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**CPA's guide to tackling tough tax issues for nonprofit organizations**

Robert R. Lyons

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A CPA's Guide to Tackling Tough Tax Issues for Nonprofit Organizations

Robert R. Lyons, CPA
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Robert R. Lyons, CPA
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This book was written to help CPAs deal with selected complex tax issues facing nonprofit organizations in today's environment. Many contemporary issues facing nonprofit organizations have been created as a matter of law. Helping clients deal with these matters can and often does allow the nonprofit organization to continue its privileged position in our tax structure.

The book was written by Robert R. Lyons, CPA, a Member of Watkins, Meegan, Drury & Company, LLC, Bethesda, Maryland, with technical assistance from Lorraine Sexton, CPA, and Michael Yuen, CPA. They have extensive experience meeting the tax, audit, and consulting needs of not-for-profit organizations. We also wish to thank William G. Kistner, CPA, a partner with Ernst and Young LLP, Chicago, Illinois, for his careful technical review. This book is dedicated to Kris.

Linda Prentice Cohen, Publisher
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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>SECTION</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>OVERVIEW</td>
<td>1</td>
</tr>
<tr>
<td>CHAPTER 1 — THE USE OF MULTIPLE STRUCTURES WITH EXEMPT ORGANIZATIONS</td>
<td></td>
</tr>
<tr>
<td>INTRODUCTION</td>
<td>3</td>
</tr>
<tr>
<td>SEPARATION OF ACTIVITIES</td>
<td>7</td>
</tr>
<tr>
<td>USE OF CHARITABLE SUBSIDIARIES</td>
<td>9</td>
</tr>
<tr>
<td>Domestic Charities</td>
<td>9</td>
</tr>
<tr>
<td>Foreign Charities and the Use of Subsidiaries</td>
<td>14</td>
</tr>
<tr>
<td>SUPPORTING ORGANIZATIONS</td>
<td>18</td>
</tr>
<tr>
<td>Responsiveness Test</td>
<td>18</td>
</tr>
<tr>
<td>Integral Part Test</td>
<td>19</td>
</tr>
<tr>
<td>TREATMENT OF CHARITABLE CONTRIBUTIONS</td>
<td>19</td>
</tr>
<tr>
<td>Requirements for Deductibility</td>
<td>19</td>
</tr>
<tr>
<td>TREATMENT OF CONTRIBUTIONS AND TRANSFERS BETWEEN ORGANIZATIONS</td>
<td>21</td>
</tr>
<tr>
<td>THE USE OF SUBSIDIARIES WITH CHARITABLE ORGANIZATIONS</td>
<td>21</td>
</tr>
<tr>
<td>Entity Relationships</td>
<td>21</td>
</tr>
<tr>
<td>CHARITABLE REMAINDER TRUST/POOLED INCOME FUNDS</td>
<td>22</td>
</tr>
<tr>
<td>Pooled Income Fund</td>
<td>22</td>
</tr>
<tr>
<td>TRANSFER OF PAYMENTS BETWEEN ORGANIZATIONS</td>
<td>23</td>
</tr>
<tr>
<td>Revenue Ruling 55-192</td>
<td>23</td>
</tr>
<tr>
<td>Utility Bill Contributions</td>
<td>24</td>
</tr>
<tr>
<td>TAX-EXEMPT ORGANIZATIONS USE OF FOR-PROFIT SUBSIDIARIES</td>
<td>25</td>
</tr>
<tr>
<td>Structuring the For-Profit Activity</td>
<td>26</td>
</tr>
<tr>
<td>FOR-PROFIT SUBSIDIARIES - ORGANIZATION</td>
<td>29</td>
</tr>
<tr>
<td>CORPORATE CONTROL</td>
<td>30</td>
</tr>
<tr>
<td>MAINTENANCE OF SEPARATE IDENTITY</td>
<td>30</td>
</tr>
<tr>
<td>RELATIONSHIP CONSIDERATIONS</td>
<td>31</td>
</tr>
<tr>
<td>FUNDING THE FOR-PROFIT SUBSIDIARY</td>
<td>32</td>
</tr>
<tr>
<td>Investment</td>
<td>32</td>
</tr>
</tbody>
</table>
CONTENTS

PAGE

ALLOWABLE EXPENSES IN COMPUTING UNRELATED BUSINESS INCOME .................. 58
EXPENSES IN GENERAL .................................................................................. 58
Indirect/Direct Expenses Allocation .................................................................. 60
Use of Facilities ............................................................................................... 61
DEDUCTIBILITY ............................................................................................... 63
Charitable Contributions Made by Another Exempt Organization ................. 63
Specific Deduction ......................................................................................... 64
ADVERTISING AND CIRCULATION INCOME — PUBLICATIONS ............. 64
Terminology ..................................................................................................... 64
Allocable Membership Receipts ........................................................................ 65
Deductions Attributable to Periodicals .............................................................. 66
Direct Advertising Cost .................................................................................. 67
Readership Cost .............................................................................................. 67
Excess Advertising Costs ................................................................................ 68
Consolidation .................................................................................................... 70

SUMMARY ........................................................................................................ 70

CHAPTER 3 — CURRENT TRENDS AND TECHNIQUES IN INCOME-PRODUCING VENTURES

INTRODUCTION ............................................................................................... 73

CURRENT TRENDS/TECHNIQUES ................................................................ 73
MAILING LIST AGREEMENTS ...................................................................... 74
IRS/Congressional Involvement ....................................................................... 75
IRS Interpretations ........................................................................................... 76
RECENT RULINGS ......................................................................................... 77
Sale of Mailing Lists ......................................................................................... 77
AFFINITY CREDIT CARD PROGRAMS .......................................................... 78
Separate Agreements ......................................................................................... 78
Recent Court Decisions ................................................................................... 80
Sierra Club (U.S. Court of Appeals for the Ninth Circuit, June 20, 1996) ........ 81
Mississippi State University Alumni, Inc., Case ............................................... 86
Need for Contract Modifications ...................................................................... 87
RENTAL OF MAILING LIST GENERATES UBTI ........................................ 90

INSURANCE PROGRAMS .............................................................................. 90
IRS INTERPRETATIONS ............................................................................... 90
COURT DECISIONS ....................................................................................... 91
CHAPTER 4 -- DEVELOPMENTS ON LOBBYING RULES

INTRODUCTION ................................................................. 99

SECTION 501(h) ELECTION .............................................. 100
SECTION 501(c)(3) ORGANIZATIONS .................................. 100
Eligibility Requirements .................................................. 100
Lobbying Expenditures ................................................. 101
Disclosures by Nonelecting Public Charities ...................... 101
LIMITATIONS ON EXPENDITURES FOR GRASS-ROOTS LOBBYING .......................................................... 102

THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993 ......................................................... 103

AFFECTED ORGANIZATIONS ......................................... 103
DEFINING LOBBYING EXPENSES ................................. 103
"PURPOSE-BASED" RULE ............................................. 105
Presumptions ................................................................. 106
Paid Volunteers ............................................................... 107
Substantial Purpose Test .............................................. 107

METHODS OF COST ALLOCATION ................................. 108
COST ALLOCABLE TO LOBBYING ACTIVITIES .............. 108
Labor Costs ................................................................. 108
General/Administrative Costs ....................................... 109
SPECIFIC METHODS .................................................. 109
Ratio Method ............................................................... 110
Gross-Up Method ........................................................ 111
UNIFORM CAPITALIZATION ALLOCATION METHOD ................................................................. 113

LOBBYING EXPENSE DEDUCTION ................................ 113
DUES ........................................................................ 113
Proxy Tax .................................................................. 114
MAKING THE ELECTION .............................................. 116
RECORD-KEEPING REQUIREMENTS ................................. 116
# CONTENTS

| LOBBYING DISCLOSURE ACT OF 1995 | .......................................................... 116 |
| LOBBYIST | .......................................................... 117 |
| LOBBY ACTIVITY | ........................................................................ 117 |
| REPORTING GUIDELINES | ........................................................................ 119 |

| REPORTING OF TAXES ON LOBBYING AND POLITICAL EXPENDITURES | ........................................... 119 |
| FORM 990 — SCHEDULE A — PARTS VI-A & VI-B | ........................................... 120 |
| FORM 5768 | ........................................................................ 124 |

## CHAPTER 5 — TAX EXEMPTION OF HOSPITALS AND HEALTH-CARE PROVIDERS

| INTRODUCTION | ........................................................................ 125 |
| PURPOSE OF EXEMPTION FOR HEALTH-CARE PROVIDERS | ........................................................................ 125 |
| OPERATING STRUCTURE OF HEALTH-CARE ORGANIZATION | ........................................................................ 126 |
| Corporations | ........................................................................ 127 |
| Community Chest | ........................................................................ 128 |
| Trust Fund | ........................................................................ 128 |
| Foundation | ........................................................................ 128 |

| HEALTH-CARE FACILITY USE OF PARTNERSHIPS AND JOINT VENTURES | ........................................................................ 128 |
| CONCEPTUAL DESIGN OF PARTNERSHIPS AND JOINT VENTURES | ........................................................................ 129 |
| LIMITED PARTNERSHIP/LIMITED LIABILITY COMPANY VS. GENERAL PARTNER | ........................................................................ 129 |

| THE USE OF PARTNERSHIPS BY TAX-EXEMPT HEALTH-CARE FACILITIES | ........................................................................ 133 |

| PARTNERSHIPS AND THE ISSUE OF PRIVATE INUREMENT | ........................................................................ 138 |

<p>| USE OF JOINT VENTURES — REVENUE RULING 98-15 | ........................................................................ 140 |
| BASICS | ........................................................................ 140 |
| ANALYSIS | ........................................................................ 140 |
| SALE OR TRANSFER OF A REVENUE STREAM FROM A NONEXEMPT ENTITY | ........................................................................ 142 |
| SALE OF THE REVENUE STREAMS THAT BENEFIT RECIPIENTS | ........................................................................ 144 |
| SALE OF THE REVENUE STREAM FROM A HOSPITAL ACTIVITY IN VIOLATION OF FEDERAL LAW | ........................................................................ 145 |
| OFFICE OF INSPECTOR GENERAL'S POSITION ON HOSPITAL INCENTIVES TO PHYSICIANS | ........................................................................ 146 |</p>
<table>
<thead>
<tr>
<th>CONTENTS</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charitable Solicitation Requirements</td>
<td>169</td>
</tr>
<tr>
<td>Filing Requirements</td>
<td>169</td>
</tr>
<tr>
<td>STATE-BY-STATE ANALYSIS OF REGISTRATION AND FILING REQUIREMENTS</td>
<td>170</td>
</tr>
<tr>
<td>STATE-BY-STATE SUMMARY OF REGISTRATION AND FILING REQUIREMENTS</td>
<td>170</td>
</tr>
<tr>
<td>FORM 990</td>
<td>198</td>
</tr>
</tbody>
</table>
OVERVIEW

INTRODUCTION

Traditionally, tax exemption has been limited to situations in which a not-for-profit organization gains exemption as a result of a properly completed application. To take this even further, exemption has been divided into two subgroups:

1. Those organizations qualifying under §501(c)(3), and
2. Those qualifying under other sections of the Code.

The obvious advantage to meeting the operational and organizational test of §501(c)(3) is the ability to draw on a much broader base of public support.

Because of the obvious attraction to receiving support on a tax-exempt basis, many organizations have gone to great lengths to either protect their tax exemption or to take a for-profit activity and qualify it for exemption. With effective tax rates possibly in excess of 39% for federal and state purposes, tax-exempt status gives a decisive advantage to those organizations that qualify.

A further in-depth study of exempt organizations serves several useful purposes:

- For those organizations that are already exempt, it will help them maintain their not-for-profit status while reducing the fear of loss of exemptions.
- For organizations entering into new ventures, it will help structure those activities in such a way to take maximum advantage without affecting the status of the controlling organization.

In keeping pace with advancements in the not-for-profit area, the IRS has stepped up its monitoring activity in order to curtail the real or perceived abuses to exempt status. The IRS has, in recent years, also stepped up examinations of "exploited activities."

Along with structural considerations, it is also important to have an in-depth understanding of how "exploited activities" relate to the rest of the organization. Sections 511 through 514 lay out the basic rules for unrelated business income as it relates to exempt organizations. However, they do not address the "how to" in handling a variety of issues related to such problems, such as allocation of staff time and dual use of facilities.

If an activity is conducted on a for-profit basis or the IRS determines that an activity has been improperly handled and should be taxed, another series of problems arises. Many CPAs do not realize the problems associated with the impact of:
Accounting methods,

Alternative Minimum Tax.

Tax credits, and

Ruling request on exemption.

These issues are normally associated with for-profit activities but nevertheless have to be addressed when dealing with the for-profit activities of an exempt organization.

Finally, like all disciplines in accounting, the issues surrounding not-for-profit organizations are constantly changing. An in-depth understanding regarding current issues makes a difference in how well clients are served.

The rationale behind not-for-profit organizations depends, in part, on the nature of the activity. Organizations that fall under the category described in §501(c)(3) and, to a lesser degree, §501(c)(4) are created for the most part to serve a public good. The Code describes §501(c)(3) organizations as those created for educational, religious, scientific, literary, and other related purposes. Section 501(c)(4) organizations generally fall under a category of "social welfare" activities that normally are perceived as meeting community needs.

When categorizing activities, it is important to make a distinction between "charitable" activities described in §501(c)(3) and those described in §501(c)(4). Although activities described in §501(c)(4) are generally considered "charitable," donations to these activities are usually not tax-deductible. Likewise, amounts paid for membership, services, or fees to the other types of organizations currently enjoying tax-exempt status are not deductible as charitable donations, with a few limited exceptions discussed in the book. Even though an item may not be deductible under §170 as a contribution, it may be deductible under another section of the Code, such as §162, as an ordinary and necessary business expense.

Exempt organizations of all types have grown into multimillion-dollar operations with intricate business structures that rival commercial business enterprises. Exempt organizations often conduct their businesses through both exempt and nonexempt divisions and companies. Much of this activity has gone beyond caring for community needs. At the present time, Congress is taking a hard look at the various aspects of exemption for nonprofits.

Exempt organization management is faced with the monumental task of adhering to the philosophies of its respective organization while trying to conduct its businesses in a complex environment.

Note: For detailed discussion of sanctions, see Page 38.
CHAPTER 1

THE USE OF MULTIPLE STRUCTURES
WITH EXEMPT ORGANIZATIONS

INTRODUCTION

The use of multiple structures, whether exempt or taxable, has gained popularity over the past several years. It has become common for exempt organizations to structure their undertakings in a series of related organizations. In some cases, these activities are conducted as tax-exempt and in other cases through taxable entities. This has been especially true where there was a chance the activity could cost the organization its exemption due to either the magnitude or the nature of a business venture or prohibited activity. An exempt organization may not engage in prohibited activities even through its subsidiaries.

As stated above, there are a variety of reasons for the development of business combinations of tax-exempt organizations. Initially, state law created the framework for most exempt activities. Some examples of these types of activities include:

- Business Ventures.
- Educational Programs and Schools.
- Homeowner Associations.
- Lobbying Activities.
- Title-Holding Corporations.

A common example would be the inclusion of a business that generates unrelated business income in a for-profit subsidiary.

Part of the reason for the increase in popularity of multiple structures is the increase in sophistication of associations and their management. In a field that has been traditionally managed by volunteers, the advent of the professional highly paid manager has increased the visibility and often the criticism of exempt organizations. Organizations are separated into a variety of related activities to create smaller operating units in order to conceal certain elements of their operations.
A trade association was in the news several years ago because the total compensation package for its executive director was in excess of $900,000.

- It has become common practice to spread out compensation among various related organizations to limit visibility. However,
- Form 990 has been revised to include information concerning compensation paid through affiliates.

There is often a variety of considerations in determining whether an activity should be housed in a single organizational structure or broken into separate activities. Separation may be a result of legal issues or compatibility of projects. By way of example, trade associations are usually created for the benefit of members of a particular industry. In some cases, the organization provides member services or licensing for a particular industry. In other cases, the organization may be, in part, concerned with research, scholarships, or other philanthropic activities. In the latter case, we may be dealing with an activity totally dependent on public donations for its existence. In this case, the organization needs to be structured so contributors can deduct contributions for federal income tax purposes. In other cases, for example, grants can be given only to an exempt organization. You might find that an organization is conducting two similar operations at the same time—one an exempt organization receiving grants from the government or industry, and the other the operation of a for-profit activity doing exactly the same business. This type of operation will be explained further in the section covering the use of for-profit subsidiaries.

Multiple entities can also be beneficial if there are incompatible activities. If an organization attempted to conduct lobbying activities along with a "bundle" of major activities, such as scholarships, seminars, and publishing, there is a possibility the political activity would jeopardize the exempt activity.

Therefore, the organization must structure itself (exempt or nonexempt) strategically, i.e., to attract the type of grantor most likely to give it grants and still be able to accomplish its organizational purpose.

The following is a list of the various types of exempt organizations under §501 which the exempt activities can be divided into:

**501(c)(1)** Corporation organized under an Act of Congress which is an instrumentality of the U.S. but only if such corporation is exempt from federal income taxes.

**501(c)(2)** Corporation 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 §501.
501(c)(3) Corporation and any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation, and which does not participate in or intervene in any political campaign on behalf of any candidate for public office.

501(c)(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

501(c)(5) Labor, agricultural, or horticultural organizations.

Note: The scope of the exemption provided in §501(c)(5) for labor, agricultural, and horticultural organizations is the subject of a newly proposed regulation. An organization would not qualify for an exemption if its principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs. The IRS indicated it will continue to oppose claims of tax-exempt status made by organizations the principal activity of which is the management of retirement savings plans.

501(c)(6) Business league, chamber of commerce, real estate boards, boards of trade, or professional football leagues, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

501(c)(7) Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of net earnings of which inures to the benefit of a private shareholder.

501(c)(8) Fraternal beneficiary societies, orders, associations operating under lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system and providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

501(c)(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such an association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures to the benefit of any private shareholder or individual.
A CPA’S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

501(c)(10) Domestic fraternal societies, orders, or associations operating under the lodge system the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and which do not provide for the payment of life, sick, accident, or other benefits.

501(c)(11) Teachers’ retirement fund associations of a purely local character.

501(c)(12) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

501(c)(13) Cemetery companies owned and operated exclusively for the benefit of their members.

501(c)(14) Credit union without capital stock organized and operated for mutual purposes and without profit.

501(c)(15) Insurance companies or associations other than life if the net written premiums for the taxable year do not exceed $350,000.

501(c)(16) Corporation organized by an association subject to farmers’ cooperative rules or members thereof.

501(c)(17) Trust or trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits.

501(c)(18) Trust or trusts created before June 25, 1959, forming part of a plan providing for the payment of benefits under a pension plan funded only by contribution of employees.

501(c)(19) Post or organization of past or present members of the Armed Forces or an auxiliary unit or society of, or a trust or foundation for, any such post or organization at least 75 percent of the members of which are past or present members of the Armed Forces, and substantially all of the other members of which are individuals who are cadets or are spouses, widows, or widowers of past or present members.

501(c)(20) Organization or trust created or organized in the U.S., the exclusive function of which is to form part of a qualified group legal services plan or plans, within the meaning of IRC §120.

501(c)(21) Trust established in writing, created or organized in the U.S, and contributed to by any person if the purpose of such trust is exclusively to satisfy in whole or in part the liability of such person for claims for compensation for disability or death due to Black Lung Acts.
THE USE OF MULTIPLE STRUCTURES WITH EXEMPT ORGANIZATIONS

501(c)(22) Trust created or organized in the U.S. and established in writing by the plan sponsors of multiemployer plans if the purpose of such trust is exclusively to pay any amount described in §4223(c) or (h) of ERISA.

501(c)(23) Any association organized before 1880 of which more than 75 percent of the members are present or past members of the Armed Forces and of which a principal purpose is to provide insurance and benefits to veterans or dependents.

501(c)(24) Trust described in §4049 of ERISA.

501(c)(25) Any corporation or trust which has no more than 35 shareholders or beneficiaries, has only one class of stock or beneficial interest, and is organized for the exclusive purposes of acquiring real property and holding title to and collecting income from such property and remitting the entire amount of income from such property to organizations described as a qualified pension, profit-sharing, or stock bonus plan that meets the requirements of §401(a), a government plan, or the U.S., or any state or political subdivision, etc.

501(c)(26) Exemption from income tax to state funded membership organizations founded specifically to provide healthcare coverage on a not-for-profit basis to individual residents of the state, who, because of a pre-existing condition, cannot obtain coverage through insurance or a HMO at a rate equivalent to that offered by the membership organization. The code provides membership constituencies of such organizations shall be determined by the state.

501(c)(27) Exempts state sponsored organizations created before June 1, 1996 for the express purpose of reinsuring their members against losses incurred under workers' compensation acts. Membership of such organizations must consist of all persons offering insurance coverage of workers compensation losses and all persons and governmental bodies which self-insure against such losses in the state. Such organizations must function as nonprofits by periodically returning surplus income to members or workers' compensation policyholders and by reducing initial premiums in anticipation of investment income.

This detailed list shows the diversity in exempt organizations. For the most part, the majority of exempt organizations fall within the first ten listed. Of all the organizations, 501(c)(3) organizations are usually the only ones that allow for a deduction of contributions. As explained later, it is possible for another type of exempt organization to allow for charitable deductions when acting as a conduit or agent for the members of the organization.

SEPARATION OF ACTIVITIES

Initially, the separation of exempt organizations was often between organizations which, in themselves, were also exempt.
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Example 1-2:

- Charitable organization that operated in its own building may have a separate organization (tax-exempt title-holding corporation) to house the building activity and a separate exempt organization to carry on its exempt activity.
- In some cases, the operations can be conducted through a for-profit entity with an exempt foundation to carry out its philanthropic activities.

One of the most common groupings for trade associations is to have:

- 501(c)(6) organization for its professional activities,
- Foundation for scholarships and/or research,
- Political action committee¹ (PAC) for the political agenda, and
- For-Profit subsidiary for the organization's unrelated business activity.

One of the primary advantages of this multi-entity organizational structure is that an organization may carry out its professional agenda while allowing members to also carry out a social agenda for the public good. As a 501(c)(6) trade association, its activities may not include soliciting tax-deductible contributions. That activity is restricted to 501(c)(3) organizations as "public charities." Once an eligible activity is transferred to a 501(c)(3) exempt organization, it will have available a much larger variety of resources on which to draw.

Example 1-3:

- If the trade association wishes to grant scholarships to deserving students in a given profession, conducting the activity in its own exempt foundation under §501(c)(3) can offer members an incentive for making tax-deductible contributions.

¹ See Chapter 4 regarding discussion of lobbying activities for exempt organizations. The treatment of lobbying expenses is, in part, dependent on whether the organization is a §501(c)(3) or "other" 501(c)(4), 501(c)(5), etc.
Parental Control

For the most part, the newly created organization functions as a true subsidiary of the creating parent. The parent organization normally maintains a tight control on the subsidiary. Although these organizations are not necessarily required to be controlled by the creating organization, it is very rare for them to be totally freestanding. The foundations are often set up as the result of an emotional need on the part of the organization's officers or key members. Because of this and because the creating organizations normally have made a substantial financial commitment, they are often reluctant to lessen their control.

With the passage of time, the laws governing tax-exempt organizations are becoming more complex. This is both a blessing and a curse. Expanding laws are creating flexibility for the organization manager while at the same time creating a need for a much higher level of sophistication on the part of administrators.

Use of Charitable Subsidiaries

Domestic Charities

Although trade associations and business leagues have traditionally made the most frequent use of setting up a charitable subsidiary, they are by no means the only ones to do so. Any organization wishing to take advantage of fund-raising for its social goals may find the use of a 501(c)(3) tax-exempt subsidiary to be beneficial.

Tax-exempt subsidiaries are usually more beneficial to membership organizations because they allow for the private philanthropy of their members while also allowing for tax-deductible donations. As we said, trade associations and business leagues are not the only organizations that can take advantage of this type of structure. Other types of membership organizations might include:

- Social Welfare Organizations.
- Labor Organizations.
- Social Clubs.
- Fraternal Organizations.
- Veterans Organizations.

An example of the relationship between these types of organizations might be where a fraternal organization [501(c)(10)], which is a membership activity, would use a foundation exempt under §501(c)(3) to carry out its social agenda. The social goals can meet both the operational and organizational test for 501(c)(3) charitable organizations. These can range from scholarships to historic preservation.
Fund-Raising

On the surface, it might appear that there is little to be gained where one 501(c)(3) exempt organization forms another 501(c)(3) exempt organization, especially where the parent organization can, in its own right, accept contributions. However, where fund-raising is a particular issue, you often see separate organizations. The idea of the separate organization has merit if the emphasis of the new entity is on fund-raising and there is a board and a support system of highly visible individuals in the community. Moreover, organizations may not want a particular spokesperson to be associated with the charity on a permanent basis once the fund-raising campaign is over and the organization wants to concentrate on its charitable purpose. There may also be legal reasons for the separation. This is particularly true where there is a highly conservative board of directors whose primary consideration is to limit exposure to the kinds of liability that may be associated with fund-raising.

When a tax-exempt organization forms another tax-exempt organization, it must also abide by all the appropriate tax and accounting requirements met by the parent. If the new exempt organization has its own articles, bylaws, and charter, then it has to meet all the same organizational and operational tests that any other similar exempt organization has to meet. It also has to address the same issues, such as avoiding private foundation status, that any other tax-exempt organization would have to face. While fund-raising may be the primary reason for the subsidiary, it must also have a basic philanthropic reason for its existence.

Qualifications

The rules are basic—to qualify for exemption from income taxes under §501(c)(3), an organization must be an entity organized and operated entirely as follows:

Corporations, and any community chest, fund, or foundation organized and operated exclusively (emphasis added) for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, of which no part of the net earnings inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation (except as otherwise provided in IRC Section 501(h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) a candidate for public office.

