end of the year.

Nothing is ever really put to rest. It comes back with a twist. Some tax professionals are advocating or promoting the revival of the accelerated charitable remainder trust in different form.

The new technique relies on the use of standard fixed payment unitrust. It is designed to meet the new 10 percent requirement of IRC 664(b)(2)(D).

(1) The trustee will borrow a large sum against the trust assets. Assume a unitrust with assets (real estate) of $1,000,000, a term of 4 years and a fixed unitrust amount of 48 percent.

(2) The real estate produces no net income but is appreciating at the rate of 10 percent per year. Assume the trustee borrows in the first year the sum of $480,000 pledged by the real estate, and the interest rate is 10 percent, payable with principal at the end of four years.

(3) In year one, the trustee distributes $480,000 of borrowed funds to the donor/income beneficiary as payment of his unitrust amount. The unitrust has earned no income in the first year. This is crucial to the technique because the distribution of $480,000 is treated, by the proponent of this scheme, as a distribution from trust principal.

(4) The unitrust payment is nontaxable to the recipient, it is asserted, because it is not a distribution of income under trust accounting principles but is a distribution of principal.

(5) At the beginning of year 2, the net asset value of the unitrust is $620,000 ($1,000,000 asset plus appreciation of 10 percent or $100,000 less the first year loan obligation distribution of $480,000 equals $620,000).

(6) In year 2, the trustee borrows $297,600 to pay the unitrust amount ($620,000 x 48% = $297,600). According to the promoters the 2nd unitrust payment is a return of principal.

(7) The unitrust payments will decline in future years and in some year there may be a sale so that the noncharitable beneficiary will realize some income. However, overall he has realized a substantial reduction in tax liability compared to a sale of the real estate for $1,000,000.

Another variation of this technique is where the trustee obtains cash for payment of the unitrust amount by entering into a forward sale contract. A forward sale contract is much like a loan against the trust property. Once the property is sold, the seller is obligated to transfer property to the person who advanced the cash under the forward sale contract.

The forward sale contract is not considered as a sale at the time the cash is advanced to the property holder because the property holder has retained the benefits and burdens of ownership. Again, in this

variation, the proponent of this scheme may argue that the distribution of cash by the trustee to the noncharitable beneficiary is treated as a tax free distribution of principal rather than the distribution of any income generated by the unitrust.

The Service issued proposed regulations on October 21, 1999, to address the problems caused by loans or forward sale contracts. The explanation of the proposed regulation states:

> The IRS and Treasury Department are aware of certain abusive transactions that attempt to use a section 664 charitable remainder trust to convert appreciated assets into cash while avoiding tax on the gain from the disposition of the assets. In these transactions, a taxpayer typically contributes highly appreciated assets to a charitable remainder trust having a relatively short term and relatively high payout rate. Rather than sell the assets to obtain cash to pay the annuity or unitrust amount to the beneficiary, the trustee borrows money, enters into a forward sale, or other similar transaction. Because the borrowing, forward sale or other similar transaction does not result in current income to the trust, the parties attempt to characterize the distribution of cash to the beneficiary as a tax-free return of corpus under section 664(b)(4).

The explanation also discussed legislative intent:

> When section 664 was amended by the Revenue Reconciliation Act of 1997, Congress indicated that a scheme that, in effect, attempts to convert appreciated assets to a tax-free cash distribution to the non-charitable beneficiary is "abusive and is inconsistent with the purpose of the charitable remainder trust rules." Rep. No. 33, 105th Cong., 1st Sess. 201 (1997).

The explanation goes on to state that under the authority provided by IRC 643(a)(7), the proposed regulations modify the treatment of certain distributions by charitable remainder trusts for purposes of section 664(b) to prevent a result inconsistent with the purposes of the charitable remainder trust rules.

The language of Proposed Reg. 1.643(a)-8(b) includes the following provisions to address the problem:

> (b) Deemed sale by trust. (1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year for which a distribution of an annuity or unitrust amount from the trust is due, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount-
>
> (i) Is not characterized in the hands of the recipient as income from categories described in section 664(b)(1), (2), or (3), determined without regard to this paragraph (b); and
>
> (ii) Was made from an amount received by the trust that was not --

(A) a return of basis in any asset sold in the trust

(B) Attributable to cash contributed to the trust with respect to which a deduction was allowable.

In effect, the proposed regulation will treat the proceeds from the loan proceeds or proceeds from a forward sale contract as if such proceeds resulted from a deemed sale of the appreciated asset by the trust, thus, requiring the recipient to recognize the inherent gain in the year of distribution of proceeds notwithstanding that a sale under the local law provisions may not occur until some future date. The language of the proposed Regulations also set forth certain exceptions to the rule.

2. VULTURE TRUSTS

Similar to the vulture, the promoters of this form of charitable lead trust circle in on mortally ill young people. The promoter, prepared with the names and medical records of ailing young people, offers to set up a charitable lead trust using these unrelated individuals as the measuring lives for their wealthy, healthy donors. Described by critics as "the grotesque and the ghoulish", this trust takes advantage of the actuarial tables used by the Service to calculate life expectancy for gift-tax purposes. This structure yields big benefits for the donor and the donor's beneficiaries. In effect, the donor pays minimal gift taxes, provides insignificant amounts in total payments to the named charity and transfers the remaining but significantly valuable trust assets to the donor's beneficiaries. In response to this practice, Treasury published proposed regulations this past April barring this abusive tax scheme. The new regulations limit the measuring life to the life of the grantor, the grantor's spouse, or a lineal ancestor of the remainder beneficiaries.

G. CONTROL AND POWER: ISSUES INVOLVING SUPPORTING ORGANIZATIONS, DONOR ADVISED FUNDS, AND DISQUALIFIED PERSON FINANCIAL INSTITUTIONS - by RON SHOEMAKER AND BILL BROCKNER

"IT IS NOT WHAT YOU OWN;
IT'S WHAT YOU CONTROL"
ATTRIBUTED TO JOHN D. ROCKEFELLER

"THE DESIRE OF POWER IN EXCESS CAUSED THE ANGELS TO FALL"
FRANCIS BACON FROM "OF GOODMEN"

1. INTRODUCTION

The 1997 CPE Text, Topic I, and the 2000 CPE Text, Topic P, addressed some of the more common issues and problems of organizations asserting supporting organization status under IRC 509(a)(3). The 1997 CPE Text concentrated primarily on the "operated in connection with" relationship test under Regs. 1.509(a)-4(i), although other important issues were discussed. The 2000 CPE Text focused on the IRC 509(a)(3) control test. This topic will elaborate on the control test; discuss the IRC 501(c)(3) "threshold" requirements; and comment on other IRC 509(a)(3) issues under Regs. 1.509(a)-4(b), (c), (d), and (e) relating to the organizational and operational tests. Part 7 includes a supporting organization check sheet, "SOCHECK", to guide EO specialists through a IRC 509(a)(3) determination.

In addition, this article will provide an update of control and power issues, discussed in prior CPE Texts, relating to donor advised funds ("DAFs") under IRC 501(c)(3) and IRC 4941 self- dealing with respect to disqualified person financial institutions and their financial products and services. The topic will also update the 2000 CPE Text, Topic P, p. 225, discussion on the treatment of IRC 4947(a)(2) distributions to private foundations under IRC 4940. Finally, the topic will touch on the Charitable Family Limited Partnership, another recent tax plan with EO connections and tax abuse potential.

2. IRC 509(A)(3) SUPPORTING ORGANIZATIONS

NOTE: Hereafter we will identify the terms "supporting organization" and "supporting organizations" as "SO" and "SOs" respectively; an "operated, supervised or controlled by" SO as a "SO1", a "supervised, or controlled in connection with" SO as a "SO2", and an "operated in connection with" SO as a SO3"; IRC 509(a)(1) and 509(a)(2) supported organization(s) will be identified as "SD" and "SDs"; and disqualified persons will be referred to as DPs.

A. THRESHOLD REQUIREMENT -- IRC 501(c)(3) STATUS

Before considering IRC 509(a)(3) classification, it is necessary to determine if the organization is exempt under IRC 501(c)(3), or, in the case of a non exempt trust under IRC 4947(a)(1), whether all unexpired interests are devoted to solely charitable purposes.

In explaining IRC 509(a)(3) in conjunction with certain grandfather exceptions for existing organizations, the General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-171, p. 59, footnote 29, (Blue Book) states:

> However, this does not change the basic requirement for exemption in section 501(c)(3) that the organizations have been organized and operated exclusively for tax exempt purposes listed in that provision.

EO Determination Specialists, Examination Agents, and Tax Law Specialists should initially review the IRC 501(c)(3) charitable credentials of a IRC 509(a)(3) applicant as vigorously as they would initially review the IRC 501(c)(3) charitable credentials of an applicant claming public charity status under IRC 509(a)(1) or 509(a)(2).

One recent concern is the appearance of a line of cases wherein the 1023 applicant is performing services for unrelated specified charities as a primary activity. Organizations that provide noncharitable services to such a class of organizations do not qualify for exemption themselves unless they are covered by statute, i.e., IRC 501(e) or IRC 501(f), or they provide services at substantially below cost. See Rev. Rul. 71-529, 1971-2 C.B. 234, and Rev. Rul. 72-369, 1972-2 C.B. 245, and the 1986 CPE Text, Topic H.

Recent T:EO examples of unrelated services proposed to be performed by 1023 applicants for unrelated IRC 501(c)(3) organizations include facilitating bond issuances for community trusts or environmental charities, prepaid tuition programs for a number of private colleges, and job placement services for a group of colleges and their alumni. See also Topic E of this Text on College Housing.

B. ORGANIZATIONAL AND OPERATIONAL REQUIREMENTS

(1) OVERVIEW

Applicants must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more SDs.

Pursuant to Reg. 509(a) -- 4 (c) and (d), an SO's articles must:

(a) Limit purposes to IRC 509(a)(3)(A) purposes;

(b) Not expressly empower SO to engage in activities not in furtherance of purposes in (a);

(c) State the specified SDs on whose behalf such SO is to be operated; and

(d) Not expressly empower the SO to operate to support or benefit any SD other than those referred to in (c).

Further, Reg. 1.509(a)-4(e) provides that an SO will be regarded as "operated exclusively" to support one or more specified SDs only if it engages soley in activities which support or benefit the specified SDs.

In Trust under will of Bella Mabury v. Commissioner, 80 T.C. 733 (1983), the terms of a decedent's trust described in IRC 4947(a)(1) provided that the trust would terminate upon the earlier of (1) the publication of a book by a specified IRC 509(a)(1) church or (2) the expiration of 21 years from the date of the survivor of the persons named in the decedent's will. If (1) occurred, the trust estate would be distributed to the church. If (2) occurred, the trust estate would be distributed to two other organizations designated in decedent's will not stipulated in the facts as IRC 509(a)(1) or 509(a)(2) entities.

The Tax Court held that the trust failed the organization test within the meaning of IRC 509(a)(3) and Regs. 1.509(a)-4(c) because the Trust's articles "expressly empower" the trust to benefit organizations other than specified organizations described in IRC 509(a)(1) or (2).

(2) SPECIFICITY IN GENERAL AND SO1 AND SO2 REQUIREMENTS

Reg. 1.509(a)-4(d) provides that the articles of the SOs must specify the IRC 509(a)(1) and 509(a)(2) SDs by name. However, more latitude is granted to SO1s (Reg. 1.509(a)-4(g)) and SO2s (see Reg. 1.509(a)-4(h)). In such cases, the articles of organization need not specify the SDs by name but may,

instead benefit one or more beneficiary organizations designated by class or purpose. Example (1) of Reg. 1.509(a)-4(d)(2)(iii) describes organization, X, which operates for the benefit of institutions of higher learning in State Y. X is controlled by these institutions. If X's articles require it to operate for the benefit of such institutions, X will meet the organizational test. In Example (2), M is an organization described in IRC 501(c)(3), which was organized and operated by representatives of N church to run a home for the aged. M is controlled by N. The care of the sick and the aged are long standing temporal functions and purposes of organized religion such as N. By operating a home for the aged, M is operating to support or benefit N church in carrying out its temporal functions. Thus M operates to support one of N's purposes without designating N by name.

Under the regulations and the examples cited, articles that merely provide the SO would benefit all IRC 501(c)(3) public charities in a particular geographical area do not meet the specificity requirements.

Reg. 1.509(a)-4(d)(2)(iv) provides another special rule for SO1s and SO2s. A SO will meet the organizational test even though its articles do not designate each "specified" organization if there has been an "historic and continuing" relationship between the SO1 or SO2 and the SDs, and, by reason of the relationship, there has developed a "substantial identity" of interests between the organizations. In Windsor Foundation v. U.S., 1977-2 USTC 9709, the Tax Court held that the SO failed the organization test because of the failure to establish a "substantial identity" of interests between the SO and the SD.

Finally, Reg. 1.509(a)-4(d)(3) provides more special rules for SO1s and SO2s. A SO will not fail the test of being organized for the benefit of "specified" organizations solely because its articles:

(i) Permit the substitution of one SD within a designated class for another SD, either in the same or a different class designated in the articles;

(ii) Permit the SO to operate for the benefit of new or additional SDs of the same or a different class designated in the articles; or

(iii) Permit the SO to vary the amount of its support among different SDs within the class or classes of organizations designated by the articles.

The key to achieving the latitude granted in the regulations is to provide for it in the organizing document. Thus, a change of SDs in the organizing instrument of the SO1 or SO2 that was not covered by articles permitted under Reg. 1.509(a) -- 4(d)(3), may cause the SO to fail the organization test, the operational test (when distributions are made by the SO to substituted SDs), and the SO1 or SO2 relationship test. See, for example, PLR 9052055, October 4, 1990. See also PLR 97309040, October 6, 1997, involving substitutions made pursuant to a governing instrument reformation approved by a court.

(3) REQUIREMENTS FOR SO3S

SO3s, the "razor edge" organizations described in Reg. 1.509(a)-4(i), must have governing instruments that designate a specified SD. However, there is some flexibility permitted by the Regulations. Reg. 1.509(a)-4(d)(i)(a) provides that an SO will not be disqualified merely because its articles permit an SD designated by class or purpose, rather than by name, to be substituted for the SDs designated by name in the articles, but only if the substitution is conditioned on an event "beyond the control" of the SO, such as loss of exemption. Also, Reg. 1.509(a)-4(d)(4)(i)(a) provides that the articles may permit the SO3 to vary the amounts of its support between different SDs, so long as the amounts meet the requirements of the integral part test of Reg. 1.509(a)-4(i)(3) with respect to at least one beneficiary. A third exception in Reg. 1.509(a)- 4(d)(4)(i)(b) is likely to be of limited application. It permits the SO3 to have governing instrument language allowing it to operate for the benefit of a

beneficiary organization that is not publicly supported, but only if the SO3 currently operates for the benefit of an IRC 509(a)(1) or (a)(2) SD and the possibility of operating for the benefit of the other SD is a remote contingency. Reg. 1.509(a)- 4(d)(4)(c)(ii) and (iii) make clear, however, that once the SO3 is no longer supporting the SD and the SO3 is supporting the non IRC 509(a)(1) or (2) organization, because the remote contingency has occurred, the SO3 would then fail to continue to qualify as SO. As with SO1s and SO2s, the flexibility permitted in the Regulations for SO3s is conditioned on appropriate language in the governing instrument.

(4) SPECIFICITY EXAMPLES

A number of authorities illustrate the rules. In Rev. Rul. 79-197, 1979-1 C.B. 204, a SO1's articles of organization required it to pay its future income to specific SDs named in the articles, until a specific sum was paid. After that, it would pay all its assets to public charities selected by the substantial contributor to the SO1. Rev. Rul. 79-197 explains that the organization failed as a SO under IRC 509(a)(3) because, in the end, it was not supporting a SO designated by name, class, or purpose. Although the organization was described as a SO1 and thus was entitled to the more liberal designation requirements of Reg. 1.509(a)-4(d)(2), it failed to qualify as an IRC 509(a)(3) SO because its articles did not specifically designate the SD by class or purpose.

In Quarrie Charitable Fund v United States, 603 F.2d 1274 (7th Cir.,1979), the trust document allowed the trustee to transfer the income to a SD other than the designated charity when, in the trustee's discretion, the charitable uses would become unnecessary, undesirable, impractical, or no longer adapted to the needs of the public. The court found that the language failed the organizational requirement of Reg. 1.509(a)-4(d)(4)(i)(a). The court explained that the problem was not that the charitable use may become impractical or undesirable, but that in the trustee's discretion, such use may become impractical or undesirable etc. In contrast, the Regulations establish objective standards of when the charitable recipient may be changed.

Other cases on the organizational and designation requirements of the regulations were discussed in the 1997 CPE Text, Topic I, page 123-125. In the Goodspeed, Callahan, and Cockerline scholarship cases, the respective courts found that the SOs, by virtue of the language in the trust documents, were supporting specific organizations, i.e., specific high schools or colleges, even though they may not have been directly named in the trust documents.

The organization and operation test discussion herein fits within the major theme of this Topic regarding control and power of DPs or others. As evident in Rev. Rul. 79-179 and the Quarrie case, if discretion (i.e., control or power) is given or retained to select the SD outside the parameters is permitted in the regulations, the SO will fail to qualify under IRC 509(a)(3). For example, retained power in SO3 X's trust instrument to allow descendent DPs to substitute Community Trust A with Community Trust B when such DPs move to the B geographic area would cause X to fail the organization test. It is again important to note that the regulations do allow some flexibility in terms of substituting or adding SDs, provided appropriate language is included in the articles of organization.

C. IRC 509(a)(3)(C) -- PROHIBITION OF DP CONTROL OF SOs

(1) OVERVIEW

IRC 509(a)(3) is an area of aggressive tax planning by some taxpayers and their advisors, particularly entities claiming status as SO3s. Applicant SO3s often, and inappropriately, attempt to avoid private foundation status and IRC Chapter 42 regulation while their DPs retain control of assets. This was discussed in Inappropriate Use of a Supporting Organization at page 222 of the 2000 CPE Text, Topic P.

This year's topic leads off with a quote attributed to oil industry titan, John D. Rockefeller, the essence of which is that control may be a more important factor than ownership itself. Control may be the most critical or meaningful factor in the plethora of requirements that must be met for an organization to be classified as an IRC 509(a)(3) SO. SO1 and SO2 applicants generally display facts and circumstances tending to indicate that SDs are in control. On the other hand, SO3 applicants have a greater proclivity to display facts and circumstances tending to show that DPs directly or indirectly control the SOs.

Excess benefits transactions under IRC 4958 may also occur in SOs with Boards consisting of DPs without adequate conflict of interest procedures. The "rebuttable presumption" rules under proposed Regs. 53.4958-6 provides a standard.

(2) CONTROL -- REGULATORY AUTHORITY

IRC 509(a)(3)(C) provides that an organization will fail to qualify as a SO if it is directly or indirectly controlled by one or more DPs as defined under IRC 4946, other than foundation managers.

Reg. 1.509(a)-4(j)(1) provides that if a person who is otherwise a DP with respect to a SO, for example, a substantial contributor, is appointed or designated as a foundation manager of the SO by a SD to serve as the representative of the SD, such person will still be regarded as a DP, rather than as a representative of the SD.

Reg. 1.509(a)-4(j)(1) also provides:

> Under the provisions of IRC 509(a)(3) a SO may not be controlled directly or indirectly by one or more DPs. An organization will be considered "controlled" for purposes of IRC 509(a)(3), if the DPs, by aggregating their votes or positions of authority, may require such organizations to perform any act which significantly affects it operations or may prevent such organization from performing such act. . . . a SO will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting right with respect to stocks in which members of the governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization."

(3) THE ESSENCE OF CONTROL -- FOUR EXAMPLES

(a) EXAMPLE 1 -- REV. RUL. 80-207

Rev. Rul. 80-207, 1980-2 C.B. 113, provides an example of indirect control. In Rev. Rul. 80-207, two of the four SO directors were also employees of a corporation in which the substantial contributor to the organization owned more than 35 percent of the voting power of the corporation. This individual was also a director of the SO. Because of the employment relationship of the two employee board members, Rev. Rul. 80-207 concluded that the SO was controlled indirectly by the DP.

Rev. Rul. 80-207 provides the following analysis:

> Because only one of the organization's directors is a disqualified person and neither the disqualified person nor any other director has a veto power over the organization's actions, the organization is not directly controlled by a disqualified person under section 1.509(a)-4(j) of the regulations. However, in determining whether an organization is indirectly controlled by one or more disqualified persons, one circumstance to be considered is whether a disqualified person is in a position to influence the decisions of members of the organization's governing body who are not themselves disqualified persons. Thus, employees of a disqualified person will be considered in determining whether one or more disqualified persons controls 50 percent or more of the voting power of an organization's governing body.

Rev. Rul 80-207 clarifies that all pertinent facts and circumstances will be considered in determining whether a DP does in fact indirectly control an SO such as through a position of influence.