Charitable Purposes

In defining the nature of an activity, the use of the word "charity" is often misleading. The term "charitable" is used in §501(c)(3) in a generally accepted legal sense and is not limited to the specific topics listed. This list has been greatly expanded in the legal sense by judicial decisions. In the broad sense, the term has grown to include (but is not limited to) the following [Reg. §1.501(c)(3)-1(d)]:

10
THE USE OF MULTIPLE STRUCTURES WITH EXEMPT ORGANIZATIONS

- Relief of the poor, distressed, and underprivileged.
- Advancement of religion.
- Advancement of education or science.
- Erection or maintenance of public buildings or monuments.
- Lessening the burdens of government.
- Promotion of social welfare by organizations designed to accomplish any of the above purpose.
- Lessening neighbor tension.
- Elimination of prejudice and discrimination.
- Defense of human and civil rights secured by law.
- Combating community deterioration and juvenile delinquency.

One of the issues regarding the formation of charities regards the concept of inurement of benefits to the organizers and the idea of "services for sale." Although an organization, organized and operated for the relief of indigent persons, may receive voluntary contributions from the persons intended to be relieved, that fact will not necessarily prevent the organization from receiving exemption status. Additionally, even though an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinions on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its view, it is not precluded from qualifying under §501(c)(3) as long as it is not an "action" organization that becomes political in nature. (This will be discussed thoroughly in Chapter 4.)

**Educational/Scientific Purposes**

While the concept of operating an organization for educational or scientific purposes would appear to be straightforward on the surface, it can also be complicated because of the nature of the educational or scientific purpose of the charity.

**Educational** An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts which permits an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.
The determination whether research is "scientific" does not depend on whether such research is classified as "fundamental" or "basic" as contrasted with "applied" or "practical." On the other hand, for purposes of the exclusion from unrelated business taxable income provided by §512(b)(9), it is necessary to determine whether the organization is operated primarily for purposes of carrying on "fundamental," as contrasted with "applied," research.

Scientific research under 501(c)(3) does not include activities ordinarily carried on as incident to commercial or industrial operations as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment.

Scientific research will be regarded as carried on in the public interest:

- If the results of the research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis.

- If the research is performed for the United States, or any of its agencies or instrumentalities, or for a state or political subdivision thereof.

- If the research is directed toward benefiting the public.

  - The following are examples of scientific research considered as directed toward the public benefit and, therefore, will be regarded as carried on in the public interest [Reg. §1.501(c)(3)-1(d)(5)(iii)(c)]:

    - Scientific research carried on for the purpose of aiding the scientific education of college or university students.

    - Scientific research carried on for the purpose of obtaining scientific information which is published in a treatise, thesis, trade publication, or in any other form available to the interested public.

    - Scientific research carried on for the purpose of discovering a cure for a disease.

    - Scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.

Even though there is significant discussion regarding private inurement throughout the charitable statutes, the regulations provide that scientific research described in this section will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from the research.
Nonqualifying Scientific Research

Equally important to understand are those organizations that are not considered as being organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under §501(c)(3) as a "scientific" organization if [Reg. §1.501(c)(3)-1(d)(5)(iv)]:

- These organizations perform research only for persons who are (directly or indirectly) its creators and who are not described in §501(c)(3).

- These organizations retain (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from their research and do not make such patents, copyrights, processes, or formulae available to the public. For purposes of §501(c), a patent, copyright, process, or formula will be considered as being made available to the public if it is made available on a nondiscriminatory basis.

- In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, the patent, copyright, process, or formula is to be considered as made available to the public if the granting of this exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public. It will be regarded as carried on in the public interest.

The fact that any organization, including colleges, universities, and/or hospitals, may carry on research which is not in furtherance of an exempt purpose described in §501(c)(3) will not necessarily preclude the institution from meeting the requirements of §501(c)(3) so long as the organization meets the organizational test and is not operated for the primary purpose of carrying on the research. In essence, this means that the research can be carried on as a nonexempt program. However, it will either generate unrelated business income or it may more appropriately be conducted through a for-profit entity.

State Considerations

Each of the states has the sovereign authority to tax business operations within its jurisdiction whether or not the business was organized and incorporated in the state. Each of the states must decide what activities are exempt within its jurisdiction. In some cases, exempt organizations may enjoy partial or total exemption. For the most part, if a not-for-profit entity conducts a trade or business within the state, the state maintains the authority to tax the activity as it would any other business. In some cases, a partial or complete exemption from income taxes may be given without giving an exemption for such things as real estate taxes, sales taxes, and franchise taxes. Incorporation within a given state is a state matter where articles of incorporation and bylaws are drawn up, and a charter is granted.
Once the organization is operating as either a corporation, trust, or association under the given laws of a state, it must then address the issue of state exemption. Normally, this is a simple process whereby the state accepts the federal exemption and may or may not require a copy of Form 990. On the other extreme, there are taxing authorities such as the District of Columbia which makes it particularly difficult on not-for-profits. In this jurisdiction, the not-for-profit must submit a detailed application and wait months for an approval. In the meantime, they are technically operating as a for-profit entity. Additionally, most states allow exemption in the same subclassification as the Code [i.e., 501(c)(3), (4), (5), etc.]. Again, the District of Columbia does not allow all the various classifications that other states or the federal government allow. This points out the need to thoroughly investigate the requirements of a jurisdiction before you advise a client to operate in one jurisdiction or another.

A more detailed discussion of the state requirements is covered in Chapter 6.

Foreign Charities and the Use of Subsidiaries

Once a U.S. charitable organization has met the domestic requirements of operating as a tax-exempt activity, it is not precluded from operating its activities in foreign countries (Rev. Rul. 71-460, 1971-2 C.B. 231).

Example 1-4:

- If the charitable organization's primary function is to feed the poor or provide medical supplies to underprivileged families, the activity is no less honorable or allowable just because the activity is conducted outside the U.S.

- In Revenue Ruling 68-117, 1968-1 C.B. 251, the IRS took the position that a charity formed to assist people in a developing country, and to provide educational opportunities for underprivileged persons in Latin America as well as create self-help programs, was nevertheless exempt even though the recipients of the charitable contributions were not U.S. persons.

Support can take many forms, such as program or project grants, provision of equipment or materials, and scholarships or fellowship grants.

Section 170(c)(2), defining "charitable contribution," provides that contributions must be to or for the use of a 501(c)(3) corporation, trust, or community chest, or a fund or foundation created or organized in the United States or in any possession thereof or under the laws of the United States.
Limitations on Deductions

In addition to the above exclusion of deductions for foreign contributions, if the contribution is received by a domestic charity and transferred to a foreign charity, there may be a limitation on the deductibility. In Revenue Ruling 63-252, 1963-2 C.B. 101, the IRS listed five illustrations or examples of supporting domestic charities and how the contributions given to each of the activities should be deducted. The "foreign organization" referred to in each of the examples is an organization chartered in a foreign country, organized, and operated in such a way that it meets all the requirements of §170(c)(2) except for the requirements previously discussed under §170(c)(2)(A) which creates the need for a U.S. entity. Additionally, the "domestic organization" in each example is assumed to meet all the requirements in §170(c)(2).

Example 1-5:

- In pursuance of a plan to solicit funds in this country, a foreign charitable organization caused a domestic charitable organization to be formed.

- At the time of formation, it was proposed that the domestic organization would conduct a fund-raising campaign, pay the administrative expenses from the collected fund, and remit any balance to the foreign organization.

Discussion:

- Generally, contributions in this situation will not be deductible.

Example 1-6:

- Certain persons in this country, desirous of furthering a foreign organization's charity work, formed a charitable organization within the U.S.

- The charity of the domestic organization provides that it will receive contributions and send them, at convenient intervals, to the foreign organization.

Discussion:

- Generally, contributions in this situation will not be deductible.
Example 1-7:

- Foreign charitable organization entered into an agreement with a domestic charitable organization which provides that the domestic organization will conduct a fund-raising campaign on behalf of the foreign organization.

- Domestic organization has previously received a ruling that contributions to it are deductible under §170.

- In conducting the campaign, the domestic organization represents to prospective contributors that the raised funds will go to the foreign organization.

Discussion:

- *Generally, contributions in this situation will not be deductible.*

Example 1-8:

- Domestic charitable organization conducts a variety of charitable activities in a foreign country.

- When its purposes can be furthered by granting funds to charitable groups organized in the foreign country, the domestic organization makes the grants for purposes which it has reviewed and approved.

- The grants are paid from its general funds and although the organization solicits from the public, no special fund is raised by a solicitation on behalf of particular foreign organizations.

Discussion:

- *Generally, contributions in this situation are deductible because there is no earmarking of contributions.*

- *Use of such contributions will be subject to control by the domestic organization.*
Example 1-9:

- A domestic charitable organization, which does charitable work in a foreign country, formed a subsidiary in that country to facilitate its operations there.

- The foreign organization was formed for the purposes of administrative convenience, and the domestic organization controls every facet of its operations.

- In the past, the domestic organization solicited contributions for the specific purpose of carrying out its charitable activities in the foreign country, and it will continue to do so in the future.

- However, following the formation of the foreign subsidiary, the domestic organization will transmit funds it receives for its foreign charitable activities directly to that organization.

Discussion:

- Generally, contributions in this situation are deductible because the foreign organization is merely an administrative arm of the domestic organization with the domestic organization considered "the real recipient" of the contribution.

It is recognized that special earmarking of the use or destination of funds paid to a qualifying charitable organization may deprive the donor of a deduction. In S.E. Thomason v. Commissioner, 2 T.C. 441 (1943), the court held that amounts paid to a charitable organization were not deductible where the contributions were earmarked for the benefit of a particular ward of the organization (see also Rev. Rul. 54-580, C.B. 1954-2, 97). These cases point out that an inquiry about the deductibility of a contribution need not stop once it is determined that an amount has been paid to a qualifying organization. If the amount is earmarked, then it is appropriate to look beyond the fact that the immediate recipient is a qualifying organization to determine whether the payment constitutes a deductible contribution.

Earmarking

The aforementioned examples were expanded and amplified in Revenue Ruling 66-79, 1966-1 C.B. 48. As in the case of Example 1-8, the IRS was most concerned with the issue of "earmarking" and stated that "the test in each case is whether the organization has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes."

When addressing "earmarking," the problem is further compounded depending on whether the recipient of the contribution is a domestic or foreign entity. If the recipient is a domestic corporation conducting activities both in the U.S. and abroad, the contributions are generally deductible as charitable gifts. The entity is extremely important in determining how the IRS will view a contribution. In the case of
Bilingual Montessori School of Paris, Inc., v. Commissioner, 75 T.C. 480 (1980), the corporation had no employees in the U.S., nor did it conduct any of its charitable activities in this country, nor did it house any facilities here. The court took the position that in this case "form" over "substance" was going to be the determining factor. Referring to §170(c)(2)(A), the basic requirement is the need for the charity to be created or organized in the U.S. or any possession thereof, or under the law of the U.S. a state, the District of Columbia, or any possession of the U.S.

**Supporting Organizations**

To qualify as a public charity without regard to the domestic-foreign issue, the charity must either be publicly supported or serve in the capacity of a supporting organization. If a charity does not receive sufficient support from the general public, it may be classified as a private foundation. As an alternative, there is a second set of rules under §509(a)(2) for supporting activities. In order to qualify, there is a narrowly defined set of rules to establish the relationship between the supporting and supported activities. According to the regulations [Reg. §1.509(a)-4(a)], a supporting organization (domestic) will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" and the "integral part test."

**Responsiveness Test**

A supporting organization will be considered to meet the "responsiveness test" if the organization is responsive to the needs or demands of the publicly supported organizations. This can be established in one or more ways between the domestic and foreign operations:

- One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations.

- One or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organizations.

- The officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations.

- By reason of the above relationships, the officers, directors, or trustees of the publicly supported organizations have a sufficient voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by such supporting organizations, and in otherwise directing the use of the income or assets of such supporting organizations.
The Use of Multiple Structures with Exempt Organizations

Integral Part Test

A supporting organization will be considered to meet the "integral part test" if it maintains a significant involvement in the operations of one or more publicly supported organizations, and these publicly supported organizations are, in turn, dependent upon the supporting organization for the type of support being provided. To meet these criteria, the supporting organization must either:

Activities

Engage in activities for or on behalf of the publicly supported organizations that carry out the purposes of these organizations and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves, or

Payments

Make payments of substantially all its income to or for the use of one or more publicly supported organizations. The amount of support received by one or more of these publicly supported organizations should be sufficient enough to insure the attentiveness of these organizations to the operations of the supporting organization.

For a domestic organization to qualify as a supporting organization to a foreign charity, the "integral part test" will be met as long as the U.S. entity makes payments of substantially all its income to the foreign charity. The relationship between the entities is a double-edged sword. There must be independence between the U.S. and foreign entities to qualify for deductible contributions and, at the same time, they must have a close enough relationship to satisfy the requirements of a supporting organization.

Treatment of Charitable Contributions

As previously stated, the IRS has repeatedly taken the position that contributions to a U.S. charity soliciting funds for a specific project of a foreign charity may or may not be deductible depending on the circumstances. On the other hand, contributions made directly to a foreign charity are not deductible. In the text of Revenue Ruling 63-252, 1963-2 C.B. 101, the IRS ruled that a charity formed in the U.S. for the express purpose of fund-raising and transmitting those funds to a foreign charity was not allowed to treat the support as a charitable contribution.

Requirements for Deductibility

Creation/Organization in U.S.

In determining whether contributions to or for the use of a particular corporation, trust, community chest, fund, or foundation are deductible, it must first be determined that the recipient organization was
validly created or organized as a charitable organization in the U.S., a state or territory, the District of Columbia, or a possession of the U.S., as required by §170(c)(2)(A). If the organization was not organized or created in the U.S., contributions to or for its use are not deductible under §170.

**Purpose of Organization**

The rules become more complicated in that it must further be found that the recipient was organized and operated exclusively for one of the purposes stated in §170(c)(2)(B):

- Organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.

**Complications**

Assuming an organization meets the requirements in §170(c)(2), a further problem arises for a foreign charitable organization. As previously noted, contributions made directly to the foreign organization would not be deductible. The question presented by the ruling is whether the result should differ when funds are contributed to a domestic charity which then transmits those funds to a foreign charitable organization.

It should be noted that §170(c)(2)(A) relates only to the place of creation of the charitable organization to which deductible contributions may be made and does not restrict the area in which deductible contributions may be used.

**One final complication** appears when considering deductibility of contributions. Under normal circumstances, when a corporation makes a contribution to a charity, it is deductible only insofar as the gift is used in the U.S., or its possessions, for allowable charitable purposes. However, when the donee is also a corporation there is an exception. This is due to the wording of §170(c)(2) which states that a "corporation, trust, or community chest, fund, or foundation may qualify as a charitable donee," while the restriction in the last sentence of §170(c)(2) applies to a gift to a trust, community chest, fund, or foundation. According to Revenue Ruling 69-80, 1969-1 C.B. 65, "...while the last sentence in IRC Section 170(c)(2) denies a deduction for a charitable contribution by a corporation to a trust, community chest, fund, or foundation if it is used outside the United States or any of its possessions, that sentence contains no limitation as to deductions by a corporation for charitable contributions to a domestic charitable corporation. Thus, the statute does not preclude the deductibility of contributions to a domestic charitable corporation which uses its funds for a charitable purpose in a foreign country."

One final word of caution: when dealing with charitable contributions to foreign entities, some contributions are covered by tax treaty which supersede the above rules.
THE USE OF MULTIPLE STRUCTURES WITH EXEMPT ORGANIZATIONS

TREATMENT OF CONTRIBUTIONS AND TRANSFERS BETWEEN ORGANIZATIONS

THE USE OF SUBSIDIARIES WITH CHARITABLE ORGANIZATIONS

Exempt organizations that erect multi-entity structures generally operate to achieve a common purpose. The organizations are usually stand alone and work "in conjunction with" and not "as a result of" another organization’s activities. Exempt organizations are generally broken into two major groups of either 501(c)(3) organizations or "other" exempt organizations. The obvious distinction is that a 501(c)(3) can receive deductible donations and be tax-exempt. "Other" types of organizations may be exempt from federal income tax under §501(c) and still not allow for a charitable deduction on the part of the donor. Even though membership dues or fees are not normally deductible as a contribution in the ordinary course of business, they may be deductible under other sections, such as §162, for ordinary and necessary business expenses.

Entity Relationships

The relationship between the entities will normally take one of several forms:

- Charitable subsidiary of a noncharitable exempt organization.
- Charitable subsidiary of a charitable organization.
- Charitable organization associated with a for-profit business enterprise.
- For-profit subsidiary of a charitable organization.
- For-profit subsidiary of a noncharitable exempt organization.

To determine the proper format for the relationship, the organization has to analyze the purpose of the subsidiary. In some cases, a charitable organization may create a noncharitable exempt organization to house an activity which could potentially threaten the parent’s tax-exempt status.

Example 1-10:

- Charitable organization may tend to become too deeply involved in legislative activities.
- In order to avoid the possibility of upsetting the organization’s exempt status, it could transfer the political activity into a social welfare organization [501(c)(4)].
- Contributions to this type of organization are not deductible even though it continues with its exempt status.
Trade associations, etc., associated with an exempt charitable organization would be another example of a noncharitable tax-exempt organization. While both are exempt under either 501(c)(3) or 501(c)(6), only the 501(c)(3) can solicit contributions.

**Charitable Remainder Trust/Pooled Income Funds**

Charitable remainder trusts and pooled income funds are used to support activities of 501(c)(3) organizations and have gained popularity over the last several years. While they are not formal subsidiaries, they do function in many of the same ways.

The charitable remainder trust is a type of trust that pays a predetermined dollar amount or a percentage of the initial or annual value of the trust to a noncharitable beneficiary for either a single or joint lifetime and then terminates the interest in favor of the charity (remainderman-beneficiary). Normally, the grantor of the charitable remainder trust receives an income stream and a gift tax deduction or possibly an estate tax deduction if the trust has been funded by a testamentary transfer for the actuarial present value of the charity’s remainder interest.

**Advantages**

**To Donor**

The advantage of this type of vehicle to a donor is, of course, the current charitable contribution deduction.

**To Charity**

The advantage to the charity is the potential ability to receive property or cash sometime in the future.

**Disadvantages**

One of the major disadvantages to the charity is the administrative cost of carrying the property in the trust. In some cases, it can produce a negative cash flow for the charity if the property is not income-producing. In order to meet the payout requirements, the charity may have to borrow money to make the necessary distributions. This type of vehicle works best with an older donor because of the actuarial life expectancies. The older the individual, the greater the charitable portion of the gift and the shorter the time for the charity to claim the benefit.

**Pooled Income Fund**

The second vehicle, the pooled income fund, operates much like the charitable remainder trust in that, based on life expectancy, there is a charitable portion to the fund. Individuals collectively pool their money together and receive the income on a quarterly basis. At their death, the funds go to the charity.
Any more detailed discussion concerning the use of charitable remainder trusts or pooled income funds is more appropriately covered in estate planning publications.

**TRANSFER OF PAYMENTS BETWEEN ORGANIZATIONS**

Because of the relationship existing between these multiple organizations, it is not at all uncommon for one organization to receive all or a portion of the funds directed to the other related organization. When the funds are transferred between the organizations, the tax treatment is dependent on whether the payments were meant for the original donee or were given to the original donee with the express anticipation that all or a part of the funds were to be turned over to the other organization. Often the original organization is nothing more than a conduit for the second organization. In some cases, the relationship is formal enough to create an agency relationship. If this is the case, the contribution is deemed to have been made to the ultimate donee for tax purposes.

**Revenue Ruling 55-192**

Often, the donor's intent is not completely clear. In what appears to be an old revenue ruling (Rev. Rul. 55-192, 1955-1 C.B. 294), the issue was:

- Did a portion of membership dues for a social club earmarked for distribution to qualified charities and paid by individual members to the treasurer of the club acting as a duly constituted collecting agent for certain charities constitute a charitable donation?

- The rules of the social club provided that each member pay dues of 100x dollars annually.
  - Of this amount, 30x dollars is in payment of two tickets to a dinner-dance, and
  - 70x dollars constitutes a direct contribution by the member to charitable organizations, contributions deductible under the provisions of §23(o) of the Code (1939) (predecessor to §170).

- Checks in payment of dues were made payable to the treasurer of the club, who was authorized both by the club and the donee organization to act as agent to receive members' contributions for such purposes.

- Section 23(o) of the Code (1939) provided, in part, that in computing taxable net income, there shall be allowed as deductions (in the case of an individual) contributions or gifts, payment of which is made within the taxable year to or for the use of a corporation, trust, or community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, or educational purposes.
The ruling stated: "Contributions made by members of the social club under the foregoing arrangement and paid over to organizations which are of the type set out in §23(o) of the Code (1939) constitute allowable deductions to the members in computing their taxable net income in the manner and to the extent provided by that section."

"Contributions received by the treasurer who is also acting as agent of such donee organizations, will be deductible by the donors at the time such contributions are paid to him."

Note:

- "However, if the treasurer has not been designated by the organization involved to act as its agent, he is considered to be the agent of the contributor. Accordingly, in that case, such contributions are deductible only in the taxable year in which they are actually transferred to the donee organization."

Utility Bill Contributions

In Revenue Ruling 85-184, 1985-2 C.B. 84, customers were able to make a contribution while paying their utility bills. In fact, over the last several years, this practice has become widespread. Regarding the ruling, the issue was whether customers who pay additional amounts on their utility bills to a utility company acting as an agent for a charitable organization that assists individuals with emergency energy needs are allowed a charitable contribution deduction for the added amounts under §170(a).

- In the facts surrounding the ruling, a local chapter of a national charitable organization described in §170(c) established a program designed to provide financial assistance to elderly and handicapped individuals in meeting their emergency energy-related needs.

- The chapter entered into an agreement with the utility company to facilitate the collection of charitable contributions made by customers of the utility and others.

- Under their agreement, the chapter designated the utility as its authorized agent to collect contributions to the program on the chapter's behalf.

- Customers were given the opportunity of making contributions to the utility's financial assistance program for the elderly and handicapped when making payments for utility services.
  - If a customer pays the monthly bill in full, an additional amount may be paid to the utility and designated, in a space provided on the bill, as being earmarked for the chapter's financial assistance program.
  - The earmarked amounts collected by the utility are then transferred to the chapter on a weekly basis.
At all times, the utility segregated the funds from its own resources.

The ruling relies heavily on §170(a) which provides, in part, for a deduction for charitable contributions and gifts for the use of organizations described in §170(c), payments of which are made within the taxable year.

Additionally, "Section 1.170A-1(b) of the Income Tax Regulations provides that, ordinarily, a contribution is made at the time delivery is effected." (See the discussion on page 23 regarding Rev. Rul. 55-192, 1955-1 C.B. 294, where membership dues earmarked for distribution to a qualified charity and paid by individual members to the treasurer of a social club acting as a collecting agent were deductible under §170 for the year in which the contributions were paid to the treasurer.)

In the case of the ruling, the IRS determined that a customer of the utility who makes a contribution under the program by adding an amount to the customer's utility bill will be entitled to a deduction for such amount in the manner and to the extent provided by §170 in the taxable year the contribution is paid to the utility.

Discussion:

One interesting issue that was not raised by the ruling was whether the utility received any prohibited private benefit as a result of this arrangement. The utility was receiving both a direct and indirect benefit by this activity. The immediate benefit was the ability of these individuals to pay their utility bills presumably back to the utility company. The indirect benefit to the utility is the enhanced public image. There is no question that there is a benefit to the utility. However, as long as the utility is serving only in an agency relationship, similar to that found in Revenue Ruling 55-192 above, the deductions should be allowed.

TAX-EXEMPT ORGANIZATIONS USE OF FOR-PROFIT SUBSIDIARIES

Over the last several years, it has become almost fashionable, if not essential, for exempt organizations to have a for-profit subsidiary. This for-profit subsidiary is normally a taxable entity and houses activities normally reported on Form 990-T. The two primary reasons for forming these subsidiaries are:

1. Business operations are totally different in nature and are unrelated to the exempt organization purpose.

2. Business operations are so successful they would tend to swamp the not-for-profit activity, possibly causing the loss of exemption and/or jeopardizing its exempt status.
For all that, there is normally no question regarding a not-for-profit organization's ability to have a trade or business. There are no exact percentages as to how much of an organization's activities can be conducted through a trade or business; however, when it generates income that exceeds 50% of the nonprofit organization's income, there may be cause for concern. In some cases, there is clearly no question when as little as 5 to 10% of the activities constitute a trade or business. On the other hand, when the exempt activity generates as little as $25,000 in gross receipts and the for-profit activity exceeds $1,000,000 in gross receipts, there is definitely a problem. If the organization were to file a Form 990-T, it is fairly evident the exemption would be in jeopardy because of the disparity in activities. However, when evaluating what constitutes the primary activity of a nonprofit, other factors besides gross income are considered.

**Structuring the For-Profit Activity**

When attempting to make a determination about the nature of the business, first determine whether the business should be or even could be conducted as an exempt activity. The problem is further complicated when facing the decision whether the activity has a close enough nexus to the original organization to be conducted under the same exemption as a new related activity. The decision may be that a new exempt organization is needed. On the other hand, depending on the profit motive, it may clearly be the type of activity that merits its own for-profit corporate structure.

**Factors to Consider**

The primary (business) factors to consider when deciding the exact nature of the venture are:

- Is there sufficient need for exemption to merit the additional recordkeeping and tax filings?
- What will be the impact on the exempt organization in creating an asset that may grow in value and have the potential of transferability of ownership by its shareholders?
- Is the purpose of the activity to carry on the exempt organization's goals or is it to make a profit?
- What compensation arrangements have been made for employees of the new entity and how is it going to be managed?

**Subsidiary Network**

The relationship between the for-profit subsidiary and the exempt parent was the subject of Private Letter Ruling 9016072 which addresses the establishment of a network of subsidiary organizations to carry on certain activities which, if carried on directly by the not-for-profit, could adversely affect the organization's tax-exempt status.
The organization was created to carry on educational and similar activities to assist its members in their respective lines of business.

- The organization was created as an association exempt under §501(c)(6).
- Additionally, the organization also has a licensing agreement with two unrelated for-profit corporations regarding the use of the organization's name and logo.

The association received a ruling that the income was exempt as royalty income under §512(b)(2).

Additionally, the organization established a wholly owned for-profit subsidiary.

- The ultimate goal was to have the for-profit subsidiary establish a network of for-profit subsidiaries.
- The association owned all the stock in the for-profit subsidiary which in turn owned all the outstanding stock of the other related for-profit entities created over time.
- As new entities were created, the association made additional capital contributions to be used in funding the new entities.
- The for-profit entities conducted their business on a commercially competitive basis, and the association was not involved in the day-to-day activities of the businesses.

In the ruling, the association appointed the board of directors.

- As discussed in more detail later, the directors, officers, and employees of the association did not sit on the board of directors of the for-profit subsidiary.
- Additionally, none of the directors, officers, or employees were allowed to be the chief executive officer of any of the entities in the network.

The association expected to be compensated for its investment through the payment of dividends.

To further complicate the matter, the for-profit subsidiary subleased space from the association.

The basic scheme of Code sections relating to this ruling are relevant to most similar cases:

**Section 501(c)(6)** Provides, in part, for the exemption from federal income tax of business leagues, chambers of commerce, real estate boards, and boards of trade, not organized for profit and of which no part of the net earnings inures to the benefit of any private individual or shareholder.
Section 511(a) Imposes a tax upon the unrelated business taxable income of organizations exempt from federal income tax.

Section 512 (a) Defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less related deduction and with certain modifications.

Section 512(b)(2) Excludes all royalties for the computation of an exempt organization's unrelated business taxable income.

Section 512(b)(13) Provides that, notwithstanding subparagraph (b)(1), (2), or (3) of §512, interest, rents, and royalties derived from a controlled organization [within the meaning of §368(c)] is to be included in gross income in a ratio determined according to that section.

Section 368(c) Defines "control" for these purposes as ownership of stock possessing at least 80 percent of the voting power of all classes of stock entitled to vote and 80 percent of each other class.

The determination of control under this section is made with respect to direct stock ownership only.

Result

- Based on the information provided by the association, the IRS concluded that the wholly owned subsidiaries of the for-profit subsidiary would not be deemed to be controlled by the association within the meaning of §512(b)(13). Therefore, any interest and royalty payments the association received from the subsidiary organizations would not be taxable to the association by reason of the exclusions provided in §512(b)(1) and (2).

- Two interesting results of the ruling were:
  - Dividends received did not jeopardize the exempt status of the organization under §501(c)(6).
  - The IRS took the position that it would express no opinion whether the provisions of §513(h)(1) might affect the conclusions contained in the ruling.

Purpose as Purchasing Vehicle

In Private Letter Ruling 8706012, the IRS addressed the issue of whether the creation of a for-profit subsidiary for the purpose of serving as a vehicle for the association's member agencies in purchasing various kinds of group insurance, such as life, health, and accident, under the circumstances described in the ruling, would affect the association's exempt status under §501(c)(6). Secondly, a ruling was requested regarding how many subsidiaries or affiliated entities an exempt organization could create for the purpose of conducting a commercial activity without jeopardizing its exempt status.
THE USE OF MULTIPLE STRUCTURES WITH EXEMPT ORGANIZATIONS

- The ruling concluded that the association's exempt status under §501(c)(6) is not adversely affected by the creation of a for-profit subsidiary or the commercial insurance activities of the subsidiary.

- Secondly, the creation of multiple subsidiaries does not jeopardize the association's exempt status.

It appears that in the case of exempt organizations with for-profit subsidiaries, the issue is more a question of form rather than substance.

The elements discussed in these rulings are relevant to most for-profit subsidiaries and will be discussed in detail throughout the book.

FOR-PROFIT SUBSIDIARIES - ORGANIZATION

Inasmuch as the for-profit subsidiary is essentially a stand-alone business, most of the same considerations necessary in forming any new business are relevant to the formation of the subsidiary. Because of the ease in holding stock over assets, the corporate form of doing business is most usual. The corporate form creates a buffer between the activity and the exempt organization. Along with the more familiar advantages, such as limited liability, the corporate form at the very least offers an appearance of separation.

As an alternative, the for-profit could conduct its business operations as a partnership in conjunction with another party or operate through a limited liability company. The limited liability company is essentially a partnership with corporate liability protection. The use of a limited liability company will be discussed along with partnerships.

If the for-profit subsidiary is to operate in corporate form, it may function as a C corporation.

An alternative corporate form, an S corporation can now be used under certain conditions. This is a significant change that came about under the 1996 Small Business Act. According to the Act, organizations described under §501(c)(3) and exempt from taxation under §501(a) can now be an eligible S corporation shareholder. In addition, the organization will count as one of the shareholders for determining the number of shareholders in an S corporation. However, organizations must contend with the taxability of the income as unrelated business taxable income (UBTI). All items of income, loss, credit, or deduction and any gain or loss on the disposition of the stock of the S corporation will be taken into account in computing UBTI of the tax-exempt organization's shareholder. All of the items of income and loss, regardless of the source or nature of the income, will flow through to the tax-exempt shareholder.

One other change affecting the ultimate taxability is that if a tax-exempt organization purchases the stock of a C corporation or one that converts to S status with prior earnings and profits, any distribution of dividends (C corporation) will reduce the basis in the stock. As such, the basis for determination of gain or loss will be affected. It is important to note that regulations, once issued, may provide that such
reduction would only apply to the extent the dividends are deemed to be allocable to subchapter C earnings and profits accruing on or before the date of acquisition.

The 1997 Taxpayer Relief Act repealed application of UBTI to S corporation ESOPs.

**CORPORATE CONTROL**

There is normally a close enough nexus between the exempt organization and its for-profit subsidiary or subsidiaries indicating a need for continued control over the subsidiary. Most exempt organizations forming a subsidiary wish to maintain continued control if for no other reason than a profit motive. For-profit subsidiaries usually represent a fairly significant financial commitment for the exempt organization. They also have a reporting responsibility to their members, bankers, contributors, and/or the federal government. Because of this fiduciary responsibility, the exempt organization will normally maintain a fairly tight control over the for-profit’s activities of the subsidiary.

The exempt organization will normally control the for-profit subsidiary by virtue of stock ownership. Because of the rights granted to the shareholder, the exempt organization can exercise control through the election of directors and officers.

**MAINTENANCE OF SEPARATE IDENTITY**

As long as there is adequate separation between the activities of the exempt organization and its for-profit subsidiary or subsidiaries, the entities will be allowed to maintain a separate identity. If the entities operate in tandem and it becomes apparent that the separation is, for example, a tax-motivated transaction, the operations may be combined at the cost of the organization’s exemption.

Even though it is not an exempt organization case, *Britt v. United States*, 431 F.2d 227 (5th Cir. 1970), points out the need for a separate identity. Cited in the case is *Paymer v. Commissioner*, 2 Cir. 1945, (45-2 USTC 9353) 150 F.2d 334, which reflects "judicial reluctance" to disregard the corporate entity where a corporation has conducted some "business" within the meaning of the term. The problem that arises is the determination of how much business is enough and what is the primary business of the venture. As pointed out in *Universal Church of Jesus Christ, Inc., v. Commissioner*, 55 T.C.M. 143 (1988), courts will look at the manner in which the organization’s activities are conducted, inferring an end from the chosen means.
THE USE OF MULTIPLE STRUCTURES WITH EXEMPT ORGANIZATIONS

RELATIONSHIP CONSIDERATIONS

Rulings on relationship considerations have consistently indicated that no one factor will make or break the relationship between the exempt organization and its for-profit subsidiary. Apparently, the IRS will consider a variety of factors and come to a conclusion based on the significance of factors taken in the aggregate. Among the issues most often addressed are the following:

- **Business Purpose** — This is the easiest of the factors to support. There is not much difficulty establishing the need for a for-profit subsidiary. For-profit subsidiaries have been held to be valid for purposes such as segregating income that would traditionally be classified as unrelated business income when of such a magnitude as to possibly cause loss of exemption. Some other less specific reasons may include — limiting liability of the tax-exempt parent; generating funds to support activities; segregating activities that are unrelated to the parent's exempt activities.

- **Nonspecific Relationship** — For the most part the rulings have consistently indicated a need for separation of activities and lack of involvement in the day-to-day activities of the subsidiary. This would not necessarily preclude the parent from participating in some of the long-term planning sessions. Even though exemption could be in jeopardy with too much day-to-day involvement, this does not include the sharing of employees and facilities. However, there must be a distinct separate corporate identity with separate stationery and by the subsidiary entering into contracts in its own name and signed by one of its own officers, as an officer of the subsidiary.

- **Common Directors** — The board of directors of the taxable subsidiary should consist, wherever possible, of individuals who are not board members of the parent even though they technically could elect 100% of the board. The IRS has often cited lack of common board as one of the positive factors when maintaining separation. The rulings are specific enough about common board members that an alternative solution would be to find a "friendly board" made up of members of the parent who are not currently sitting on its board.

- **Officers and Employees** — A bigger issue involves sharing of officers or key employees. The risk is that the subsidiary's activities would be attributed to the parent because the overlap tends to show that the parent is managing the subsidiary on a daily basis.

One of the more recent changes to Form 990 requires reporting compensation paid by related organizations to the executive who exceeds $10,000. For these purposes, a related organization is any entity that owns or controls, or is owned or controlled (directly or indirectly) by the filing organization, or that supports or is supported by the filing organization. For this purpose, a 50% test is used for ownership or control. In this case control looks to common officers, directors, trustees, and key employees.

The IRS has been a little more reasonable when it comes to use of employees as long as all related charges are reasonable and properly documented. It is very important for "shared employees."
It is very important for shared employees to keep detailed, contemporaneous time records of their work for each corporation to substantiate the allocation of cost. If at all possible, shared employees should be paid at the same rate no matter whether they are being paid by the parent or the subsidiary. Because wages serve a better purpose as an expense for the taxable subsidiary, there is a natural tendency to weigh heavier where it can do the most good.

- **Facilities and Services** — The parent and subsidiary often share office space, equipment, supplies, telephones and utilities. Separation is respected as long as reimbursement is calculated on an arm's-length basis and any reimbursement is based on actual usage. In addition, the parent may provide administrative, data processing, or other non-management services to the subsidiary so long as the fees charged for the services are based on market.

*(Tip: The parent and the subsidiary should enter into an arm's-length written agreement covering all aspects of the shared facilities, equipment, supplies, services and employees. There should be every effort to follow the agreement.)*

### Funding the For-Profit Subsidiary

Funding the for-profit subsidiary can create a series of perplexing problems. The exempt parent will most likely transfer cash, tangible assets, or technology, or both, to get the for-profit subsidiary started. Because the officers and directors are acting in a fiduciary capacity, they must make a determination regarding the best interest of the tax-exempt parent. On the one hand, underfunding may doom the venture to failure while adequate or overfunding may be an improper transfer of funds from the exempt parent to the taxable subsidiary. The IRS is clearly taking the position that only limited resources are to be transferred to the for-profit subsidiary.

Underfunding at the outset creates another problem. Continuous financing as opposed to lump-sum or upfront financing of total capital requirements may lead the IRS to treat the for-profit subsidiary as an operating division of the exempt parent.

### Investment

The most proper line of action for the exempt parent is to look at the for-profit subsidiary as an investment along with all its other investments. Assuming the exempt organization has limited resources, the decision to fund the venture should rest with how the board would expend funds on an alternative arm's-length transaction. If the investment seems reasonable in light of the organization's exempt activity and does not inure to the benefit of any private individuals then, most likely, it would be a prudent investment. Like any corporate venture, the more support, including budgets, forecasts, and projections, that are documented as part of the official records, the more likely the venture would pass the review of the IRS. While there are alternative ways of funding the venture, caution should be taken due to adverse consequences discussed later.
**IMPACT OF SUBSIDIARY REVENUES**

Businesses transferred to for-profit subsidiaries are normally such that, if operated on a smaller scale, would probably be left in the tax-exempt organization as unrelated business income. The need for a subsidiary is generally to protect the tax-exempt status. With the business venture sitting in a subsidiary, it is necessary to find ways to transfer funds to the parent in such a way as not to aggravate the unrelated business income issue. This can be done in a variety of ways.

*Expense Reimbursements*

If the two or more activities are sharing facilities, it may be necessary to reimburse the exempt parent for use of staff, equipment, and supplies. The natural tendency would be to determine a reasonable rent which includes these various elements. However, it may be more beneficial to treat the payments as expense reimbursement rather than rent.

*Loans*

As an alternative to the traditional capitalization of a business venture, it may be necessary to handle part of the funding as a loan to avoid the issue raised in the previous section of overcapitalizing the subsidiary. If it becomes necessary to make a loan to the for-profit subsidiary, a reasonable rate of interest should be charged for the use of the funds. If necessary, the loan should be secured.

*Royalties*

Depending on the nature of the relationship between the parent and the subsidiary, it may be possible to pay a royalty if the parent's name, logo, or acronym is used in selling the subsidiary's products, services, etc.

*Dividends*

Dividends may be another source of revenues for the parent. Earnings and profits from the subsidiary's operations can be paid out either on a quarterly or an annual basis as the funds are either available or needed.

*Passive Income*

It would appear on the surface that you could have the best of both worlds in the relationship of the funding between the exempt parent and the for-profit subsidiary. Under normal circumstances, there are several modifications of the rules affecting passive income for an exempt organization. Section 512(b) allows for several modifications in the normal rules of reporting income as earned. Section 512(b)(1) provides that: "There shall be excluded all dividends, interest, payments with respect to securities loans amounts received or accrued as consideration for entering into agreements to make loans and annuities and all deductions directly connected with such income." Additionally, §512(b)(2) provides that: "There shall be excluded all royalties whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income."
In the case of rental income [§512(b)(3)], aside from the issue of debt-financed property, rents are excluded from income for all rents from real property and all rents from personal property leased with such real property.

Although it may appear that the parent and the subsidiary could have the best of both worlds, passive income being excluded from UBIT by the exempt parent while the for-profit subsidiary enjoyed the benefit of a deduction as a normal and necessary business expense, Congress, in its wisdom, saw fit to disallow this double benefit. Ordinary passive income, which would normally be excluded, is taxable if received from a controlled taxable subsidiary. Section 512(b)(13) provides:

Notwithstanding paragraphs (1), (2), or (3), amounts of interest, annuities, royalties, and rents derived from any organization (in this paragraph called the "controlled organization") of which the organization deriving such amounts (in this paragraph called the "controlling organization") has control (as defined in section 368(c))² shall be included as an item of gross income (whether or not the activity from which such amounts are derived represents a trade or business or is regularly carried on) in an amount which bears the same ratio as —

(i) in the case of a controlled organization which is not exempt from taxation under section 501(a), the excess of the amount of taxable income of the controlled organization over the amount of such organization's taxable income which, if derived directly by the controlling organization, would not be unrelated business taxable income, or

(ii) in the case of a controlled organization which is exempt from taxation under section 501(a), the amount of unrelated business taxable income of the controlled organization bears to —

the taxable income of the controlled organization (determined in the case of a controlled organization to which...applies as if it were not an organization exempt from taxation under section 501(a), but not less than the amount determined in...as the case may be. Both amounts computed without regard to amounts paid directly or indirectly to the controlling organization. There shall be allowed all deductions directly connected with amounts included in gross income under the preceding sentence.

The following illustrations show the application of the principles discussed above.

For purposes of this discussion, excess taxable income refers to the excess of the controlled organization's taxable income over the amount of such taxable income which, if derived directly by the controlling organization, would not be unrelated business taxable income.

² "Control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.
Illustration 1: HC, an exempt health-care facility described in §501(c)(3) owns all the stock of S, a nonexempt controlled organization. During 1998, S leases a laboratory and a factory from HC for a total annual rent of $100,000. During the taxable year, S has $500,000 of taxable income, disregarding the rent paid to HC:

- $150,000 from a laboratory used as part of HC’s facilities;
- $350,000 from the operations of a factory which is unrelated to patient care.

HC’s deductions for 1998 with respect to the leased property is $4,000 for the laboratory and $16,000 for the factory. Under these circumstances, $56,000 of the rent paid by S will be included by HC as net rental income in determining its unrelated business taxable income, computed as follows:

S’s taxable income (disregarding rent paid to HC) ................................................................. $500,000  
Less taxable income from laboratory ...................................................................................... 150,000  

Excess taxable income ............................................................................................................. $350,000  

Ratio ($350,000/$500,000) ....................................................................................................... 7/10  

Total rent paid to HC .............................................................................................................. $100,000  
Total deductions ($4,000 + $16,000) .................................................................................... $ 20,000  
Rental income treated as gross income from an unrelated trade or business (7/10 of $100,000) ................................................................................................................................. $ 70,000  
Less deductions directly connected with the income (7/10 of $20,000) ................................. 14,000  

Net rental income included by HC in computing its unrelated business taxable income ................................................................................................................................. $ 56,000  

Illustration 2: Assume the facts as stated in Illustration 1, except that S’s taxable income (disregarding rent paid to HC) is $300,000 consisting of $350,000 from the operation of the factory and a $50,000 loss from the operations of laboratory. Thus, S’s "excess taxable income" is also $300,000, since none of S’s taxable income would be excluded from the computation of HC’s unrelated business taxable income if received directly by S. The ratio of S’s "excess taxable income" to its taxable income is therefore one ($300,000/$300,000). As such, all the rent received by HC from S ($100,000), and all the deductions directly connected therewith ($20,000), are included in the computation of HC’s unrelated business taxable income.
To summarize:

- If an exempt organization receives rents, royalties, interest, or any other form of passive income from its for-profit subsidiary, it will be subject to UBIT.

- As is often the case, there is an exception to the exception.
  
- In this case, because dividends are not deductible to the for-profit subsidiary, they are not taxable to the tax-exempt parent.

**1997 TAXPAYER RELIEF ACT**

Unfortunately, the Taxpayer Relief Act plugged a major loophole affecting second-tier subsidiaries. Prior to the Act, it was possible to use a second-tier subsidiary to avoid §512(b)(13) relating to payments to a controlled organization. While §512(b)(13) addressed the issue of attribution between directly related organizations, it did not do so for second-tier organizations. This allowed for the creation of a second-tier organization to avoid reattribution.

Otherwise exempt income was treated as unrelated business taxable income (UBTI) if the income was received from a taxable or tax-exempt subsidiary that was 80% controlled by the parent organization, as previously discussed. The '97 Act modified the test for determining where a tax-exempt organization had sufficient enough control of another organization for the tax-exempt organization to have UBTI from the unrelated activity. For this purpose, "control" means ownership by vote or value of more than 50% of the stock of a corporation. For partnership purposes, control means ownership of more than 50% of the profits, capital, or beneficial interest.

The constructive ownership rules of §318 are now applied to §512(b)(13). As such, a parent exempt organization is deemed to control any subsidiary in which it holds more than a 50% voting or value interest directly or indirectly (as in the case of a second-tier subsidiary). This is effective for taxable years beginning after August 5, 1997. There is a binding contract exception for contracts entered into prior to enactment for a period of two years. Specifically, the changes do not apply to any payment made during the first two taxable years beginning on or after August 5, 1997, if the payment was made under a written binding contract that was in effect on June 8, 1997, and the contract was in effect at all times thereafter before the payment was made.

**LEASING OF PROPERTY**

The main point to the rules covering leasing of property is to require investors to stretch the allowable depreciation over a longer period of time. For the most part, the rules covering leasing are a result of the Tax Reform Act of 1984 and apply to property placed in service after May 23, 1983.
Recovery Periods

Regarding recovery periods, these rules apply to both tangible personal property and to real property. To the extent these rules apply, depreciation is determined using the straight-line method (without regard to salvage value). The recovery period has to be at least 125% of the lease term.

TAX-EXEMPT USE PROPERTY

The term "tax-exempt use property" is defined in §168(h)(1)(A) as property other than nonresidential real property. The term "tax-exempt use property" means that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity.

Nonresidential Real Property

In the case of nonresidential real property, the term "tax-exempt use property" means that portion of the property leased to a tax-exempt entity in a disqualified lease.

Disqualified Lease

As used in this context, the term "disqualified lease" means any lease of the property to a tax-exempt entity, but only if:

- Part or all of the property was financed (directly or indirectly) by an obligation whose interest is exempt from tax under §103(a), and
  - The entity participated in such financing.
- Under this lease, there is a fixed or determinable price purchase or sale option which involves the entity, or
  - There is the equivalent of such an option.
- Lease has a lease term in excess of 20 years.
- Lease occurs after a sale of the property by or lease of the property from the entity, and
  - Property has been used by the entity or lease.
Depreciation

Applicable depreciation today runs from three to 39 years with the 39-year time frame for nonresidential real property. In the case of any tax-exempt use property subject to a lease, the recovery period used for purposes of this section is in no event less than 125% of the lease term. Special rules apply to certain property assigned to classes. The classes generally fall between five and 50 years.

RULES APPLICABLE TO A TAX-EXEMPT CONTROLLED ENTITY

For purpose of the "tax-exempt entity leasing rules" any tax-exempt controlled entity is treated as if it were also a tax-exempt entity. For this purpose, §168(h)(6)(F)(ii) provides for the possibility of an election by the tax-exempt controlled entity not to be treated as a tax-exempt entity. If the election is made, any gain recognized by a tax-exempt entity on any disposition of an interest in the entity is going to be treated as unrelated business income under §511. If the election is made, it is irrevocable and will bind all of the tax-exempt entities holding interest in the tax-exempt controlled entity.

Definition of Tax-Exempt Controlled Entity

The term "tax-exempt controlled entity" means:

1. Any corporation if 50% or more (in value) of the stock in the corporation is held by one or more tax-exempt entities.
2. Only 5% shareholders are taken into account in the case of publicly traded stock.
   - For purposes of (1) in the case of a corporation whose stock is publicly traded on an established securities market, stock held by a tax-exempt entity will not be taken into account unless the entity holds at least 5% (in value) of the stock in the corporation.
3. Section 318 applies.
   - A tax-exempt entity is treated as holding stock which it holds through application of §318 (determined without regard to the 50% limitation).

SANCTIONS

There is no question regarding the seriousness the IRS is placing on following rules. In the past the only real recourse they had against an exempt organization was to revoke the exemption. While this may have been an effective approach, it was not very efficient and, as such, where some form of legitimate sanction was merited it was passed. It was easy to see how many real and perceived abuses took place.
with exempt organizations. A recent far reaching development with exempt organizations has been the imposition of sanctions. Intermediate sanctions and additional filing and public disclosure requirements were enacted as part of the Taxpayer Bill of Rights 2 (TBOR2) H.R. 2337; P.L. 104-168).

The following is an overview of the intermediate sanctions provisions:

**MULTI-TIER STRUCTURE**

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

- **On the disqualified person** — An initial tax of 25% of the excess benefit transactions is imposed on each disqualified persons. Once assessed, the tax is payable by the disqualified person.

- **On the management** — An initial tax of 10% of the excess benefit (not to exceed a maximum amount of tax of $10,000 due to the participation of any organization manager associated with the transaction. Participating management is fined unless participation is not willful and is due to reasonable cause. The tax is paid by the manager participating in the excess benefit transaction.

- **Second level tax** — At any point where the disqualified person is subject to the tax due to an excess benefit transaction and the excess benefit transaction is not corrected within the current taxable year, a second level of tax is imposed equal to 200% of the excess benefit. As in the previous cases, the tax is payable by the person creating the infraction.

Because of the severity of penalties and the IRS intention to enforce §4958 it is important to have a concise understanding of what constitutes an "excess benefit transaction" and an "excess benefit."

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

In due course, the definition of excess benefit transactions will be expanded by virtue of IRS regulations. It is anticipated they will include any transaction in which the amount of any economic benefit provided to or for the use of the "disqualified person" is determined in whole or in part by revenues of the exempt organization's activities. However, this is the case only if the excess benefit transaction would result in inurement under presently existing prohibitions.
The following is one suggested list of benefits which, depending on circumstances, could be viewed as an economic benefit:

- Contributions to pension and profit-sharing plans;
- Deferred compensation;
- Low- or no-interest loans;
- Life, liability, etc., insurance premiums;
- Personal use of an employer-provided automobile;
- Employer-paid commuting expenses;
- Personal use of an employer-provided club membership;
- Personal expenses (housing, food, furnishings, etc.);
- Travel and entertainment expense reimbursements under a nonaccountable plan;
- Tuition and related education fees and expenses;
- Vacations;
- Home remodeling;
- Limousines;
- Maid service;
- Health spas;
- Sporting events and theater tickets;
- Bargain purchases; sales and exchanges in excess of fair market value; and,
- Higher than market rate loans to an organization by a disqualified person.

It is also important to note that there is joint and several liability for the tax. If more than one person is liable for the tax, then all persons subject to the tax are jointly and severally liable.
Tax is imposed on the disqualified person or the organization manager. Both terms have rather broad meanings. A disqualified person is any person who was, at any time during the previous five years from the transaction, in a position to exercise substantial influence over the affairs of the exempt organization. In the same context, a disqualified person also includes family members and 35% controlled entities. An organization manager refers to any officer, director, or trustee of the exempt organization exercising authority. This would apply to other individuals performing similar functions though not specifically addressed by those titles.

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

(1) The board was comprised of individuals with no direct or indirect connection to the disqualified person or persons involved in the transaction.

(2) The board made a diligent study into the level of reasonable compensation to the disqualified person. They must have relied on detailed objective criteria including but not limited to salary surveys; compensation paid by similar organizations for comparable positions in similar geographic areas.

(3) Documentation of criteria used as a basis for determination.

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

Intermediate sanctions, for the most part, are effective for transactions entered into after September 13, 1995. However, there is an exception for transactions pursuant to a written contract that was binding as of September 13, 1995 and there has been no material change in the terms of the contract from inception. Legislative history indicates that agreements entered into after September 13, 1995 but before 1997 can rely on the "rebuttable presumption if within a 90 day period after entering into the compensation package the parties satisfy the criteria referred to above in regards to the three presumptions. After 1996, the rebuttable presumption applies only if the three criteria are met prior to payment of the compensation."

OTHER PENALTIES AND SANCTIONS

In addition to the penalties and sanctions referred to above, the IRS has also increased the "Failure to File" and "Failure to Allow Inspection" penalties for exempt organizations. Section 1314(a) of TBOR2 amends §6652(c)(1)(A) to increase the penalties on exempt organizations for failure to file complete and timely annual information returns. Section 6652 provides that a failure to timely file an annual
information return, failure to include any of the information required to be shown on the return, or failure to show the correct information, results in a penalty, to be paid by the organization, of $20 per day (increased from $10 per day) for each day during which the failure occurs. The maximum penalty with respect to any one return will not exceed the lesser of $10,000 (increased from $5,000) or 5% of the gross receipts of the organization for the year.