(b) EXAMPLE 2 – CONTROL OF BOARD OF DIRECTORS

Consider the following example: "T" seeks status as a SO1. T has a five member board of directors. Two directors, substantial contributors, "M" and his wife, are DPs under IRC 4946. The other three directors are officers or directors of the SD. One of the three SD directors, "O", is a partner in a law firm that represents the substantial contributors, T, and the SD. O and his firm represent M and his wife on their personal tax affairs. Further, the SO's directors elect M as the initial operating CEO of the SO. Two of T's three remaining officers are also DPs. Reg. 1.509(a)-4(j)(i) provides that if a SD designates a person who is otherwise a DP, aside from being a foundation manager to the SO, that person is still regarded as a DP. Under the circumstances, T appears indirectly controlled by DPs as in Rev. Rul 80-207. It would be difficult to see how O could remain independent or be objective in his T board of director dealings with M and his wife. Other cumulative evidence of DP control of T is the fact that three of the four officers are DPs.

(c) EXAMPLE 3 – COMPLEX TRUSTEE STRUCTURE

The control issue should be thoroughly analyzed if organizational documents or other facts indicate that: 1) DPs select the "non DPs" or "independents" or "community members" on the Board; or 2) committees controlled by DPs nominate Board members. Other control indicia might include bylaws that provide that DP members of the Board of Directors cannot be removed, even for cause. This is strong evidence of prohibited control. See, for example, D below.

Consider this hypothetical: X is a charitable trust that claims IRC 509(a)(3) status as an SO3 following Rev. Proc. 72-50, 1972-2 C.B. 830. X will provide support to specified SDs as provided in the trust document.

X will receive contributions, make investments, and make grants to SDs in the board's discretion, except that grants totaling over $100,000 to single recipients within a 12-month period must be approved either by (1) the vote of at least 2/3rds of the X Board of Trustees, or (2) two majority votes of the Board, one preceding and one following the annual reconstitution of the Board.

X's Board consists of two "Class A" trustees and three "Class B" trustees. The Class A trustees will be A, the grantor/creator, and a family member of A, or an employee of an entity that A owns. Class B trustees cannot include any DPs.

X's Board will be reconstituted every year. The Class A trustees select the successor Class A trustees. Class B trustees are selected by majority action of the Trustee Electors from among nominations approved by the Class B Nominating Committee. The Trustee Electors, who elect their successors, will be officers or directors of an SD, but cannot include DPs. X's Nominating Committee consists of two individuals selected by the Class A trustees and one selected by the Trustee Electors, and may include trustees. A majority of the Nominating Committee approves the slate of candidates, which includes at least two candidates for each position to be filled. The Trustee Electors then vote on the slate. If the Trustee Electors do not elect a Class B trustee position, then the Nominating Committee proposes a different slate of candidates for each unfilled position. If the Trustee Electors do not fill the Class B trustee position after two slates, then the Class A trustees shall elect the Class B trustee to fill the unfilled position. Trustees of either class may be removed, but only for cause and only by the affirmative vote of 2/3rds of the Trustee Electors. A trustee may delegate in writing his or her rights to any other trustee.

A's approval is expressly required to amend X's trust instrument. Given A's power over the trustee selection process discussed above, A can effectively prohibit grants exceeding $100,000 to a single recipient within a 12-month period. Moreover, a trustee may delegate his or her voting rights on substantive matters to A in making distributions upon dissolution.

If individual A is legally competent, X trust instrument may be amended only with his written approval. If he is dead or incompetent, X's board may amend with an 80% vote. The trust instrument provides that A's charitable preferences will be used as a guide.

In this hypothetical, X fails to meet the control test as a SO because X is indirectly controlled by a DP. A directly controls his own position on the board and indirectly controls the other Class A trustee positions through family or employment relationships. Further, the facts and circumstances show that A exercises indirect control over the three Class B trustee positions through his control over the slate of nominees for those positions. Although A cannot ensure that a particular individual will be on X's Board (because two candidates must be offered for each open position), A can ensure that particular individuals will not be on the X Board. A has in effect veto power over the return of any or all of the incumbent Class B trustees to the board, such as trustees who may not agree with his ideas on the direction of X. As the Board is reelected every year, A can depend on an X Board that will endorse A's views and proposals. By controlling the nomination process, A also maintains the ability to steer grants to the charities of A's choice. A's control is also manifested by the trust instrument's expressed intent that X not survive A's death or incompetence for very long, and that the Board use A's charitable preferences as a guide in making distributions upon dissolution.

(d) EXAMPLE 4 -- SO ASSETS CONTROLLED BY DPs

Consider this hypothetical:

Business owner G loans cash to his wholly-owned corporation, H, in an exchange for a promissory note (NOTE) issued by H. NOTE is secured by real estate owned by H and used in its business. Further, H has purchased key man insurance to pay off the debt in the case of G's death. G transfers NOTE to newly organized SO3, "J". G and his wife serve as two of the five directors of J and one director is appointed by SD, "Q". G is DP by virtue of being a substantial contributor in addition to being a foundation manager.

J's asset is H's NOTE. Because G controls H, G controls NOTE transferred to J. If he wished, G could consume all of H's income and liquid assets through salary and dividends leaving nothing to be paid on NOTE. G could also operate H in an imprudent manner, such as an untimely expansion of H's product or service without adequate capital support, which could work to the detriment of J.

J asserts that J holds NOTE secured by H real estate and by the corporate life insurance policy on G. The life insurance can be cancelled or cashed in by H. G's control of H allows him control over the real estate. Any number of actions taken by G could impair the security. For example, G, in operating H, could incur debt (or have incurred debt) secured by the real estate with a priority equal to or greater than the priority of the security held by J. Further, G could impair the going concern value of the H business in a manner that impairs the market value of H's underlying real estate asset.

Whether a DP indirectly controls the supporting organization is based on "all pertinent facts and circumstances." Regs. 1.509(a)-4(j)(I), extracted in (2) above, mention that the time length of the retention of SO assets, as well as the manner of exercising voting rights in stock in which members of the SO's governing body also have interests, are factors to suggest that a DP's continuing relationship with certain SO assets have a bearing on the control issue. In this hypothetical, NOTE held by J and G's connection to NOTE are relevant facts.

Since G exercises, in large part, control over J's asset, it would be difficult not to conclude that G is exercising indirect control over J. Inurement issues may also arise where DPs, such as G, may use assets of IRC 501(c)(3)s for their use. See, for example, Rev. Rul. 67-5, 1967-1 C.B. 123.

Other SO control examples are discussed in the 1997 CPE Text, page 116, et. seq.

D. SOs AND DONOR ADVISED FUNDS ("DAFs")

T:EO is considering situations in which a DAF associated with an IRC 501(c)(3) SD is claiming SO status. As we will discuss through the example below, a DAF may not be compatible with an SD in terms of being classified as an IRC 509(a)(3). In Part 3 of this Topic, we will update past CPE topics on DAFs with a claimed public charity status other than IRC 509(a)(3).

Consider the following example of proposed DAF SO3 X associated with an SD:

X is a charitable trust described in IRC 4947(a)(1). Pursuant to Rev. Proc. 72-50, 1972-2 C.B. 830, X applies for status as a SO3 under IRC 509(a)(3). X's trust instrument provides that the assets are devoted to benefit Christian activities, and that X's primary mission is to support Christian educational activities, such as Christian youth organizations worldwide, with an emphasis on education and scholarship grants. X will receive gifts from its donor founders, invest them, and use the principal and income to support various programs of Christian organizations worldwide.

X's substantial contributor founders are A and B. They are also X's trustees, along with a third trustee. A and B cannot be removed as trustees except upon resignation, death, or incapacitation. Future trustees shall be selected from the direct descendants of A and B. If there are insufficient descendants to constitute a majority, X will be dissolved. X will also be dissolved after the death or permanent incapacitation of the last grandchild of the donors.

The SD named in the trust instrument is Z. Z claims IRC 501(c)(3) and 170(b)(1)(A)(vi) status. Z has the power to enforce the trust agreement and compel an accounting. X may make its grants either through Z or directly, with Z's prior approval, in amounts a majority of X's Trustees determine. Most Board decisions, including trustee selections and grant approvals, must be reviewed by Z. Z cannot unilaterally withhold approval but must provide a valid reason to X for any disapproval. Z has no review approval over X's investment policies.

Z is a relatively large organization with prior year total revenues and expenses in the millions of dollars. Z provides the following public information about its operations:

> Here's how we operate: You approach us with a particular project, either educational, scientific, religious, or charitable. Our board reviews it, and if we believe it falls

within our purposes, we accept it as a 'foundation account' or a Z foundation.

The control of a "foundation at Z" is in the hands of the Donor/Applicant, or his designee, under the final authority of the Z. For there to be a "completed gift", the final authority has to be given to the charity -- just like it would be if you set up your own "three person Board" in a private foundation. But we make our living by helping you accomplish your bona fide charitable purposes, and we would be swiftly out of business if we crossed up any bona fide charitable suggestions you or your designee might make . . . your foundation can support any qualified charity, except those where your gift will encourage (1) violence (2) promote atheism, or (3) compromise the freedoms guaranteed in our Constitution. We also permit your foundation within this framework to also conduct independent charitable activities.

The facts here make it difficult for X to establish its SO3 status under IRC 509(a)(3). A majority of X's board consists of DPs, who cannot be removed except upon resignation, death, or incapacitation, and, in the future, descendants of DPs. X's board approval is required for X to take most actions. Although Z maintains an approval power over certain decisions, this power does not extend to investment decisions and cannot in any case be exercised unilaterally. Moreover, Z has publicly acknowledged that it will not disapprove any proposal that is charitable in nature and fits within its extremely broad guidelines. In form and in substance, X is controlled by DPs.

Further, X has failed to establish that it meets the operational test of IRC 509(a)(3)(A) and Reg. 1.509(a)-4(e)(1), because in addition to making payments to Z and making grants and providing services to the individual members of the charitable class benefited by Z, X will also make grants to other organizations besides Z. Although Z may approve these grants to other organizations, its authority to disapprove them is significantly restricted, as discussed above. Moreover, Z can make no grants of X's assets without the approval of a majority of X's board. Thus, the grants to other organizations are made by X rather than by Z.

X can carry on independent activities that may not promote Z's purposes and activities. This may conflict with the Reg. 1.509(a)-4(i)(3)(ii) SO3 integral part test (See FY 1997 EO CPE Text, page 108) and/or the organizational and operational tests that are discussed earlier in 2.B of this topic. Also, the power of X to make grants to other organizations without Z's authority and Z's lack of a voice in investment policies make it difficult to meet the Reg. 1.509(a)-4(i)(2)(ii) responsiveness test.

As a collateral matter, Z's status under IRC 509(a)(1) and IRC 170(b)(1)(A)(vi) appears questionable if Z's activities are primarily to service entities such as X.

E. IRC 6104(d) DISCLOSURE REQUIREMENTS AND IRC 509(a)(3) ORGANIZATIONS

Final Regulations under IRC 6104(d), effective March 13, 2000, and published as T.D. 8861 in 2000-5 I.R.B. 441, January 31, 2000, make it clear that IRC 509(a)(3) organizations are subject to the disclosure requirements in the same manner as all other tax- exempt organizations. They include IRC 4947(a)(1) charitable trusts classified as IRC 509(a)(3) organizations through application of the procedures under Rev. Proc. 72-50, 1972-2 C.B. 830. See Reg. 301.6104(d)-1(b)(2); 2000-5 I.R.B. 445.

F. SOCHECK ON IRC 509(a)(3) -- A CHECKSHEET GUIDE TO STATUS DETERMINATIONS

The SOCHECK checksheet may be found in Part 7.

3. DONOR ADVISED FUNDS -- POWER AND CONTROL ISSUES

A. GENERAL UPDATE

Donor advised funds (hereafter "DAFs") are a thriving industry. According to the Chronicle on Philanthropy, November 4, 1999, the donor advised Fidelity Charitable Gift Fund was number 3 on the Philanthropy 400 for 1998. Only the Salvation Army and the YMCA garnered more receipts.

DAFs have been discussed in a number of recent CPE texts, most recently in Topic C, page 222 of the 2000 CPE Text. Over the last year, T:EO has seen an increasing number of exemption applications or ruling requests involving DAFs. The Service continues to closely scrutinize these cases, especially their public charity status under IRC 509(a)(1) and 170(b)(1)(A)(vi).

T:EO continues to review exemption applications or ruling requests with a DAF feature using the principles similar to the material restriction or condition requirements of Reg. 1.507-2(a)(8). Based on this approach, the Service will look closely at applications that include contractual or promotional material that indicates the DAF would follow donor advice as to charitable distributions all the time, provided that the distribution was made to a public charity. Authority for treating this as a negative factor is found in Reg. 1.507-2(a)(8)(iv)(A)(1) and Example (4) of Reg. 1.507-2(a)(8)(v). The facts of Example (4) involve a transfer of funds to a community trust, which is a public charity described in IRC 170(b)(1)(A)(vi). Under the terms of the transfer, a creator of the transferor foundation retains the right to determine what charities are to receive distributions from the funds and the community trust has no right during the lifetime of the creator to vary his direction as to distribution of funds to the ultimate charity. Example (4) concludes, that, under such facts, there is a restriction on the transferred funds. In the example, the community trust/transferee is precluded from determining the charitable distributee different than that designated by the creator of the transferor and, thus, precludes the transfer as being treated as part or a component fund of the community trust. The Example treats the funds as a separate trust. Compare this with PLR 200028038, April 14, 2000, which describes a donor advised component in a community trust that follows the requirements of Reg. 1.507-2(a)(8) and represents that it will adopt an annual 5 percent distribution.

Many, if not most, DAFs have implicit or explicit contractual relationships with their donor advisors that require that distributions from the DAFs may only be made with the recommendation of the donors. Put another way, distributions from donors may only be triggered by donor recommendations.

T:EO presently is considering whether this triggering mechanism should be a negative factor. The regulations provide that a retained power to direct the timing of distributions may constitute an adverse factor. Specifically, Reg. 1.507-2(a)(8)(iv)(A)(1) provides that an adverse factor includes, with respect to distributions, the reservation of a right by a disqualified person to direct the timing of distributions to public charities described in IRC 509(a)(1) or (2). The purpose of this material restriction or condition requirement of the Regulation is to ensure that the transfer has relinquished dominion and control ("ownership") of the transferred property. It would be logical to assert that if a DAF is unable to initiate a charitable distribution to a public charity, it lacks dominion and control or "ownership" over the property.

Some DAFs promote, with respect to their donor advisors, specific programs of giving. Depending on the vigor with which such programs are carried out, and the nature of the timing of the promotional communications, such promotions may be viewed as tantamount to requests or demands for distribution.

Further, some DAFs may place more stringent requirements on donor advisors than others. Some DAFs impose an annual 5 percent distribution of net fair market value of assets on each separate donor advised account comparable to the IRC 4942 distribution requirement for private foundations. A failure to recommend such distribution by a donor advisor would result in transfer of funds from the non-compliant donor advisor's account to the DAF's unrestricted account. Such a default provision may be viewed as a method by which the DAF initiates a distribution.

B. LEGISLATIVE PROPOSAL

In February, 2000, the Department of the Treasury issued the General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals. The Revenue Proposals included tax provisions addressing DAFs. At page 106, this document states, in part, as follows:

> In recent years, the use of so-called "donor advised funds" maintained by charitable organizations has grown dramatically. These funds generally permit a donor to claim a current charitable contribution deduction for amounts contributed to the charity and to provide ongoing advice regarding the investment or distribution of such amounts, which are maintained by the charity in a separate fund or account. Several financial institutions have formed charitable corporations for the purpose of offering such donor advised funds, and other existing charities have begun operating donor advised funds. Although these donor advised funds resemble the separate funds maintained by community trusts, the rules governing their operation are unclear.
>
> Some, but not all, charities that maintain donor advised funds have voluntarily adopted minimum annual payout requirements. As a result, there is concern that amounts maintained in donor advised funds are not being distributed currently for charitable purposes. The lack of uniform guidelines governing the operation of donor advised funds also raises concerns that such funds may be used to provide donors with the benefits normally associated with private foundations (such as control over grantmaking), without the regulatory safeguards that apply to private foundations. Accordingly, legislation is needed to encourage the continued growth of donor advised funds by providing clear rules that are easy to administer, while minimizing the potential for misuse of donor advised funds to benefit donors and advisors.
>
> The proposal would provide that a charitable organization which has, as its primary activity /14/, the operation of one or more donor advised funds may qualify as a public charity only if: (1) there is no material restriction or condition that prevents the organization from freely and effectively employing the assets in such donor advised funds, or the income therefrom, in furtherance of its exempt purpose; (2) distributions are made from such donor advised funds only as contributions to public charities (or private operating foundations) or governmental entities: and (3) annual distributions from donor advised funds equal at least five percent of the net fair market value of the

organization's aggregate assets held in donor advised funds (with a carry forward of excess distributions for up to five years). It is intended that the definition of "material restriction" generally will be based on current-law regulations under section 507, but the existence of a material restriction will not be presumed from fact that a charity regularly follows donor advice. Failure to comply with any of these requirements with respect to any donor advised fund would result in the organization's being classified as a private foundation, and, therefore, being subject to the current-law private foundation rules and excise taxes. In addition, the proposal would require any other charitable organization that operates one or more donor advised funds, but not as its primary activity, to comply with the above three requirements. If such an organization (e.g., a school that operates donor advised funds) fails to satisfy these requirements with respect to its donor advised funds, the organization's public charity status would not be affected, but all assets maintained by the organization in donor advised funds would be subject to the current-law private foundation rules and excise taxes.

Various groups have submitted comments on the administration's proposal to Congress and to the Treasury Department. See, proposed legislative recommendations from some of the most important DAFs and the Council of Foundations in the Exempt Organization Tax Review, July 2000, vol. 29 No. 1. Page 208 et. seq. As of August 1, 2000, no DAF bill has been introduced in Congress.

4. UPDATE ON IRC 4941 -- FOUNDATION MANAGER BANK'S USE OF PRIVATE FOUNDATION FUNDS TO FURTHER BANK'S COMMERCIAL ENDEAVORS

A. OVERVIEW

T:EO has been considering the IRC 4941 implications of foundation manager banks that invest the funds of their private foundation customers. This investment activity may serve the needs of the private foundation for investment income and simultaneously benefit the bank (or other financial institution) by furthering a specific business opportunity. As in the quote from Francis Bacon, extracted on the title page of this topic, power in excess caused the angels to fall. Non-bank trust function activity can be a self- dealing act. This issue was discussed at some length in the 1999 EO CPE Text, Topic P, pages 324-326, and the 2000 EO CPE Text, Topic P, pages 234 to 237. In the 2000 EO CPE Text, we discussed two examples. The respective offices of T:EO and CC:TEGE:EOEG have reached a tentative consensus on these two examples which we will identify as A and B.

B. EXAMPLE A

(1) FACTS (EXTRACTED FROM THE 2000 EO CPE TEXT, PAGE 234)

The foundation manager, X, is a national banking institution, which serves as trustee of a number of private foundations. Corporate entities related to the parent corporation of X have created two business trusts (BTs) under state law to invest in large commercial investments not otherwise available to the public at large. Under the placement agreement between the parties, X is obligated to use its reasonable efforts to procure subscriptions for the purchase of beneficial interests in the

(BTs) by eligible investors in accordance with the provisions of the agreement. For such services, X is contractually entitled to receive a percentage fee of the amounts procured for subscriptions to the BTs. Thus, the ability of the X to procure subscriptions not only will entitle it to a fee for its efforts, but also establishes its business credibility with the customer and enable it to live up to its contract terms with the BTs.

X has invested a significant portion of the assets of one private foundation for which it is a foundation manager in one of the BTs.

X-Sub, as a wholly-owned subsidiary of X, is a disqualified person under IRC 4946(a)(1)(E), since X is conceded to be a foundation manager within the meaning of IRC 4946(a)(1)(B). X-Sub also has a business relationship with the BTs and also provides sub-advisory services to the BTs for a fee. Pursuant to the agreement with the parties, X-Sub, the sub-adviser, has full authority to manage the assets of the BTs, allocate and reallocate the BTs' assets among the Investment Funds and monitor the performance in each Investment Fund. It also provides administrative and accounting services to the BTs, including bookkeeping and distribution of quarterly reports, and the preparation of financial statements and tax information reports for investors. In return for these services, the BTs pay X-Sub a fee equal to a percentage of the BTs net assets per annum.

It may be argued that the benefit to X of providing subscriptions to the BTs is magnified. Not only does X receive a fee directly for the subscriptions secured and not only do such subscriptions build its business credibility and goodwill with the customers (the trusts), but subscriptions also further the business interests of its subsidiary X-Sub, a disqualified person, by providing it fees for its services.

The BTs are not an investment vehicle merely to serve X's charitable or trust department fiduciary clients with a needed investment opportunity. Rather, it is a complete investment business endeavor serving existing general bank customers and non-bank customers alike. Admission as an investor to the BTs is open to all individual and institutional investors that meet the qualifications for investment under the terms of the private placement agreement. Thus, the BTs are conducting an investment business endeavor in which X and its subsidiary have a substantial economic interest by virtue of the contractual relationships with the BTs. Procuring subscriptions to these BTs furthers the establishment of these endeavors, lends credibility to them, and generates fees for the disqualified persons.