FAILURE TO ALLOW INSPECTION OF ANNUAL RETURNS AND EXEMPTION APPLICATIONS

Section 1704(s) of the Small Business Job Protection Act enacted August 20, 1996, amends §§6652(c)(1)(C) and (D) to increase the penalties for failure to allow inspection of any return or application. Under the amended sections, any person failing to allow inspection of annual returns will face a $20 per day penalty (increased from $10) for each day during which such failure continues, not to exceed $10,000 (increased from $5,000). Under the amended sections, any person failing to allow inspection of any organization’s application for exemption must pay $20 per day (increased from $10 per day) for each day such failure continues.

WILLFUL FAILURE TO ALLOW INSPECTION

Section 1313(b) of TBOR2 amends §6685 to increase the penalty for a willful failure to allow inspection of any return or application for exemption under §§6104(d) and (e) from $1,000 to $5,000. The amendment to §6685 does not take effect until 60 days after Treasury first issues regulations which took place in December 1996.

SPECIAL PENALTY FOR LARGE TAX-EXEMPT ORGANIZATIONS

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

The amended penalties apply to returns for taxable years ending on or after July 30, 1996.
PUBLIC INSPECTION AND DISTRIBUTION OF ANNUAL INFORMATION RETURNS

The discussion concerning sanctions and penalties thus far is limited to the penalty for failure to comply. The IRS recently issued Proposed Regulations 301.6104(e)-1, which outline procedures to follow in compliance with the disclosure requirements. Prior to the issuance of the Proposed Regulations, there was considerable inconsistency in how individuals requesting information were treated. Some organizations made it nearly impossible to gain access, while others tried to get around the perceived invasion of privacy by charging exorbitant amounts for copies of the returns and applications for exemption.

With few exceptions, tax-exempt organizations, including private foundations, must make available for public inspection their application for tax exemption and related schedules. Inspection can be at the organization’s principal, regional, or district offices during normal business hours. Tax-exempt organizations, other than private foundations, must make available their annual information returns at the same locations and under the same conditions. These returns must be available for three years beginning on the date the return is required to be filed. According to the regulations, organizations must provide copies without charge, other than a reasonable fee for reproduction and actual postage costs, of all or any part of the application or return required to be made available for public inspection. Copies are provided to anyone who requests the copy in person or in writing.

TIME AND PLACE FOR PROVIDING COPIES

As a general rule, exempt organizations are required to provide copies of the requested documents, when requests are made in person, at the time of the request. There are special rules where the request is made to an agent. However, as long as the request is made at the primary business location of the organization, it must be honored at the time. If an organization has more than one office (regional offices) with three individuals, it is considered substantial enough to require a copy of the return to be on file. The regulations provide for limited exceptions where the information cannot be made immediately available:

- Receipt of a volume of requests that exceeds the organization’s daily capacity to make copies;

- Requests received shortly before the end of regular business hours that require an extensive amount of copying; or,

- Requests on a day when the organization’s managerial staff is conducting special duties (student registration, etc.).

In these cases, the information requested must be made available on the next business day.
The regulations appear to be a little more liberal in the case of requests by mail. Exempt organizations have to honor written request for a copy of the documents under the following conditions:

- Requests are addressed to, and delivered to the principal, regional, or district office of the exempt organization; and,

- The request provides the address where the copies are to be sent.

When the exempt organization receives the written request for the copies, they must respond within 30 days from the date it received the request. If the organization requires payment for the copies, the time limitation commences on receipt of the payment.

There are also elaborate special rules that are beyond the scope of this book. For more specific information, see the regulations under 301.6104(e)-1.

**SUMMARY**

Exempt organizations have traditionally operated with relatively simple structures with a major portion of work handled through volunteers. While this remains the case for relatively small exempt organizations, it is no longer applicable for larger charities or the ever-growing number of noncharitable exempt organizations. Because of the competition for limited resources, charities have had to develop sophisticated fund-raising programs to support their projects. At the same time, noncharitable organizations, such as trade associations, social clubs, and fraternities, are not only competing for funds but are facing a maze of government regulations concerning such areas as dues, lobbying, etc. This has created the need for the professional organization/association manager who, in turn, brings the expertise to create the complex structures.

These structures may be as simple as a charitable subsidiary for a 501(c)(3) organization or as complicated as a foreign for-profit subsidiary of a trade association that is looking for an outlet for its members' goods and services. In each of these cases, there is a trade-off between the needs of the organizations and legislation which in recent years appears determined not only to tax the exempt activities but, in some cases, to put them out of business. This creates the need to insulate the organization from the potential of possible loss of exemption.
INTRODUCTION

Overall, unrelated business income (UBI) is the most used and abused area of the Internal Revenue Code. Even though most organizations are exempt from federal income tax on their tax-exempt related activities, they will be taxed on their unrelated business income. To some organizations, excessive unrelated business income could mean the revocation of their tax-exempt status. Another classification of income, not related to the organization, is also not taxed except as discussed in Chapter 1. This income is made up of passive rents, royalties, and interest. There are some exceptions that will be covered in this chapter.

Along with the income from unrelated business activities, organizations must identify related expenses in order to determine the bottom line. In some cases, such as direct costs, it is clear which expenses are directly related to the activity. However, especially in the case of indirect costs, it may be more difficult to determine a relationship between the expenses and the project.

In this chapter, we focus on §511 through §514 of the Code.

ORGANIZATIONS SUBJECT TO TAXATION

Unrelated business income tax rules apply to virtually all not-for-profit organizations. Included in this group of organizations are:

- Trusts, corporations, and other organizations exempt from tax under §501(c), excluding U.S. instrumentalities.

- Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include in their gross income their entire pro rata share, whether distributed or not, of the taxable income of the association or corporation for such year.
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- Qualified pension, profit-sharing, and stock bonus plans described in §401(a).

- Colleges or universities which are an agency or instrumentality of any government or any political subdivision thereof or which are owned or operated by a government or any political subdivision thereof or by an agency or instrumentality of one or more governments or political subdivisions.

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

- U.S. instrumentalities described in §501(c)(1).

- Farmers’ cooperatives.

- Shipowners’ protection and indemnity associations.

- Political organizations.

- Homeowners’ associations.

**Definition of Trade or Business**

The term "unrelated trade or business" means any trade or business carried on by an exempt organization, the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

**Exclusions**

The term does not include any trade or business:

- In which substantially all the work is performed for the organization without compensation.

- Which is carried on by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment, or

- Which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.
Normally, the IRS appears to take the position that any activity that produces income is a trade or business subject to tax. This interpretation is not consistent with the regulations under §1.513-1(b).

According to the regulations above, the primary objective of adopting the unrelated business income tax rules was to eliminate a source of unfair competition by placing an unrelated business activity on the same basis with its for-profit counterparts. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of §162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply because the organization is not in competition with taxable organizations.

Activities

In general, any activity of an otherwise exempt organization carried on in a commercial fashion that is similar to a trade or business (within the meaning of §162) and which, in addition, is not substantially related to the performance of the organization’s exempt function is sufficiently close to the concept of a trade or business to be taxable. As such, for purposes of §513 (Unrelated Trade or Business) the term “trade or business” has the same meaning it has in §162 and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

The term "trade or business" in §513 is not limited to integrated aggregates of assets, activities, and goodwill which comprise businesses for the purposes of various other Code sections. Producing or distributing unrelated goods or performing unrelated services from which a particular amount of gross income is derived does not lose the separate identity as trade or business just because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may or may not be related to the exempt purposes of the organization.

Example 2-1:

- Regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as a trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes.

Similarly, soliciting, selling, and publishing commercial advertising does not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.
Where an activity carried on for the production of income constitutes an unrelated trade or business, no part of the trade or business is excluded from that classification merely because it does not show a profit. This reinforces the concept that the trade or business aspect, not profitability, is the primary criterion in determining tax treatment.

**Judicial Interpretations of "Trade or Business"**

The courts have generally taken a more moderate approach than the IRS in determining what constitutes a trade or business. The following is a summary of some of the more relevant cases:

- **Hope School v. U.S., 80-1 USTC, 9134 (7th Cir. 1980)**

  The school, through a third party, sent out greeting cards to potential contributors. They did not ask for a specific contribution or infer that the cards should be sent back if the potential donor was not interested. The only connection the school had with the third party was to furnish names of potential contributors. Beyond that, school personnel did not assist in either mailing the solicitations or producing the cards. At the time of the case, the court determined under the criteria of Reg. §1.5131(b) that there was not sufficient activity to constitute a trade or business. Additionally, the court looked at the situation from the point of view of whether there was any unfair competition in the way the donations were solicited. Today the case would most likely be decided on the insignificant value of the packages of cards.


  In this case, the court determined that the issue of unfair competition was not relevant. The facts of the case had to rest on the criteria in §513(c) whether there was a trade or business.


  In this case, the purpose of the association was to promote and improve independent farm equipment distributors. The association entered into an agreement with an insurance carrier to make available various types of insurance to its members. In this case, unlike Hope School, above, the association was actively involved with the project. The employees distributed information pamphlets to members, prepared insurance premium notices, remitted premiums, and answered questions about the program. For their effort, the association received a 7% commission on collected premiums. The court took the position in this case that the association was involved in the project to provide a benefit to its members and not to make a profit. As such, the court determined there was not a sufficient profit motive to constitute a trade or business.
Fragmented Business Operations

Section 513(c) provides that an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may or may not be related to the exempt purposes of the organization. Where an activity is carried on for profit and constitutes an unrelated trade or business, no part of the trade or business will be excluded merely because it does not result in a profit. Based on the ability to "fragment" a business operation, the IRS can take an exempt organization's operation, break it up into components, and tax those activities constituting a trade or business.

Example 2-2:

- If an exempt organization solicited, sold, or published advertising in its trade journals, the IRS would break out the advertising income even though the publication itself was the organization's newsletter.

- Museum activities are often targets for the fragmentation rule.
  - In Revenue Ruling 73-105, 1973-1 C.B. 263, the IRS took the position that the sale of souvenirs unrelated to the museum's purpose constituted an unrelated trade or business.

- In the example of a museum of natural history selling replicas of dinosaurs, there could be an argument that the sale is sufficiently close enough to constitute a related activity.
  - On the other hand, if the natural history museum sold freeze-dried ice cream that astronauts use in space, there would most likely be unrelated business income, even though it would be treated as related if it were sold in the air and space museum.

- Similarly, income derived by a tax-exempt organization from operating a mailing service for other exempt organizations was unrelated business income even though all the mailings were for other exempt organizations.

"Regularly Carried On" Requirement

According to §512(a)(1) and the related regulations under §1.512(a)-1(a), the trade or business must be "regularly carried on" by the exempt organization. For determining whether a business has been regularly carried on, particular concern has to be given to the frequency and continuity with which the activities producing the income are carried on and in what manner they are pursued. Keep in mind that this requirement has to be applied in light of the purpose of the unrelated business income tax to place a trade or business on the same tax basis as the business endeavors with which it competes.
Example 2-3:

- Specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

The concept of regularly carried on can best be illustrated with the following examples:

Example 2-4: Revenue Ruling 75-200 (1975-1 C.B. 163)

- To support a symphony orchestra, a charity prepared and published a weekly concert program to be distributed at the performances.
- Programs were distributed free to the patrons over the eight-month concert season.
- Programs contained sketches of musicians, annotations of musical selections, and paid advertising.
- Advertising was sold as a result of a full-time advertising staff and was generally concentrated during the four-month off-season.
- For purposes of determining whether the sale of the advertising was regularly carried on, the IRS considered the relevant activity to consist of the four-month selling period.
- The IRS concluded:

  It is a matter of common knowledge that many nonexempt organizations make a regular practice of publishing and distributing a seasonal series of special interest publications covering only a portion of each year with a format that includes substantial amounts of advertising matter. It would not be unusual for such an organization to concentrate its efforts to sell the advertising space thus made available during similar periods of intensive activity that would frequently last for no more than three or four months of each year.

Conclusion:

- In this case, the IRS concluded that the sale of the advertising was conducted in a sufficiently commercial manner and was regularly carried on.
In a second ruling issued almost at the same time, the IRS took a different approach:

**Example 2-5: Revenue Ruling 75-201 (1975-1 C.B. 164)**

- In this case, the IRS also looked at the sale of advertising in a concert book.
- Charity was organized under §501(c)(3) and, like the subject of the previous ruling, had the primary purpose of raising funds for the symphony orchestra.
  - Concert book was distributed at the orchestra’s annual charity ball.
- Ruling did not discuss the exact time frame over which the solicitation of advertising took place.
  - However, it was stated that the sale of advertising was largely conducted by a volunteer committee and did not continue for an extended period of time.

**Ruling:**

- The IRS ruled in this case that the activity was not regularly carried on because it was conducted as an integral part of an annual charitable fund-raising event.

The concept of "regularly carried on" as discussed in Reg. §1.513-1(c) depends on the frequency and continuity with which activities are conducted and the manner in which they are pursued. This concept has to be considered not only in light of the charity’s activities but also the business’s activities.

**Determining Rules**

Regulation §1.513-1(c) provides three special rules for determining whether an activity is regularly carried on. These rules are not mutually exclusive. These include:

1. Normal time span of activities.
2. Intermittent activities—in general.
3. Infrequent intermittent activities.
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Normal Time Span of Activities

Regulation §1.513-1(c)(2)(i) provides that where income-producing commercial activities of a type that can normally be conducted by a charitable organization during the ordinary course of business on a year-round basis are conducted over a shorter period of time, the activity is not considered to be regularly carried on.

Example 2-6:

- An exempt hospital auxiliary operated a sandwich stand at a state fair for two weeks.
- This was not regularly carried on because the activity is normally a year-round activity.

Discussion:

- A word of caution is in order when comparing the example in the regulations illustrated above and the context of Revenue Ruling 75-200 discussed earlier.
- The comparison is between a two-week operation of a sandwich shop, an activity which is normally conducted over a period of a year, and a venture that has a four-month season which is normally conducted over an entire year.
- Regularly carried on is always in the context of time actually spent compared to the amount of time that could have been spent on a comparable commercial enterprise.

Intermittent Activities — In General

By definition, intermittent activities are conducted on other than a continuous basis at some specific interval. Regulation §1.513-1(c)(2)(ii) provides that in determining whether an intermittent activity is regularly carried on by the exempt organization the manner in which the activity is conducted should be compared to the manner in which commercial enterprises in the same business are conducted. Normally, business activities engaged in by an exempt organization on a periodic basis will not be considered to be regularly carried on if the business operations are conducted without the competitive and promotional efforts of a commercial enterprise.

Regulation §1.513-1(c)(2)(ii) gives the example of the publication of advertising in programs for sports events or for music or drama performances. Normally, this would not give rise to a regularly carried on trade or business.
Casual v. Systematic/Consistent

Where an organization sells goods or services to a particular class of persons in pursuance of its exempt function or "primarily for the convenience" of such persons within the meaning of §513(a)(2) (as would be the case of selling textbooks to college students in the college book store or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in §513(a)(2) will not be treated as regularly carried on. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the §512 requirement for regularity.

Example 2-7:

- Hospital exempt under §501(c)(3) makes a limited number of consultation and examination rooms available to its medical staff for treating their private patients.
  - These rooms are used only when it is mutually convenient for the patient and physician to meet at the hospital.
  - Patients visiting their physicians in these rooms are not patients of the hospital.
- If during the course of such visits, patients receive a prescription from the physician, they may fill it at any pharmacy.
- The hospital maintains a pharmacy for the use of its own patients.
  - Sales to nonpatients are not ordinarily permitted.
- As a courtesy to its medical staff, the pharmacy will occasionally fill prescriptions written by the physicians for their private patients, but such sales are not promoted by the hospital, do not occur with frequency, and represent only an insignificant portion of the pharmacy's total sales.
**Example 2-7:** (continued)

**Discussion:**

- Under the circumstances, such sales would normally constitute unrelated trade or business as defined in §513, because they are neither primarily for the convenience of the hospital's patients within the meaning of §513(a)(2) nor substantially related to the exercise of the manner in which they are conducted. These nonqualifying sales are considered casual sales within the meaning of Reg. §1.513-(c)(2)(ii).

- Income derived from such casual sales does not constitute income derived from an unrelated trade or business that is regularly carried on and therefore does not constitute "unrelated business taxable income" within the meaning of §512.

**Infrequent Intermittent Activities**

Regulation §1.513-1(c)(2)(iii) provides that certain intermittent income-producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as a trade or business regularly carried on.

**Example 2-8:**

- Income-Producing or fund-raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically.

- Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis.

- As such, income derived from the conduct of an annual dance or similar fund-raising event for charity would not be income from unrelated trade or business regularly carried on.

**"NOT SUBSTANTIALLY RELATED" REQUIREMENT**

Gross income from "unrelated trade or business," within the meaning of §513(a), means income from a trade or business of the exempt organization not substantially related (other than through the production of funds) to the purposes for which the exemption was granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question, the activities, that is, of producing or distributing the goods or performing the services involved, and the accomplishment of the organization's exempt purposes.
DEALING WITH UNRELATED BUSINESS INCOME AND RELATED ISSUES

Relationship Required

According to Reg. §1.513-1(d)(2), the trade or business is "related" to the exempt purpose of the charity only where the conduct of the business activities has a causal relationship to the achievement of the exempt purpose (other than through the production of income), and it is "substantially related," for the purposes of §513, only if the relationship is a substantial one.

Substantially Related

In order for the conduct of a trade or business to be substantially related to the purposes for which the exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of the exempt organization's purposes. Where the production or distribution of the goods or the performance of services does not contribute importantly to the accomplishment of the exempt purposes of the organization, the income from the sale of the goods or the performance of the services does not derive from a related trade or business. Whether the activity which produces gross income contributes importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case on the facts and circumstances.

Size and Extent of Activities

All activities are evaluated for appropriateness in regard to the size and extent of the activity for which they are associated. In determining whether an activity contributes importantly to the accomplishment of the exempt purpose, the size and extent of the activity involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Where income is realized by an exempt organization from activities which are partly related to the performance of its exempt function, but which are conducted on a larger scale than necessary, the activity should be divided into its related function income and unrelated business income elements. The income derived from the production or distribution of goods or the performance of services which do not contribute importantly to the accomplishment of any exempt purpose of the organization will be taxed in the same way as its commercial counterpart.

The following examples in Reg. §1.513-1(d)(4)(i) illustrate the application of this principle:

Example 2-9:

- M, an organization described in §501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing.

- It presents performances by its students and derives gross income from admission charges for the performances.

(continued)
Example 2-9: (continued)

■ The students' participation in performances before audiences is an essential part of their training.

Discussion:

■ Because the income realized from the performances derives from activities that contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business.

Example 2-10:

■ N is a trade union qualified for exemption under §501(c)(5).

■ To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals.

  • N receives payments from its members for these services and materials.

Discussion:

■ Development and improvement of its members' skills is one of the purposes for which exemption is granted to N, and the activities described contribute importantly to that purpose.

■ Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

Consider

Based on the information given in these two examples, would the answer be any different if the theater group had to produce two additional plays to meet budget for the year? What if the additional performances were to raise enough money to take the school children on a ski trip?
Disposition of Product

Many rehabilitation facilities sell the products developed through the covered workshops of their patients. This creates a problem of how the income from these sales is reported. Ordinarily, the gross income from the sale of products or the performance of services resulting from the performance of exempt functions does not constitute gross income from the conduct of unrelated business activities if the product is sold in substantially the same state. For charities described in §501(c)(3) and engaged in a program of rehabilitation of handicapped persons, income from the sale of articles made by this group as a part of their rehabilitation training would not be gross income from the conduct of unrelated trade or business. The income is treated as coming from the sale of goods or services, the production of which contributes importantly to the accomplishment of purposes for which the exemption was granted (rehabilitation of the handicapped). On the other hand, if the production resulting from an exempt function is used or exploited in further business activities, then it is considered as coming from an unrelated trade or business.

Dual Use of Assets or Facilities

The assets or facilities of an exempt organization may be used for both its exempt and nonexempt activities. Even though the equipment or facilities are primarily for use in the exempt activity, it does not preclude a portion of the asset's usage from being attributed to unrelated trade or business. When there is a dual use of the asset or facility, the commercial aspect constitutes an unrelated trade or business unless the conduct of the commercial activities themselves contributes importantly to the accomplishment of an exempt function. Revenue Ruling 68-550, 1968-2 C.B. 249, addresses this issue in regard to the dual use of mailing equipment. To the extent the equipment is used for commercial mailing projects for other groups, there is unrelated business income from a trade or business because it does not contribute significantly to the organization's exempt function.

Exploitation of Exempt Functions

As discussed in Reg. §1.513-1(d)(4)(iv), in certain situations, activities carried on by an organization in the performance of an exempt function may generate goodwill or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits the activity, the mere fact that the resultant income depends in part on an exempt function of the organization does not make it gross income from a related trade or business. In such a case, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of an unrelated trade or business.
Example 2-11:

- U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research.
- It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers.

Discussion:

- The endorsing of laboratory equipment does not contribute importantly to the accomplishment of its exempt purpose.
- Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.

Exceptions

There are several exceptions cited in Reg. §1.513-1(e). Briefly, they are:

- Any trade or business in which substantially all the work in carrying on the trade or business is performed for the organization without compensation.
- Any trade or business carried on by an organization described in §501(c)(3) or by a governmental (state) college or university described in §511(a)(2)(B), primarily for the convenience of its members, students, patients, officers or employees.
- Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as a gift or contribution.

ALLOWABLE EXPENSES IN COMPUTING UNRELATED BUSINESS INCOME

EXPENSES IN GENERAL

One of the most difficult areas in both the Code and regulations is proper allocation of operating expenses. To the extent an exempt organization has unrelated business income, it operates much in the same fashion as its commercial counterpart. This means offsetting revenues with related expenses including depreciation, state income taxes, etc. The obvious issue is the creation of a net operating loss which not only keeps taxes from being paid this year but also becomes available for carryover to subsequent years. This generally comes about by either a legitimate business loss or an overallocation of
costs. Where the commercial activity is sharing facilities, personnel, or consuming assets of the exempt activity, a proper allocation must be made. Unfortunately, the only guidance offered is that the allocations must be applied on a reasonable basis. The problem is reasonable to whom? In this regard, Reg. §1.512(a)-1(c) points out that any portion of any item that has been used or set aside for the benefit of the commercial activity has to be related to the commercial business. The portion of any item that is attributable to the unrelated business income is allowed as a deduction in computing taxable income.

Example 2-12:

- In Revenue Ruling 80-297, 1980-2 C.B. 196, an exempt private school contracted with an individual to run a tennis camp during the summer.
- The tennis camp not only made use of the school facilities but also made use of some of the school personnel.

Discussion:

- The portion of the personnel and facilities applicable to the tennis camp was allowed as a deduction from the unrelated business income derived by the camp.

Example 2-13: Reg. §1.512(a)-1(c)

- Assume that X, an exempt organization subject to the provisions of §511, pays its president a salary of $20,000 a year.
- X derives gross income from the conduct of unrelated trade or business activities.
- The president devotes approximately 10% of his time during the year to the unrelated business activity.

Discussion:

- For purposes of computing X’s unrelated business taxable income, a deduction of $2,000 would be allowable for the salary paid to its president.
Indirect/Direct Expenses Allocation

The problem that arises is not so much an issue of whether expenses can be deducted but rather a question of how much can be deducted. For example, if the tennis camp provides lunch in the school cafeteria for the participants, is a portion of the cafeteria also allocable as an expense? What about custodial care for the premises, etc? The real question is where is the dividing line between exempt facilities and personnel and those associated with the tennis camp. The allocation of direct or indirect expenses becomes a problem when it is either profit- or tax-motivated.

What constitutes a reasonable basis under Reg. §1.512(a)-1(c) for the allocation of cost will change in every case because it will depend on the facts in each situation.

Example 2-14:

- *Disabled American Veterans v. U.S.* (704 F.2d 1570; Fed. Cir. 1983) aff’g and rem’g 82-2 USTC 9440 (Ct. Cl. 1982) was a case involving a veteran's organization (DAV) which conducted a mail solicitation program in which it offered various items in exchange for a $2, $3, or $5 contribution.
  
  - The treatment of each of the contributions was fragmented based on the amount of contribution in relationship to cost.
  
  - In the case of the $2 and $3 contribution levels, the contributions greatly exceeded the fair market value of the items given and, as such, the activity level did not constitute a trade or business.
    
    - The results of the $5 contribution were significantly different.
  
  - The $5 contribution did not exceed the fair market value of the item offered, and the activity was construed as the active conduct of a trade or business.

Discussion:

- The amount of gross income that DAV was required to include in unrelated business taxable income was equal to the retail value of the item given in the exchange.
  
  - To the extent the $5 exceeds the fair market value of the item, there would be an allocation for a charitable donation.
  
  - The most relevant issue in this case was the allocation of both direct and indirect cost and how they were going to be applied in this case.
Example 2-14: (continued)

- The direct-cost included items attributable to the direct-mail campaign, including but not limited to such cost as cost of goods sold, postage, and handling.
- The problem arose with the allocation of the indirect cost attributable to the general operations of DAV which included salaries and general overhead.
- The Court of Claims directed that allocations be based on gross receipts, and the Court of Appeals for the Second Circuit affirmed that the gross receipts were a reasonable basis for allocation.
- The deductible amount of direct expenses was based on the ratio of the gross receipts from the $5 premiums to the gross receipts from the entire direct-mail campaign.
- As for the indirect expenses, the deductible amount was based on the ratio of the gross receipts from the $5 premiums to DAV’s total gross receipts.

Use of Facilities

Some expenses are more obvious, such as the use of facilities. In regard to the allocation of fixed expenses between the organization’s related and unrelated activities, allocations can be based on either actual floor dimensions or it can be determined based on time and charges.

Example 2-15:

- In a Court of Appeals decision, *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), the court was concerned with the allocation of field house facilities.
- The University incurred three types of expenses associated with the field house.
  - The first group of expenses included those directly attributable to the commercial use of the facility.
    - These expenses were deductible in full.
  - The second type included variable expenses incurred in both the exempt and nonexempt activities which were directly attributable to the use of the facility.

(continued)
Example 2-15: (continued)

- These expenses were allocated based on their actual usage.
- The third classification consisted of fixed expenses including salaries and fringe benefits, depreciation, repairs, and other operating expenses.
- All the parties were in agreement that this classification should be divided based on actual time.
- The university allowed the facilities to be used, in part, for nonexempt events.
- The allocation of time was based on the actual hours the facilities were used for both the exempt and nonexempt events rather than based on the total hours the facilities were available for use.

Discussion:

- The IRS took the position that fixed expenses should be allocated on a 24-hour-a-day, 12-months-per-year basis using a ratio of hours used for the different events.

Example 2-16:

- In Private Letter Ruling 9147008, the IRS looked at the taxability of the income received by an exempt university for the use of its auditorium for 75 days a year for commercial events.
- The facility was also used for the school's exempt purposes including class registration, intercollegiate athletic events, and commencement activities.

Ruling

- In this case, the IRS ruled that the income from the unrelated events was taxable because it did not relate to the exempt purpose.
- The IRS concluded that the appropriate method of allocating the fixed expenses of the facility to the days of unrelated use was to divide the 75 days it was used for the events in question by the 365 days the auditorium was available for use during the course of the year.

(continued)
Example 2-16: (continued)

- Alternatively, the university had argued that the allocation should be based on the actual usage.
- It is probably safe to assume the IRS will continue to press colleges and universities on the allocation issue.

DEDUCTIBILITY

According to Reg. §1.512(a)-1(a), if an organization derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. Additionally, if there is a loss from one of the activities, it can be used to offset the income from another activity. However, if the loss is to be used, it must be carried on with a profit motive in mind. If one of the activities has consistently been operated at a loss and all indications are that it will continue to do so in the future, the IRS will most likely take the position that the activity is lacking in a profit motive. If this is the case, the loss activity would not constitute a trade or business and the loss would not be allowed. Again, you must always look to the activities' comparability with similar commercial enterprises.

Charitable Contributions Made by Another Exempt Organization

When tax-exempt organizations are acting as their commercial counterparts, they are allowed a deduction from their unrelated business income for charitable contributions as long as they are made within the requirements of §170. However, the deduction is limited to 5% of the organization's unrelated business taxable income computed without regard to the deduction.

Example 2-17:

- University described in §501(c)(3) which is exempt from tax and which operates an unrelated business is allowed a deduction, not in excess of 5% of its unrelated business taxable income, for gifts or contributions to another university described in §501(c)(3) for educational work, but not allowed any deduction for amounts expended in administering its own educational program.
Specific Deduction

If a tax-exempt organization has unrelated business income, a specific deduction from gross income of $1,000 is allowed. The specific deduction is not allowed in computing the net operating loss.

ADVERTISING AND CIRCULATION INCOME PUBLICATIONS

Any time an exempt organization publishes a journal, periodical, or any other publication reaching a wide variety of readers, there is a good possibility advertising is being sold. Unless it bears directly on the exempt purpose of the organization, the sale of advertising in the publication is unrelated business income. The sale of commercial advertising in an organization’s journal is an example of exploitation where the business exploits the circulation and readership of the publication that was developed to disburse editorial comment to the members. In addition, the publication of articles and other content is an activity normally carried on by profit-motivated businesses that sell advertising space. Expenses associated with advertising income will be deducted in computing unrelated business taxable income of the advertising operations.

Terminology

There are several rules with some rather specific terminology associated with the sale of advertising and circulation income that are important to understanding allocations of cost to these two areas.

Gross Advertising Income

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

Circulation Income

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

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

- Periodical was that of a taxable organization.
DEALING WITH UNRELATED BUSINESS INCOME AND RELATED ISSUES

■ Periodical was published for profit.

■ Member was an unrelated party dealing with the taxable organization at arm's length.

Allocable Membership Receipts

Reg. §1.512(a)-1(f)(4) provides three methods of determining the allocable membership receipts of an exempt organization’s periodical. The use of the methods are progressive insofar as, if it is not possible to apply the first method, the next method is applied and so on. The methods are applied as follows:

1. Subscription Price Charged to Nonmembers

If 20% or more of the total circulation of a periodical consists of sales to nonmembers, the subscription price charged to these nonmembers will determine the price of the periodical for purposes of allocating membership receipts to the periodical.

2. Subscription Price to Nonmembers

If the first method does not apply, and if the membership dues from 20% or more of the members of an exempt organization are less than those received from the other members because the former members do not receive the periodical, the amount of the reduction in membership dues for a member not receiving the periodical will determine the price of the periodical for purposes of allocating membership receipts to the periodical.

3. Pro Rata Allocation

The last method (to be applied behind method 1 or method 2) is based on the pro rata allocation of membership receipts. Because it can generally be assumed that membership receipts and gross advertising income are equally available for all the exempt activities of the organization, the share of membership receipts allocated to the periodical is an amount equal to the organization's membership receipts multiplied by a fraction the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization.

Example 2-18:

■ M is an exempt research organization of 1,000 members, and the annual dues for each member is $60.

■ M publishes a monthly research journal whose editorial content and advertising are directed toward the research interests of its members.

(continued)
Example 2-18: (continued)

- All M's members receive the journal.
- No journal is distributed to nonmembers.

\[ \text{M has total receipts of } \$80,000, \text{ comprised of } \$60,000 \text{ from membership and } \$20,000 \text{ from advertising.} \]

\[ \text{M's total costs for the journal and its other exempt activities amounts to } \$80,000. \]

\[ \text{M has total periodical costs of } \$40,000 \text{ of which } \$10,000 \text{ are direct advertising expenses and } \$30,000 \text{ are readership costs.} \]

Discussion:

- Because no copies of the journal are distributed to nonmembers, the allocation of membership receipts must be made in the following manner according to the regulations.

\[ \text{The total periodical costs of } \$40,000 \text{ should be divided by the total costs of the journal and the research organization's other exempt activities (} \$80,000). \]

\[ \text{The } \$60,000 \text{ in membership receipts would be multiplied by this fraction resulting in } \$30,000 \text{ in membership receipts being allocated to circulation income} \]

\[ (\$60,000 \times \$40,000/\$80,000). \]

Deductions Attributable to Periodicals

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

- Salaries may generally be allocated among various activities on the basis of the time devoted to each activity.
Occupy costs, such as rent, heat, and electricity, may be allocated on the basis of the portion of space devoted to each activity.

Depreciation may be allocated on the basis of space occupied and the portion of the particular asset utilized in each activity.

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

**Direct Advertising Cost**

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

The following expenses are normally attributable to direct advertising cost:

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

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

**Readership Cost**

Readership cost of an exempt organization periodical consists of operating expenses including depreciation where applicable or similar items directly connected to the production and distribution of the readership content of the periodical.
Excess Advertising Costs

Advertising cost and income along with readership cost and circulation income create a maze that has to be deciphered before it is possible to determine if there is income or loss to be reported between the advertising activities and the circulation activities. The final resolution as far as advertising is concerned depends on the following:

Gross Advertising Revenues Greater Than Direct Advertising Cost

If the gross advertising income from an exempt organization’s periodical exceeds the direct advertising cost, the readership cost may be deductible when computing the unrelated business taxable income subject to several limitations [Reg. §1.512(a)-1(f)(2)(ii)]:

1. Readership costs are deductible in computing unrelated business taxable income only to the extent these costs exceed the circulation income derived from the production and distribution of the periodical.

2. Readership costs cannot be used to the extent the deduction of such items would result in a loss, a loss carryover, or a loss carryback with respect to the unrelated advertising activity.

3. Readership costs cannot be taken into account in computing unrelated business taxable income attributable to any unrelated business activity other than the advertising activity.

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

Direct Advertising Costs Greater Than Gross Advertising Income

If the direct advertising costs of the exempt organization’s periodical exceeds the gross advertising income, Reg. §1.512(a)-1(f)(2)(i) allows the excess advertising cost to be used in determining unrelated business taxable income. However, there is one limitation—the losses from the sale of advertising can be used only if the organization is involved in the advertising on a regular and continual basis and the activity is engaged in with a determination to make a profit. Accordingly, if the circulation income to be reported from the periodical equals or exceeds its readership cost, the unrelated business taxable income attributable to the periodical is going to be the excess of the gross advertising income of the periodical over its direct costs. A problem can arise when readership costs of the periodical exceed circulation income. The unrelated business taxable income is the excess, if any, of the total income attributable to the periodical over the total periodical cost [Reg. §1.512(a)-1(f)(2)(ii)(b)].
Example 2-19:

- X, an exempt trade association, publishes a single periodical which carries advertising.

- During 1998, X realizes a total of $40,000 from the sale of advertising in the periodical (gross advertising income) and $60,000 from the sale of the periodical to members and nonmembers (circulation income).

- Total periodical costs are $90,000, of which $50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and $40,000 is attributable to the production and distribution of the readership content (readership costs).

- Because the direct advertising costs of the periodical ($50,000) exceeds gross advertising income ($40,000), the unrelated business taxable income attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Gross Advertising Revenue</td>
<td>$40,000</td>
</tr>
<tr>
<td>Direct Advertising Costs</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Loss Attributable to Advertising</td>
<td>$(10,000)</td>
</tr>
</tbody>
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- X has realized a loss of $10,000 from its advertising activity.

Discussion:

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

Example 2-20:

- Assume the same facts as in Example 2-19, except that the circulation income of X's periodical is $100,000 instead of $60,000 and, of the total periodical costs, $25,000 is direct advertising costs and $65,000 is readership costs.

Discussion:

- Because the circulation income ($100,000) exceeds the total readership costs ($65,000), the unrelated business taxable income attributable to the advertising activity is $15,000, the excess of gross advertising income $40,000 over direct advertising costs of $25,000.
Example 2-21:

- Assume the same facts as in Example 2-19, except that of the total periodical costs, $20,000 are direct advertising costs and $70,000 are readership costs.

Discussion:

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

Consolidation

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

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

- Organization generally receives gross advertising income from the periodical equal to at least 25% of the readership costs of the periodical.
- Publication of the periodical is an activity engaged in for profit.

SUMMARY

Many tax-exempt organizations, regardless of whether they are exempt under §501(c)(3) or other subsections, must deal with the issue of unrelated business income. To some, this simply means paying an income tax every year, while to others unrelated business income could mean the revocation of their tax-exempt status. Given the IRS's attitude towards the unrelated business income of tax-exempt organizations, this issue cannot be taken lightly. Every executive director or manager of an exempt organization should at least acquire some basic understanding of what constitutes unrelated business.
income. This may take on a three-step approach by first understanding what constitutes a trade or business, determining whether it is regularly carried on, and then assessing its contribution to the accomplishment of the exempt purposes of the organization.

It is not uncommon for an exempt organization to have unrelated business income. It may be in the form of advertising in the organization's journal or magazine, selling membership mailing lists to non-501(c)(3) organizations, or endorsing affinity cards or products of for-profit enterprises, etc. If unrelated business income does exist, a determination must be made to allocate direct and indirect expenses to offset such income. There is some guidance provided in the regulations to allocate expenses to offset unrelated business income. Some specific rules are also provided to deal with advertising income and the allowable expenses.
CHAPTER 3
CURRENT TRENDS AND TECHNIQUES IN INCOME-PRODUCING VENTURES

INTRODUCTION

In recent years, income received by nonprofit organizations from certain passive sources has come under increased IRS scrutiny. In fact, this may well be the most important area concerning nonprofits. The IRS has increasingly sought to categorize this passive income as resulting from the organization's participation in an unrelated trade or business. As such, this income would be subject to taxation.

Nonprofit organizations, on the other hand, maintain that the income is from passive sources or otherwise not taxable because it relates to their exempt function. A significant number of court cases, rulings, etc., have been generated as a result of these more exotic types of income. Some of these cases have drawn considerably more attention than the associated organizations would have hoped for.

CURRENT TRENDS/TECHNIQUES

For the last decade, nonprofit organizations have looked outside traditional fund-raising programs to find new sources of revenue. Some of the methods currently being used received a good deal of negative publicity because they tend to exploit the name and reputation of the organization. In many cases, the name of the organization and its mailing list are among its most important assets.

Based on current fund-raising trends using passive activity projects, the following programs are among the most commonly used:

- Mailing List Agreements.
- Affinity Card Programs.
- Insurance Programs.
- Travel Tours.
- Corporate Sponsorships.

Unfortunately, through use and abuse, these activities have stirred a great deal of controversy among the organizations that sponsor the programs, the legal system, and the IRS.
MAILING LIST AGREEMENTS

During the 1970s, there were several cases dealing with the classification of income from an exempt organization's sale or rental of its mailing list. Typically, the organization argued that this should be considered passive income and exempted from federal income tax. The IRS usually countered that the income was generated through unrelated business activity and was therefore subject to federal income tax. However, the current IRS position in this area is based largely on the results of two later cases: Disabled American Veterans v. U.S., 650 F.2d 1178 (Ct.Cl. 1981) (hereinafter DAV I) and Disabled American Veterans v. Commissioner, 942 F.2d 309 (6th Cir. 1991) (hereinafter DAV II).

Like many nonprofits, the Disabled American Veterans (DAV) rented its mailing list to outside exempt and nonexempt organizations. In fact, it sold the list in much the same way as direct-mail houses. The list was available throughout the year, except during periods when DAV conducted its own solicitation campaigns. The summary and interrelationship of the two cases is as follows:

DAV I

In DAV I, the Court of Claims considered the organization's practice of renting names on its mailing list to both tax-exempt and commercial organizations. The court stated:

DAV's list rentals are the product of extensive business activity by DAV and do not fit within the types of "passive" income set forth in IRC §512(b). The "royalties" there referenced are those which constitute passive income, such as the compensation paid by a licensee to the licensor for the use of the licensor's patented invention....For the same reason that personal property rentals constituting unrelated business income are taxable, it is concluded the DAV's receipts from the rental of its mailing list cannot be classified as "royalties" as that term is used in IRC §512(b)(2). Rather, DAV's list rental income constitutes unrelated business income pursuant to IRC §511-513.

DAV II

In DAV II, the U.S. Court of Appeals for the Sixth Circuit reversed the Tax Court decision which had concluded that the payments received by DAV for use of its mailing list were made in exchange for the right to use intangible property, and held that those payments were royalties, and therefore excludable from unrelated business income under §512(b)(2). The Appeals Court found that DAV I controlled the issue in DAV II, and therefore the Tax Court was collaterally estopped from reconsidering the issue.
Chronology of Events

After the IRS classified the rentals as a source of unrelated business income, DAV filed suit in the U.S. Court of Claims (DAV I). The Court ruled DAV had engaged in "extensive business activity," which produced income subject to unrelated business income tax. However, the impact of this decision was weakened by Revenue Ruling 81-178, C.B. 1981-2, 135, which expressed the IRS’s position on licensing agreements that involved an exempt organization’s trademarks, trade names, copyrights, etc. The IRS was concerned with the distribution, sale, and advertising of a licensee’s products and services. More specifically, Revenue Ruling 81-178 held that payments received from various business enterprises for the use of an organization’s trademark and similar properties were royalties within the meaning of §512(b)(2) and were not taken into account in determining unrelated business income. However, payments the organization received for personal appearances and interviews by its members were compensation for personal services and were to be taken into account in computing unrelated business income. The ruling states that to be a royalty, a payment must relate to the use of a valuable right.

The entire issue came to a head when Congress enacted a special exception for mailing lists between exempt organizations [§513(h)(1)(B)].

In a later Tax Court case, the organization argued that its income from mailing list rentals should be considered nontaxable royalties under §512(b)(2). The Tax Court found in favor of DAV, although this decision was later reversed by the Court of Appeals in DAV II. The reversal was granted, however, on the basis of collateral estoppel.¹

IRS/Congressional Involvement

Following DAV I, the IRS developed Revenue Ruling 81-178. This set forth the IRS’s position on licensing agreements where an exempt organization’s trademarks and copyrights were used in the licensee’s marketing efforts. Such agreements were generally considered to generate nontaxable royalty income unless they included the performance of personal services by the exempt organization. In that instance, income received would be fully taxable.

Although many organizations structured their mailing list agreements as licensing agreements, some did not. Thus, Revenue Ruling 81-178 did not provide guidance to all exempt organizations. In an attempt to remedy this, Congress enacted §513(h)(1)(B). This provided a special exception from unrelated business income tax for income resulting from the rental or exchange of mailing lists between two 501(c)(3) organizations. Section 513(h)(1)(B) effectively overruled the decision from DAV I, because more than 80% of the mailing list agreements discussed in that case were between DAV and other 501(c)(3) organizations.

¹ Doctrine of collateral estoppel: Prior judgment between same parties on different cause of action is an estoppel as to those matters in issue or points controverted, on determination of which finding or verdict was rendered. When an issue of ultimate fact has been determined by a valid judgment, that issue cannot be again litigated between the same parties (Black’s Law Dictionary).
A CPA's Guide to Tackling Tough Tax Issues for Nonprofit Organizations

It should be noted, however, that §513(h)(1)(B) did not address the treatment of similar agreements between 501(c)(3) organizations and non-501(c)(3) entities. In fact, a congressional report states specifically that "no inference is intended as to whether or not revenues from mailing list activities other than those described in [IRC §513(h)(1)(B)] constitute unrelated business income."\(^2\)

**IRS Interpretations**

The IRS has consistently held §513(h)(1)(B) to be the only means through which rental income from mailing lists can be considered tax-exempt. It has applied a strict standard to income which would, at least in part, appear to be exempt royalties under Revenue Ruling 81-178. In some instances, it has ruled that actions taken by an organization beyond supplying its mailing list and passively endorsing the programs of its licensee are personal services. Following this interpretation, the IRS has frequently concluded that all of an organization's income from such agreements would be subject to tax. For the most part, the IRS has not attempted to allocate this income between passive and nonpassive sources.

Section 513(h)(1) provides:

In the case of an organization which is described in Section 501 and contributions to which are deductible under paragraph (2) or (3) of Section 170(c), the term "unrelated trade or business" does not include — (in part) — (B) any trade or business which consists of (i) exchanging with another such organization names and addresses of donors to (or members of) such organizations, or (ii) renting such names and addresses to another such organization.

The IRS has taken a strict interpretation of the section to mean that only exempt organizations fall under the exception and as such all other organizations do not qualify for the exclusion. Section 513(h)(1)(B) came about as a result of the 1986 Tax Reform Act. In review of the floor discussions during the debate on the act, the discussion specifically addressed the exchange of lists between exempt organizations. In fact, during the debate, Dan Rostenkowski (D.-Ill.) specifically stated that the discussion did not include the commercial use of the list and, therefore, there was no opinion regarding the issue of exempt organizations renting lists to commercial enterprises.

**Payments for Use of Valuable Right**

In one case which involved an exempt business league [a 501(c)(6) organization], the IRS originally determined (PLR 9220054) that amounts paid to the league were royalty payments for the use of its letterhead, logo, and name. According to the facts of the case, a tax-exempt organization was established as a state affiliate of a national organization representing the building industry. The organization entered into an agreement with an insurance service provider to make various types of insurance available to the organization's members. The insurance company was responsible for developing the insurance package and for providing and sending all mailings, advertisements, and promotional materials. The employees, facilities, and tax records of the insurance company are entirely separate from those of the organization.

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The organization's only participation in the insurance program was to endorse the insurance package by permitting the insurance company to use its name, letterhead, and logo. The organization would be paid a fee for the use of its name, letterhead, and logo based on a percentage of insurance premiums. The organization provided the insurance company with its mailing list, but it would provide no further mailing lists or updates to the mailing list.

In the original favorable ruling (PLR 9220054), the IRS ruled that the payments by the insurance company to the organization were excluded from the organization's computation of unrelated business taxable income as royalties under §512(b)(2). The IRS determined that because the payments were solely for the use of the name, letterhead, and logo of the organization and were in no way attributable to the provision of a mailing list, the organization's involvement in the arrangement was sufficiently passive for the payments to be characterized as payments for the use of a valuable right.

Payments for Services

A year later the IRS revoked this decision based on the following considerations:

The Service has reconsidered and revoked its prior ruling, holding that the income the exempt organization received from the insurance company did not constitute royalty income and may not be excluded from unrelated business income tax. The Service found that, contrary to the organization's representations, it was "directly and extensively involved in the insurance program." It also noted that the insurance company's payments to the organization for the use of the organization's name, letterhead, and logo were inseparable from the company's use of the organization's mailing list. Therefore, following Revenue Ruling 81-178, the payments are consideration for services and not royalties.

The IRS reasoned that the organization publishes advertisements for the insurance program in its magazine and granted the insurance company access to its membership list at least once. It also found that representatives from the insurance company were permitted to attend the organization's board meetings and to meet informally with members.

RECENT RULINGS

Sale of Mailing Lists

A tax-exempt organization exchanged its mailing list with other organizations whose members would have similar interests to the members of the tax-exempt organization in question. The exchanges were completed to keep the mailing list up-to-date and to expand the mailing list of the organization. The IRS found that the mailing list exchanges resulted in UBITI to the tax-exempt organization. The exchanges were found to be "offsetting rentals" which did not contribute importantly to the exempt purposes of the organization (PLR 9250001).

A tax-exempt organization agreed to purchase a subscription to the magazine of a publisher for each of its members. The publishing company in turn paid an amount equal to the subscription price to the tax-
exempt organization for each name on its mailing list. Since providing the magazine to the members of the tax-exempt organization was found to further the tax-exempt purpose of the organization, the payments to the organization for the mailing list did not constitute UBTI (TAM 9249001).

A tax-exempt trade association allowed insurance administrators to use the mailing list of the association to promote the insurance plan. Amounts received for use of the association's mailing list were consideration for services and were deemed to be UBTI (TAM 9318005; PLR 9306030).

**Affinity Credit Card Programs**

From the mid-1980s on, affinity credit card programs have gained in popularity and complexity. The taxation of these programs revolves more around the mailing list aspect of the program rather than the pure royalty derived from the use of the organization's name, logo, or letterhead. The typical affinity card program consists of a credit card issued by a bank with the exempt organization's logo printed on the card. The organization, in a typical arrangement, will receive payments from the bank on a quarterly basis. The bank normally pays a certain amount for each person who signs up, in addition to a percentage of the usage of the card. Again, the most noticeable thing about the card is the presence of both the organization's name and logo. Usually, the organization will furnish the mailing list to the bank unless an alternative arrangement has been made. As discussed later, there is very little likelihood the IRS will let the arrangement stand as exempt income unless there are separate agreements for the mailing list as well as for royalties.

**Separate Agreements**

The affinity card programs normally consist of two parts. The first is the exempt organization's licensing of its name and/or logo. The second part consists of the organization's mailing list which is either sold or leased to the third party. In order to avoid problems with the IRS, the two components of the agreement should be treated separately. Regarding the licensing agreement, the Code and regulations should be strictly adhered to if there is any hope of having the arrangement classified as a passive royalty arrangement. The IRS has gone back and forth on this issue from the beginning. So far, favorable results have been due to judicial interpretation. The IRS has repeatedly changed its mind (normally against the taxpayer).

**Issues of Concern to IRS**

The IRS appears to be looking beyond the agreement itself. It has become more an issue of substance over form. The two issues that the IRS appears to be most interested in are:

- Evaluation of the performance of services, including endorsements, marketing, promotion, etc.
- Separation of the mailing list from the logo, name, or letterhead.
Ever since the IRS's revocation of PLR 8747066, it has been very clear on its position regarding the affinity card programs and the rental of mailing lists. The IRS has taken a hard-line position in virtually every case. However, if one reads between the lines, the IRS has closed a door and left a window open. The IRS appears to be explicit on what will not work but silent on what will work. That part of the interpretation seems to be left to the courts.

To support this contention, PLR 9316045 addressed payments for use of a name and logo. In this case, the IRS ruled against the association. However, the rationale for the IRS's position is important because if one looks at the reverse side of the ruling, it is possible to make some inference concerning what will work. The following summarizes the ruling:

The stated purpose of the association (exempt under IRC Section 501(c)(6)) was to extend medical knowledge, improve quality of public health, and to attempt to develop interest of its members. As a service, the association offered group insurance programs to its members. The association entered into an agreement with an insurance company that would function as its agent for obtaining major medical insurance for members and their dependents.

The following is a summary of the agreement. The company:

- Will negotiate with insurers,
- Is responsible for implementing programs,
- Will prepare and process applications,
- Will recommend any changes in programs offered,
- Will market the programs, and
- Will provide written reports on marketing.

The association will allow the insurance company to advertise in its program.

The agreement provides the following:

- The company will be allowed to use the association's name and logo.
- The association will receive a payment based on the overall membership count.
- The payment will increase or decrease based on the increase or decrease in the number of members of the association.
- The organization will also allow the company to use its mailing list in connection with the promotion of the insurance plan.
The association intends to approve in advance the form and content of all mailings to its members.

The association will endorse the insurance plan and will advise the membership of the availability of the plan.

The association will include information about the insurance program in materials sent to new members.

While the IRS's ruling did not help this particular association, it did shed some light on IRS current thinking. The IRS ruled that the payments by the company to the association for the use of its name and logo were not royalty income under §512(b)(2) and were to be included in the computation of unrelated business taxable income. The reason for its decision was based on the opinion that the association was directly and extensively involved in the insurance program and, as such, the payments constituted consideration in exchange for services rendered.

Recent Court Decisions

The courts have been considerably more liberal in their interpretation of §512(b)(2) than the IRS. The courts have been as interested in the form of the arrangement as they are in the substance. This is in contrast to the IRS which seems to be interested in only the substance of the arrangement.

Sierra Club

Careful wording of a licensing agreement was partially responsible for the Sierra Club (Sierra) prevailing in a 1993 Tax Court case (Sierra Club v. Commissioner, T.C. Memo 1993-199). The central issue in this case was treatment of income resulting from Sierra's 1986 agreement with a bank card service. Under terms of this agreement, the bank card service arranged for credit cards bearing the Sierra name and logo to be issued through a local bank and offered to Sierra members. A percentage of the payments received by the bank from credit card users were given to a financial service which, in turn, remitted payments to Sierra. The agreement between Sierra and the financial service contained the following clause:

6.3 Nothing in this Agreement shall be construed as constituting a partnership or agent/principal relations between the parties.

The IRS held that Sierra had engaged in a joint venture with a financial institution for the purpose of selling financial services. Because this constituted an unrelated business activity, the IRS held that payments made to Sierra under this arrangement were subject to taxation. Sierra held that the payments were nontaxable royalties. Citing, among other things, §6.3 of its agreement (quoted above), the Tax Court upheld Sierra's position.
Factors

Other factors which the Tax Court cited were as follows:

■ Sierra did not actively participate in the development of promotional materials or assume responsibility for costs incurred for marketing efforts of the affinity card program.