(2) ANALYSIS AND CONCLUSION

X's actions in Example A constitute acts of self-dealing within the meaning of IRC 4941(d)(1)(E) as use by a disqualified person of the income or assets of X's private foundation customers for X's own financial and/or business benefit. In both GCM 39107 and 39632, self dealing was held to exist merely on the basis that the use of the private foundation assets by the foundation manager to make a loan to a business customer (at the going interest rate) was self-dealing simply because the use of the assets enhanced the goodwill of the foundation manager with his customer.

X, as trustee of the Foundation, has authority and a duty to invest the assets of the Foundation in income producing assets. By directing a substantial sum of money belonging to the Foundation for investment in the BTs, X is benefiting a significant business partner, one that is a source of revenue for X. Thus, the subscription not only fulfills its contractual obligation to the BTs and develops goodwill with this business partner, X directly profits by generating a fee for its subscription services to the BTs. The use of the Foundation's assets in this regard constitutes the use of trust assets for X's business gain within the meaning of IRC 4941(d)(1)(E). X is also indirectly benefited in that X-Sub's business interests are also furthered by such action.

Is benefit to X by virtue of the subscription transaction merely an incidental or tenuous benefit within the meaning of Reg. 53.4941(d)-2(f)(2)? Even assuming that X's only benefit is the goodwill generated with the BTs, we have concluded that such benefit may not be viewed as incidental or tenuous. The promotion of financial products is at the very core of the business by which X generates a profit. Further, by virtue of the various relationships with the BTs, X is generating fees for services both directly and indirectly.

Does the IRC 4941(d)(2)(E) personal service exception delineated under Reg. 53.4941(d)-2(c)(4) and Reg. 53.4941(d)-3(c)(2) [see e.g. examples 2 and 3] excuse X from self-dealing? In example A, we do not have a bank arranging a common trust fund to provide a better investment opportunity for all or many of its trust accounts. This is an individual and selective investment transaction for this one private foundation, which is also open to all non-fiduciary customers and non-customers of bank X who meet certain investment qualifications. What separates this from being within the normal investment trust functions of bank X is that the transaction in question is not just serving the investment needs of the foundation, but it is also serving the financial needs of X's business partner, and, thus, furthers X's own core business activity beyond that as merely serving as a fiduciary in providing a trust function. Compare with Example B involving a bank that meets the trust personal service exception.

C. EXAMPLE B -- A TRUST FUNCTION PERSONAL SERVICE SCENARIO

Example (B) was first described in the 2000 EO CPE Text, page 236. It is also the subject of PLR 200023051, dated March 10, 2000.

FACTS

M and N are national banking associations. Each is a direct, wholly-owned subsidiary of O. M is a national bank offering a full range of banking, trust, and investment services. M maintains certain funds exclusively for the collective investment of monies contributed thereto by M in its capacity as a trustee, executor, administrator, guardian, or custodian. Some of these common trust funds have been established primarily for the investment of assets of private foundations (PFs) to carry out investment responsibilities of M. It has been represented that these funds are common trust funds described in IRC 584(a). M wants to convert the two common trust funds maintained primarily for the investment of PF assets into P's mutual funds (P's Funds) described in IRC 851 and terminate the common trust funds.

M is the investment advisor to P, a family of open-end management investment companies. P's Funds are a series of bank advised funds legally separate in corporate form. Each corporate entity

consists of a series of distinct portfolios of assets having different investment policies and objectives.

Subject to the approval of the members of the Boards of Directors of P, M will be substituted for N as custodian of P's Funds.

It has been represented that none of the Funds own any stock of O. M does not own any shares of any of the P's Funds, except on behalf of other parties.

M has determined, in its capacity as fiduciary of the PFs participating in the common trust funds, that investments be made directly to P for investment in P's Funds. To effect this conversion, substantially all of the assets of each common trust fund will be transferred to a P Fund in exchange for shares equal in value to the transferred assets. Each common trust fund will then terminate. A Diagram follows:

[diagram omitted]

It is represented that:

(a) All of the fees charged by M to the PFs for its services as trustee are reasonable and necessary for the services rendered, in accordance with industry practice, and consistent with local laws governing fiduciaries.

(b) All of the fees charged P's Funds by M or N for representative services as investment advisor, sub-administrator and custodian of P's Funds, are reasonable and in accordance with industry practice.

LAW AND ANALYSIS

To fall within the exception provided by IRC 4941(d)(2)(E), three requirements must be met:

(a) The services must consist of trust functions and/or general banking services. The latter term includes only checking accounts, saving accounts, and safekeeping activities;

(b) The services must be reasonable and necessary to carrying out the exempt purposes of the PFs; and

(c) The compensation paid by the PFs to DP banks must not be excessive.

M and N will be compensated for their services in managing the assets of the PFs. P's Funds are not controlled by M or N or any of their affiliates and none of M or N's assets or any assets of their affiliates will be invested in P's Funds. The services provided by M and N fall within "trust functions" under Reg. 53.4941(d)- 2(c)(4) and in Example 2 of Reg. 53.4941(d)-3(c) which describes investment management. It is represented that the services provided are reasonable and necessary to obtain funds to carry out the exempt purposes of the PFs. It has been represented that the amount of compensation to be paid M and N will be reasonable.

D. COMPARISON OF EXAMPLE A AND EXAMPLE B

In example A, in contrast to example B, there was more than a fiduciary relationship involving the payment of fees for trust functions such as investment advisory services. In B, the investment vehicle (mutual funds) was not controlled by DP bank. In A, the DP bank was inextricably intertwined with a commercial business activity that does not fall within the self-dealing personal service banking exceptions for trust functions.

T:EO continues to review the IRC 4941 financial products and personal service issue areas including variations of the scenarios described in A and B.

5. UPDATE ON IRC 4940 TREATMENT OF DISTRIBUTIONS FROM CHARITABLE LEAD TRUSTS

Topic P of the 2000 CPE Text, page 225, discussed the definition of net investment income under IRC 4940(c)(1) in the context of income distributions from a charitable lead trust to a private foundation (PF). The specific concern is whether the ordinary income component of distributions received by a PF from a IRC 4947(a)(2) trust should be included in the calculation of net investment income for purposes of IRC 4940. Reg. 53.4940-1(d)(2) requires that the PF include the ordinary income component of a distribution from section 4947(a)(2) trusts in the calculation of its net investment income as if the income were its own.

We believe that courts would likely hold that the Reg. 53.4840-1(d)(2) goes beyond the statutory authority. Accordingly, distinctions should not be made for purposes of IRC 4940 between distributions from taxable entities and private foundations, including trusts described in IRC 4947(a)(1) or 4947(a)(2). Similar treatment should be afforded IRC 4942 minimum investment return treatment of IRC 4947(a)(2) trust distributions following Ann Jackson Family Foundation v. Commissioner, 97 T.C. 534 (1991), aff'd 15 F.3d 917 (9th Cir. 1999).

Exempt Organizations personnel should contact the appropriate EO Area Managers regarding development of cases involving private foundations that receive distributions from IRC 4947(a)(2) Trusts.

6. CHARITABLE FAMILY LIMITED PARTNERSHIPS

This planned giving scheme known in the trade as the "CHAR-FLIP" displays the control and power elements that have been discussed in this article. As noted in the Wall Street Journal on July 13, 1999, the CHAR-FLIP is "a complicated tax avoidance method that uses charities as partners in business ventures." It may be this years favorite charity scam superseding the charitable split-dollar transaction discussed in the 2000 EO CPE Text, Topic R, and presumably put to rest in recent legislation noted in the Current Developments section of this EO CPE Text.

The charitable family limited partnership technique is touted as avoiding the capital gain tax on the sale of the donor's appreciated assets, allowing the donor to continue to control the assets until some subsequent sale date, often many years in the future, and still provide the donor with a current charitable deduction on his or her income tax return. Another "benefit" is reducing estate taxes. The technique is promoted by one or more commercial firms.

A typical charitable family limited partnership works as follows: Donor "D", having substantially appreciated assets, which are often not readily marketable, such as real estate or proprietary interest in a closely held business, sets up a donor family limited partnership ("DFLP"). D transfers highly appreciated assets to DFLP in exchange for both a general and limited partnership interest with the general partnership interest comprising a very modest 1 or 2 percent of the total partnership interests. The DFLP agreement usually provides for a term of 40 to 50 years.

D contributes a large percentage of the DFLP interest to charity "Z", usually as much as 95 to 98 percent, in the form of a limited partnership interest. D will usually retain the general partnership interest. D may also retain a modest limited partnership interest or transfer such an interest to D's children. D obtains an independent appraisal of the value of the partnership interests in order to establish the fair market value of the IRC 170(c) charitable contribution deduction. Z receives whatever assets are held by DFLP at the end of the partnership term, assuming the partnership interest was not sold prior to the expiration of the partnership term.

D claims an IRC 170(c) tax deduction based on the value of the gift of the partnership interest to Z. The value likely has been discounted to take into account the lack of Z control and management of partnership operations as well as the lack of marketability of the limited partnership interest in the context of a closely held business.

The key point is control. Control remains with D as the general partner. Z holds a limited partnership interest with no voice in the day to day management or operations of the partnership.

If appreciated property held by DFLP is sold by DFLP, most of the gain escapes taxation by virtue of the IRC 501(c)(3) exempt status of Z. Only the modest limited or general partnership interests held by D and his family are subject to capital gain taxation.

D generally receives a management fee as compensation for operating and managing the partnership.

Z holds a DFLP interest that may produce current income (although many charitable family limited partnerships produce little or no income) as well as an interest in a (hopefully) appreciating asset which will be sold or exchanged no later that the expiration of the partnership term, usually 40 years or even 50 years.

One of the aspects of the "CHAR-FLIP" is a feature which gives a DFLP the right to sell the property to D or his family at a price specified in the partnership agreement. This right is essentially a put option. While such option may serve to benefit Z, the option is often viewed by critics of this technique as working more for the benefit of D or his family than for Z.

The CHAR-FLIP technique raises a number of potential tax issues. Depending on the facts of each particular partnership agreement, the operation of the partnership may cross over into the area of clear tax abuse. An examination of an organization holding an interest in a CHAR-FLIP should include close scrutiny of the partnership agreement as well as the manner of operation, valuation, management compensation and other matters relating to the legal relationships.

In a nutshell, EO examination may uncover IRC 170, IRC 501(c)(3) inurement and private benefit, IRC 511, and IRC 4958 issues. If the charity is a private foundation, there may be issues under IRC 4941 and 4943.

The FY 2000 EP and EO/GE Work plans, dated August 18, 1999, provide the following EO Examinations instruction on page 6:

> Referrals should be made to the Examinations Division if an EO agent identifies an entity holding an interest in a charitable family limited partnership.

7. SOCHECK ON IRC 509(a)(3) -- A CHECKSHEET GUIDE TO STATUS DETERMINATIONS

FOOTNOTE

/14/ Any charity that maintains more than 50% of its assets in donor advised funds would be deemed to meet this primary activity test.

END OF FOOTNOTE

SOCHECK

(CHECKSHEET QUESTIONNAIRE FOR IRC 509(a)(3) SUPPORTING

ORGANIZATIONS DETERMINATIONS)

Selected Regs.; Readings; and Notes

Legend

SO = Supporting Organization
SO1 = "operated, supervised or controlled by" SO
SO2 = "supervised or controlled in connection with" SO
SO3 = "operated in connection with" SO
SD = Supported Organization described in IRC 509(a)(1) or (2)
DP = Disqualified Person
("s" for plural form; e.g., "SOs, "SDs")

[Caveat; SOCHECK may not include and/or sketch all possible facts and circumstances tests. Please refer to the Regulations.]

Note: SOCHECK contains 5 parts. All SO applicants must satisfy all parts.

1. THRESHOLD REQUIREMENT

2001 CPE Topic G. Note: No exemption for organizations primarily operated to carry on UTB for unrelated SDs.

A. Is the SO claiming IRC 501(c)(3) status organized and operated exclusively for charitable purposes?

(1) [ ] Yes - go to Part 2
(2) [ ] No - Organization is not eligible for SO status.

Rev. Proc. 72-50

B. Is trust entity SO, not claiming IRC 501(c)(3) status, described in IRC 4947(a)(1)?

(1) [ ] Yes - go to Part 2
(2) [ ] No - Organization is not eligible for SO status.

2. RELATIONSHIP TESTS - [Including relationships with IRC 501(c)(4), (c)(5), or (c)(6) entities treated like IRC 509(a)(2)s]

A. Is the SO a SO1?

Reg. 1.509(a)-4(g)

(1) Do the SD(s) officials select a majority of Directors or Trustees of SO?

a. [ ] Yes - go to Part 3
b. [ ] No - go to B.

B. Is the SO a SO2?

Reg. 1.509(a)-4(h)

(1) Is control of management of the SO vested in the same persons who control or manage the SD(s)?

a. [ ] Yes - go directly to Part 3
b. [ ] No - go to C.

Reg. 1.509(a)-4(i)

C. Is the SO a SO3 because it meets both the Responsiveness test (in either (1) or (2) below) and the Integral Part test (in (3) below)?

Reg. 1.509(a)-4(i)(2)(ii)

(1) Responsiveness test - The SO must meet a, b, or c and also must meet item d OR meet Alternative Responsiveness test

at (2) below.

a. Do the officers, directors, trustees, or membership of the SDs elect or appoint one or more of the officers, directors or trustees of the SO? Or

b. Are one or more members of the governing bodies of the SDs also officers, directors or trustees or hold other important offices of the SO? Or

c. Do officers, directors or trustees of the SO maintain a close and continuous working relationship with the officers, directors, or trustees of the SDs?

AND

In Windsor Foundation, 77-2 USTC 9709, Tax Court held that SO failed Responsiveness Test for failure to meet (d). 1982 CPE, p. 28.

d. By reason of the relationship described above, does the SD have a significant voice in the SO's investment policies, timing of grants, manner of making grants, and selection of recipients of grants, etc.?

i. [ ] Yes - go to (3)
ii. [ ] No - go to (2)

Reg. 1.509(a)-4(I)(2)(iii) Note: More common for SO to meet (2) than (1).

(2) Alternative Responsiveness test - If Responsiveness test (1) above is not met, the organization must meet a, b, and c below.

a. Is the SO a charitable trust under State law (or an entity treated as a trust)? and

b. Is each specified SD(s) a named beneficiary under the SO's governing instrument? and

c. Do the specified SD(s) have the power to enforce the trust and compel an accounting under State law?

1982 CPE, p. 29.

i. [ ] Yes - go to (3).
ii. [ ] No - organization fails to meet SO3 relationship test

1997 EO CPE, Topic I; IRM 7.8.3 (5.2)

(3) Integral Part test - The SO must meet requirement a or b below.

Reg. 1.509(a)-4(i)(3)(ii). Note: "FS Test" rarely satisfied. Grantmaking not considered supportive enough. TAM 9730002. Grant making to other public charities may be supportive if SD is a community trust. G.C.M. 38417. 1997 CPE, p. 108.

a. The "Functional Support" test. Does the SO engage in activities, not including grant making, for or on behalf of SD(s) which perform the functions of or carry out purposes of the SD(s) and which the SD(s) would otherwise normally undertake, but for the involvement of the SO?

i. [ ] Yes - go to Part 3.
ii. [ ] No - go to b.

OR

b. The "Attentiveness" test: Requires satisfaction of tests i; ii(a), (b), or (c); and iii, below.

Reg. 1.509(a)-4(i)(3)(iii).

Note: Most SO3s meet this test because they distribute to SDs.

(i). Does the SO make payments of substantially all (85%) of its income (including short term capital gain) to or for the use of the designated SD(s)? and

IRM 7.8.3 (5.2.4.2)

G.C.M. 36379

(ii). (a). Does the SO's support of the SD (within the meaning of IRC 509(d)) constitute at least 10% of the SD's total support? (Or, if SO supports multiple SDs, 10% of the total support of one of the SDs?) or

Note: See Reg. 1.509(a)-4(i)(3)(iii) examples; G.C.M. 36326 looks favorably on significant program with 50% SO support.

(b). Does the SO earmark its support for a significant particular program or activity of the SD and, if so, can the SO demonstrate that if its funding of such program or activity is discontinued, the SDs operation of such program or activity will be interrupted?

Reg. 1.509(a)-4(i)(3)(iii)(d); G.C.M. 36379
Note: New organizations do not have a history. Special 5 year rule with H & C at Reg. 1.509(a)-4(i)(1)(iii); 1982 CPE, p. 32.

(c). Is the SD attentive based on all pertinent facts and circumstances often involving a historic and continuing relationship?

and

G.C.M. 36326

(iii) Does the SO's support which meets (ii) above, consistently constitute 33 1/3% of the SO's total support?

(a) [ ] Yes - go to Part 3.
(b) [ ] No - organization fails SO3 test.

3. ORGANIZATIONAL TEST

Reg. 1.509(a)-4(c)(1). IRM 7.8.3 (5.3)

A. Does the SO's organization instrument limit its purposes to those for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified SDs, and does not expressly empower the SO to engage in activities which are not in furtherance of such purposes?

(1) Are purposes limited appropriately?

a. [ ] Yes - go to (2).
b. [ ] No - organization fails Organizational Test

(2) Do SO1s, SO2s, and SO3s meet specificity requirements?

Reg. 1.509(a)-4(d)(2)(iii); Special community trust rule - Rev. Rul. 81-43

a. SO1s and SO2s - Are beneficiary SDs specified or designated by class or purpose in governing instrument?

(i) [ ] Yes - go to c.
(ii) [ ] No - Is there an historic and continuing relationship with the SD? If yes, go to c. Otherwise, SO fails the organization test.

Reg. 1.509(a)-4(d)(2)(iv); IRM 7.8.3 (5.4.3)

b. Specificity requirements for SO3s - Are SDs

specified by name?

(i) [ ] Yes - go to c.
(ii) [ ] No - SO fails organization test.

c. Governing Instrument Provisions - Are there governing instrument provisions involving substitutions, etc.? If so, are there conflicts with the specificity requirements?

(i) If there are no conflicts, SO meets Organization Test. Go to 4. If there are conflicts, SO does not meet Organization Test.

SO1s & SO2s - Reg. 1.509(a)-4(d)(3); SO3s - Reg. 1.509(a)-4(d)(4). IRM. 7.8.3 (5.3); 2001 CPE, Topic G.

4. OPERATIONAL TEST

A. Is the SO operated exclusively for the benefit of, to perform the functions of, or carry out the purposes of one or more specified SDs?

Reg. 1.509(a)-4(e)(I); IRM 7.8.3 (5.5); 2001 CPE, Topic G.

(1) Does the SO support or benefit only the specified SDs meeting the Organization Test in 3 above?

a. [ ] Yes - go on to (2)
b. [ ] No - organization fails Operational Test.

Special permissible activities include fundraising, alumni activity, etc. Reg. 1.509(a)-4(e)(2); 1982 CPE, p. 36.

(2) Does SO support or benefit SD through disbursements to SD or other permissible activities?

a. [ ] Yes - go on to 5.
b. [ ] No - SO fails Operational Test

5. CONTROL TEST - Often the Most Critical Factor

Reg. 1.509(a)-4(j); 2000 CPE, p. 222; 2001 CPE, Topic G; IRM 7.8.3 (5.6)

A. Is the SO controlled directly or indirectly by DPs other than foundation managers and other than one or more SDs?

(1) SO1s and SO2s

By nature of meeting these relationship tests, SOs are generally controlled by the SDs. There should be an analysis to discover whether SDs select or designate SO board members that may be DPs, for a reason in addition to being foundation managers, or are connected to DPs through family or economic associations. Otherwise go to (3).

(2) SO3s

DP power to annually designate charitable recipients is control. Rev. Rul. 80-305.

Rev. Rul. 80-207

a. Do DPs control SO?

(i) Directly through majority presence on the Board, or positions of authority, veto power, etc.?

(ii) Indirectly, through board nomination process, or manipulation of board structure, or through presence of board members or persons of authority that have family or economic association with DPs?

(iii) Indirectly, through control of SO assets or other facts and circumstances?

[ ] If Yes, SO fails Control Test.
[ ] If No, go to (3).

(3) If SO1 or SO2 or SO3 is not controlled by DPs, Control Test is met and if all SOCHECK parts have been met, SO qualifies as a IRC 509(a)(3).

SOs may not support IRC 509(a)(3) but see G.C.M. 39508. 2% rule - Reg. 1.170A-9(e)(6)(i). Domestic Government entity is a good SD- IRC 170(b)(1)(A)(v); G.C.M. 36523; foreign nongovernment SD is o.k. Rev. Rul. 74-229; Rev. Proc. 92-94. Lobby election restriction - IRC 501(h)(4)(F); 1997 CPE, p. 126.

COLLATERAL NOTES:

1. There should be a representation that SD organization is a valid IRC 501(c)(3) and IRC 509(a)(1) (including a government entity) or 509(a)(2) organization. Note that an IRC 509(a)(3) is not excepted from the 2 percent source limit for IRC 170(b)(1)(A)(vi), thus, SO support may affect the public charity status of its SD.

2. SOs that support an IRC 501(c)(4), (c)(5), or (c)(6) can not make the lobbying election under IRC 501(h).

3. ALL 509(a)(3)s are subject to IRC 6104(d) disclosure rules.

H. PRIVATE BENEFIT UNDER IRC 501(c)(3) - by ANDREW MEGOSH, LARY SCOLLICK, MARY JO SALINS AND CHERYL CHASIN

1. INTRODUCTION

This article discusses the concept of "private benefit" under IRC 501(c)(3) and then describes how it applies to specific fact patterns that raise private benefit issues in two areas: housing and charter schools. Several prior CPE articles have discussed the concepts of private benefit and inurement in greater detail. The most comprehensive of these is Topic C in the 1990 CPE text, Overview of Inurement/Private Benefit Issues in IRC 501(c)(3).

2. PRIVATE BENEFIT -- CODE AND REGULATIONS

IRC 501(c)(3) explicitly prohibits inurement, but does not mention "private benefit." However, the statute does provide that an entity be "organized and operated exclusively for religious, charitable, scientific" and other specified purposes. Reg. 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Reg. 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. Thus, even if an organization has many activities which further exempt purposes, exemption may be precluded if it serves a private interest. Applying the Supreme Court rationale in Better Business Bureau Of Washington, D. C., Inc. v. United States, 326 U.S. 279 (1945), the presence of private benefit, if substantial in nature, will destroy the exemption regardless of an organization's other charitable purposes or activities.

Inurement and private benefit have often been confused. The inurement prohibition comes from the section 501(c)(3) statutory language ". . . no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . . " There is general agreement that inurement is a subset of private benefit and involves unjust payment of money. For purposes of this article, we are focusing on the broader concept of private benefit, especially as it must be addressed and judged by the determination specialist in processing Form 1023 applications for section 501(c)(3) exemption.

3. PRIVATE BENEFIT AND THE APPLICATION PROCESS

Whether an organization's activities will serve private interests excessively is a factual determination. In reviewing an application for exemption under IRC 501(c)(3), a determination specialist must exercise judgment in determining whether the facts show that the applicant serves public rather than private interests. Information must exist in the file that clearly shows the organization has met the requirement. This may require further factual development, especially if the applicant will be controlled by a relatively small group or the class served by the organization is narrowly drawn. If an organization is closely controlled, either by a board of directors comprised of related persons or a for-profit management company that operates with a great amount of autonomy, the application file must clearly show the organization meets the requirements of Reg. 1.501(c)(3)-1(d)(1)(ii) that it HAS ESTABLISHED that it is not or will not be organized or operated for the benefit of private interests. Although factors such as close control of the applicant, a proposed purchase from, financial transaction with, or management agreement with persons in control or related parties do not necessarily preclude exemption, they require adequate documentation and analysis to establish that the applicant operates for public rather than private purposes.

In Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980) aff'd, 670 F.2d 104 (9th Cir. 1980), the Tax Court considered the qualification for exemption of an organization purporting to be a church. The applicant was controlled by three family members. The court stated:

> While this domination of petitioner by the three Harberts, alone may not necessarily disqualify it for exemption, it provides an obvious opportunity for abuse of the claimed tax-exempt status. It calls for open and candid disclosure of all facts bearing upon petitioner's organization, operations, and finances so that the Court, should it uphold the claimed exemption, can be assured that it is not sanctioning an abuse of the revenue laws. If such disclosure is not made, the logical inference is that the facts, if disclosed, would show that petitioner fails to meet the requirements of section 501(c)(3).

Thus, close control of an applicant, because of the potential for abuse, requires a clear demonstration that private interests will not be served

4. PRIVATE BENEFIT -- DEFINED

The Tax Court, in American Campaign Academy v. Commissioner, 92 TC 1053 (1989), has provided a useful definition of private benefit: "nonincidental benefits conferred on disinterested persons that serve private interests." We will consider each part of this definition in turn.

A. NONINCIDENTAL

Genuine public benefit often provides an incidental benefit to private individuals. But if private interests are served other than incidentally, exemption is precluded. GCM 37789 helps define incidental by explaining that private benefit must be both qualitatively and quantitatively incidental.

QUALITATIVELY incidental means that the private benefit is a mere byproduct of the public benefit. A good example is Rev. Rul. 70-186, 1970-1 C.B. 128, in which an organization was formed to preserve and enhance a lake as a public recreational facility by treating the water. The lake is large, bordering on several municipalities. The public uses it extensively for recreation. Along its shores are public beaches, launching ramps, and other public facilities. The organization is financed by contributions from lake front property owners, members of the adjacent community, and municipalities bordering the lake. The revenue ruling concluded the benefits from the organization's activities flow principally to the general public through well maintained and improved public recreational facilities. Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners.

In contrast, Rev. Rul. 75-286, 1975-2 C.B. 210, describes an organization formed by the residents of a city block to preserve and beautify that block, to improve all public facilities within the block, and to prevent physical deterioration of the block. Its activities consist of paying the city government to plant trees on public property within the block, organizing residents to pick up litter and refuse in the public streets and on public sidewalks within the block, and encouraging residents to take an active part in beautifying the block by placing shrubbery in public areas within the block. Membership in the organization is restricted to residents of the block and those owning property or operating businesses there. The organization's support is derived from receipts from block parties and voluntary contributions from members. The revenue ruling concluded that the organization did not qualify for 501(c)(3) exemption because it operated to serve private interests by enhancing members' property rights as evidenced by its restricted membership and area served.

For private benefit to be quantitatively incidental, it must be insubstantial in amount. The private benefit must be compared to the public benefit of the specific activity in question, not the public benefit provided by all the organization's activities. The more exactly you can quantify the private benefit, the

more likely it is to be non-incidental. You should also consider the number of entities benefiting. That is, if all of an organization's business dealings are with a single entity (or group of related entities), or promoter or developer, private benefit is more likely to be present. Further, private benefit is more likely to be substantial if the group receiving the benefit is small.

B. BENEFITS

Unlike inurement, private benefit does not necessarily involve the flow of funds from an exempt organization to a private party. Rev. Rul. 76-206, 1976-1 C.B. 154, considered an organization formed to promote broadcasting of classical music in a particular community. The organization carried on a variety of activities designed to stimulate public interest in the classical music programs of a for-profit radio station, and thereby enable the station to continue broadcasting such music. The activities included soliciting sponsors, soliciting subscriptions to the station's program guide, and distributing pamphlets and bumper stickers encouraging people to listen to the station. The organization's board of directors represented the community at large and did not include any representatives of the for-profit radio station. The revenue ruling concludes that the organization's activities enable the radio station to increase its total revenues and therefore benefit the for-profit radio station in more than an incidental way. Therefore, the organization is serving a private rather than a public interest and does not qualify for exemption.

Rev. Rul. 76-206 demonstrates several important ideas about private benefit. There was no control by the for-profit radio station. There was no direct flow of funds from the applicant to the for-profit. However, it provided services that the radio station would have otherwise had to purchase. As far as can be determined from the ruling, the motivation of the organization's creators was purely a desire to continue the broadcasting of classical music in their community. Although the organization's broad purpose of promoting interest in classical music and encouraging programing of classical music provides a public benefit, the activities served the private economic interests of the for-profit radio station to a substantial degree. Therefore, because private interests were served, exemption was precluded.

Also unlike inurement, finding private benefit does not require that payments for goods or services be unreasonable or exceed fair market value. For example, in est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), the Tax Court stated:

> Nor can we agree with petitioner that the critical inquiry is whether the payments made to International were reasonable or excessive. Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefited substantially from the operation of petitioner.

Similarly, in Church by Mail v. Commissioner, 765 F. 2d 1387 (9th Cir. 1985), aff'g TCM 1984-349 (1984), the Tax Court found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers. The 9th Circuit Court of Appeals, in affirming the Tax Court's decision, stated:

> The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church.

C. DISINTERESTED PERSONS

Inurement involves benefit to insiders such as officers or directors. Private benefit, on the other hand, can involve benefits to anyone other than the intended recipients of the benefits conferred by the

organization's exempt activities. These intended recipients would be the poor, sick, elderly, students, the general public, or other group constituting a charitable class. Disinterested persons can include insiders as well as related or unrelated third- parties, such as the radio station in Rev. Rul. 76-206, the business owned by the officers in Church by Mail, the travel agency in International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), and the developers in Columbia Park & Recreation Association, Inc. v. Commissioner, 88 T.C. 1 (1987), aff'd 838 F.2d 465 (4th Cir. 1988). Of course, in most cases, private benefit occurs with respect to entities or persons that have some relationship with the persons controlling the exempt organization.

In American Campaign Academy, the Service argued that the Academy substantially benefited the private interests of Republican party entities and candidates, thereby advancing a nonexempt private purpose. The relationship between the Academy and "Republican party entities and candidates" was not one of control, although the Academy was an outgrowth of a training program operated by National Republican Congressional Committee. In fact, the Academy argued that the prohibition against private benefit is limited to situations in which an organization's insiders are benefited. The Tax Court, however, disagreed with this view, and stated that an organization's conferral of benefits on disinterested persons may cause it to serve a private interest within the meaning of section 1.501(c)(3)- 1(d)(1)(ii).

D. SERVING PRIVATE INTERESTS

The regulations cited above contrast private, non-exempt purposes with public, exempt purposes. Note that it is the organization's true purpose, not the stated purpose or the organizational language, that we must consider. A benefit that is a necessary part of the exempt purpose of the organization does not serve private interests. On the other hand, anything flowing from an organization's activities other than public, charitable benefits may be serving private interests and therefore a nonexempt purpose. Examples include excessive compensation paid to employees, certain payments to outsiders for goods or services, or steering business to a for-profit company. Even activities that appear to further an exempt purpose may serve private interests. An organization may be serving private rather than public interests even though the primary beneficiarieas are members of a charitable class, if the organization provides benefits using criteria other than those that define the charitable class.

The holding in Westward Ho v. Commissioner, TCM 1992-192 (1992) illustrates this point. An organization was created by three restaurant owners to provide funds to "indigent and antisocial persons" to enable them to leave Burlington, Vermont. The Tax Court concluded that the organization's true purpose was to provide its creators with a more desirable business environment by removing disruptive homeless persons from the area. The organization did not qualify for exemption even though it provided direct "assistance" to members of a charitable class.

In Rev. Rul. 68-504, an organization conducted an educational program for bank employees. It furnished classrooms and employed university professors and others to teach courses on various banking subjects. It had insubstantial social activities. Only members could take courses, but membership was open to all bank employees in the area. In American Campaign Academy an organization conducted an educational program for professional political campaign workers. It furnished classrooms, materials, and qualified instructors. Admission was through a competitive application process.

The actual activity in both cases, teaching a particular subject in a structured, formal way, was the same. So why didn't the Academy qualify for exemption?

In the Academy's case, the true purpose of the admittedly educational activity was to benefit private interests (Republican candidates) by providing them with trained campaign workers. If the Academy had been truly non-partisan, it probably would have qualified for exemption. If the organization in Rev. Rul. 68-504 had provided training for employees of only one bank, it would not have qualified for exemption.

Discerning the "true purposes" of an organization's activities may sometimes be difficult. The best guide is the actual result or operation of an organization's activities. However, on initial applications, activities may only be proposed and intensive development and analysis must be focused on the creation and organization of the applicant, proposed transactions, and the parties to those transactions.

Other indicators of private purposes are derived from a common sense view of business methods. Most for-profit businesses and well-run exempt organizations deal with a number of different entities to purchase the goods and services they need. They rent office space from one company, buy supplies from another, and go to yet another firm for consulting services. If most goods and services are purchased from one entity, or a group of related entities, private benefit is more likely. Most businesses (and probably most individuals) also compare prices before making significant purchases. While a formal competitive bidding process is not always necessary, the failure to consider alternative sources or to compare prices is another indicator of private benefit.

In est of Hawaii, 71 T.C. at 1081, the court identified certain kinds of contractual provisions as indicating non-exempt purposes. These include agreements not to compete, significant control by a for-profit of an exempt organization's activities, a requirement that the exempt organization maintain exempt status, a lengthy term, and any other provisions that appear to favor the for- profit.

5. PRIVATE BENEFIT IN THE REAL WORLD

At first glance, it appears from the above discussion that straightforward rules or principles can be applied to private benefit issues. American Campaign Academy defines private benefit as "nonincidental benefits conferred on disinterested persons that serve private interests." Court cases, revenue rulings, and GCMs further define nonincidental, benefits, disinterested persons, and private interests. We understand that private benefit must be both qualitatively and quantitatively incidental. We think we can distinguish between substantial and insubstantial benefits. We believe we can distinguish interested and disinterested persons. We can identify direct and indirect benefits.

In reality it is difficult to apply the private benefit analysis. The Tax Court in Church by Mail may have said it best when it quoted its opinion in Pulpit Resource v. Commissioner, 70 T.C. 612 (1978) and stated that "decided cases provide only broad bench-marks, with the result that the 'relevant facts in each individual case must be strained through those [established] principles to arrive at a decision on the particular case.'" Ultimately, we must take the "facts and circumstances" of each individual case and apply the law discussed above to determine the presence of private benefit. For example, benefits that are nonincidental in one factual situation may be incidental in another given the totality of the circumstances.

Having considered the concept of private benefit in general, let's take a look at some specific cases. Note the amount of detailed information secured during the application process, and how this information was analyzed to arrive at a conclusion.

The first two situations discuss the application of private benefit analysis to two schools. These schools were formed as open-enrollment charter schools, as the term is defined in state law. They entered into charter contracts with the state, pursuant to which they are authorized to establish and operate charter schools, and to receive financial aid from the State Education Agency. The charter contract with the state is in effect for a five-year period. The schools intend to continue operation of the school indefinitely. The schools also entered into management agreements with for-profit corporations to operate and manage the schools.

The third and fourth situations involve low-income housing. Like charter schools, the availability of substantial amounts of government funding (in the form of tax credits and tax exempt bond financing) make this a fertile area for private benefit. In all four situations, fictitious names are used for easier

reading.

Remember, before making the private benefit analysis in an application case, it must first be ascertained that the applicant has an exempt purpose and meets any other requirements for exemption. For example, an organization which intends to provide housing to low income families and individuals must satisfy the safe harbor or facts and circumstances test of Revenue Procedure 96-32, 1996-1 C.B. 717. An organization providing housing to the elderly must relieve the conditions that beset the elderly as a class in accordance with Rev. Rul. 79-18. A charter school must be a school as that term is defined in IRC 170(b)(1)(A)(ii) and the regulations thereunder. In all four situations discussed below, assume that the relevant requirements have been met and focus on the private benefit issues presented.

SITUATION 1

Oleander Private School was created by Mr. and Ms. Birch, who are husband and wife. They are two of its three directors. Ms. Celosia was selected by Mr. and Ms. Birch as Oleander's third director. Oleander's application lists the address of all three board members as c/o Birch Management Company, a for-profit corporation. Oleander's board does not include any representatives of the community Oleander will serve.

Mr. and Ms. Birch are also Directors of Birch Management Company ("Birch Management"). The management agreement was executed by Mr. Birch on Oleander's behalf and also by Mr. Birch on behalf of Birch Management. The agreement acknowledges that two members of Oleander's Board of Directors have a substantial financial interest in Birch Management, and that the agreement was approved by the third board member.

Mr. and Ms. Birch were instrumental in the creation of Oleander. They incorporated Oleander, prepared the application to become a charter school, and prepared the curriculum and related documents essential for the operation of Oleander.

Birch Management is responsible for the provision of all labor, materials and supervision necessary for the provision of educational services to students, and the management, operation and maintenance of Oleander. Birch Management has sole responsibility and authority to determine staffing levels, and to select, evaluate, assign, discipline and transfer personnel. The school administrator of Oleander is an employee of Birch Management. The school administrator and Birch Management, in turn, have similar authority to select and hold accountable the teachers of Oleander.

Birch Management is compensated 12% of the per pupil expenditures ("PPE") that Oleander receives and spends from all sources for the students enrolled. PPE is defined to include grants, donations and other student charges in addition to the state per pupil aid received by Oleander. Birch Management is also entitled to an incentive fee of fifty percent (50%) of the excess of revenue over expenditures of Oleander for each year of the agreement.

All costs associated with providing the educational program are Oleander's responsibility. Those include, but are not limited to, salaries for all personnel, curriculum materials, textbooks, library books, computer and other equipment, software, supplies, building payments, maintenance, and capital improvements.

Birch Management may provide additional programs, including pre-kindergarten, summer school and latch-key programs. Birch Management may also provide food and transportation services to Oleander's students. Birch Management retains the full amount of any and all revenue collected from these or any other additional program and also is responsible for the full cost.

Birch Management may provide computers, printers, servers, and related equipment, for the classrooms, school offices, and school administration on a lease basis at the prevailing lease rate.

Oleander is obligated to pay the prevailing rate for the lease of the computer equipment, and be subject to all of the other terms and conditions set forth in Management Company's form equipment lease.

Birch Management may terminate the agreement if Oleander makes decisions regarding the personnel, curriculum or program inconsistent with the recommendations of Birch Management.

DISCUSSION

Oleander operates to a substantial degree for nonexempt purposes in that it benefits the Birch family through its management contract with Birch Management.

Generally, the intended beneficiaries of the operation of a school are the students, in the sense that they receive educational benefits. In the case of a school, benefits other than educational benefits or benefits flowing to anyone other than the students should be scrutinized for possible private benefit. In this case, Birch Management benefits from its contractual arrangements with Oleander. While it could be argued that Birch Management, as founder and having directors in common, should be considered an insider for private inurement purposes, technically it is Mr. and Mrs. Birch who are the insiders with respect to Oleander.

In contrast to the preserve the lake situation in Rev. Rul. 70-186, the benefit Birch Management receives is not a necessary result of the operation of the school. Certainly, a school may contract for management expertise; however, it has the option to hire experienced employees or use volunteer staff. To improve the lake water so that the lake can be enjoyed as a public recreational facility, all areas must be improved including areas that do not directly benefit the public -- there is no option. Oleander's educational activities could be performed without benefit being conferred on Birch Management. In fact, Oleander is contracting with Birch Management to have Oleander's own officers manage and operate the school. Additionally, Birch Management has control of the complete operation of the school, pre-school and after-school programs, hiring, curriculum, materials and all other school functions. Birch Management receives substantial compensation although all costs remain the responsibility of Oleander.

The nature of the benefit appears largely financial, although not all benefits are easily identified. Birch Management receives substantial compensation. It allows Birch Management's entrance into the charter school arena normally reserved to nonprofit organizations by state statute. It guarantees a significant source of cash flow to Birch Management. It also gives Birch Management access to Oleander's tax exempt status. As was the case in est of Hawaii and Church by Mail, Birch Management benefits substantially from the operations of the school.

This situation is strikingly similar to that in Church by Mail. In both cases, a non-profit organization was created to further the for-profit interests of its creators. Evidence of this intent is significant. As with the Harberts in Church by Mail, Mr. Birch signed contracts for both Oleander and Birch Management. As in Church by Mail, the Birch family has been significantly benefited. The Court, in Church by Mail, made clear that the reasonableness of compensation was not the pivotal issue; it was the extent of the benefit. The Birch Management has benefited to a substantial extent.

SITUATION 2

Live Oak School has a three member Board of Directors, which meets annually. The Board of Directors consists of the three members of the original organizational committee.

Prior to Live Oak School's actual formation, its organizational committee contracted with Live Oak Management Company ("Live Oak Management"), a for-profit corporation, to develop and operate the school. Live Oak School looked only at Live Oak Management for services. Live Oak School entered into a Management Agreement with Live Oak Management. The initial term of this contract is 5 academic years and is automatically renewable for successive five (5) year periods. In conjunction with

the Management Agreement, Live Oak School has also entered into a Lease Agreement, a Loan and Security Agreement, a Revolving Note, and a Deficit Coverage Guaranty Agreement with Live Oak Management. All of these agreements are contingent on the simultaneous execution of the Management Agreement. We will describe various provisions in these agreements that work in favor of Live Oak Management.

MANAGEMENT AGREEMENT

Live Oak School entered into a Management Agreement for the organization, implementation and operation of a "complete educational program" with Live Oak Management. This included Live Oak School's retention of Live Oak Management's attorney to represent Live Oak School in its formation, application for the charter contract, application for 501(c)(3) status and other legal requirements. The contractual relationship Live Oak School entered into governs the manner in which Live Oak School provides services to the public. The Management Agreement incorporates the charter contract and contains a list of services to be provided by Live Oak Management. The services provided include, but are not limited to, liaison services with the State Chartering Agency regarding continuing to meet the charter contract requirements; ongoing consultation with Live Oak School's board regarding school management; utilization of Live Oak Management's operations manuals and forms for teacher contracts, enrollment applications and management procedures; ongoing support on integration of the company-developed curriculum; ongoing teacher training; advice on admissions and terminations; accounting and bookkeeping systems; training school employees; consultation on staff recruitment, selection, evaluation and retention; and consultation on physical plant layout, maintenance and capital improvements.

Live Oak Management will also consult on Live Oak School's insurance needs by introducing Live Oak School to its insurance providers. It will allow Live Oak School access to its sources of supply to obtain purchasing discounts. Live Oak Management controls Live Oak School's long term budgeting decisions.

Both this agreement and the charter contract provide that representatives of Live Oak Management will be present at Live Oak School's board meetings and involved in all planning for Live Oak School's operations. All decisions must be agreed to by Live Oak Management. Under the terms of this Agreement, Live Oak School has no ability to make decisions independently of Live Oak Management. In addition, Live Oak Management provides the use of its copyrights, trademarks, trade names, etc., as well as various other services.