■ Sierra did not engage in marketing efforts related to the affinity card program or direct any of the marketing efforts which actually took place.

■ Sierra maintained its independence from the other entities involved in the affinity card program.
   • For example, Sierra billed the financial service for advertisements appearing in Sierra publications to promote the credit card program.
   • It also began collection proceedings against the financial service when its account became past due.

■ Sierra did not maintain separate books of account for the affinity card program, relying instead on monthly reports provided to it by the financial service.

■ Sierra’s payments under the affinity card program were based on a percentage of total sales volume.
   • If the program had been a joint venture, Sierra’s payments would have been calculated as a share in the net profits.

■ Under the terms of the agreement, Sierra did not assume any risk of loss for the affinity card program.

Sierra Club (U.S. Court of Appeals for the Ninth Circuit, June 20, 1996)

The IRS actively continued its aggressive attack on the affinity card issue by appealing the Tax Court decision in Sierra Club. The court denied IRS motion in August 1996. The IRS clearly will continue to vigorously pursue the matter in other Circuits. They do not believe Sierra Club is the best case to take to the Supreme Court.

Oregon State University Alumni Association, Inc.

The IRS continues its losing streak with Oregon State University Alumni Association, Inc. (TC Memo 1996-34). However, this case is more significant in many ways than the previously discussed case of Sierra. In OSUAAI, there is a much higher level of participation by both the University and the Alumni Association.
A CPA'S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

The Alumni Association was incorporated as an Oregon nonprofit corporation and received its exemption under §501(c)(3). The Alumni Association was created to promote the interests and ideals of Oregon State and to stimulate and encourage loyalty in its students.

The Association’s affinity card program was created in 1987. They felt the credit card program would help alumni maintain ties to OSU and to provide a low-cost benefit to alumni and other OSU supporters. The other fairly common reason for creating the program was the need for revenues.

The agreement provided that the bank would mail, promote and process applications and the program. In addition, the bank agreed:

- To announce petitioner's activities and alumni news four times each year, at the bank’s expense, on periodic statements mailed to alumni credit card holders; and
- To place a full-page color ad in the school’s publication.

The Alumni Association agreed to:

- Give the bank the names, addresses, and graduation dates of its members,
- License the use of its name, logo, and the official seal of OSU; and
- Inform members of the affinity credit card program, at its expense, at least once a year.

One thing relatively unique to this agreement is that the Alumni Association, at its discretion, could provide information to be distributed to members in their statements. The agreement, however, did not require the Alumni Association to mail any solicitation materials to alumni.

The Alumni Association through the OSU printing department participated in the arrangement to a limited degree. The following is a summary of the Alumni Association's activity in regard to the solicitation:

- The printing department mailed a letter that the Alumni Association wrote along with bank materials to 58,809 alumni in 1988;
- They remailed 4,234 packets to alumni missed in the first mailing;
- They printed and mailed letters written by the bank to 2,393 OSU seniors; and,
- They printed and mailed letters written by the bank to 9,212 OSU students in 1988, promoting other bank products.

Material went out under the signature of the Association’s president which had been given to the bank to be used on all promotional material. In addition to the aforementioned activity, similar activity and involvement took place in other years. One additional relevant fact involves the Association’s Executive Director. During 1988 and 1989, the Executive Director met with the bank on a very limited basis. However, he performed enough services so that 15% of his compensation was allocated to the program.
Like most other organizations, the Association entered into other arrangements. In addition to the affinity card program, they were involved with a travel program and a program promoting rings and watches.

The real insight to be gained by this case comes in a "point-counterpoint" dialogue between the Association and the IRS.

**Issue 1 — Whether the bank paid the Association to use valuable intangible property rights.**

The IRS contended the bank did not pay the Association to use valuable intangible property right because the bank did not display the Association's logo on the credit cards.

The court felt all of the conditions of use were present in the arrangement. The agreement gave the bank the right to use the University's seal along with the Association's logo. The use of the seal and logo were restricted to a specific period with any rights not specifically transferred to the bank retained by the Association.

The court concluded that the income from the affinity card program was received in exchange for the use of valuable intangible property rights.

**Issue 2 — Whether the Association's use of its mailing list is inconsistent with royalty treatment.**

The IRS contended that the Association's income from its mailing list were not royalties because the use of the list constituted a trade or business. The IRS made a strong argument for Disabled American Veterans (DAV) (previously discussed). However, the court distinguished DAV from the Association. The Association received income from the use of its mailing list only for:

- Alumni trips;
- Alumni class rings and commemorative watches; and
- The affinity credit card program.

The Association had other opportunities to generate funds off of the list but chose not to because the uses did not produce a benefit to members. The court additionally noted that the Association did not regularly rent its mailing list and was not involved with the direct mail industry. Compared to DAV, the Association's involvement was minimal. The court found that the Association was making use of its list in a fashion consistent with the concept of a royalty arrangement.

**Issue 3 — Whether the bank’s payments were for services; extent of Association’s role.**

The IRS contended the bank paid to obtain the Association's cooperation and assistance.
1. Association's solicitation of its members

The IRS contended that the Association's solicitation of its members for the credit card program precluded royalty treatment for the resulting income because the Association mailed some solicitation materials twice during the years at issue and four times in prior years. In addition, they hired a professional writer to write one letter and used an off-campus print shop three times along with reviewing all solicitation materials produced by the bank.

The court disagreed with the IRS. They felt the Association's involvement was de minimis and intended to increase exposure to the University's alumni. In the agreement, the Association agreed to inform members at least once a year of the program but was not "required" to send any materials during the year. The bank developed all marketing materials except for the one letter.

The Association reviewed all materials but the bank had the final say regarding the mailings. The court determined that the Association was using the credit card program, in part, to encourage alumni to join the Association.

The Association's involvement was found to be similar to Sierra Club (previously discussed).

2. Association's providing of services to promote the affinity card program

The IRS contended the Association's income from the credit card activity was not a royalty because the Association referred occasional requests for credit card applications or complaints about the denial of a credit card application to the bank; told several alumni to contact the Association's office for additional assistance; and requested that the bank preapprove applications to certain alumni along with some other de minimis activities.

The court disagreed with the IRS insofar as the activities were minimal and were done to protect the Association's goodwill with its members. The court held that the bank's payments to petitioner were not compensation for services rendered and that the Association's activities were compatible with the treatment of those payments as royalty income.

**Issue 4 — Association's financial risks and rewards.**

In deciding whether income a taxpayer receives is royalty income, the court considered the taxpayer's financial risks and rewards, including whether the taxpayer has a net profits or a gross profits interest. A gross profits interest is the right to share in the gross profits without bearing the risk of loss. Gross profits are the difference between sales and the cost of goods sold.

The Association maintained a gross profits interest in the credit card program instead of an interest in the net profits. The Association received a fixed percentage of all of the authorized cash accounts, regardless of whether the bank had losses from the affinity card program. The court felt that the Association did not have a net profits interest which supports the Association's contention that its income from the program was a royalty. A net profits interest is something less than a gross profits interest. If the Association was
responsible for any of the marketing cost beyond a de minimis amount they could have been held to something less than a gross profits interest.

**Issue 5 — Association's desire to make money from the affinity credit card program.**

The IRS pointed out the Association entered into the affinity credit card program, in part, to make money. The court felt this was not a basis to conclude that the Association’s income from the affinity credit card program was not a royalty. The court also felt that the desire alone to make money was not indicative of a profit motive. The court cited *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), in which it stated "...to be engaged in a trade or business, petitioner must be involved in the activity with continuity and regularity and the primary purpose for engaging in the activity must be for profit."

**Issue 6 — Whether the enactment of §513(h) prevents treatment of the bank's payments to the Association as royalties.**

The IRS argued that the enactment of §513(h) showed Congress intended to treat income earned from mailing list rentals as income from a trade or business. Section 513(h) exempts from tax amounts earned by certain tax-exempt organizations from the trade or business of exchanging or renting mailing lists to other tax-exempt organizations. Section 513(h) is effective for exchanges and rentals of member lists after October 22, 1986. The IRS contended that the enactment of §513(h) implies that renting mailing lists is generally a trade or business. In this case, the IRS asked the court to infer from the enactment of §513(h) that Congress generally views gross income from the licensing of mailing lists as UBIT unless excepted by §513(h). The court did not share the IRS’s opinion.

In its rejection of the IRS position, the court cited the floor discussions related to §1601 of the 1986 tax bill:

The question relates the Section 1601 of the bill which excludes from unrelated trade or business income revenue from the use of a tax-exempt organization’s mailing list by another such organization. Section 1601 of the bill, which specifically exempts certain such revenues from the tax on unrelated business income mailing list revenue beyond its scope or prior to its effective date should be considered taxable to an exempt organization.

The court concluded that §513(h) did not apply in this case. The court cited the *Sierra Club* case previously discussed.

This case is far-reaching because it attacks virtually every IRS argument regarding affinity credit card programs. More importantly, it points out the importance of a well-structured agreement. When advising an organization regarding its program, each aspect of the operation should be reviewed and measured against the list of issues.
Mississippi State University Alumni, Inc., Case

Most recent cases involved alumni associations, which greatly aids in comparability. In the most recent case, Mississippi State University Alumni, Inc. TC Memo 1997-397, the issues narrowed to a finite area involving participation by the sponsoring organization. MSUA is a classic case for any exempt organization about how to handle the affinity arrangement. There are generally two parties involved — an association and a bank. As far as participation is concerned, MSUA had a single long-time employee who processed annual fund gifts, made address changes on the database, and produced lists, labels, and diskettes during the year. When the workload was heavy, a part-time student assistant was employed to help. The bank, on the other hand, operated a large, full-time affinity card department. When the bank originally contracted with the Association, they wanted the use of MSUA's mailing list, marks, and logos.

There was one aspect of the affinity card agreement between MSUA and the bank that could have caused a major problem. The bank agreed to pay MSUA 45¢ for each cardholder transaction and for each card membership and annual fee paid. However, in drawing up the agreement, the bank did not specify whether they were paying a royalty or providing a business service. While the substance of a transaction is crucial, of equal importance is the form of the transaction. There are some common characteristics for successful arrangements, not the least of which is a well-prepared agreement.

Beyond the agreement, the success or failure of the affinity card arrangement rests on the level of participation of the sponsoring organization. In the MSUA case, participation varied. However, that was not as significant as it was in the previously discussed case concerning Oregon State University Alumni Assn., Inc.

By way of contrast, the bank's involvement in MSUA was limited to:

- Processing applications;
- Establishing and loading accounts onto a computer system;
- Producing credit cards;
- Accepting and posting transactions;
- Generating statements;
- Processing payments;
- Drafting and sending letters to promote the program; and,
- Developing all solicitation materials.

Compared to the previous case, MSUA had relatively minor direct involvement. The Association gave the bank copies of its mailing list twice during the year. They estimated that it took about 30 minutes to list the 55,000 names. MSUA asked the bank to advertise the credit cards in a newsletter. The remainder
of the advertising of the program was the bank's responsibility. The bank, independently, went as far as asking a well-known sports announcer to endorse the affinity credit card.

What MSUA did not do is especially important to the case. They (unlike OSUAA) did not mass mail any credit card applications or marketing materials; nor did they interfere with the bank's credit policy. The decision as to who would receive cards rested entirely with the bank.

The IRS contended that the bank was paying MSUA for the performance of significant services related to the affinity card program, while the court felt that the assistance was minimal and infrequent and was not conducted on a commercial basis. The IRS was clearly mixing up membership services with affinity card related activities. The IRS tried to mischaracterize some of the Association's activities as services that are related to the affinity card program. At one point, the IRS referred to the messages that the Association included in the credit card billing as promotional materials, even though they were used only to promote MSUA's activities to its members. The material sent to the members clearly was not promotional material for the card. In another area under question, the IRS characterized the maintenance and updating of its mailing list as a substantial service for the bank and the affinity card program. This, of course, has been a major problem in virtually every case. Even without the affinity card program, the list must still be maintained by the Association.

As with every other case, the IRS contended that MSUA regularly rented its mailing list. Consistent with the previous cases, the IRS cited DAV I and DAV II, where the income from the rental of the list was not treated as royalty income. In MSUA, the court disagreed again with the IRS. They argued that in DAV I, the Court of Claims held that the DAV conducted a trade or business of renting its mailing list and that it was not royalty. From 1974 to 1979, DAV rented parts of its donor list 451 times. In so doing, DAV followed common practices followed by the direct mail industry. DAV prepared rate cards showing the rates it charged to customers. DAV employed two staff personnel full-time to administer its list rentals. In MSUA, they did not use list brokers, employ anyone to administer the mailing list, or make any other attempt to rent the list, as opposed to what was done in DAV. In MSUA, the court cited Sierra Club, Inc. They pointed out that the taxpayer in Sierra set the rental rates, rented its mailing lists, and had the right to review requests to rent the lists and to approve the proposed mailing materials and schedules for each mailing, but took no other action. In that case, the U.S. Court of Appeals for the Ninth Circuit held that payments for rental of mailing lists were royalties because the taxpayer did not provide any services with the mailing lists.

**Need for Contract Modifications**

In light of cases such as Sierra Club, Oregon State, and DAV II, the agreements between the tax-exempt organizations and their commercial contracting partners will most likely need to be modified to protect the exempt status of the royalty income. Restructuring is necessary to dissociate the royalty income from the sale or rental of the organization's mailing list in a manner that will satisfy the standards required by the IRS in PLR 9029047.

In this ruling, the IRS reconsidered and revoked a letter ruling that it had issued two years earlier to a charity. The original ruling involved an insurance plan marketed to the members of an organization.
Initially, the IRS held that most of the income received by the organization constituted tax-exempt royalty income for the use of the organization's name and logo. In PLR 9029047, the IRS reversed its previous position and claimed the income was from personal services or list rentals.

**Amount of Involvement**

PLR 9029047 is a variation of the normal situation since the organization was somewhat more involved with the insurance program than the typical organization. Initially, the organization operated the insurance business itself without the assistance of an insurance company until the Supreme Court determined that such activities were taxable in *American Bar Endowment v. U.S.*, 477 U.S. 105 (1986). Because of this decision, the organization restructured its agreement with the hopes of protecting the passive nature of the program. The agreements were restructured to resemble a royalty arrangement more closely.

Even though PLR 9029047 addresses active involvement on the part of an organization that did not have a typical arrangement, it is nevertheless an important ruling because it addresses the necessary strategy in creating a successful royalty arrangement. The ruling was not, by itself, trying to separate the mailing list and royalty arrangement for the use of the name and logo from the mailing list.

As quoted in an article, "Logos, UBIT, and a Strict IRS Approach to Affinity Card Programs," *The Journal of Taxation of Exempt Organizations*, Vol. 2, No. 4, Winter 1991, p. 10, Marcus Owen, Director of the IRS Exempt Organizations Technical Division, addressed the ruling in a speech before the Tax Section of the American Bar Association. He stated:

I don't think it's meant to stand for the fact that you cannot divide up transactions into their component parts. The key is, how closely related are the parts?

Because part of the income is being recharacterized as personal service income, Revenue Ruling 81-178 again becomes relevant. In the second situation in the ruling, the IRS took the position that the royalty exclusion did not apply where personal services were involved. This was not only a case of licensing a logo and name, but a case involving the granting of endorsements. Revenue Ruling 81-178 and related rulings have made it clear that the royalty exception is allowed only for passive sources of income.

*The IRS cited the following examples of the organization's involvement:*

- Advertising the plan in the association's magazine.
- Endorsement of the plan and an active mail campaign to encourage enrollment.
- Permitting the insurance company to use the organization's name, logo, mailing list, etc., in the promotion of the plan.
- Approving in advance the form and content of all mailings.
If any arrangement has all or a significant number of the afore-mentioned attributes, then it clearly is a service arrangement and not a royalty agreement. To the extent any of the above attributes are insignificant or nonexistent, the agreement has a much better chance of surviving. Section 512(b)(2) provides, in part:

There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

There is no question that, if handled properly, the royalty arrangement should stand. The problem is created when there is clearly no delineation between the royalty arrangement and the use of the mailing list. This ruling again reaffirms the IRS's position that the rental of the mailing list constitutes a trade or business subject to tax. The IRS has repeatedly argued that it does not matter whether the court's position in DAV II is correct or not because of §513(h)(1)(B). Any attempt to treat the rental of the mailing list as royalty income will be challenged by the IRS. Part of the solution rests with the royalty arrangement.

**Crossover Between Arrangements**

If personal services are involved, then clearly the income will be taxable. However, if there is no personal service involvement, the next hurdle is to separate the royalty arrangement from the mailing list. In PLR 9029047, the IRS pointed out the specific references to the crossover between the arrangements. These are:

- Royalty changed with the use of the list.
- Amount of the royalty was determined through a formula keyed to the number of pieces mailed.
- Organization was involved with the advertising, endorsement, and approval of literature.
- Organization sold the entire package to the insurance program—mailing list, logo, name, etc.

Exempt organizations that continue to rely on income from affinity card programs and mailing lists need to devise ways to strengthen their position and eliminate problem areas in most of the agreements currently in use. To build a more defensible position, exempt organizations should consider the following:

- Make sure the mailing list and the royalty contracts are separate agreements.
- Agreements should be written in such a way that the royalty does not increase at the same rate as the list usage increases.
If possible, have the royalty agreement allow for commercial usage of the name and logo by the contracting partner.

- This supports the position that the name and logo have economic value over and above their association with the list.

It is critical that the exempt organization have as little to do with the administration and promotion of the program as possible.

- Involvement should not go much beyond "quality control" to ensure the articles are in good taste.

Organization should avoid endorsements or promotion of the project in its literature.

There are no guarantees that any affinity card program could be designed with a 100% ability to pass review by the IRS. However, with proper planning, the organization should be able to minimize exposure.

**Rental of Mailing List Generates UBTI**

A tax-exempt organization endorsed the credit card program of a company and also performed substantial services for the company pursuant to a licensing agreement. The payments for the use of the name and logo of the tax-exempt organization were found to be inseparable from the payments for the use of the names of the members of the organization, and the rental of the mailing list and licensing of the logo of the organization to the credit card company constituted UBTI (TAM 9321005).

**Insurance Programs**

Many tax-exempt organizations raise money for their exempt functions by providing insurance services to their members. Some organizations merely endorse a program offered to their members, while others negotiate premium amounts and process insurance claims. Compensation to the tax-exempt organization may take the form of a commission on insurance purchases or, sometimes, "experience" dividends paid if the insurance company pays fewer claims than anticipated.

**IRS Interpretations**

The IRS has issued several rulings dealing with the issue of whether payments received from insurance companies should be treated as taxable income. Factors which are normally considered by the IRS include:

- Whether the tax-exempt organization plays an active or passive role in administering or promoting the insurance programs.

- Whether the insurance-related activities further the organization's tax-exempt functions.
Whether organization members receive benefits from the insurance coverage as individuals (i.e., health insurance) or as group members (i.e., workers' compensation insurance).

**COURT DECISIONS**

*Active/Passive Involvement by Exempt Organizations*

**American Bar Endowment**

One case involving the taxable nature of income from insurance programs came before the U.S. Supreme Court. *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986), dealt with an exempt organization whose mission centered around the furtherance of legal research and justice administration. As a method of raising funds for this purpose, American Bar Endowment offered various types of group insurance (health, life, disability, etc.) to members.

Although the policies were underwritten by outside parties, American Bar Endowment performed administrative services which included:

- Negotiating insurance premiums.
- Keeping files on covered individuals.
- Paying premiums to insurance companies providing coverage.
- Advising policyholders about their insurance coverage.

The Supreme Court ruled that American Bar Endowment was actively involved in carrying on an insurance-related business. Consequently, the court stated that "experience" dividend payments made to American Bar Endowment by the insurance companies were unrelated business taxable income.

**Oklahoma Cattleman's Association**

By contrast, in *Oklahoma Cattleman's Assoc. v. U.S.*, 310 F. Supp. 320 (W.D. Okla. 1969), overruled by *U.S. v. American Bar Endowment*, above, the District Court held that the association's income from its dealings with an insurance program was not subject to unrelated business income tax.

The association had performed services, such as:

- Providing member names and addresses to the insurance company.
- Writing and distributing one letter to members outlining the insurance coverage.
- Agreeing to the use of its name, etc., on literature used to promote and describe the program.
Although the association had some involvement in negotiating premium rates, the District Court held that making sure members were provided coverage at "economic rates" was not inconsistent with the association’s exempt function.

**Unrelated/Related Activities by Exempt Organizations**

**Associated Master Barbers and Beauticians**

In *Associated Master Barbers and Beauticians of America, Inc., v. Commissioner*, 69 T.C. 53 (1977), the organization's tax-exempt status was revoked due to the nature of insurance services it offered members. Among the services offered were claims processing and maintenance of self-insurance programs for members denied coverage by the organization's group plan.

**California Farm Bureau Federation**

Conversely, a U.S. District Court in California ruled that a farm bureau's involvement in a workers' compensation program did not constitute unrelated activity. The decision in *California Farm Bureau Federation v. U.S.*, 91-1 USTC ¶50300 (E.D. Ca. 1991), noted that the farm community as a group benefitted from the existence of the workers' compensation program. Such benefits were found to be consistent with the bureau's overall mission as set forth in its articles and bylaws.

**Nature of Benefits Received—Individuals v. Membership as a Whole**

**Louisiana Credit Union League**

The Fifth Circuit Court of Appeals in Louisiana heard a case concerning taxable treatment for the insurance-related income of an exempt business league [*Louisiana Credit Union League v. U.S.*, 693 F.2d 525 (5th Cir. 1982)]. Although the league had provided a variety of administrative services to the insurance program, including clerical support for its billing process, the court cited other reasons for rejecting its claims. Specifically, the court ruled that the league's insurance services constituted unrelated business activity because insurance benefits were granted to members as individuals rather than as part of a collective group. The court held that obtaining such benefits for members was not part of the league's exempt purpose and, as a result, all the insurance income was subject to tax.

**California Farm Bureau**

*California Farm Bureau Federation v. U.S.*, above, provides an example of insurance benefits inuring to members as a collective. Witnesses in this case testified that the bureau's activities relating to workers' compensation provided insurance coverage for the farm community, contributing to its overall sense of well-being.
Texas Farm Bureau

Payments received by a farm bureau from two affiliated insurance companies were held to constitute unrelated business taxable income and did not qualify as excludable royalties (Texas Farm Bureau v. U.S., CA 5, No. 94-50034, 6/1/95). The court found that the organization received the payments for endorsement and administrative services, not for the use of its name. It also ruled that the insurance business was not substantially related to the organization's exempt agricultural purposes under §501(c)(5).

TRAVEL TOURS

Several recent rulings have involved exempt organizations providing travel tours for their members. Most of these rulings addressed the issue of whether the tours are educational as opposed to recreational. Income from educational tours which further the organization's exempt purpose is nontaxable. Income from tours found to be recreational or otherwise separate from the organization's exempt purpose is taxable.

In discussions regarding these rulings, the IRS has relied on the definition of "educational" found in §501(c)(3), namely, "the instruction or training of an individual for the purpose of improving or developing his capabilities."

One such ruling dealt with an organization offering sea cruises to churches (Rev. Rul. 77-366, 1977-2 C.B. 192). The organization claimed its mission was to educate church members and their families and also provide them an opportunity for spiritual renewal. It purported to accomplish these goals by providing winter cruises where educational tours were conducted aboard ship. Upon reviewing this case, the IRS discovered attendance at these tours was not mandatory and that the tours were conducted for only four hours of a nine-day cruise. Not surprisingly, the IRS ruled against the organization.

A tour program which was considered educational by the IRS was given by an organization created to promote intercultural understanding. This organization's sole purpose was the development and administration of travel study programs to locations such as national parks and foreign countries. The tours, which were directed by state-certified individuals, required that five to six hours each day be devoted to organized study programs. Students were given school credit for these tours provided they passed a written exam. Income from these tours was found by the IRS to be nontaxable under §501(c)(3).³

A CPA’S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

Conditions

In judging whether a given program is educational, the IRS looks to the following conditions:

- Formal educational program espousing a legitimate methodology.
- Organized study and lectures.
- Homework.
- Monitored student attendance.

CORPORATE SPONSORSHIPS

During the late 1960s, the IRS ruled that a tax-exempt organization whose mission was to provide general education could publicly acknowledge its corporate sponsors without forfeiting its tax-exempt status. Revenue Ruling 67-342, 1967-2 C.B. 187 dealt specifically with an organization's plan to credit its corporate sponsors at the beginning of various programming, without mentioning any products attributable to those sponsors. The IRS took the position that incidental benefits inuring to sponsors of such events was not subject to unrelated business income tax.

For the next decade, the IRS maintained the position in Revenue Ruling 67-342. However, a series of events in the late 1970s and early 1980s relating to the sale of the Cotton Bowl broadcast rights caused changes in the IRS position.

The events occurred as follows:

- The IRS informally advised the Cotton Bowl Athletic Association (CBAA) and four affiliated universities that revenue from the sale of the Cotton Bowl broadcast rights would be subject to unrelated business income tax.
- The IRS, reversing its earlier position, held that the revenue mentioned above was related to the exempt purposes of the CBAA.
- Following the CBAA decision, the IRS issued several public and private letter rulings.
  - Generally, these took the same position as in the CBAA decision.
  - Even so, the CBAA’s regional office in Dallas contacted the IRS seeking technical advice.

In response to the CBAA request, the IRS issued a Technical Advice Memorandum in 1991 (TAM 9147007) which addressed the tax treatment of corporate donor payments to exempt organizations. The TAM dealt primarily with the question of whether the organization was being compensated for services unrelated to its tax-exempt function which would give rise to taxable income.
Other considerations discussed were:

- Whether payments to the organization were the result of its participating in a trade or business.
  - The test commonly used was whether or not the organization intended to realize a profit.
- Whether the organization’s activities giving rise to the payments were "substantially related" and contributed to the organization’s exempt purpose.
- Whether the organization was engaging in a "regularly carried on" activity. Regulation §1.513-1(c)(2)(ii) defines this as one which is "systematically and consistently promoted and carried on by the organization."
- Whether payments received by the exempt organization would meet IRS standards for excludable royalty income.
  - This would require that the corporate sponsor pay only for the right to use a well-known name (such as the Cotton Bowl) and that the organization receive the funds without being expected to provide services to the corporate sponsor.