Live Oak Management is responsible for all labor, materials and supervision necessary for management, operation and maintenance of Live Oak School. Live Oak Management has sole responsibility and authority to determine staffing levels, and to select, evaluate, assign, discipline and transfer personnel. The school administrator of Live Oak School is an employee of Live Oak Management. Live Oak Management has similar authority to select and hold accountable the teachers of Live Oak School. Live Oak School agrees that for a period of two (2) years after the termination of this agreement, it shall not employ any employee or independent contractor engaged by Live Oak Management.

Live Oak School has agreed to pay a $50,000 non-refundable payment deemed fully earned when paid, for the Live Oak Management's performance of, among other items, the submission and negotiation of the Charter School Contract and a monthly fee of 12% of the per pupil expenditures ("PPE"). PPE is defined to include grants, donations and other student charges in addition to the state per pupil aid received by Live Oak School. Live Oak Management is also entitled to an incentive fee of twenty-five percent (25%) of the excess of revenue over expenditures of Live Oak School for each year of the agreement. Live Oak School agrees to pay any extraordinary travel and other costs that are pre-approved and additional compensation as mutually agreed upon for services requested that are outside

the scope of this contract. Finally, Live Oak School agrees to pay 2% of PPE to be used for advertising. One percent will be used for non-local advertising to benefit the school and other schools using Live Oak Management's proprietary marks with the remaining one percent used for local advertising.

Live Oak Management may provide additional programs, including pre-kindergarten, summer school and latch-key programs. Live Oak Management may also provide food and transportation services to Y's students. Live Oak Management retains the full amount of any and all revenue collected from these and any other additional program but is only responsible for the additional operational cost.

REAL PROPERTY LEASE

Live Oak School entered into a Real Property Lease for the school building with Live Oak Management. It is a standard commercial triple-net lease. Under the terms of the lease, Live Oak School's base annual rent is $48,000 plus 6% of annual gross revenues in excess of $800,000. Gross revenues as used in the lease mean all revenues from any source whatsoever and do not specifically exclude donations. As is standard in a triple-net lease, Live Oak School pays as additional rent all of the operating expenses of the building, including insurance, property taxes, utilities, and repairs and maintenance for both the interior and exterior.

Although Live Oak School pays the full operating expenses under this lease, Live Oak School does not have exclusive dominion and control over this property. Live Oak School is entitled to use the premises only between the hours of 7:00 a.m. and 3:30 p.m. when school is in session or on teacher in-service days. Live Oak Management has the right to lease portions of the building to other tenants and to use a portion of the leased premises for office space for its personnel. Live Oak School is required to take full responsibility for this building and indemnify Live Oak Management for any and all claims arising from the use of the building. Live Oak School is also required to maintain insurance covering both Live Oak School's interest and the Live Oak Management's interest in the property during the term of the lease.

Live Oak School is in default if Live Oak School fails to pay, or otherwise breaches any other term of the lease and does not correct the default within 10 days. Live Oak School waives service of any notice of the intention to terminate. If Live Oak Management chooses to declare the lease in default, it may proceed against Live Oak School for all damages and may elect to terminate the lease. If Live Oak Management elects to terminate the lease, Live Oak School is not entitled to any refund of any fees already paid and must vacate the premises. Any sums that are late bear interest at 18% interest or the maximum rate permitted by law.

EQUIPMENT LEASE

Live Oak School entered into an Equipment Lease with Live Oak Management for personal property. Personal property includes classroom and office furniture as well as computers and other electronics. This lease, like the Real Property Lease agreement described above, is a net lease in which Live Oak School pays for the right to use the equipment and bears full responsibility for all ongoing operating expenses. The lease provides that Live Oak School accepts the equipment unconditionally and that Live Oak Management bears no liability for any claim, loss or damage caused, directly or indirectly, by the equipment. It also states that Live Oak Management makes no express or implied warranties of any kind, including merchantability or fitness for a particular purpose.

The rental terms for the personal property were set by determining actual cost of the equipment provided (fair market value) and adding a 10% fee for the cost of financing the purchases. Live Oak School is obligated to continue making payments during the term of the lease no matter what happens to the equipment or whose fault it is. Live Oak School is separately responsible for delivery, installation, maintenance and repair. Live Oak School also bears the entire risk of loss and damage. Live Oak School

is required to insure both Live Oak School's interest and Live Oak Management's interest in the property.

REVOLVING LOAN AND SECURITY AGREEMENT

Live Oak Management, through the Revolving Loan and Security Agreement, also agreed to extend loans of up to $500,000 to Live Oak School to provide working capital and/or for capital expenditures or improvements. This contract, like the others, is an adjunct to the Management Agreement and is effective only during the term of that agreement.

The Revolving Loan and Security Agreement provides that Live Oak Management will extend credit not to exceed an aggregate outstanding principal amount of $500,000. All advances are made at the sole discretion of Live Oak Management. The loan is subject to yearly extensions at Live Oak Management's sole discretion and may be terminated earlier on Live Oak Management's demand. Interest on the unpaid principal runs at a fixed rate of 10%. Interest after maturity or default on the principal and unpaid interest runs at 5% above the fixed rate or 15%. The interest is payable on a monthly basis or on demand. In addition to the interest payment, Live Oak School pays an amount of principal necessary to fully amortize the principal balance over a period of 60 months. These interest and principle payments are in addition to any operating surpluses or excess of revenues over expenses that are required to be paid under the Deficit Coverage Guaranty Agreement. In the event that Live Oak School wants to terminate the Agreement under any provision while Live Oak Management has loaned funds to Live Oak School, guaranteed any debt or other financial obligation of Live Oak School, or provided credit support, whether in the form of a letter of credit or otherwise, to Live Oak School, termination is not effective until the loan has been repaid or guarantee has been released.

Live Oak School has provided Live Oak Management a security interest in all of Live Oak School's assets, regardless of whether such collateral is now owned or later acquired. The security interest extends to all equipment (including computers, fixtures, machinery, office and other machinery, furniture . . .), all inventory, all accounts, collateral accounts, contract rights, and general intangibles including all of Live Oak School's right, title and interest in any amounts due from the state or any other governmental body. Live Oak School has also agreed that upon default Live Oak Management may take control of all of the collateral without notice.

Under the Revolving Loan and Security Agreement, Live Oak School has the additional affirmative duty to apply for and maintain tax exempt status under section 501(c)(3) of the Code. If Live Oak School breaches any of the affirmative agreements in this contract, Live Oak School will pay all expenses incurred by Live Oak Management in connection with enforcement. Live Oak School gives up its right to make any financial decisions without the consent of Live Oak Management. Live Oak School may not borrow funds from any other source.

Live Oak Management may declare this loan in default if Live Oak School is 5 days late in making payments on the revolving loan or on any other outstanding indebtedness to Live Oak Management. Live Oak Management may also declare the loan in default if Live Oak School breaches any contract provision in the Management Agreement or any other related contract.

REVOLVING NOTE

The Revolving Note accompanies the Revolving Loan and Security Agreement. The Note repeats the terms stated in the Agreement and again waives "demand, presentment for payment, notice of dishonor, protest and notice of protest, notice of intention to accelerate, notice of acceleration, diligence in collecting or bringing suit against any party hereto, and all other notices other than as expressly provided in the Loan Agreement." The terms of payment and the timing of payments on this loan are within the discretion of Live Oak Management.

DEFICIT COVERAGE GUARANTY AGREEMENT

Under the Deficit Coverage Guaranty Agreement, Live Oak Management guarantees all of Live Oak School's operating deficits limited by 1) the annual operating deficit set forth in the school's budget as approved by Live Oak Management and 2) the amount of the revolving note in the amount of $500,000. To secure this coverage, Live Oak School agrees as follows:

- o To submit Live Oak School's budget to Live Oak Management for approval;
- o To get Live Oak Management 's approval for any capital expenditure over $2,500;
- o To get Live Oak Management 's approval for any replacement of the principal or business manager and also to promptly notify Live Oak Management of the resignation or termination of the principal or business manager;
- o To maintain salary and benefit levels within Live Oak Management 's recommended structure;
- o To maintain Live Oak School's non-profit status; and
- o To maintain Live Oak School's exempt status under section 501(c)(3) of the Code.

The Deficit Coverage Guaranty Agreement terminates automatically if Live Oak School's Management Agreement with Live Oak Management is terminated. It may also be terminated at Live Oak Management 's election if Live Oak School has two successive years of operating deficits or operating deficits in any 3 out 5 years; upon 30 days notice; upon Live Oak School's failure to maintain Live Oak School's charter contract; or upon any material change in state funding.

DISCUSSION

The facts in Situation 2 differ from those in Situation 1 in that, although the Board of Directors appears to be unrelated to the Live Oak Management, control of Live Oak School is ceded to Live Oak Management through the use of a web of related contracts. While the facts differ, much of the analysis used in Situation 1 equally applies to Situation 2. Live Oak Management is a disinterested person and receives a nonincidental benefit from its relationship with Oak Tree School.

The facts above are purposely extensive to highlight the fact that many factors should be considered when reviewing an application for exemption. A partial list of factors one should consider is listed below. The list is, however, not meant to be all inclusive or that any one factor alone is sufficient to approve or deny exemption.

- o Live Oak School contracted with Live Oak Management prior to Live Oak School's actual formation,
- o The Agreements are automatically renewable,
- o Live Oak School has entered into multiple contracts with the same for-profit service provider, all of which automatically terminate if one is terminated,
- o Live Oak School has contracted for a "complete educational program,"
- o Live Oak School used the Live Oak Management's attorney for

all its legal needs,

- o All decisions considering Live Oak School must be agreed to by Live Oak Management,
- o Live Oak Management employs all faculty and staff at Live Oak School including the principal,
- o Live Oak School agreed to non-solicitation of employees provision,
- o Live Oak Management compensation includes lump-sum payment, a percentage of Live Oak School's total revenue, an incentive fee, reimbursement of costs and a fee for advertising,
- o Live Oak School facilities are leased from Live Oak Management on terms that appear to be above market rate,
- o Live Oak School equipment is leased from Live Oak Management at terms unfavorable to Live Oak School,
- o Live Oak Management has approval rights for Live Oak School's budget,
- o Live Oak School must maintain its exemption status under section 501(c)(3).

Live Oak School's relationship with Live Oak Management is very similar to the structure of the organization described in est of Hawaii. Live Oak School purchases everything it needs to operate from Live Oak Management. Live Oak School's ability to remove itself from the Live Oak Management system is severely impaired. If Live Oak School wanted to remove Live Oak Management, it would lose its name, lose its curriculum, lose its facility, lose its equipment, and owe all of the money it had borrowed. As in est of Hawaii, Live Oak School is totally dependent on one for-profit organization for its operation. Live Oak School has, in fact, ceded so much control of its operations and financial future to Live Oak Management that Live Oak School only operates at Live Oak Management's sufferance.

SITUATION 3

Mahogany, Inc. has applied for exemption under IRC 501(c)(3). It proposes to develop, own, and operate a nursing home financed by tax exempt bonds. Mahogany is one of several affiliated organizations controlled by an existing entity, Pachysandra. Pachysandra has previously been recognized as exempt under IRC 501(c)(3). Like Pachysandra and its other subsidiaries, Mahogany was formed by an individual, Mr. Zelkova, who is also engaged, on a for- profit basis, in the development, ownership and management of facilities similar to the one described by Mahogany.

Mahogany is governed by a five member board of directors, three of whom also serve as officers. The president of Mahogany is a former employee of a company controlled by Mr. Zelkova. Another of the directors has had past business dealings with Mr. Zelkova. Mahogany's other directors are acquaintances of Mr. Zelkova and were appointed to the board after an interview by the two initial members of the board.

The proposed facility will be financed with the proceeds of tax exempt bonds, will be developed by a partnership in which Mr. Zelkova is a partner (Zelkova LP), will acquire the property from an entity in which Mr. Zelkova holds a substantial interest, and will be managed by a management company (Zelkova Management) owned by Mr. Zelkova. Mahogany represents that all dealings with Mr. Zelkova, whether it be with Mahogany or one of Pachysandra's other affiliates, will either be at cost, or at or

below market value depending on the property or service in question. Although the bond offering statement relating to Mahogany's facility has not been drafted, Mahogany submitted an appraisal report for the facility it proposed to construct. This appraisal presented several estimates of value, first "as is" for the value of the vacant land, next upon completion of construction, third upon the project reaching stabilized occupancy, fourth and finally, the highest value was estimated when taking into consideration the value of tax-exempt bond financing. Mahogany proposes to acquire the facility at approximately this last, highest valuation.

Mahogany intends to contract with Zelkova Management to manage the facility. No competitive bids will be solicited because Mahogany views Zelkova Management as uniquely qualified to develop and manage the facility.

DISCUSSION

Clearly the activities of a charitable organization will result in benefits to both its intended charitable class of persons, and to other business entities such as vendors of goods and services required to advance the organization's goals. Benefits to non- charitable entities are permissible so long as they remain incidental to the accomplishment of the charitable goals of the organization. Deciding whether benefits conferred are incidental to, or one of the intended consequences of, an applicant's proposed activity cannot be decided by a fixed set of principles. Many applicants focus on the class of persons being served to justify their claim to exempt status and ignore or fail to provide information indicating the presence of other motivations. Facts indicating the presence of private benefit are not easy to elicit. Specialists must be aware that benefits in the form of fees, commissions and other payments to developers and contractors can be substantial. Careful scrutiny is necessary to insure an applicant organization is not under the influence of private interests so as to act in a way that benefits those same private interests.

The facts indicate the transaction described above is motivated, in part, by private interests and exemption should not be recognized. This is so even if it were demonstrated that all transactions between Mahogany, other subsidiaries of Pachysandra, and Mr. Zelkova and his companies were at or below fair market value. It benefits Mr. Zelkova and his controlled entities to expand and extend their commercial activities and one purpose of Mahogany is to further that benefit. Further, the transfer price, which takes into consideration the value of the tax exempt bond financing, has the effect of transferring to Mr. Zelkova a benefit intended for Mahogany.

SITUATION 4

Loganberry, an applicant for IRC 501(c)(3) exemption, will be a partner in a partnership which will own and operate housing for use by low and moderate income families within the safe harbor guidelines in Revenue Procedure 96-32. Loganberry intends to acquire more than 1,000 rental units. A private developer (Dogwood) had previously agreed to purchase these properties from their owners six months before Loganberry's creation. Loganberry stated it was asked by Dogwood if it was interested in forming a partnership to acquire and renovate the properties. Loganberry stated:

> Dogwood recognized that to purchase and renovate the properties, a nonprofit joint venture partner was needed to secure key funding sources and facilitate lender and governmental agency approval of the transfers.

To this end, Loganberry and Dogwood executed a joint venture agreement which specified that each property will be held by an individual partnership. Loganberry and Dogwood will be co-general partners in each, with funds being provided by investor limited partners who will obtain tax credits in exchange for their investment. Other terms of the joint venture agreement include the following:

- o Dogwood Management Company, an affiliate of Dogwood, will serve as the property manager for each of the properties. Loganberry stated that Dogwood Management Company was selected as property manager because it is an affiliate of Dogwood.
- o Dogwood Management Company is to be paid a fee for its services that is the maximum customary for subsidized projects approved by HUD/USDA;
- o Loganberry grants to Dogwood, for a period of two years the right of first refusal to be a joint venture partner with Loganberry if Loganberry should acquire and develop properties not identified by Dogwood.

Pursuant to the joint venture agreement, Loganberry and Dogwood also entered into a Limited Liability Company Agreement (LLC) which took the name of one of the properties identified above. The purpose of this LLC is to serve as the general partner in a limited partnership which also assumed the name of the identified property. The LLC agreement provides that any fees and cash received by the LLC will be split between Loganberry and Dogwood with a higher percentage allocable to Dogwood. In addition, the agreement provides Dogwood Management Company will serve as the manager of any property held by the partnership in which the LLC serves as general partner. Other terms of the agreement make it clear the LLC is to treated as a partnership for federal tax purposes.

DISCUSSION

The development of real property is an industry with enormous profit potential. Fees associated with the acquisition, development and operation of rental property provide profits to a significant segment of the economy. An organization engaged in the development of low income properties will normally confer the benefit of these fees in the normal course of its activities. Where the organization has bargained to find the best supplier of goods and services to suit its purpose, the benefits conferred will be incidental to the conduct of its charitable endeavors.

In the facts above, however, Loganberry is closely aligned with Dogwood with respect to the property acquisition and development. Based upon the controls maintained by Dogwood there is little to distinguish results obtained by Dogwood from those obtained in a transaction where an organization such as Loganberry is absent, except as regards tax credits. Low Income Housing Tax Credits are allocated by various state agencies established for that purpose. States are required to allocate at least 10% of such credits to organizations that have status under section 501(c)(3) or 501(c)(4) of the Code. Many states, in order to insure compliance with this requirement, give priority to applicants holding exempt status. It appears the only purpose for the presence of Loganberry in the proposed transactions is to enhance the ability of the partnerships to be awarded tax credits permitted by IRC 42. The activities outlined by Loganberry in its application are being undertaken, in significant part, for the benefit of Dogwood and exemption should be denied.

I. STATE CHARITABLE SOLICITATION STATUTES - by

Karl E. Emerson, Director Bureau of Charitable Organizations, Pennsylvania Department of State

1. Introduction

According to the latest edition of Giving USA, Americans gave $190 billion to charity in 1999 -- up 6.7 percent from 1998 after adjusting for inflation. As a result, the nonprofit sector continues to grow in both size and significance.

In fact, according to the Fall 1998 issue of the Internal Revenue Service Statistics of Income Bulletin, between 1975 and 1995 the number of tax-exempt organizations more than doubled to 1,200,000, their assets increased by 312 percent to $1.9 trillion, and their revenue increased by 380 percent to $899 billion. The nonprofit sector's growth in assets and revenue significantly outpaced the country's 74 percent growth in Gross Domestic Product in the same period.

The astonishing growth of the tax-exempt sector reflects the significant contributions charitable organizations make to society. They perform many important functions that would otherwise need to be performed by government or not at all. Unfortunately, the charitable community is no different than any other sector of the economy in that it also has its share of unscrupulous individuals who seek to profit by defrauding innocent donors out of their hard-earned income and, in some cases, their lifetime savings. These fraudulent schemes harm not only contributors who respond in the mistaken belief they are helping charitable causes, but also the charitable community, as each new scandal hurts every legitimate charitable organization by increasing skepticism in the giving public. The states have the difficult, but essential, tasks of protecting their citizens from charlatans who prey on their charitable natures while challenging them to recognize that we all benefit when worthy charitable organizations are generously supported. Their role is even more critical when major government cutbacks shift the responsibility for relieving many of society's burdens to the charitable sector.

To protect their residents and legitimate charitable organizations, approximately 40 states have enacted charitable solicitation statutes. Although specifics vary, state statutes usually require organizations to register with the state before they solicit the state's residents for contributions.

State solicitation statutes generally serve two important purposes. First, they allow the public to get basic information about organizations asking for contributions so donors can make better, more informed charitable giving decisions.

For example, in Pennsylvania, residents can easily obtain basic information about registered organizations by either calling a toll-free number or visiting the Bureau of Charitable Organizations' web site. Either method allows residents to quickly and easily learn an organization's total income for its most recently completed fiscal year, its total contributions, and how much it spent in three key categories: program services, administration, and fundraising.

The Bureau's web site links directly to the Guidestar web site at www.guidestar.org/. As Guidestar makes copies of charitable organizations' Forms 990 available, residents can easily view, and even download them 24 hours a day from the comfort of their homes. However, as significant as this recent technological innovation is, our recent experience in Pennsylvania shows that any suggestion that disclosure can replace regulation is overly optimistic, or at least premature. Pennsylvania's recently hired auditors and investigators now regularly document that many organizations' Forms 990 contain material omissions, misrepresentations, or even falsifications.

In addition, the Chronicle of Philanthropy recently documented that as many as one out of every four organizations that reported at least $500.000 in contributions on their Form 990 failed to report any fundraising expenses! That's one quarter of the largest charitable organizations in the country! The

Chronicle of Philanthropy study confirmed what Pennsylvania's auditors and investigators have been documenting for some time now: that a significant number of the Forms 990 contain material omissions, misrepresentations, or falsifications.

The Chronicle of Philanthropy study and the Bureau's auditors' findings highlight the second, and equally important, purpose state solicitation statutes serve: they help protect state residents from charitable solicitation fraud and misrepresentations. Although most charitable organizations are fine, worthy organizations that deserve to be generously supported, unfortunately, many are fraudulent, employ deceptive solicitation practices, or mislead the public by submitting false or inaccurate Forms 990.

Pennsylvania's experience demonstrates the importance of enforcement. Under the previous administration, the Bureau had only been staffed to serve as a registration office. However, when the infamous Foundation For New Era Philanthropy scandal occured a few months after he took office, Governor Tom Ridge quickly decided the Bureau needed a staff of investigators and auditors to fulfill its long-standing statutory mandate to detect and prosecute charitable solicitation fraud. As a result, the Bureau is now headed by a prosecuting attorney with extensive experience investigating fraud. In addition, the Bureau created a Special Investigation Unit (SIU) staffed with five investigators and four auditors, two of whom are licensed CPAs. Recently, several prosecuting attorneys have been either permanently or temporarily assigned to prosecute some of the many cases being documented by this new unit.

By attempting to discover and prosecute those individuals and organizations engaged in solicitation fraud, the various state registration offices, like the IRS Tax-Exempt/Government Entities Division, help protect the interests of both the public and the legitimate charitable community.

2. Charitable Organization Registration Requirements

Pennsylvania's Solicitation of Funds For Charitable Purposes Act, 10 P.S. section 162.1 et seq., is very similar to the solicitation statutes in most states. The basic registration requirements are not complicated.

Generally, Pennsylvania requires an organization to register with the Department of State's Bureau of Charitable Organizations before it solicits contributions in Pennsylvania. However, like most state solicitation statutes, certain organizations are specifically excluded or exempt from the Act. Although most states exempt similar types of organizations, specific exemptions vary from state to state. For example, in Pennsylvania, bona fide religious institutions and organizations of law enforcement personnel, firefighters, and other persons who protect the public safety are excluded from the Act's requirements if they meet certain criteria in the Act. 10 P.S. section 162.3

In addition, educational institutions, hospitals, veteran's organizations, volunteer firemen organizations, ambulance associations, rescue squad associations, public nonprofit library organizations, senior citizen centers, nursing homes, and parent teacher associations are typically exempt from the Act's registration requirements if they meet any applicable criteria in the Act. 10 P.S. section 162.6

Finally, organizations receiving annual contributions of $25,000 or less are exempt from the Act's registration requirements as long as they don't compensate anyone to conduct solicitations. 10 P.S. section 162.6(a)(8)

Organizations that are not excluded or exempt must file annual registration statements for their immediately preceding fiscal year. 10 P.S. section 162.5

Each year organizations must also file reviewed financial statements if their gross contributions exceed $25,000 per year and audited financial statements if their gross contributions exceed $100,000

per year. 10 P.S. section 162.5(f) Some states don't require reviewed or audited financial statements while others have review and audit thresholds different from Pennsylvania's.

These audited and reviewed financial statements must be accompanied by a report prepared and signed by a licensed, independent public accountant or certified public accountant. Pennsylvania routinely scrutinizes audits and reviews to make sure they are performed by licensed, independent public accountants or certified public accountants. As a result, we have discovered over 110 unlicensed accountants who have submitted reviews and audits to the Bureau. These unlicensed accountants have been, or are being, referred to the State Board of Accountancy for appropriate disciplinary action.

The Bureau has the discretion to waive the requirement for reviewed or audited financial statements if there are "special facts and circumstances" that justify doing so. 10 P.S. section 162.5(j) Requests for waivers must be in writing and must set forth "special facts and circumstances" that justify granting a waiver. So, even though the Bureau will generally have audits or reviews available for registered organizations, in certain limited circumstances they may not be available for any given year.

Like the IRS, the Bureau can grant extensions up to 180 days for organizations to file their registration or financial statements. 10 P.S. section 162.5(k) However, requests for extensions must be in writing and be filed before an organization's registration expires. Otherwise, statutorily mandated late fees of $25 per month must be paid before any extension can be granted.

Organizations required to register must also submit copies of their Form 990. 10 P.S. section 162.5(b)(6) As mentioned earlier, the basic information from these returns is entered into the Bureau's database and made available to the public through the Bureau's toll- free number and web site.

Lastly, organizations must submit copies of other official documents such as their organizational charters, articles of incorporation, and by-laws, the first time they register. 10 P. S. section 162.5(c) Copies of these documents are also available for public review.

These are the basic registration requirements for charitable organizations. Should you need copies of these documents for an IRS examination, you can write the Bureau of Charitable Organizations at 124 Pine Street, 3rd Floor, Harrisburg, Pennsylvania 17101; call the Bureau toll-free at 1-800-732-0999; or request the documents through the Bureau's web site at www.dos.state.pa.us.

3. Professional Solicitor and Fundraising Counsel Requirements

The basic requirements for solicitors and fundraising counsels are also quite straightforward. Solicitors must register before soliciting for charitable organizations in Pennsylvania and counsels must register before providing services related to solicitations in Pennsylvania. 10 P.S. section 162.9(a) and 10 P.S. section 162.8(a)

Solicitors and counsels must also file annual registration statements and copies of their contracts with charitable organizations no less than ten working days before conducting solicitation campaigns, events, or providing services. 10 P.S. section 162.9(e) and 10 P.S. section 162.8(d)

Solicitor registration statements must contain the following information: 1) the address of the solicitor's principal place of business and any Pennsylvania addresses; 2) the form of the solicitor's business; 3) the names and residence addresses of all the solicitor's principals, including all officers, directors, and owners; 4) whether any of the solicitor's owners, directors, officers, or employees are related by blood, marriage, or adoption to any of the solicitor's other directors, officers, owners, or employees, to any officer, director, trustee, or employee of any charitable organization under contract with the solicitor, or to any supplier or vendor providing goods or services to any charitable organization under contract with the solicitor; and 5) the name of all persons in charge of any solicitation activity. 10 P.S. section 162.9(a)

Solicitor contracts with charitable organizations must be written and contain the following basic provisions: 1) the legal name and address of the charitable organization as registered with the Bureau; 2) a statement of the charitable purpose for which the solicitation campaign is being conducted; 3) a statement of the respective obligations of the solicitor and the charitable organization; 4) a statement of the guaranteed minimum percentage of the gross receipts from contributions that will be remitted to or retained by the charitable organization, if any; 5) a statement of the percentage of the gross revenue that the solicitor will be compensated; and 6) the effective and termination dates of the contract and the date solicitation activity is to commence in Pennsylvania. 10 P.S. section 162.9(f)

In addition to filing their contracts with charitable organizations, solicitors must also file written solicitation notices at least ten working days before commencing any solicitation campaign in Pennsylvania. The solicitation notice must be accompanied by a $25 fee and contain the following information: 1) a description of the solicitation event or campaign; 2) each location and telephone number from which the solicitation is to be conducted; 3) the legal name and residence address of each person responsible for directing and supervising the conduct of the campaign and each person who is to solicit during the campaign; 4) a statement whether the solicitor will at any time have custody or control of contributions; 5) the account number and location of each bank account where receipts from the campaign are to be deposited; 6) a full and fair description of the charitable program for which the campaign is being carried out; and 7) the date the solicitation campaign or event will begin or be held and the termination date for each campaign or event. 10 P.S. section 162.9(e)

Lastly, solicitors must also obtain a $25,000 bond and file campaign reports within 90 days of the end of each solicitation campaign or annually for campaigns lasting more than a year. 10 P.S. section 162.9(c) and 10 P.S. section 162.9(l) These campaign reports must detail how much the public contributed as a result of the campaign and how much of the total amount contributed the charitable organization actually received after the solicitor and all its related expenses were paid.

Fundraising counsel registration statements must contain the following information: 1) the address of the counsel's principal place of business and any Pennsylvania addresses; 2) the form of the counsel's business; 3) the names and residence addresses of all the counsel's principals, including all officers, directors, and owners; 4) whether any of the counsel's owners, directors, officers, or employees are related by blood, marriage, or adoption to any of the counsel's other directors, officers, owners, or employees, to any officer, director, trustee, or employee of any charitable organization under contract with the counsel, or to any supplier or vendor providing goods or services to any charitable organization under contact with the counsel; and 5) the name of any person in charge of any solicitation activity. 10 P.S. section 162.8(a)

Fundraising counsel contracts with charitable organizations must also be written and contain the following basic provisions: 1) the legal name and address of the charitable organization as registered with the Bureau; 2) a statement of the charitable purpose for which the solicitation campaign is being conducted; 3) a statement of the respective obligations of the counsel and the charitable organization; 4) a clear statement of the fees that will be paid to the counsel; 5) the effective and termination dates of the contract and the date services will commence with respect to the solicitation of contributions in Pennsylvania; 6) a statement that the counsel will not at any time have custody or control of contributions; and 7) a statement that the charitable organization exercises control and approval over the content and volume of any solicitation. 10 P.S. section 162.8(d)

These are the basic requirements for solicitors and fundraising counsels. Again, should you need copies of a solicitor's or counsel's annual registration statements, copies of their contracts with charitable organizations for whom they solicited contributions in Pennsylvania, or copies of final or interim campaign reports or solicitation notices for campaigns conducted in Pennsylvania, you can contact the Bureau as noted above.

4. The Unified Registration Statement

Organizations that solicit contributions nationally typically can save time and money by utilizing the relatively new Unified Registration Statement (URS), which was developed through a collaborative effort between the charitable community and the National Association of State Charity Officials (NASCO). The URS can currently be filed in 34 different states in lieu of the states' own registration statements. The form can be downloaded at www.nonprofits.org/library/gov/urs/.

5. Internet Solicitations

The subject of Internet solicitation is definitely one of the hottest topics currently being debated within both the charitable and regulator communities.

Because the way this type of solicitation activity will be addressed has not yet been finalized and may differ from state to state, I must give you the standard disclaimer that any opinions I express on this topic at this time are my personal opinions and not necessarily those of the Secretary of the Commonwealth of Pennsylvania or the Attorney General of Pennsylvania, the officials who will ultimately decide how this issue will be handled in Pennsylvania.

Equally, if not more, important, any opinions I express are not necessarily those of the various Attorneys General and Secretaries of State throughout the country. The President of NASCO simply doesn't have that authority! All I can share are my personal opinions concerning how I think the area of Internet solicitation might be handled and the current status of NASCO's review of this issue.

NASCO held its most recent conference in October 1999. This was the annual meeting of the state and federal officials responsible for enforcing the charitable solicitation statutes and Internal Revenue Code provisions that govern the conduct of tax- exempt organizations.

Last year's conference covered a wide variety of topics, including Internet solicitations. In fact, the conference's entire public session dealt with how to address this rapidly growing way to solicit contributions because, as we all know, each day more and more charities are using the Internet to do so.

The Internet has opened up a whole world of possibilities for both large, well-established charities and small, recently-formed charities. It may be especially helpful for smaller charities that do not have the resources to conduct extensive telephone or direct mail campaigns because even small charities can develop relatively inexpensive web sites that can be accessed from anywhere in the world. The potential to inexpensively publicize a charity's mission and message on the Internet is enormous and, as a result, more and more money is being raised via the Internet every day.

According to a recent article in the Chronicle of Philanthropy, Toys For Tots raised $475,000 in cash and received 42,000 toys as a result of its Internet solicitation efforts during the month between Thanksgiving and Christmas last year. According to the same article, the American Red Cross raised $2.5 million on-line last year.

Soliciting on the Internet is now a hot topic at fundraising conferences all around the country and several books on the topic have recently been published. Charities of all sizes are being urged to set up web sites to solicit contributions. At least one organization is developing web sites for charities for free so they can take advantage of this new and exciting way to raise funds.

In addition, there are now at least 15 "Internet shopping malls" where you can make purchases from hundreds of retailers and the "Internet shopping mall" will donate a small portion of your purchase price to the charity of your choice. There are now even "Internet shopping malls" where you can make similar purchases and these particular "shopping malls" will donate a small portion of your purchase price to your child's school. According to a recent article, there are at least 6 of these new "Internet shopping malls" that specialize in raising funds just for schools.

The bottom line is that the Internet is being used more and more each day by hundreds of worthy charities to raise funds. However, like all things, this incredible technological advancement also has enormous potential to be abused. One could easily create a so-called "charity" that has an impressive web site that tugs at your heartstrings, but really only exists in the web site designer's mind.

Recent articles in the New York Times, the Chronicle of Philanthropy, and elsewhere have questioned whether some "Internet shopping malls" always follow through with their promises to donate a portion of each purchase price to the charity or school of the donor's choice. Sometimes these "Internet shopping malls" have administrative policies or procedures that result in no actual donations being made in certain circumstances such as when a minimum amount must be designated for a particular charity or school before any actual donation is made. As a result of these factors and others, there's now considerable media interest in the growing number of charities soliciting on the Internet and how, if at all, they should be regulated.

The press and the public expect the regulators to address this issue. Because of its rapid growth and increasing visibility, the issue of Internet solicitation can no longer be ignored by regulators with the vague hope that it will just quietly go away. There's no getting around the fact that a strict reading of most states' solicitation statutes would require that charities maintaining web sites that include a request for contributions register in those states.

The Pennsylvania Attorney General's Office has recently taken the position that charities soliciting on the Internet do violate Pennsylvania's solicitation law if they're not registered because our law defines "solicitation" as "[a]ny direct or indirect request for a contribution on the representation that [the] contribution will be used in whole or in part for a charitable purpose, including, but not limited to, any of the following:

> . . . [a]ny written or otherwise recorded or published request that is mailed, sent, delivered, circulated, distributed, posted in a public place or advertised or communicated by press, telegraph, television or any other media."

Clearly, the Internet falls into the "any other media" category. However, taking such a position poses enormous practical difficulties given there are now thousands of charities whose web sites ask for contributions. It seems rather unfair and burdensome to require a charity to suddenly have to register in the approximately 40 states that have solicitation statutes simply because the charity creates a web site that, among other things, asks for contributions. Yet, is it really fair to direct mail and telephone solicitors to allow those soliciting over the Internet to play by a different set of rules?

At last year's NASCO conference there was extensive discussion about how states can fulfill their statutory responsibilities to protect their residents and see they have access to basic information about the charities asking them for contributions without unduly burdening the ever-growing number of charities that are, and will be, using the Internet to raise substantial sums.

NASCO hopes to adopt a formal policy on this important subject soon. A draft policy was discussed extensively at both the public and private sessions of our annual conference in October. However, because of concerns expressed by several states and one county, the draft policy has since been modified several times. The most recent version has now been circulated among the NASCO membership and there have been several very long conference calls where NASCO members from around the country have discussed the latest draft in great detail. We hope to arrive at some consensus among the NASCO membership soon so the draft policy can be circulated to our bosses: the various Attorneys General and Secretaries of State for review and comment. It will then be circulated to the general charitable community for further comment and review.

Of course, even if NASCO is able to arrive at a consensus about how to address Internet solicitation, any policy it adopts would not be legally binding on any state. Nonetheless, adopting such a policy would be a significant step in the right direction because it would at least give some much needed guidance to both regulators and the charitable community about when registration in a particular state would, or would not, be required.

One of the many suggestions being considered by NASCO to deal with this problem is to not require out-of-state web sites to register if they only "passively" solicit donations and don't "affirmatively target" residents of a particular state. In other words, if a charity based in Utah has a web site that asks for contributions and a Pennsylvania resident simply finds the web site while surfing the Internet one night from his computer in Pennsylvania, the charity would not have to register in Pennsylvania because the Utah-based charity did not "actively and affirmatively" seek out the Pennsylvania resident and ask him for a donation. Rather, the Pennsylvania resident in this scenario sought out the Utah-based charity.

However, even assuming for the sake of argument that this type of scenario would not require the Utah-based charity to register in Pennsylvania, the reality of fundraising is that, once the Pennsylvania resident has made a donation to the Utah-based charity, it's only a matter of weeks, months, or, at the most, a year before the Utah-based charity will ask the Pennsylvania resident for another donation either by phone, mail, or the Internet. When that happens, everyone agrees the charity would have to register because using the Internet to directly solicit a specific individual is no different from sending the individual a letter or calling the individual on the telephone.

The bottom line on the subject of Internet solicitations is that most states are undecided at this time about how they're going to deal with this rapidly growing way to solicit contributions. As a result, the entire public session of NASCO's annual conference this year will once again be devoted to this important topic.

6. Prohibited Conduct

Finally, Pennsylvania's solicitation statute, like most other states', prohibits certain conduct and authorizes the Bureau, the Pennsylvania Attorney General, and local District Attorneys to prosecute organizations and individuals for various improper activities.

In Pennsylvania, the prohibited conduct is outlined in Section 15 of the Act, 10 P.S. section 162.15, and includes, among other things:

1) utilizing any unfair or deceptive acts or practices or engaging in any fraudulent conduct that creates a likelihood of confusion or misunderstanding;

2) utilizing any representation that implies a contribution is for or on behalf of a charitable organization, or utilizing any emblem, device, or printed matter belonging to or associated with a charitable organization without first being authorized in writing to do so by the charitable organization;

3) utilizing a name, symbol, or statement so closely related or similar to that used by another charitable organization that the use thereof would tend to confuse or mislead a solicited person;

4) misrepresenting or misleading anyone in any manner to believe that an organization on whose behalf a solicitation is being conducted is a charitable organization or that the proceeds of such solicitation will be used for charitable

purposes when such is not the case;

5) misrepresenting or misleading anyone in any manner to believe that any person sponsors, endorses, or approves a particular solicitation when the person has not given consent in writing to the use of his or her name for such purpose;

6) misrepresenting or misleading anyone in any manner to believe that goods or services have sponsorship, approval, characteristics, ingredients, uses, benefits, or qualities they do not have or that a person as a sponsorship, approval, status, affiliation or connection that he or she does not have;

7) utilizing or exploiting the fact of registration to lead any person to believe that such registration in any manner constitutes an endorsement or approval by the state;

8) representing directly or by implication that a charitable organization will receive an amount greater than the actual net proceeds reasonably estimated to be retained by the organization for its use; and

9) representing that any part of the contributions received will be given or donated to any other charitable organization unless such organization has consented to the use of its name before the solicitation.

Section 17(b)(3) of the Act authorizes the Bureau to impose fines of up to $1,000 per violation and additional penalties of up to $100 per day for each day an organization, solicitor, or fundraising counsel violates the Act. 10 P.S. section 162.17 (b)(3)

7. Conclusion

I hope this basic overview of one of the many state solicitation statutes is helpful, if only to inform you that you can obtain additional documentation concerning charitable organizations, professional solicitors, fundraising counsels, or their contracts that may be useful as you conduct your audits and investigations of tax-exempt organizations. I have not attached a copy of Pennsylvania's solicitation statute since it is readily available from the Bureau's web site at www.dos.state.pa.us.

In conclusion, as the President of the National Association of State Charity Officials (NASCO), I assure you that NASCO members throughout the country will be pleased to assist you in any way they can with your efforts to combat charitable solicitation fraud and thereby protect both the donating public and the legitimate charitable community.

PART II - CURRENT DEVELOPMENTS - by Lynn Kawecki and Toussaint Tyson

1. Announcements

A. Announcement 99-101, 1999-43 I.R.B. 544 (October 25, 1999)

This announcement solicits comments from the public with respect to a study conducted by the Department of the Treasury concerning the scope of taxpayer confidentiality, including confidentiality and disclosure provisions of the Code concerning tax exempt organizations. This study is mandated by section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-106, 112 Stat. 685.

The Joint Committee on Taxation was required to conduct a similar study. Volume II of their report, Study of Disclosure Provisions Relating to Tax-Exempt Organizations (JCS-1-00), Staff of the Joint Committee on Taxation (January 28, 2000), is of particular interest.

B. Announcement 99-102, 1999-43 I.R.B. 545 (October 25, 1999)

This document announces changes to the Forms 990, 990-EZ, 990-T, and 990-PF to reflect changes in Reg. section 301.7701-1 with respect to classification of certain business organizations pursuant to election by the taxpayer. An organization with multiple owners may be treated as an association or as a partnership. An organization with a single owner may be treated as an association or may be disregarded as an entity separate from its owner. The changes in the forms clarify that a tax-exempt owner must report, as its own, the operations and finances of a disregarded entity.

C. Announcement 2000-2, 2000-2 I.R.B. 295 (January 10, 2000)

This announces release of general information letters for public inspection. The announcement applies to information letters made in response to inquiries postmarked (if mailed) or received (if sent by other means) after January 1, 2000. An information letter is a general statement of well-defined law without applying the law to a specific set of facts. They are advisory only and have no binding effect on the IRS.

D. Announcement 2000-72, 2000-35 I.R.B.

This document announces a proposed revenue ruling. The proposed revenue ruling, which provides questions and answers about the reporting and disclosure requirements, follow up on Pub. L. No. 106-230, 114 Stat. 477, which was enacted on July 1, 2000. The law created a new set of reporting rules for political organizations described in IRC 527. Under the new law, most of these 527 groups will be required to publicly disclose information about their organization, contributors, expenditures and other information. See further discussion in the 2001 CPE Text entitled Election Year Issues.

2. Notices and Revenue Procedures

A. Notice 99-47, 1999-36 I.R.B. 391 (September 7, 1999)

This notice provides guidance with respect to a competent authority agreement implementing Article XXI (Exempt Organizations) of the United States - Canada Income Tax Convention. The purpose of the agreement is to assist religious, educational, scientific, and charitable organizations by not requiring them to go through a qualification process in both nations. The notice applies only to those organizations recognized as exempt under IRC 501(c)(3), or corresponding Canadian law. Thus, the agreement provides that charitable organizations recognized in one contracting state will automatically be recognized as tax-exempt in the other.

Since Canada does not have private foundation provisions similar to the United States, Canadian organizations would be considered private foundations unless they submit financial information to authorities of the United States.

B. Notice 99-50, 1999-40 I.R.B. 444 (October 4, 1999)

This notice sets forth a proposed revenue procedure to ensure independence of the Office of Appeals by prohibiting ex parte communications between the Appeals Office and other Internal Revenue Service employees. This notice also invites public comments on the proposed revenue procedure. The comment period closed December 3, 1999; the revenue procedure was not issued by the time of this printing.