Understandably, TAM 9147007 was not well-received by exempt organizations. The IRS responded to the criticism by issuing Announcement 92-15, a listing of proposed examination guidelines which mirrored its positions from TAM 9147007.

Announcement 92-15 stated that:

- Sponsorship payments to an exempt entity were tax-free contributions only if the exempt entity was not expected to provide a "substantial benefit return" (i.e., services such as advertising or marketing).
  - Conferring honorary titles on corporate sponsors was allowed, however.
- The existence of certain conditions "tended to indicate" that an unrelated trade or business was being carried on.
  - Among these conditions were:
    - Use of the corporate sponsor's name in the special event’s title.
    - Any requirement that the exempt organization must gain media coverage in order to receive payment from a sponsor.
    - Mandatory endorsements or appearances for persons involved in the special event.
As a result of the unfavorable public response to TAM 9147007 and Announcement 92-15, Congress tried and failed to enact legislation providing relief to organizations receiving selected types of sponsorship payments. The IRS issued proposed regulations which amended its earlier positions.

The changes in the IRS's position included:

- Definitions of the term "advertising," differentiating between unrelated business advertising and acknowledgments (defined as "mere recognition of a sponsorship payment").

  - Examples of acknowledgment include:
    - Use of sponsor logos or catchphrases, as long as they do not describe the quality of the sponsor's products or contain information such as phone numbers (which would aid viewers in obtaining the sponsor's products).
    - General descriptions of the sponsor's products, without representations of their value.
    - Sponsor's brand or trade names.

- Conditions under which an exempt organization could offset unrelated business income from sponsorship payments with expenses of its exempt activity function.

**QUALIFIED SPONSORSHIP PAYMENTS**

The subject of "sponsorship payments" has been quite controversial over the past several years. As an outgrowth of this controversy, Congress felt it was appropriate to distinguish sponsorship payments where the donor receives no substantial return benefit, other than the use or acknowledgement of the donor's name or logo as part of a sponsored event, from payments received in exchange for advertising. The Taxpayer Relief Act of 1997 created a safe-harbor which provided that UBTI does not include the activity of soliciting and receiving "qualified sponsorship payments."

Section 513(i) defines "qualified sponsorship payment" as:

Any payment made by any person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgement of the name or logo of the sponsor's trade or business in connection with the activities of the organization that receives the payment. Such a use or acknowledgement does not include advertising such person's products or services (including messages containing qualitative or comparative language), price information, or other indications of savings of value, an endorsement, or an inducement to purchase, sell, or use such products or services."
CONTINGENT PAYMENTS

There is an exception for contingent payments. The term "qualified sponsorship payment" does not include any payment if the amount of the payment is going to be contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events. It may be possible to qualify the payment if the restrictions are limited to the event taking place or the broadcast occurring.

If the name, logo, or product is continually referred to in the organization's publications, it will be treated as advertising. If it is treated as advertising, it is taxed under those rules unless the material is related to, and primarily distributed in connection with, a specific event conducted by the organization. This would follow along the same lines as regularly carried-on advertising activities, which is covered in the section on unrelated activities.

It is possible for the sponsorship arrangement to be part of a fragmented arrangement allowing for both sponsorship and advertising under the same contract. As such, if a sponsorship payment is made whereby the sponsor gains both continuous advertising and provides for the use of a name, logo, etc., the portion over and above the fair market value of the advertising is not treated as UBTI. Additionally, the provision of facilities, services, or other privileges by the exempt organization to a sponsor that is in connection with a sponsorship payment does not affect the determination of whether the payment is to be treated as a "qualified sponsorship payment." Examples of some of these benefits might include complimentary tickets, tournament slots, or possibly a reception for a major contributor. The only time receipt of these items would constitute UBTI is if they are substantial or related to activity. Another closely watched fragmented activity involves licensing arrangements. A sponsor's receipt of a license to use an intangible asset such as a trademark, logo, etc. is separated out from the sponsorship arrangement. The royalty arrangement is judged on its own merit subject to the rules of §512(b)(2), while the sponsorship payment falls under the new §513(i).

It is important to note that the introduction of §513(i) is effective for payments solicited or received after December 31, 1997, and in no way affects years prior to 1998.
INTRODUCTION

After 1993, the lobbying rules changed drastically for most exempt organizations other than those covered by §501(c)(3). Because of these new rules, organizations other than those under §501(c)(3) must now inform their members how much of their dues are allocated to political activities. For the most part, these rules apply to exempt organizations that fall under §501(c)(6) and operate through boards of trade or trade associations. Dues paid to these exempt organizations are normally deductible under §162 as an ordinary and necessary expense of doing business. What these new lobbying rules mean is that a typical association member will be able to deduct only a portion of the dues paid. The complexity comes into play regarding the exception and the application of these rules.

Section 501(c)(3) public charities (other than churches and related religious organizations) remain under the old rules. These organizations have the option of electing an objective allocation rule rather than a subjective measure of value. The subjective rule, in its simplest form, says that an organization that is exempt under §501(c)(3) will lose its exemption if too much of its activities involve political or legislative action. Historically, very few such organizations took advantage of the election. In some cases, public charities did not understand the implication or impact of making the election. However, many organizations consciously made the decision not to make the election because they felt the required information was more than they wanted to have on hand. This changed somewhat in August 1990 when the final regulations regarding the election were issued. As a general rule, most charities will benefit by making the election.

The other type of exempt organization that must be concerned with lobbying is the §501(c)(3) private foundation. Section 4945 barred private foundations from incurring lobbying costs of any kind. However, additional regulations were issued in 1972 which defined lobbying activities for private foundations and listed several exceptions.

SECTION 501(h) ELECTION

SECTION 501(c)(3) ORGANIZATIONS

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

Section 501(h) permits certain eligible public charities to spend a portion of their funds identified as "exempt purpose expenditures" to influence legislation. Organizations exempt under §501(c)(3) can make this election if Form 5768 (Election/Revocation of Election by an Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation) has been filed with and accepted by the IRS. This form is reproduced on p. 124.

Eligibility Requirements

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

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

- Churches as defined by §170(b)(1)(A)(i).
- Integrated auxiliaries of churches, associations of churches, or conventions of churches.
- Members of affiliated groups comprised of other disqualified organizations.

**Lobbying Expenditures**

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

**Direct Lobbying**

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

**Grass-Roots Lobbying**

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

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

**Disclosures by Nonelecting Public Charities**

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

**Factors**

Some factors which may be considered by the IRS are:

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

Impact of the organization’s lobbying activities on public opinion or current legislation.

**Penalties for Exceeding Limitation**

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

- Loss of tax exemption.
- Revocation of ability to solicit contributions.
- An excise tax of 5% for all lobbying costs incurred.
- In some cases, a 5% tax for all lobbying costs on the organization's managers.

**Expenditure Limits.** Following are the lobbying limits for electing charities:

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

**Limitations on Expenditures for Grass-Roots Lobbying**

When an elective nonprofit spends more than one-quarter of allowable lobbying expenditures, it is subject to a 25% excise tax on excess expenditures. Flagrant violations of excess expenditures can result in the loss of tax exemption.
THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993

The Omnibus Budget Reconciliation Act of 1993 (the 1993 Act) denied the deduction of lobbying expenses paid or incurred by businesses and certain tax-exempt organizations after December 31, 1993. As a result, organizations affected by the enacted provision have faced many questions regarding administrative compliance with the 1993 Act. The following is a summary of recent regulations, rulings, and IRS hearings that have clarified the provision and the actions that should be taken by these organizations to comply with the act.

AFFECTED ORGANIZATIONS

The IRS has issued regulations that would apply the lobbying deduction disallowance to trade associations, social welfare organizations, agricultural and horticultural organizations, as well as to businesses. Other tax-exempt organizations, such as country clubs or labor unions, would not be subject to the disallowance.

Section 501(c)(3) organizations, including charitable, religious, educational, and scientific organizations, are exempt from the lobbying deduction disallowance. However, under the 1993 Act, a donor is disallowed a deduction for a contribution to a §501(c)(3) organization if that organization engages in lobbying that is of direct financial interest to the donor’s business, and a principal purpose of the donation is to avoid the lobbying deduction disallowance that would otherwise be applicable to the donor. The principal purpose of the donation is determined by the facts and circumstances of each case.

An organization is also exempt from the lobbying deduction disallowance rules if it can establish to the satisfaction of the IRS that substantially all dues paid by its members are not deductible under any IRC provision. An example of such an organization is provided in the Conference Committee Reports to the 1993 Act. It includes an organization that receives 90% or more of its donations from taxpayers who do not qualify for the trade or business deduction. It is anticipated that in order to qualify for this exemption, an organization will be required to survey its members.

DEFINING LOBBYING EXPENSES

The 1993 Act defined lobbying expenses including amounts paid or incurred in connection with any attempt to influence legislation through communication with:

- Any federal or state member or employee of a legislative body.

- Any federal or state government official or employee who may participate in the formulation of legislation.

  - Lobbying expense also includes any amount paid or incurred for research, preparation, planning, or coordination of these activities.
"Legislative Body" Clarified

The term "legislative body" does not include executive, judicial, or administrative bodies such as school boards, housing authorities, sewer and water districts, zoning boards, and other similar federal, state, or local special-purpose bodies.

The law that was in effect with respect to grass-roots lobbying and political campaign expenses prior to the 1993 Act still applies in that those expenses remain nondeductible whether incurred at the federal, state, or local level.

"Influencing Legislation" Defined

Final Reg. §1.162-29(b), issued July 1995, defines the term "influencing legislation," for purposes of the lobbying deduction disallowance, as any attempt to influence any legislation through communication (other than any communication compelled by subpoena or otherwise compelled by federal or state law) with:

- Any member or employee of a legislative body.
- Any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation which the taxpayer desires to influence.

"Lobbying Communication" Defined

The regulations provide that only activities engaged in for the purpose of making or supporting a lobbying communication are to be treated as a lobbying activity. A lobbying communication is defined as a communication that either refers to specific legislation and reflects a view on that legislation or clarifies, amplifies, modifies, or provides support for views that are reflected in a prior lobbying communication.

Example 4-1:

- Taxpayer P’s employee, X, is assigned to approach members of Congress to gain their support for a pending bill.
- X drafts and P prints a position letter on the bill.
  - P distributes the letter to members of Congress.
- Additionally, X personally contacts several members of Congress or their staffs to seek support for P’s position on the bill.

Discussion:

- The letter and the personal contacts are lobbying communications.
  - Therefore, P is influencing legislation.
Example 4-2:

- State X enacts a statute requiring the licensing of all day-care providers.
- Agency B in State X is charged with writing rules to implement the statute.
- After the enactment of the statute, Taxpayer S sends a letter to Agency B providing detailed proposed rules S recommends Agency B adopt to implement the statute.

Discussion:
- Because the letter to Agency B neither refers to nor reflects a view on any specific legislation, it is not a lobbying communication.
  - Therefore, S is not influencing legislation.

Example 4-3:

- Taxpayer W, based in State A, notes in a letter to a legislator of State A that State N has passed a bill that accomplishes a stated purpose.
  - Taxpayer W then says that State A should pass such a bill.
- No such bill has been introduced in the State A legislature.

Discussion:
- The communication is a lobbying communication because it refers to and reflects a view on a specific legislative proposal that W supports.
  - Therefore, W is influencing legislation.

"Purpose-Based" Rule

Originally, it was anticipated that a "lookback" rule would be established whereby lobbying activities would be identified solely by "looking back" from the lobbying communication to those activities which supported it. Numerous businesses and tax-exempt organizations, however, expressed concern at an IRS hearing on April 6, 1994, that the administrative burdens associated with the "lookback" rule would be arduous. As a result, the IRS established the "purpose-based" rule.
Presumptions

To protect against taxpayers attempting to abuse the intent of the purpose-based rule by labelling their lobbying activities as "mere monitoring," the proposed regulations provide rebuttable presumptions regarding the taxpayer's purpose for engaging in certain activities:

1. Activity relating to a lobbying communication engaged in for a nonlobbying purpose prior to the first taxable year preceding the taxable year in which the lobbying communication is made is presumed to be an activity engaged in for all periods solely for that nonlobbying purpose.

2. Activity relating to a lobbying communication engaged in during the same taxable year as the communication is made or in the immediately preceding taxable year is presumed to be engaged in for the sole purpose of making or supporting that communication.

3. Activities engaged in for the purpose of complying with the requirements of any law, reading any general circulation publications, or viewing or listening to other mass media communications available to the general public are presumed to be activities engaged in without the purpose of making or supporting a lobbying communication.

Example 4-4:

- In 1997, Agency F issues proposed regulations relating to the business of Taxpayer W, a calendar-year taxpayer.
  - There is no specific legislation during 1997 that is similar to the regulatory proposal.
- W undertakes a study of the impact of the proposed regulations on its business.
  - W incorporates the results of that study in comments sent to Agency F in 1997.
- In 1998, legislation is introduced in Congress similar to the regulatory proposal.
  - W writes a letter to Senator P stating that it opposes the proposed legislation.
- With the letter, W encloses a copy of the comments it sent to Agency F.

Discussion:

- W's letter to Senator P refers to and reflects a view on specific legislation and therefore is a lobbying communication.

(continued)
Example 4-4: (continued)

- Because W used the results of its study of the impact of the proposed regulations in its letter to Senator P in the taxable year following the taxable year the study was conducted, it is presumed that W engaged in the study for the sole purpose of making or supporting that lobbying communication.

- Based on these facts, however, W can rebut the presumption entirely by showing that its sole purpose for undertaking the study was to comment on the proposed regulations.

Paid Volunteers

A special rule was established in the proposed regulations for "paid volunteers." The rule states that if a taxpayer uses the services or facilities of a second taxpayer for the purpose of making or supporting a lobbying communication and does not compensate the second taxpayer for the full cost of the services or facilities, the purpose and the actions of the first taxpayer are imputed to the second taxpayer [Reg. §1.162-29(d)].

Substantial Purpose Test

The regulations indicate that an activity engaged in for both lobbying and nonlobbying purposes is to be treated as engaged in partially for a lobbying purpose and partially for a nonlobbying purpose [Reg. §1.162-29(c)(2)]. The IRS did not adopt the principal/primary purpose test suggested by commentators at the hearing on April 6, 1994, that would treat the activity as being engaged in solely for lobbying or solely for nonlobbying purposes because:

- The IRS believed results would differ dramatically depending on individual views about which of the purposes was dominant.

- The IRS had serious doubts whether a principal/primary purpose test could be administered responsibly and fairly.

- The IRS also considered adopting a substantial purpose test with respect to distinguishing an activity as being engaged in for lobbying or nonlobbying purposes.

  - It was believed a substantial purpose test would be easier to administer than a principal/primary purpose test.
However, the IRS was concerned that the substantial purpose test would be overinclusive in that some activities engaged in predominantly for nonlobbying purposes would be treated entirely as nondeductible lobbying activities. The IRS has invited comments on whether a substantial purpose test would be more appropriate than the rule established in the proposed regulations.

METHODS OF COST ALLOCATION

Regulation §1.162-28, regarding allocation of costs to lobbying activities, describes the costs properly allocable to lobbying activities and permits taxpayers to use any reasonable method to allocate the costs between lobbying activities and other activities.

COST ALLOCABLE TO LOBBYING ACTIVITIES

In general, costs properly allocable to lobbying activities include labor costs of full-time, part-time, and contract employees and general and administrative costs.

Labor Costs

Labor costs are defined as including all elements of compensation, such as:

- Basic compensation,
- Overtime pay,
- Vacation pay,
- Holiday pay,
- Sick leave pay,
- Payroll taxes,
- Pension costs,
- Employee benefits, and
- Payments to a supplemental unemployment benefit plan.
General/Administrative Costs

General and administrative costs include:

- Depreciation,
- Rent,
- Utilities,
- Insurance,
- Maintenance costs,
- Security costs, and
- Other administrative department costs, such as:
  - Payroll,
  - Personnel, and
  - Accounting.

Reg. §1.162-28(b)(1) indicates that in order for a method to be considered reasonable it must:

- Be applied consistently,
- Allocate a proper amount of costs (including labor costs and general and administrative costs) to lobbying activities, and
- Be consistent with special rules specified in the regulations.

Specific Methods

The proposed regulations specify three methods of allocating costs to lobbying activities including:

- Ratio method.
- Gross-up method.
- Method applying the principles of §263A and the regulations thereunder.
The ratio method and the gross-up method allow taxpayers to avoid tracking certain overhead expenses because they generally require taxpayers to capture only labor costs. However, neither the ratio method nor the gross-up method can be used by partnerships or sole proprietorships whose lobbying activities are performed by owners who do not receive salaries or other guaranteed payments for services.

**Ratio Method**

Under the ratio method [Reg. §1.162-28(d)(1)], taxpayers use the following formula to allocate costs to lobbying activities:

\[
\frac{LLH}{TLH} \times TCO + TPC = \text{Costs Allocable to Lobbying Activities}
\]

**Lobbying Labor Hours**

Lobbying labor hours are defined in Reg. §1.162-28(d)(2) as hours a taxpayer's personnel spend on lobbying activities during the taxable year. Taxpayers using the ratio method may treat as zero the hours spent by personnel engaged in secretarial, maintenance, and other similar activities. In doing so, they must treat these activities as zero in determining both lobbying labor hours and total labor hours. The costs for these employees, however, would have to be included in the total costs of operations.

**Total Labor Hours**

Total labor hours, as defined in Reg. §1.162-28(d)(3), include the total number of hours of labor a taxpayer's personnel spend on the taxpayer's trade or business during the taxable year. In determining this number, a taxpayer may make reasonable assumptions concerning total hours worked by its personnel during the year. The assumptions made should be based on all the facts and circumstances.

For example:

- It may be reasonable to assume that all full-time personnel spend 1,800 hours per year on a taxpayer's trade or business.

**Total Costs of Operations**

Total costs of operations [Reg. §1.162-28(d)(4)] is defined as the total costs of the taxpayer's trade or business for a taxable year, excluding third-party costs.
Third-Party Costs

Third-party costs [Reg. §1.162-28(d)(5)] include amounts paid or incurred for lobbying activities carried on by third parties, such as:

- Amounts paid to individuals in the trade or business of lobbying,
- Nondeductible dues paid to trade associations, and
- Amounts paid for travel and entertainment relating to lobbying activities.

The following example taken from the proposed regulations shows the relationship between the components of the formula for the ratio method.

Example 4-5:

- In 1998, three full-time employees, B, C, and D, of Taxpayer W engaged in both lobbying activities and nonlobbying activities.
- B spent 300 hours, C spent 1,700 hours, and D spent 1,000 hours on lobbying activities, for a total of 3,000 hours spent on lobbying activities for W.
- W reasonably assumes that each of its three employees spends 2,000 hours a year on W's business.
- Taxpayer W's total costs of operations are $300,000.
  - W has no third-party costs.
- Under the ratio method, $150,000 is properly allocable to W's lobbying activities for 1998 as follows:

  \[
  \text{Costs Allocable to Lobbying Activities} = \left(\frac{LLH}{TLH}\right) \times \text{TCO} + \text{TPC}
  \]

  \[
  \frac{(300 + 1,700 + 1,000)}{6,000} \times$300,000 + (0) = $150,000
  \]

Gross-Up Method

Under the gross-up method [Reg. §1.162-28(e)(1)], taxpayers use the following formula to allocate costs to lobbying activities:

\[(\text{Basic Labor Costs} \times 175\%) + \text{Third-Party Costs} = \text{Costs Allocable}\]
Basic Labor Costs

Basic labor costs, under Reg. §1.162-28(e)(2), are defined as the basic costs of lobbying labor hours, except that a taxpayer may not treat as zero the lobbying labor hours of personnel who engage in secretarial, maintenance, and other similar activities if they engage in lobbying activities. Basic costs of labor include wages, guaranteed payments for services, and similar costs of labor, but do not include costs such as pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan costs.

In-House Expenditures

The lobbying deduction disallowance does not apply to any in-house expenditures for any tax year if the expenditures do not exceed $2,000. In-house expenditures include amounts paid or incurred with respect to influencing legislation or direct communications with a covered executive branch official in an attempt to influence the official’s actions or positions. They do not include payments made to professional lobbyists and dues or similar amounts that are paid or incurred by the taxpayer which are allocable to lobbying activities.

A special rule under Reg. §1.162-28(g)(1) allows a taxpayer to treat time spent by personnel on lobbying activities as zero if less than 5% of the person’s time is spent on lobbying activities. However, this de minimis rule for labor hours does not apply to direct-contact lobbying with legislators and covered executive branch officials.

The gross-up method can best be illustrated with the following example:

Example 4-6:

- In 1998, three employees, E, F, and G, of Taxpayer X engaged in both lobbying activities and nonlobbying activities.
- E spent 300 hours, F spent 1,700 hours, and G spent 1,000 hours on lobbying activities.
- Taxpayer X has no third-party costs.
- For purposes of the gross-up method, X determines that its basic labor costs are $20 per hour for E, $30 per hour for F, and $25 per hour for G.
- Thus, its basic labor costs are:

\[
($20 \times 300) + ($30 \times 1,700) + ($25 \times 1,000) = 82,000
\]
Example 4-6: continued

Under the gross-up method, $143,500 is properly allocable to X's lobbying activities for 1998 as follows:

\[ 175\% \times \text{Labor Costs Allocable to Lobbying Activities} + \text{Third-Party Costs} = \text{Costs Allocable to Lobbying Activities}, \text{or} \]

\[ [175\% \times \$82,000] + (0) = \$143,500 \]

The final regulations allow under the "alternative gross-up method" for a taxpayer to allocate to lobbying activities the sum of its third-party cost allocable to lobbying labor activities and 225% of its basic lobby labor costs. This is excluding the cost of personnel who engage in secretarial, clerical, support, and other administrative activities.

In this case, basic lobbying labor costs are the basic costs of lobbying labor hours determined for the appropriate personnel. Basic cost of lobbying labor hours are wages or other similar costs of labor including, for example, guaranteed payments for services. Basic costs do not include pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan costs or other similar costs.

**Uniform Capitalization Allocation Method**

While conceptually more difficult, if a taxpayer would use the uniform capitalization method, cost would be determined through the principles established in §263A and related regulations. Few, if any, associations use the uniform capitalization rules.

**Lobbying Expense Deduction**

**Dues**

Non-501(c)(3) exempt organizations are required to notify taxpayers regarding a reasonable estimate of the portion of their dues that are allocable to lobbying expenses and that will be nondeductible for the coming year. In drafting the provision, Congress assumed that these organizations pay for lobbying expenses using dues-income only. Therefore, Congress drafted the provision declaring the nondeductibility percentage was to be determined by comparing the organization's total dues-income with its total "lobbying expenditures."
Example 4-7:

- An association deriving 50% of its income from dues and with 10% of its expenses allocable to lobbying activities must notify its members that 20% of the dues are nondeductible.

The notice the organization sends its members can be made either at the time of the assessment or at the time of the payment of the dues. It can appear on the organization's dues bills (or membership application forms that serve as dues bills), receipts for dues payments, or on some separate notice form if issued at the time of the dues assessment or payment.

If an organization's actual lobbying expenditures for the year exceed its dues income, the excess lobbying expenditures are carried forward to be allocated to future dues income, thereby affecting members' dues deductibility during the following year. If the organization does not adjust the following year's estimated dues nondeductibility notice, it must pay a penalty tax on the excess lobbying expenditures at the highest corporate income tax rate, currently 35 percent.

Proxy Tax

If the organization responsible for the notification of the dues allocation elects not to provide the members with the necessary information or fails to include the information as to allocable lobbying expenditures (determined on the basis of actual amounts rather than on a reasonable estimate), a tax will be imposed on the organization at the highest corporate tax rate. This tax applies to the aggregate amount of expenditures not included in the notice due to either an election not to include or an underreporting of such amounts. If an organization's actual lobbying and political expenditures for a tax year exceed the estimated allocable amount of the expenditure, then the organization is required to pay a proxy tax on the excess amount. This can come about in one of two ways:

- Because of higher than anticipated expenditures, or
- Lower than projected dues.

According to the Conference Report [Conf. Rept. No. 103-213 (PL 103-66) pp. 608-609], if the amount of lobbying expenditures exceeds the amount of dues or other similar payments for the tax year, the proxy tax is imposed on an amount equal to the dues or similar payments and any excess lobbying expenditures are carried forward to the next tax year.

In most cases, the estimate of expenditures must be more than a casual guess in relation to the proxy tax. Normally, organizations are required to report the portion of dues or other similar amounts allocable to nondeductible lobbying expenses based on reasonable estimates. However, the proxy tax will be imposed if the reasonable estimate falls short for any reason.
Example 4-8:

- Organization X receives $100,000 in dues in Year 1. X spends $150,000 on lobbying and elects to pay the proxy tax rather than provide flow-through disclosure to members. The proxy tax for Year 1 would be imposed on $100,000 of lobbying expenditures. The remaining $50,000 of lobbying expenditures would be carried forward to the next year, during which X could comply with the disclosure requirements or elect to pay the proxy tax on that amount, as well as any additional lobbying expenditures incurred during that year.

Section 6033(e)(2)(B) provides an out. The IRS is authorized to waive the tax for any tax year if the organization agrees to adjust its estimate for the following tax year to correct the underreporting from the year before. When imposed, the tax is treated as an income tax and, as such, is not deductible.

Note: The proxy tax is in addition to any other charge or tax that may apply, such as the penalty for failure to file an annual return [Conf. Rept. No. 103-213 (PL 103-66) p. 609].

As noted in Internal Revenue Notice 93-55, 1993-2 CB 339, these rules apply to any dues received or assessed for organizations other than those under §501(c)(3). This includes dues assessed or received prior to January 1, 1994, to the extent that the dues are allocable to lobbying and political expenditures that are paid or incurred by the organization after December 31, 1993.