C. Notice 2000-24, 2000-17 I.R.B. 952 (April 24, 2000)

This notice provides guidance with respect to information reporting and excise tax on charitable split-dollar arrangements. No charitable deduction is allowed for a transfer to, or for the use of, a charitable organization if the organization or any other party has paid, pays, or will pay premiums on a personal benefit contract on behalf of the transferor. A personal benefit contract is any life insurance, annuity, or endowment contract that benefits, directly or indirectly, the transferor, or the transferor's family or designee.

A charitable organization that pays premiums on disallowed personal benefit contracts is required to pay an excise tax equal to the amount of premiums paid. It must also report such excise taxes on Form 4720. Because some charitable organizations may not be aware of the new excise tax, this notice extends the due dates for filing the 1999 Form 4720. In addition any organization that pay premiums subject to IRC 170(f)(10) must report this on Form 8870, a new form.

See related material on Notice 99-36, 1999-26 I.R.B. 1, in the Discussion section of this article.

D. Rev. Proc. 99-28, 1999-29 I.R.B. 109 (July 19, 1999)

This revenue procedure describes the method by which a taxpayer may request an early referral to the Office of Appeals of one or more unresolved issues from the examinations or collections divisions. Section 6 of this procedure applies, in part, to Exempt Organizations. However, the procedure does not apply to (1) private foundation or exemption issues subject to section 7428 of the Internal Revenue Code, (2) church tax inquires subject to section 7611, (3) excise tax issues in section 507, chapter 41 and 42, and (4) issues relating to revocation of exempt status

E. Rev. Proc. 99-35, 1999-41 I.R.B. 501.

This revenue procedure implements section 3105 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-106, 112 Stat. 685. It provides procedures for administrative appeals of a proposed adverse determination by an Exempt Organizations Area Office that interest on the bond issue is not excludable from gross income under IRC 103.

F. Rev. Proc. 99-42, 1999-46 I.R.B. 568

This revenue procedure sets forth inflation adjusted items for the year 2000. Adjusted items include dues paid to agricultural or horticultural organizations under IRC 512(d)(1); low cost articles under IRC 513(h)(2); and insubstantial benefits received in return for a fully deductible contribution under IRC 170.

3. Proposed and Final Regulations

A. Reg. 121946-98, 1999-36 I.R.B. 403 (September 7, 1999), 64 Fed. Reg. 43324 (August 10, 1999)

This document proposes amendments to the public disclosure requirement for private foundation pursuant to IRC 6104(d). These proposed regulations would require private foundations to make copies of applications for recognition of exemption and annual information returns available for public inspection. They would also be required to provide copies of the documents. These proposed regulations were finalized January 31, 2000 in T.D. 8861 in 2000-5 I.R.B. 441. See also T.D. 8861 at item 3D.

B. Reg. 209601-92, 2000-12 I.R.B. 829 (March 20, 2000), 65 Fed. Reg. 11012 (March 1, 2000)

This document contains proposed regulations relating to the tax treatment of corporate sponsorship payments to tax-exempt organizations. The proposed regulations reflect the addition of IRC 513(i) by section 965 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788. The document provides notice of public hearings on the proposed regulations and withdraws the previous proposed rules. It also requests comments concerning application of the unrelated business income tax to the Internet activities of exempt organizations. The comment period for these proposed regulations, and the Internet issues, closed May 31, 2000.

C. T.D. 8830, 1999-38 I.R.B. 430 (September 20, 1999), 64 Fed. Reg. 42834 (August 6, 1999)

This document contains final regulations adopting a balanced system to measure organizational performance within the IRS. The regulations also provide rules relating to the measurement of employee performance with respect to the treatment of taxpayers. This regulation implements section 1201 and 1204 of the Internal Revenue Restructuring and Reform Act, Pub. L. No. 105-106, 112 Stat. 685.

D. T.D. 8861, 2000-5 I.R.B. 441 (January 31, 2000), 65 Fed. Reg. 2030 (January 13, 2000)

Final regulations implementing changes to IRC 6104(d) disclosure requirements made by section 1004(b) of the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681- 888. The regulations provide guidance for private foundations regarding disclosure of certain annual returns filed on or after March 13, 2000, and exempt status application materials. The treasury decision makes the disclosure rules concerning the private foundations virtually uniform to the disclosure rules applicable to other tax-exempt organizations; the main difference concerns the disclosure of the contributor list. See also Reg. 121946-98 at item 3A.

E. T.D. 8874, 2000-8 I.R.B. 644 (February 22, 2000), 65 Fed. Reg. 5772 (February 7, 2000)

Final regulations under IRC 513 which clarify when travel tour activities are substantially related to an organization's exempt purposes. The regulations provide that whether the activities are "substantially related" will be determined by looking at all relevant facts and circumstances. Seven examples provide illustrations of relevant facts and circumstances.

4. Miscellaneous

Joint Committee on Taxation, Report of Investigation of Allegations Relating to Internal Revenue Service Handling of Tax- Exempt Organization Matters (JCS-3-00), March 2000.

The document reports the findings from a three year investigation of several aspects of the Service's functions, including: how the IRS administered the law relating to the determinations program; and how the IRS generally selected tax-exempt organizations for examination. Some of the report's findings include: that there was no credible evidence that the IRS delayed or accelerated issuance of determination letters based on the nature of the organization's perceived views; that there was no credible evidence that tax-exempt organizations were selected for examination based on the views

espoused by the organizations or individuals related to the organization; and that there was no credible evidence of intervention by Clinton Administration officials in the selection of (or failure to select) tax-exempt organizations for examination. While the report found no credible evidence of bias, the report does identify several procedural and administrative problems that may have created perceptions of bias or inconsistent treatment by the IRS. (Efforts are being made to reduce the incidence of the procedural and administrative problems.)

5. Court Decisions

A. Share Network Foundation v. Commissioner, T.C. Memo 1999-216

This, and the succeeding two cases, involve strikingly similar facts and William J. Tully, a promoter of tax-exempt status for organizations. The Tax Court upheld the IRS's adverse determination on the organization's application for exempt status.

Karl Goesele retained William J. Tully to create and acquire tax-exempt status for the Share Network Foundation (Foundation) controlled by the Goesele family. Although the Foundation stated it would raise funds to be distributed by other tax-exempt organizations, it was vague about its operations. Citing Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 535 (1980), aff'd 670 F. 2d 104 (9th Cir. 1981), the Tax Court stated an opportunity for abuse is present when the organization is controlled by its creators who belong to the same family. In such cases the organization must provide open and candid disclosure of all facts pertaining to the organization's operation. If such disclosure is not made, the inference is that the facts would show the organization would fail to satisfy the requirements of IRC 501(c)(3).

B. Hart Foundation v. Commissioner, TC Memo 1999-228

The facts in this case are similar to those of other cases involving William J. Tully, a promoter of tax-exempt status for organizations. The Tax Court upheld the IRS's adverse determination on the organization's application for exempt status.

The Hart family founded the Hart Foundation (Foundation) through William J. Tully, who promoted the use of tax-exempt organizations. During the development phase of processing the Foundation's application for recognition of tax-exempt status, the Service requested information on three occasions. Each time the Foundation responded with vague answers. Citing Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 535 (1980), aff'd 670 F. 2d 104 (9th Cir. 1981), the Tax Court stated an opportunity for abuse is present when the organization is controlled by its creators who belong to the same family. In such cases the organization must provide open and candid disclosure of all facts pertaining to the organization's operation.

C. Oliver Family Foundation v. Commissioner, T.C. Memo 1999-234

The Tax Court upheld the IRS's adverse determination on the organization's application for exempt status.

The facts in this case are similar to those of other cases involving William J. Tully, a promoter of tax-exempt status for organizations. Citing other Tax Court cases involving the promoter, the court concluded the Foundation did not present sufficient facts to support a finding that it satisfied the operational test of section 1.501(c)(3)-1 of the Income Tax Regulations. Citing Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 535 (1980), aff'd 670 F. 2d 104 (9th Cir. 1981), the Tax Court stated an opportunity for abuse is present when the organization is controlled by its creators who belong to the same family. In such cases the organization must provide open and candid disclosure of all facts pertaining to the organization's operation.

D. Wayne Baseball, Inc. v. Commissioner, T.C. Memo 1999-304

The Tax Court upheld the IRS's adverse determination that the organization was not described in IRC 501(c)(3).

The IRS issued a final adverse determination regarding tax-exemption of Wayne Baseball, Inc. (Wayne) finding that Wayne had a substantial purpose of furthering the social and recreational activities of private individuals in contravention of 1.501(c)(3)- 1(c)(1) of the Income Tax Regulations. The organization challenged the determination under IRC 7428. The Tax Court found that Wayne is a highly competitive amateur baseball team comprised primarily of adults, although some of the younger players ages ranged from 17 to 21. The court also found Wayne did not carry on other activities that may be construed as advancing amateur baseball.

The Tax Court reasoned that Wayne is unlike the organization described in Hutchinson Baseball Enterprises, Inc. v. Commissioner, 73 T.C. 144 (1979), aff'd 696 F.2d 757 (10th Cir. 1982), which, in addition to sponsoring an adult team, leased and maintained fields for Little League teams, a community college team, American Legion teams and a baseball camp. The activities of the organization advanced amateur baseball generally. On the other hand, the Tax Court likened Wayne's operation to the operation of the organization described in Media Sports League, Inc. v. Commissioner, T.C.M. 1986-568. The organization in Media Sports League, in addition to the promotion of amateur sports, impermissibly advanced the social and recreational interests of the players. Similarly, Wayne furthers the social and recreational interests of its players to a degree, which is substantial in comparison to Wayne's promotion of baseball to the surrounding community.

E. Jack Lane Taylor v. Commissioner, T.C. Memo 2000-17

The Tax Court held that contributions to Indianapolis Baptist Temple (IBT) were not deductible from the donor's income, because IBT had its exempt status revoked in the prior year. Announcement 95-35, 1995-19 I.R.B. 14, deleted IBT from the list of organizations contributions to which are deductible under IRC 170. The court rejected taxpayer's argument that a church is not required to meet the requirements of IRC 170(c)(2) because IRC 508(c)(1) excepts churches from applying for recognition of exemption. The Court clarified that exception from of the IRC 508 notice requirement does not relieve a church from meeting the requirements of IRC 501(c)(3).

F. Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999)

The Tax Court, in an IRC 7428 action, upheld the IRS's final determination that the organization conferred impermissible private benefit onto private parties.

In this case Redlands Surgical Services (Redlands) was a non-profit subsidiary of Redlands Health System, an organization recognized as exempt from tax under section 501(c)(3) of the Code. Redlands entered a general partnership with a for-profit entity in the business of operating surgical centers, Surgical Care Affiliates (SCA). Under the partnership agreement, Redlands and SCA have an equal voice in the operation of the partnership; deadlock could only be broken by mediation, a procedure that had never been invoked. In turn, the general partnership acquired a 61% interest in, and became the sole general partner of, a limited partnership that already owned and operated a taxable outpatient surgical facility. The long-term manager of the facility was an affiliate of SCA. The inclusion of the Redlands-SCA partnership as the general partner of the limited partnership brought no changes to the for-profit facility's operations that would cause it to further charitable interests. Additionally, Redlands had no assets other than its interest in the facility. Thus, Redlands' proof that it operated exclusively for charitable purposes rested on whether the facility was operated in a charitable manner. Redlands filed for recognition of exemption. The IRS issued a final adverse determination; and the organization filed

for a declaratory judgment on its exempt status under IRC 7428.

The Tax Court concluded that the limited partnership's operation of the surgical center had a purpose to benefit its physician-investors. Thus, without clear control over the general partnership and the operation of the limited partnership, Redlands could not support the claim that it operated exclusively for charitable purposes through the operation of the surgical center. The Tax Court ruled it was not enough that SCA could not change the facility's operation without Redlands' acquiescence. The Tax Court concluded further that Redlands could not demonstrate the necessary formal control as it was a mere co-general partner with joint control over the general partnership. Additionally, an SCA affiliate managed the surgical facility under a 15-year management contract with broad powers. And Redlands could not demonstrate other informal controls. Thus, because Redlands had ceded control to for-profit interests that have an independent economic interest in the operation of the facility, it could not insure an otherwise commercial activity of the limited partnership would be operated exclusively for charitable purposes.

G. Tax Analysts v. Internal Revenue Service and Christian Broadcast Network, 99-2 U.S.T.C. (CCH) paragraph 50,794; 84 A.F.T.R. 2d (RIA) 5457 (D.D.C. 1999); aff'd as to CBN, vacated and remanded as to IRS, No. 98cv 02345 (D.C. Cir. June 13, 2000).

The District Court in a judgment on the pleadings ruled the IRS had no authority to release a closing agreement entered into with Christian Broadcasting Network (CBN). The court separately dismissed Tax Analysts' suit against CBN, a co-defendant.

Tax Analysts filed a Freedom of Information Act (FOIA) request with the IRS to obtain copies of the closing agreement. This closing agreement, between CBN and the IRS, had terminated CBN's tax liability in conjunction with CBN's 1998 application for restoration of its tax exempt status under IRC 501(c). Tax Analysts argued that the closing agreement was issued simultaneously, or in conjunction, with the recognition of tax-exempt status. The IRS did not disclose the closing agreement. Tax Analysts sued the IRS under the FOIA, and CBN under IRC 6104, for disclosure of the closing agreement.

The court, citing to Lehrfeld v. Richardson, 132 F.3d 1463 (D.C. Cir. 1998), ruled the closing agreement is "tax return information", the disclosure of which is prohibited, and thus exempt from disclosure under FOIA Exemption 3, 5 U.S.C. section 552(b)(3); and is a document that is not discloseable under IRC 6104. The court dismissed the disclosure suit against CBN following Schuloff v. Queens College Fdn, Inc, 994 F. Supp. 425 (E.D.N.Y. 1998)(which held IRC 6104 does not provide a private right of action).

The D.C. Circuit Court vacated the District Court decision with respect to the IRS. The appellate court concluded that the District Court had insufficient evidence to determine whether any of the requested documents were disclosable under IRC 6104(a)(1)(A). This question was remanded so the District Court could review the documents to determine whether they are disclosable.

H. Stanbury Law Firm v. United States, 99-2 U.S.T.C. paragraph 50,718 (D. Minn. 1999)

The district court dismissed the Stanbury Law Firm's (the Firm) Freedom of Information Act (FOIA) suit against the IRS.

The Firm had filed a FOIA request for disclosure of a public charity's contributor list. The IRS did not respond and the Firm sought a court order directing the IRS to disclose the list. The court ruled the IRS is proscribed from releasing the names of donors to public charities pursuant to IRC 6103(a) and 6104(b). Therefore, the list is exempt from FOIA disclosure requirements under 5 U.S.C. 552(b)(3).

I. Landmark Legal Foundation v. Internal Revenue Service, 87 F. Supp. 2d 21 (D.D.C. 2000)

The district court, on summary judgment, upheld the IRS decision to withhold disclosure of 16 of 20 categories of documents requested under the Freedom of Information Act (FOIA).

Landmark Legal Foundation (Landmark) filed a FOIA request with the IRS seeking all requests by individuals or entities external to the IRS for audits or investigations of section 501(c)(3) tax- exempt organizations. Landmark made it clear that it was not requesting any information revealing whether any of the entities were actually being audited.

In response, the IRS provided Landmark with a 9253-page index of the requested documents. Subsequently, the IRS moved for summary judgment asserting that any redaction or withholding of information was authorized by FOIA exemptions 3 and 6. Exemption 3, exempts from the FOIA items the government is statutorily proscribed from disclosing; exemption 6 excepts personnel, medical and other files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy. The court agreed with the IRS's contention that certain items were nondisclosable pursuant to IRC 6103, which prohibits disclosure of return information. The court acknowledged the prohibition against disclosure of return information is very broad. It includes any information gathered by the IRS with respect to a taxpayer's liability under the Internal Revenue Code. The court noted that information concerning an organization's qualification for tax-exemption is information concerning an organization's tax liability, i.e., return information. Therefore, letters complaining about an organization's exemption, letters responding to the complaint, and memoranda to other IRS offices concerning the complaint are nondisclosable under IRC 6103 and thereby exempt from the FOIA under exemption 3.

The court denied the IRS' summary judgment motion regarding four categories of documents and permitted the IRS to submit further affidavits that more clearly define these categories. The IRS was invited to refile for summary judgment then if it chooses. However, the court gave little credence to IRS's arguments regarding exemption 6.

J. Henry E. & Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United States, 2000 U.S. App. Lexis (2nd Cir. April 2000)

The Second Circuit affirmed the lower court's opinion, which had upheld the IRS's position that gains from securities purchased on margin are subject to unrelated business income tax (UBIT).

The securities were held to produce income. Since they were purchased on margin, they were purchased with borrowed funds. The Court concluded the securities were debt financed, therefore, subject to the UBIT under IRC 514.

K. Oregon State University Alumni Association v. Commissioner, 193 F.3d 1098 (9th Cir. 1999)

The Ninth Circuit affirmed the district court's position that the taxpayers' affinity credit card programs did not generate unrelated business income tax.

Tax-exempt alumni associations of two universities raised money by conducting affinity credit card programs. The associations permitted a bank to use the names of the associations in connection with the issuance of credit cards to the members of the associations. The associations carried out approximately 50 hours of services with respect to the credit card program for the tax years at issue. They received $1.1 million during this period. /1/ The court agreed that the return in relationship to the minimal work demonstrates the payments were royalties, and, therefore, not subject to UBIT.

The opinion negatively comments on the "all-or-nothing" proposition that the payments are either completely royalty payments or completely compensation payments. The court then suggested the possibility that some part of the payments might have been compensation for services. In such a case, the compensation portion of the payments would be subject to the UBIT. The issue of allocation was not directly before the court and the court did not further explore the allocation matter.

(In a field directive dated December 16, 1999, the Director, Exempt Organizations, clarified that affinity card cases should be removed from suspense and should be resolved consistent with the existing court cases. The field directive also clarifies that the allocation issue is under consideration and that, in the appropriate case, a request for technical advice may be considered.)

L. The Fund for Anonymous Gifts v. Internal Revenue Service, 194 F. 3d 173 (D.C. Cir. 1999).

This is a decision without published opinion in favor of The Fund for Anonymous Gifts (Fund).

The Fund was organized so donors could make anonymous gifts to their selected charities. The IRS issued a final adverse determination on the Fund's exemption application. The Fund filed for declaratory judgment under IRC 7428. The district court held that the Fund was not organized and operated exclusively for charitable purposes. In part, the lower court's opinion was based on the provision in the Fund's governing instrument that authorized conditions subsequent on gifts made to the Fund.

During the appellate oral argument, the Fund offered to strike the questionable provision and, during the court's abeyance of the case, removed the provision. In a move that is unusual for IRC 7428 declaratory judgment cases, the court considered matter extraneous to the administrative record, i.e., that the questionable provision had been stricken. The court of appeals concluded the elimination of a provision authorizing conditions subsequent removed all concerns about donor control over the use of the contribution.

M. American Society of Association Executives v. United States, 195 F.3d 47 (D.C. Cir. 1999)

The court upheld the constitutionality of IRC 162(e).

A tax-exempt trade association challenged the constitutionality of amendments to IRC 162(e) because they, according to the association, burdened the association's right to lobby. The Court held that an association could avoid any burden by splitting into two separate IRC 501(c)(6) organizations, one engaging exclusively in lobbying and the other refraining from any lobbying activities.

6. Bills Introduced in the 106th Congress (2nd Session)

A. H.R. 1955

This bill would exempt certain transactions at fair market value from the tax on self-dealing. It would also require the IRS to establish a procedure to determine exempt transactions.

B. H.R. 2640

This bill would provide that long-term vehicle storage by tax-exempt organizations that conduct county and similar fairs should not be treated as unrelated trade or business.

C. H.R. 3168

This bill would exclude from unrelated business taxable income amounts set aside by a volunteer fire department for the purchase of equipment for use by the department.

D. H.R. 3249

This bill would allow a deduction of the fair market value of contributions of literary, musical, artistic, or scholarly compositions created by the donor.

E. H.R. 3496

This bill is a companion bill to S. 1976. It would specify certain uses of a facility owned by a tax-exempt organization described in IRC 501(c)(3) would not constitute private use.

F. H.R. 3674

This bill would allow tax-free rollovers from one qualified state tuition program to another program for the benefit of the same beneficiary.

G. H.R. 4163

Under this bill, IRC 7428 declaratory judgment procedures would apply to organizations described in all paragraphs of IRC 501(c). There are also several disclosure provisions, including one that would limit the examination of a taxpayer's representative without the supervisor's permission.

This bill has been approved by the House and is reported on in H.R. Rep. 566, 106th Cong., 2d Sess., (2000).

H. H.R. 4168

This bill would require political organizations to increase reporting about their organizational structure, contribution and disbursements.

I. S. 1597

This bill would provide enhanced tax incentives for charitable giving by allowing donors to claim contributions made up to the time taxes are due. It would also allow taxpayers that do not itemize to claim a $50.00 deduction.

J. S. 1976

This bill would specify certain uses of a facility owned by a tax-exempt organization described in IRC 501(c)(3) would not constitute private use.

K. S. 2077

This bill would allow taxpayers that do not itemize their deductions to deduct fifty percent of their contributions exceeding an annual total of $500 of contributions.

L. S. 2084

This bill would increase the amount of the deduction allowed for the contribution of food inventory. Under the bill a donor could claim the fair market value of the contribution but could not exceed twice the donor's basis in the contributed goods.

M. S. 2582

This bill would amend IRC 527 to better define the term "political organization."

N. S. 2583

This bill would increase the disclosure requirements for IRC 527 political organizations.

7. Discussion

1. Split-Dollar Insurance Transactions

The FY 2000 EO CPE Text, Topic R, reprinted in its entirety the text of Notice 99-36, 1999-26 I.R.B. 1. See also item 2C concerning Notice 2000-24. Notice 99-36 describes a tax avoidance scheme in which a trust is often (but not always) the vehicle for carrying out the transaction. Notice 99-36 describes a number of ways in which the Service may address the problem presented by a charitable split-dollar arrangement. In the EO area, private benefit is certainly one argument that may be asserted by the Service to deal with an abusive split-dollar insurance arrangement.

Congress addressed the problem of the split-dollar insurance arrangement by enacting IRC 170(f)(10). IRC 170(f)(10) provides that in two circumstances, no charitable deduction is allowed under the income, estate, and gift tax provisions of the Code, or for an organization described in IRC 170(c) or IRC 664(d).

No charitable deduction is allowed if, in connection with the transfer, (1) the charitable organization directly or indirectly pays, or has previously paid, any premium on a personal benefit contract with respect to the transferor, or (2) there is any understanding that any person will directly or indirectly pay any premium on a personal benefit contract with respect to the transferor.

IRC 170(f)(10)(B) defines a "personal benefit contract" as any life insurance, annuity, or endowment contract that benefits directly or indirectly, the transferor, a member of the transferor's family, or any other person designated by the transferor (other than an organization described in IRC 170(c)). A charitable gift annuity is not included under the definition of "personal benefit contract" if certain specific conditions apply.

The Service has under consideration, a project to explain what reporting and excise tax requirements will be required of organizations which are denied a deduction under IRC 170(f)(10). Such explanation of reporting and excise tax requirements will aid the public in meeting the requirements imposed under IRC 170(f)(10)(F). Such information may be issued by the Service shortly.

2. Section 1203(b)

Section 1203(b) of the Internal Revenue Service Restructuring and Reform Act of 1998 concerns mandatory termination of Service personnel for any one of ten acts of willful misconduct. This provision has caused considerable anxiety and confusion among Service personnel. On July 17, 2000, the Commissioner issued a memorandum and an attached detailed analysis of the Service's experience implementing section 1203(b). The following definition and set of examples are excerpted from the analysis.

Specific questions on section 1203(b) may be directed to the Labor Relations Section 1203 Resource Center at (202) 622-4740.

What do the concepts of willful and intent mean?

* For a violation to occur under any Section 1203 provision, some degree of intent must be present. This concept means that unintentional errors in the course of doing your job in good faith are not Section 1203 violations.

* Four of the provisions in Section 1203 refer to willfulness. Willfulness is the degree of intent required for a Section 1203 violation to have occurred for the following provisions: seizures, improper use of disclosure statutes, failure to timely file Federal tax obligations, and understatement of

Federal tax liability.

Case Examples

The following examples illustrate the most common fact patterns in Section 1203 cases. The definition of "willful" under the Subsection 1203(b)(8) is the voluntary intentional violation of a known legal duty, for which there is no reasonable cause. Thus, these case examples include information about the employee's knowledge of his or her responsibilities, including the briefings the employee may have received on those responsibilities.

Case 1 -- Section 1203(b)(10) Threat to Audit For Personal Gain -- Removal

The employee was identified as the driver of a vehicle involved in a hit and run accident. He was subsequently arrested for driving while intoxicated and leaving the scene of an accident. While in custody, the employee identified himself as an IRS employee and declared that he would "find out" about the arresting officer, and would have "a good time" with him. The employee's assertion that his judgment was impaired due to intoxication was not accepted. He had not only been able to drive home without further incident following the accident, but also responded coherently to the arresting officer's questions, and engaged him in conversation. Although the employee did not specifically use the word "audit," his remarks to the arresting officer were clearly interpreted as such, and were made for personal gain.

Case 2 -- Section 1203(b)(8) Timely File Federal Tax Return --Removal

The employee was a GS-9 Revenue Officer and had been employed with the IRS for five years. The employee acknowledged receipt of IRS Interim Handbook of Employee Conduct and Ethical Behavior on two occasions (shortly after her appointment in 1995, and again in June 1998). The handbook specifically addresses employee tax obligations. Additionally, the employee's District Director issued an annual memorandum to all employees, reminding them of their tax obligations and responsibilities.

The employee received a counseling letter in February 1996 regarding the late filing of her 1993 Federal tax return. Despite the counseling, she again failed to file her return timely for tax year 1997. The employee raised unfamiliarity with the "extension to file" provisions, and a missing/inaccurate Form 1099, as defense. Evidence was developed which proved neither to be credible. Accordingly, the employee's tax non-compliance was deemed willful.

Case 3 -- Section 1203(b)(8) Timely File Federal Tax Return --Not Willful, Other Disciplinary Action

The employee, a GS-4 Clerk, filed her 1997 tax return on January 20, 1999. The non-compliance was identified and raised by the employee herself. Shortly after attending a Section 1203 training session, the employee notified her supervisor of the matter. She learned in the training session that ALL returns must be filed timely. She advised her supervisor that for the past several years, she had not filed timely because she had always been entitled to a refund (this was subsequently corroborated). At no time prior to the training session had the Service notified her of a non-compliance matter. She acknowledged that she now fully understands her filing obligations and would ensure that they are met in the future. Accordingly, the non-compliance was not deemed willful and removal was not effected.

Case 4 -- Section 1203(b)(6) Violation of law or procedure to Harass and Retaliate --Not Substantiated as 1203 violation, Counseled for Unprofessional Conduct

A taxpayer representative alleged that a revenue agent used a hostile approach in conducting an audit, appearing to have reached conclusions before the audit started. A management inquiry found that

the revenue agent speculated about the potential outcome of the audit and the consequences of such an outcome, but was not harassing the representative. The revenue agent was counseled that speculation is inappropriate.

Case 5 -- Section 1203(b)(6) Violation of law or procedure to Harass
and Retaliate -- Not Substantiated as 1203 violation,
Counseled for Unprofessional Conduct

A taxpayer complained that a revenue agent's information request was an effort to intimidate the taxpayer. A management inquiry found the revenue agent issued a 25-page request to the taxpayer, most of which were legal references. The revenue agent explained that he was attempting to document the legal support for the Government's position, and was not attempting to intimidate the taxpayer. The revenue agent was counseled for demonstrating poor judgement.

Case 6 -- Section 1203(b)(6) Violation of law or procedure to Harass
and Retaliate --Not Substantiated as 1203 violation,
Counseled for Unprofessional Conduct

An employee was accused of harassment of a fellow employee, which involved spreading rumors about the fellow employee's military record. The subject of the complaint was counseled for causing dissension and discord in the workplace.

Case 7 -- Section 1203(b)(6) Violation of law or procedure to Harass
and Retaliate --Not Substantiated as 1203 violation, Letter
of Reprimand for Unprofessional Conduct

During a continuing professional education class, the employee questioned a guest speaker about a case both had worked on. The guest speaker had reversed the employee's action on the case. After the class session concluded, the employee again confronted the speaker about the case, and got within inches of the speaker's face. The speaker reported that he thought the employee was going to strike him. Management proposed a three day suspension for unprofessional conduct, which was reduced by the deciding official to a one day suspension. The employee grieved the suspension, and the case was settled with a reprimand.

3. Disclosure Requirements for IRC 527 Political Organization

Pub. L. No. 106-230, 114 Stat. 477, amends IRC 527 and is further discussed in the 2001 CPE Text entitled Election Year Issues.

FOOTNOTE

/1/ According to the opinion, "Oregon State grossed $254,252 and $357,998 for the two tax years at issue, [and] University of Oregon [grossed] $223,566 and $305,296."

CUMULATIVE INDEX (1977-2001)

B

C

D

G

H

I

IRC 170(b)(1)(A)(i) - Churches 1987-89
IRC 170(b)(1)(A)(vi) - Community Trusts/Regulations 1978-133
IRC 170(c)(2)(D) - Prohibited Political Activities 1989-150
IRC 170(e) - Contribution of Inventory 1994-51
IRC 170(e) - Contributions of Inventory or Property 1977-38
IRC 170(f) - Public Charity Lobbying 1977-7
IRC 170(f)(8) - New Substantiation Rules 1995-129
IRC 170(h) - Conservation Contributions 1994-16
IRC 170(m) - Deductibility, College Athletic Tickets 1989-160
IRC 274(a)(3) - Denial of Deduction for Club Dues 1995-42
IRC 403(b) - Tax-Sheltered Annuity Plans 1995-103
IRC 419 - Deductibility of Employer Contributions 1985-206
IRC 419 - Limitation on Employer Deductions 1992-190
IRC 419A - Additions to a Qualified Account 1992-197
IRC 457 - Deferred Compensation Plans of Gov't/Exempts 1997-189
IRC 457 - Deferred Compensation Plans of Gov't/Exempts 1999-161
IRC 501(c) and ERISA 1979-539
IRC 501(c) - Health Care Organizations 1980-70
IRC 501(c) - Legislative Activities 1978-30
IRC 501(c) - Political Organizations 1979-124
IRC 501(c)(1) - Exemption of PBGC 1977-35
IRC 501(c)(1) - Revised 1985-20
IRC 501(c)(2) - Title-Holding Corporations 1986-20
IRC 501(c)(2) - UBI Allowed 1995-43
IRC 501(c)(3) - "Educational" Child Care Organizations 1985-19
IRC 501(c)(3) - Amateur Athletic Organizations 1977-16
IRC 501(c)(3) - Charitable Gaming 1996-361
IRC 501(c)(3) - Churches 1978-1
IRC 501(c)(3) - Churches 1987-87
IRC 501(c)(3) - Churches and Cults 1979-165
IRC 501(c)(3) - Churches and Religion Update 1980-42
IRC 501(c)(3) - Churches and Religious Organizations 1981-43
IRC 501(c)(3) - Churches, Religious & Apostolic Orgs. 1983-1
IRC 501(c)(3) - Computer Related Organizations 1996-3
IRC 501(c)(3) - Economic Development Corporations 1992-152
IRC 501(c)(3) - Health Care Organizations 1981-1
IRC 501(c)(3) - Health Care Organizations 1979-184
IRC 501(c)(3) - Health Care Update 1995-151
IRC 501(c)(3) - Insurance Organizations 1981-285
IRC 501(c)(3) - Insurance: The Rule of '86 1997-215
IRC 501(c)(3) - Lobbying 1979-120
IRC 501(c)(3) - Lobbying 1987-144
IRC 501(c)(3) - Organizational Test 1985-32
IRC 501(c)(3) - Points to Consider in Applications 1978-248
IRC 501(c)(3) - Political Activities 1987-182
IRC 501(c)(3) - Political Activities 1993-478
IRC 501(c)(3) - Political Campaign Prohibition 1993-400
IRC 501(c)(3) - Political Campaign Prohibition 1996-365
IRC 501(c)(3) - Private School Nondiscrimination 1979-298

IRC 4945 - Scholarship Grants and Rev. Proc. 76-47 1978-139
IRC 4945 - Scholarship Grants to Individuals 1982-181
IRC 4945 - Scholarships Restricted to Certain Groups 1983-154
IRC 4945 - Taxable Expenditures 1995-305
IRC 4945(g) - Advance Approval of Scholarship Grants 1984-252
IRC 4945(g) - Grants to Individuals 1980-169
IRC 4945(g) - PF Scholarships and Fellowship Grants 1989-154
IRC 4945(g) - Processing Requests Subject to IRC 6110 1984-268
IRC 4946 - Disqualified Person 1995-261
IRC 4946(d) - Definition of Family Member 1985-17
IRC 4947 - After the Regulations 1978-128
IRC 4947 - Filing Requirements 1983-182
IRC 4947 - General Explanation of 4947 Trusts 1980-190
IRC 4947 - General Explanation of 4947 Trusts 1983-173
IRC 4947(a)(1) - NECTs and Form 5227 1982-54
IRC 4947(a)(1) - Nonexempt Charitable Trusts 1983-173
IRC 4947(a)(1) - Trusts & IRC 508 Notice 1979-393
IRC 4947(a)(2) - Split Interest Trusts 1983-176
IRC 4958 - Intermediate Sanctions 2000-21
IRC 4961 - Abatement of Second Tier Taxes 1992-141
IRC 4962 - Abatement of First-Tier Excise Taxes 1992-135
IRC 4976 - Excise Tax on Disqualified Benefits 1988-137
IRC 6033 - Filing Requirements for Church-Affiliated 1987-92
IRC 6033(b) - Disclosure of Certain Transactions 1989-147
IRC 6060 - Income Tax Return Preparers 1977-32
IRC 6103 - Confidentiality & Disclosure of Returns 1997-6
IRC 6103 - Disclosure 1977-2
IRC 6104 - Determinations with 6110 and 6104 Issues 1983-218
IRC 6104 - Public Inspection of Rulings 1977-1
IRC 6104(c) - Public Charity Lobbying 1977-7
IRC 6104(e) - Public Inspection of Applications/Returns 1989-147
IRC 6110 - Determinations with 6110 and 6104 Issues 1983-218
IRC 6110 - Disclosures 1979-536
IRC 6110 - Public Inspection of Rulings 1977-1
IRC 6110 - Public Inspection of Written Determinations 1983-210
IRC 6110 - Written Determinations Subject to 1984-268
IRC 6113 - Disclosure of Contribution Nondeductibility 1989-146
IRC 6115 - New Disclosure Rules 1995-129
IRC 6154(h) - Estimated Tax Payments 1988-157
IRC 6213(b) - Assessment in Cases of Clerical Errors 1977-34
IRC 6405(a) - Joint Committee Refund Cases 1977-35
IRC 6501 - Statute of Limitations for EO Returns 1981-230
IRC 6501 - Statute of Limitations for EO Returns 1982-47
IRC 6501 - Statute of Limitations for EO Returns 1983-189
IRC 665(b) - Accumulation Trusts 1977-31
IRC 6652(c) - Failure to Provide Information on Returns 1989-149
IRC 6652(c) - Inspection of Applications and Returns 1989-147
IRC 6655 - Amendment to Estimated Tax Provisions 1989-141
IRC 6685 - Inspection of EO Applications and Returns 1989-147

J

P

Q

R

Retroactive Exemption Under IRC 508(c)(1)(B)	1982-261
Rev. Proc. 71-17	1994-78
Rev. Proc. 76-47	1978-139
Rev. Proc. 77-32	1983-226
Rev. Proc. 79-63	1983-225
Rev. Proc. 80-28	1983-224
Rev. Proc. 81-6	1983-223
Rev. Proc. 81-7	1983-224
Rev. Proc. 82-2	1983-221
Rev. Proc. 82-39	1983-222
Rev. Proc. 82-39	1996-127
Rev. Proc. 84-46	1990-3
Rev. Proc. 90-4	1990-2
Rev. Proc. 90-5	1990-3
Rev. Proc. 92-85	1994-67
Rev. Rul. 54-44	1979-333
Rev. Rul. 61-72	1992-94
Rev. Rul. 64-14	1979-336
Rev. Rul. 64-182	1983-100
Rev. Rul. 64-231	1992-94
Rev. Rul. 64-315	1979-335
Rev. Rul. 65-528	1983-102
Rev. Rul. 67-4	1988-63
Rev. Rul. 67-247	1989-193
Rev. Rul. 67-327	1996-218
Rev. Rul. 68-26	1983-101
Rev. Rul. 70-534	1996-222
Rev. Rul. 70-585	1992-44
Rev. Rul. 71-529	1986-76
Rev. Rul. 71-581	1983-103
Rev. Rul. 72-102	1982-251
Rev. Rul. 72-124	1992-94
Rev. Rul. 72-369	1986-77
Rev. Rul. 73-164	1983-104
Rev. Rul. 74-614	1983-105
Rev. Rul. 76-204	1994-14
Rev. Rul. 77-38	1979-388
Rev. Rul. 77-366	1996-218
Rev. Rul. 78-43	1996-225
Rev. Rul. 78-88	1979-444
Rev. Rul. 79-19	1992-94
Rev. Rul. 80-63	1982-255
Rev. Rul. 81-58	1996-351
Rev. Rul. 81-69	1982-46
Rev. Rul. 81-69	1984-44
Rev. Rul. 81-69	1989-51
Rev. Rul. 81-69	1992-119
Rev. Rul. 81-95	1983-111
Rev. Rul. 82-223	1984-317

S

T

V

W

XYZ

REVENUE PROCEDURES PERTAINING TO EXEMPT ORGANIZATIONS

72-50 1972-2 CB 830 Procedures for 4947(a)(1) trusts to obtain determinations on foundation status

74-41 1974-2 CB 495 Election under 4942(h)(2) regarding treatment of qualifying distributions

75-13 1975-1 CB 662 Public interest law firm fees [modified by 92-59]

75-50 1975-2 CB 587 Private schools racially nondiscriminatory policies _ recordkeeping

76-10 1976-1 CB 548 Change of accounting period for group [see 79-3]

76-34 1976-2 CB 656 Foundation status and revocation of public charity status

76-47 1976-2 CB 670 Company scholarship programs

77-20 1977-1 CB 585 Extended reliance _ community trust

77-32 1977-2 CB 541 Company scholarship programs _ reliance

79-3 1979-1 CB 483 Change of accounting period for group [modifies 76-10]

79-6 1979-1 CB 485 Labor returns as information returns

79-8 1979-1 CB 92 Late filing of Form 990 Information Return

80-27 1980-1 CB 677 Group exemption procedures [modified by 96-40]

80-28 1980-1 CB 680 Court-determined exemption

80-39 1980-2 CB 772 Company educational loan programs

81-6 1981-1 CB 615 Contributors _ "substantial and material change" in support [see 89-23]

81-7 1981-1 CB 615 Unusual grants not requiring advance ruling

81-65 1981-2 CB 690 Company scholarship programs _ publicizing in newsletter

82-2 1982-1 CB 367 CyPres _ state laws relating to 501(c)(3) dissolution provision

82-39 1982-2 CB 759 Reliance on Publication 78, Cumulative List

82-46 1982-2 CB 788 Obsoletes 66-30 regarding 501(c)(9) organizations

83-23 1983-1 CB 687 List of exempt organizations not required to file Form 990 Information Return

83-32 1983-1 CB 723 Return filing requirements for charitable and split-interest trusts

83-87 1983-2 CB 606 Indian tribal governments treated as states

84-36 1984-1 CB 510 Indian tribal governments _ list of subdivisions

84-37 1984-1 CB 513 Indian tribal governments _ procedures for requesting determination on status

84-47 1984-1 CB 545 Nonsubstantive amendments _ 15-month rule

under 508

85-51 1985-2 CB 717 Company scholarship _ 10% test of 76-47 and 80-39 clarified

85-58 1985-2 CB 740 Change of accounting period by EO [see 97-27 for change of method]

86-17 1986-1 CB 550 Indian tribal governments _ obsoletes the 2 year limit in 83-87, 84-36 & 84-37

86-43 1986-2 CB 729 Educational methodology

87-51 1987-2 CB 650 Change of accounting method for 501(m) organizations

89-23 1981-1 CB 844 Amplifies 81-6 for grant-making foundations

90-12 1990-1 CB 471 Deductibility of payments when benefit received [amplifies Rev. Rul. 67-246]

90-27 1990-1 CB 514 Exemption applications, revocations, and modifications

91-20 1991-1 CB 524 Guidelines for determining whether an organization is a "religious order"

92-59 1992-2 CB 411 Public interest law firm guidelines [supersedes 71-39]

92-85 1992-2 CB 490 Relief under Reg. 301.9100-1

92-94 1992-2 CB 507 Safe harbor under 4942 for certain grants to foreign grantees

94-17 1994-5 CB 457 Form 990 filing relief for certain foreign organizations [supplements 83-23]

95-21 1995-1 CB 686 Treatment of 501(c)(5) associate member dues as UBI [modified by 97-12]

95-48 1995-2 CB 418 Form 990 filing relief for governmental units/affiliates [supplements 83-23]

96-10 1996-1 CB 577 Form 990 filing relief for church affiliated organizations [supplements 83-23]

96-32 1996-1 CB 717 Safe harbor for organizations providing low-income housing to be charitable

96-40 1996-2 CB 301 Annual group exemption reports to be filed in Ogden, Utah [modifies 80-27]

97-12 1997-1 CB 631 Treatment of 501(c)(5) associate member dues as UBI [modifies 95-21]

98-19 1998-7 IRB 30 Application of 6033(e) to certain organizations [supersedes 95-35 & 95-35A]

00-4 2000-1 IRB 115 Letter rulings, determination letters, closing agreements, etc.

00-5 2000-1 IRB 158 Technical advice procedures

00-8 2000-1 IRB 230 User fees

INDEX