In addition to the nonapplication of these rules to organizations under §501(c)(3), the IRS, in Announcement 94-8 (1994-3 I.R.B. 33), published for comment a proposed revenue procedure describing where, under certain circumstances, other classifications of exempt organizations may obtain relief from these rules. According to the announcement, circumstances were described under which various types of organizations could be treated as if they had met the requirements of §6033(e)(3) which allows the organization not to report or provide notice as discussed in §6033(e)(1). This exception applies to the proxy tax as well. This is discussed above and in §6033(e)(2). In the announcement, the IRS proposed to grant a blanket exemption from the reporting and notice requirements and the proxy tax for all §501(c) organizations except for §501(c)(4) social welfare organizations, §501(c)(5) agricultural and horticultural organizations, and §501(c)(6) trade associations. As such, in addition to the statutory exemption for §501(c)(3) charities, the IRS would administratively exempt other types of organizations, such as labor unions or veterans' organizations.

Even though social welfare organizations, agricultural and horticultural organizations, and trade associations would remain subject to the §6033(e) rules, the IRS proposed to grant these organizations relief as long as they met certain conditions. These types of organizations would be exempt from the reporting and notice requirements and the proxy tax if:

- The largest amount of annual dues and similar amounts (including assessments and voluntary payments) paid by any member is $50 or less.
- More than 90% of the members are §501(c)(3) organizations.
The $50 dues limitation could be exceeded if all the dues paid by the organization’s members, who pay dues of more than $50, pay, in the aggregate, no more than 10% of all membership dues and similar payments.

The largest class to be affected are those organizations under §501(c)(6). This most likely accounts for the fact that the exemption rules for §501(c)(6) are much stricter. Organizations falling under this section will be exempt from the reporting and notice requirements and the proxy tax only where 90% or more of their members were §501(c)(3) charities. Such organizations have an advantage of being able to charge dues in excess of $50 as long as they meet the 90% membership test.

According to the proposed revenue procedure, any such organization that meets the above requirements would be automatically exempt and not be required to seek the IRS determination of status under §6033(e)(3). In cases where the associations did not meet the stated requirements, it could still request a private letter ruling to the effect that it qualifies under §6033(e)(3) because 90% of the dues paid to it are not deductible without regard to §162(e).

**MAKING THE ELECTION**

To some degree, the election is a matter of default. It is initially made by not sending the required notices to members. In addition, the organization needs to answer "yes" to Question 85(g) on Form 990. The tax is paid with Form 990-T.

In addition to paying the tax, the organization might elect to increase the subsequent year’s estimate of nondeductible dues reported to members.

**RECORD-KEEPING REQUIREMENTS**

The proposed regulations contain no requirement that daily time reports or logs be maintained. However, to determine the labor hours that a taxpayer’s employees spend on lobbying during the year, it appears evident that time sheets or other records of how an employee’s time is spent should be kept. Many taxpayers are tracking their lobbying labor costs by modifying their existing travel and entertainment reports or by creating new reports to be submitted by employees on a periodic basis. The reports include items, such as the number of hours or percentage of time devoted to lobbying and, where appropriate, out-of-pocket lobbying expenses.

**LOBBYING DISCLOSURE ACT OF 1995**

The Lobbying Disclosure Act of 1995 (P.L. 104-65) (the "Act") took effect on January 1, 1996. The Act significantly overhauled the framework covering lobbying registration and reporting. These changes were brought about to provide the public with information on who is lobbying on what issues. As a result of the Act, a significant increase is expected in the number of registered lobbyists and the amount of information that they must disclose.
LOBBYIST

As it applies to tax-exempt organizations, the Act defines a "lobbyist" as any individual who is employed or retained by an organization for compensation for services that include more than one lobbying contract. This applies to individuals who spend at least 20% of their time lobbying on behalf of the organization they either work for or represent and is measured over a six-month period of time.

Even though associations by themselves are not considered lobbyist, if they have one or more employees who lobby for the organization, they are required to file a single registration for the benefit of the individuals who are handling the activity on the organization's behalf.

There are several exceptions to the above rules. An organization whose total income from matters related to lobbying activities on behalf of the organization neither exceeds nor is expected to exceed $5,000 is exempt from the registration requirements. In addition, there is also an exception where total expenses in connection with the lobbying activity do not exceed $20,000. For this exception to apply, the organization must be engaged in lobbying activities on its own behalf. Again, the lookback period is for six months.

The Act defines a "lobbying contact" as any oral or written communication to a "covered" executive branch official or a "covered" legislative branch official that is made on behalf of the organization and is in regards to:

- The formulation, modification, or adoption of federal legislation (including proposals);
- The formulation, modification, or adoption of a federal rule, regulation, Executive order, or any other program, policy, or position of the U.S. government;
- The administration or execution of a federal program or policy (including the negotiation, award, or administration of a federal contract, grant, loan, permit, or license); or
- The nomination or confirmation of a person for a position subject to confirmation by the Senate.

LOBBY ACTIVITY

The Act provides for an extensive list of exceptions to a "lobbying contact" that includes communication that is:

- Made by a public official acting in the public official's official capacity;
- Made by a representative of a media organization if the purpose of the communication is gathering and disseminating news and information to the public;
- Made in a speech, article, publication or other material that is distributed and made available to the public, or through radio, television, cable television, or other medium of mass communication;
• A request for a meeting, a request for the status of an action, or any other similar administrative request, if the request does not include an attempt to influence a covered executive branch official or a covered legislative branch official;

• Testimony given before a committee, subcommittee, or task force of the Congress, or submitted for inclusion in the public record of a hearing conducted by such committee, subcommittee, or task force;

• Information provided in writing in response to an oral or written request by a covered sector for specific information;

• Required by subpoena, civil investigative demand, or otherwise compelled by statute, regulation, or other action; and

• Made to an official in an agency with regard to a judicial proceeding, filing required by statute or required by written agency procedures.

The registration rules for exempt organizations are quite strict. Within 45 days after the lobbyist first makes a "lobbying contact" or is employed to make a lobbying contact, the lobbyist or in some cases the organization is required to register with the Secretary of the Senate and the Clerk of the House of Representatives.

In regard to the actual registrations, each of the registrations submitted under the Act must contain the name, address, business telephone number and principal place of business of either the registrant, the registrant's client or any other involved parties (including a description of their business).

These requirements pertain to any of the above who contribute more than $10,000 toward the lobbying activities of the registrant in a six-month period. These requirements also pertain to any party that plans, supervises or controls the aforementioned lobbying activity. In addition to the above, the registration must include the name, address, principal place of business, amount of any contribution of more than $10,000 to the lobbying activities of the registrant and approximate percentage of equitable ownership in the organization of any foreign entity that:

• Holds at least 20% equitable ownership in the client;

• Directly or indirectly, plans, supervises, controls, directs, finances, or subsidizes the activities of the organization; or

• Is an affiliate of the organization and has a direct interest in the outcome of the lobbying activity.

The registration must also include the name of each employee of the registrant who has either acted or is expected to act as a lobbyist on behalf of the organization. There is one final catch. If the lobbyist has served in either the covered Executive or legislative branches within the prior two years, they must disclose in the registration what position was held.
REPORTING GUIDELINES

In the event that a lobbyist is assisting multiple organizations, it will be necessary to file a separate registration for each nonprofit. However, if a lobbyist is initiating multiple contacts for the same organization, then only one registration is necessary.

In addition to the initial registration, all organizations that make use of a lobbyist must file a report every six months. The report is due no later than 45 days after the end of the semiannual period beginning on the first day of January and the first day of July. Each of the reports should contain the names of the organization’s lobbyist (or employee), any changes to the information in the lobbying registration, certain information about each general issue area in which lobbying occurred during the six-month reporting period and a reasonable estimate of related lobbying expenditures.

For the purpose of the semiannual report, estimates of income and expenses in excess of $10,000 are rounded to the nearest $20,000. In the event they do not exceed $10,000, the registrant should include a statement that income or expenses totaled less than $10,000 for the reporting period.

One final note of warning. If a defective report is filed, the registrant has 60 days to correct the report. In the event the report is not corrected, the registrant may be subject to a penalty of not more than $50,000, depending on the gravity of the violation.

REPORTING OF TAXES ON LOBBYING AND POLITICAL EXPENDITURES

Except to the extent that the §4955 tax wasn’t required to be paid, or was credited or refunded, under the §4962 abatement rule, §501(c)(3) organizations, subject to exceptions, must annually report the respective amounts of any:

... taxes under Sec. 4911, Sec. 4912, and Sec. 4955 imposed during the tax year on the organization or any organization manager of the organization, and

... reimbursements that the organization paid during the tax year with respect to any of those taxes that were imposed on any organization manager of the organization. (Sec. 6033(b)(10) as amended by the Taxpayer Relief Act of 1997 §1603(b)(1))

[Form 990—Schedule A—Parts VI-A & VI-B appears on pages 120–123]
### Lobbying Expenditures by Electing Public Charities

(See page 6 of the instructions.
(To be completed ONLY by an eligible organization that filed Form 5768)

Check here ▶ a if the organization belongs to an affiliated group.
Check here ▶ b if you checked "a" above and "limited control" provisions apply.

#### Limits on Lobbying Expenditures

(The term "expenditures" means amounts paid or incurred.)

<table>
<thead>
<tr>
<th>a) Affiliated group totals</th>
<th>b) To be completed for ALL electing organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>36 Total lobbying expenditures to influence public opinion (grassroots lobbying)</td>
<td>36</td>
</tr>
<tr>
<td>37 Total lobbying expenditures to influence a legislative body (direct lobbying)</td>
<td>37</td>
</tr>
<tr>
<td>38 Total lobbying expenditures (add lines 36 and 37)</td>
<td>38</td>
</tr>
<tr>
<td>39 Other exempt purpose expenditures</td>
<td>39</td>
</tr>
<tr>
<td>40 Total exempt purpose expenditures (add lines 38 and 39)</td>
<td>40</td>
</tr>
<tr>
<td>41 Lobbying nontaxable amount. Enter the amount from the following table—</td>
<td></td>
</tr>
<tr>
<td>If the amount on line 40 is—</td>
<td>The lobbying nontaxable amount is—</td>
</tr>
<tr>
<td>Not over $500,000</td>
<td>.20% of the amount on line 40.</td>
</tr>
<tr>
<td>Over $500,000 but not over $1,000,000</td>
<td>$.100,000 plus 15% of the excess over $500,000.</td>
</tr>
<tr>
<td>Over $1,000,000 but not over $1,500,000</td>
<td>$.175,000 plus 10% of the excess over $1,000,000.</td>
</tr>
<tr>
<td>Over $1,500,000 but not over $17,000,000</td>
<td>$.225,000 plus 5% of the excess over $1,500,000.</td>
</tr>
<tr>
<td>Over $17,000,000</td>
<td>$.1,000,000</td>
</tr>
<tr>
<td>42 Grassroots nontaxable amount (enter 25% of line 41)</td>
<td>42</td>
</tr>
<tr>
<td>43 Subtract line 42 from line 36. Enter -0- if line 42 is more than line 36</td>
<td>43</td>
</tr>
<tr>
<td>44 Subtract line 41 from line 36. Enter -0- if line 41 is more than line 38</td>
<td>44</td>
</tr>
</tbody>
</table>

Caution: If there is an amount on either line 43 or line 44, you must file Form 4720.

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#### 4-Year Averaging Period Under Section 501(h)

(Some organizations that made a section 501(h) election do not have to complete all of the five columns below.
See the instructions for lines 45 through 50 on page 7 of the instructions.)

<table>
<thead>
<tr>
<th>Calendar year (or fiscal year beginning in) ▶</th>
<th>(a) 1999</th>
<th>(b) 1998</th>
<th>(c) 1997</th>
<th>(d) 1996</th>
<th>(e) Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>45 Lobbying nontaxable amount.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>46 Lobbying ceiling amount (150% of line 45(e))</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>47 Total lobbying expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>48 Grassroots nontaxable amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>49 Grassroots ceiling amount (150% of line 48(e))</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50 Grassroots lobbying expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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#### Lobbying Activity by Nonelecting Public Charities

(For reporting only by organizations that did not complete Part VI-A) (See page 8 of the instructions.)

During the year, did the organization attempt to influence national, state or local legislation, including any attempt to influence public opinion on a legislative matter or referendum, through the use of:

a Volunteers.  
b Paid staff or management (include compensation in expenses reported on lines c through h).  
c Media advertisements.  
d Mailings to members, legislators, or the public.  
e Publications, or published or broadcast statements.  
f Grants to other organizations for lobbying purposes.  
g Direct contact with legislators, their staffs, government officials, or a legislative body.  
h Rallies, demonstrations, seminars, conventions, speeches, lectures, or any other means.  
i Total lobbying expenditures (add lines c through h).  

If "Yes" to any of the above, also attach a statement giving a detailed description of the lobbying activities.
national or international amateur sports competition (not including providing athletic facilities or equipment, other than by qualified amateur sports organizations described in section 501(h)(2)).

2. The allocable portion of administrative expenses paid or incurred for the above purposes.

3. Amounts paid or incurred to try to influence legislation, whether or not for the purposes described in 1 above.

4. Allowance for depreciation or amortization, and

5. Fundraising expenditures, except that exempt purpose expenditures do not include amounts paid to or incurred for either the organization's lobbying unit or other organizations, if the amounts are primarily for fundraising.

See also Regulations section 56.4911-4(c) for a discussion of excluded expenditures.

Lobbying expenditures. The term "lobbying expenditures" means expenditures paid or incurred for the purpose of attempting to influence legislation.

- Through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation, and

- By attempting to affect the opinions of the general public.

To determine if an organization has spent excessive amounts on lobbying, you must know which expenditures are lobbying expenditures and which are not lobbying expenditures. An electing public charity's lobbying expenditures for a year are the sum of its expenditures during that year for (1) direct lobbying communications ("direct lobbying expenditures") plus (2) grassroots lobbying communications ("grassroots expenditures").

Direct lobbying communications ("direct lobbying expenditures") for a direct lobbying communication is any attempt to influence any legislation through communication with:

- Any member or employee of a legislative body, or

- Any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation, but only if the principal purpose of the communication is to influence legislation.

A communication with a legislator or government official will be treated as a direct lobbying communication, if, but only if, the communication:

- Refers to specific legislation, and

- Reflects a view on such legislation.

Grassroots lobbying communications ("grassroots expenditures"). A grassroots lobbying communication is any attempt to influence any legislation through an attempt to affect the opinions of the general public or any part of the general public.

A communication is generally not a grassroots lobbying communication unless (in addition to referring to specific legislation and reflecting a view on that legislation) it encourages recipients to take action about the specific legislation.

A communication encourages a recipient to take action when it: (1) states that the recipient should contact legislators; (2) states a legislator's address, phone number, etc.; (3) provides a preprinted, tear-off postcard, or similar material for the recipient to send to a legislator; or (4) specifically identifies one or more legislators who will vote on the legislation as opposing the communication's view on the legislation, being undecided about the legislation, being the recipient's representative in the legislature, or being a member of the legislative committee that will consider the legislation.

Also, a communication described in (4) above generally is grassroots lobbying only if, in addition to referring to and reflecting a view on specific legislation, it is a communication that cannot meet the "full and fair exposition" test as nonpartisan analysis, study, or research.

Communication with members. For purposes of section 4911, expenditures for certain communications between an organization and its members are treated more leniently than are communications to nonmembers. Expenditures for a communication that refers to, and reflects a view on, specific legislation are not lobbying expenditures if the communication satisfies the following requirements:

1. The communication is directed only to members of the organization.

2. The specific legislation the communication refers to, and reflects a view on, is of direct interest to the organization and its members.

3. The communication does not directly encourage the member to engage in direct lobbying (whether individually or through the organization), and

4. The communication does not directly encourage the member to engage in grassroots lobbying (whether individually or through the organization).

Expenditures for a communication directed only to members that refers to, and reflects a view on, specific legislation and that satisfies the requirements of paragraphs 1, 2, and 4, but does not satisfy the requirements of paragraph 3, are treated as expenditures for direct lobbying.

Expenditures for a communication directed only to members that refers to, and reflects a view on, specific legislation and satisfies the requirements of paragraphs 1 and 2, but does not satisfy the requirements of paragraph 4, are treated as grassroots expenditures, whether or not the communication satisfies the requirements of paragraph 3.

See Regulations section 56.4911-5 for details.

There are special rules regarding certain paid mass media advertisements about highly publicized legislation; allocation of mixed purpose expenditures; certain transfers treated as lobbying expenditures and special rules regarding lobbying on referenda, ballot initiatives, and similar proposals. See Regulations sections 56.4911-2 and -3.

Legislation. In general, the term "legislation" includes Acts, bills, resolutions, or similar items. "Specific legislation" includes both legislation that has already been introduced in a legislative body and a specific legislative proposal that the organization either supports or opposes.

Exceptions to the definitions of direct lobbying communication and grassroots lobbying communication. In general, engaging in nonpartisan analysis, study, or research and making its results available to the general public or segment or members thereof, or to governmental bodies, officials, or employees is not considered either a direct lobbying communication or a grassroots lobbying communication. Nonpartisan analysis, study, or research may advocate a particular position or viewpoint as long as there is a sufficiently full and fair exposition of the pertinent facts to enable the individual to form an independent opinion or conclusion.

Instructions for Schedule A (Form 990)
A communication that responds to a governmental body's or committee's written request for technical advice is not a direct lobbying communication.

A communication is not a direct lobbying communication if the communication is an appearance before, or communication with, any legislative body whose action might affect the organization's existence, its powers and duties, its tax-exempt status, or the deductibility of contributions to the organization, as opposed to affecting merely the scope of the organization's future activities.

Affiliated groups. Treat members of an affiliated group as a single organization to measure lobbying expenditures and permitted lobbying expenditures.

Two organizations are affiliated if one is bound by the other organization's decisions on legislative issues (control) or if enough representatives of one belong to the other organization's governing board to cause or prevent action on legislative issues (interlocking directors).

If you are not sure whether your group is affiliated, you may ask the IRS for a ruling letter. To request a ruling letter, Assistant Commissioner (Employee Plans and Exempt Organizations), Exempt Organizations Technical Policy Division, CP-ESQ, 1111 Constitution Ave, NW, Washington, DC 20224. There is a fee for this ruling.

Members of an affiliated group measure both lobbying expenditures and permitted lobbying expenditures on the basis of the affiliated group's tax year. If all members of the affiliated group have the same tax year, that year is the tax year of the affiliated group.

However, if the affiliated group's members have different tax years, the tax year of the affiliated group is the calendar year, unless all the members of the group elect otherwise. See Regulations section 56.4911-7(e)(3).

If the electing organization belongs to an affiliated group, complete in Part VI-A, lines 36 through 44:
- Column (a) for the affiliated group as a whole, and
- Column (b) for the electing member of the group.

If there are no excess lobbying expenditures on either line 43 or 44 of column (a), treat each electing member as having no excess lobbying expenditures.

However, if there are excess lobbying expenditures on either line 43 or 44 of column (a), treat each electing member as having excess lobbying expenditures. In such case, each electing member must file Form 4720, Report of Excess Tax Under Section 4946, 4959, and 501(h), or Form 5047, Information Return for Certain Other Persons Under Chapters 41 and 42 of the Internal Revenue Code and must pay the tax on its proportionate share of the affiliated group's excess lobbying expenditures.

To find a member's proportionate share, see Regulations section 56.4911-8(d). Enter the proportionate share in column (b) on line 43 or line 44, or on both lines.

**Attached schedule.** Attach a schedule showing each affiliated group member's name, address, EIN, and expenses. Use the format of Part VI-A for this schedule. Show which member exceeded and which did not.

Include each electing member's share of the excess lobbying expenditures on the attached schedule. Each electing member does have own tax, but remain subject to the general rule, which provides that no substantial part of their activities consist of carrying on propaganda or otherwise trying to influence legislation.

**Limited control.** If two organizations are affiliated because their governing instruments provide that the decisions of one will control the other only on legislation, apply expenditures as follows:

1. Charge the controlling organization with its own lobbying expenditures and the national legislation expenditures of the affiliated organizations.
2. Do not charge the controlling organization with other lobbying expenditures (or other exempt-purpose expenditures) of the affiliated organizations.
3. Treat each local organization as though it were not a member of an affiliated group; i.e., the local organization should account for its own expenditures only and not any of the national legislation expenditures deemed as incurred by the controlling organization in 1 above. When this type of limited control is present, each member of the affiliated group should complete column (b) only.

**Group returns.** Although membership in a group affiliated for lobbying does not establish eligibility to file a group return, a group return can sometimes meet the filing requirements of more than one organization in an affiliated group. (General Instruction R of the Instructions for Form 980 and Form 990-EZ explains who may file a group return.)

If a central or parent organization files a group return on behalf of two or more members of the group, complete column (a), Part VI-A, for the affiliated group as a whole. Include the central, electing, and nonelecting members.

In column (b), except on lines 43 and 44, include the amounts that apply to all electing members of the group if they are included in the group return.

Attach the schedule described above under Affiliated groups. Show what amounts apply to each group member.

If the group return includes organizations that belong to more than one affiliated group, show in column (a) the totals for all such groups. On the attached schedule, show the amounts that apply to each affiliated group and to each group member.

If the parent organization has made the lobbying expenditure election, its separate return must also show in column (a) the amounts that apply to the affiliated group as a whole and, in column (b), the amounts that apply to the parent organization only.

A subordinate organization not included in the group return would also complete column (a) for the affiliated group as a whole and column (b) for itself only.

However, if "limited control" (defined above) exists, complete only column (b) in Part VI-A of the group return for the electing members in the group.

Attach a schedule to show the amounts that apply to each electing member.

In the separate returns filed by the parent and by any subordinate organizations not included in the group return, complete only column (b).

**Lines 36 through 44.** Complete column (b) for any organization using Part VI-A but complete column (a) only for affiliated groups.

Use lines 36 through 44 to determine whether any of the organization's current year lobbying expenditures are subject to tax. File Form 4720 if you need to report and pay the excise tax. Lines 45 through 50. Lines 45 through 50 are used to determine if the organization exceeded lobbying expenditure limits during the 4-year averaging period.

Any organization for which a lobbying expenditure election under section 501(h) was in effect for its tax year beginning in 1999 must complete columns (a) through lines 45 through 50 except in the following situations:

1. An organization first treated as a section 501(c)(3) organization in its tax year beginning in 1999 does not have to complete any part of lines 45 through 50.
2. An organization does not have to complete lines 45 through 50 for any period before it is first treated as a section 501(c)(3) organization.
3. If 1999 is the first year for which an organization's first section 501(h) election is effective, that organization must complete line 45, columns (a) and (e).
4. The organization must then complete all of column (e) to determine whether the amount on line 47, column (e), is equal to or less than the lobbying ceiling amount calculated on line 46 and whether the amount on line 50 is equal to or less than the grassroots ceiling amount calculated on line 49.
5. The organization does not satisfy both tests if either its total lobbying expenditures or grassroots lobbying expenditures exceed the applicable ceiling amounts. When this occurs, all five columns must be completed and a recomputation made unless exception 1 or 2 above applies.
6. If 1999 is the second or third tax year for which the organization's first section 501(h) election is in effect, that organization is required to complete only the columns for the years in which the election has been in effect, entering the totals for those years in column (e).
7. The organization must determine, for those 2 or 3 years, whether the amounts entered in column (e), line 47, is equal to or less than the lobbying ceiling amount reported on line 46, and whether the amount entered in column (e), line 50, is equal to or less than the grassroots ceiling amount calculated on line 49.
8. The organization does not satisfy both tests if either its total lobbying expenditures or grassroots lobbying expenditures exceed applicable ceiling amounts. When that occurs, all five columns must be completed and a recomputation made, unless exception 1 or 2 above applies.
9. If the organization is not required to complete all five columns, attach a statement explaining why. In the statement, show the ending date of the tax year, the organization made its first section 501(h) election and state whether or not that first election was revoked before the start of the organization's tax year that began in 1999.

**Note:** If the organization belongs to an affiliated group, enter the appropriate affiliated group totals from column (a), lines 36 through 44, when completing lines 45, 47, 48, and 50.
Part VI—Lobbying Activity by Nonelecting Public Charities

The Part VI-A instructions defining direct and grassroots lobbying activities by organizations that made the section 501(h) election do not apply to nonelecting organizations that complete Part VI-B.

Part VI-B provides a reporting format for any organization that engaged in lobbying activities in its 1995 tax year but did not make a section 501(h) lobbying expenditure election for that year by filing Form 5768.

A nonelecting public charity will generally be regarded as lobbying if the organization either: (1) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation of the government’s budget process; or (2) advocates the adoption or rejection of legislation.

Nonelecting organizations must complete Part VI-B to show lobbying expenditures paid or incurred.

Note: In item g, “direct contact” means a personal telephone call or visit with legislators, their staffs, or government officials.

These nonelecting organizations must also attach a statement giving a detailed description of their lobbying activities. The detailed description of lobbying activities should include all lobbying activities, whether expenses are incurred or not (e.g., even lobbying activities carried out by unreimbursed volunteers).

For example, the activities should be included in the attached statement if an organization (either through its employees or volunteers) attempts to influence legislation in any of the following ways:

• Sending letters or publications to government officials or legislators; meeting with or communicating with the official or legislators; sending or distributing letters or publications (including newsletters, brochures, etc.) to members of or to the general public; using direct mail, placing advertisements, issuing press releases, holding news conferences; or holding rallies or demonstrations.

Part VII—Information Regarding Transfers To and Transactions and Relationships With Noncharitable Exempt Organizations

Part VII is used to report on:

• Direct and indirect transfers to (line 51a),
• Direct and indirect transactions with (line 51b),
• Relationships with (line 52) any other noncharitable exempt organization (section 503(b)(9)).

A “noncharitable exempt organization” is an organization exempt under section 501(c) that is not exempt under section 501(c)(3), or a political organization described in section 527.

For purposes of these instructions, the section 501(c)(3) organization completing this Schedule A (Form 990) is referred to as the reporting organization.

A noncharitable exempt organization is related to or affiliated with the reporting organization if:

1. The two organizations share some element of common control or
2. A historic and continuing relationship exists between the two organizations.

A noncharitable exempt organization is unrelated to the reporting organization if:

1. The two organizations share no element of common control and
2. A historic and continuing relationship does not exist between the two organizations.

An “element of common control” is present when one or more of the officers, directors, or trustees of one organization are elected or appointed by the officers, directors, trustees, or members of the other. An element of common control is also present when more than 25% of the officers, directors, or trustees of one organization serve as officers, directors, or trustees of the other organization.

A “historic and continuing relationship” exists when two organizations participate in a joint effort to work in concert toward the attainment of one or more common purposes on a continuous or recurring basis rather than on the basis of one or several isolated transactions or activities. Such a relationship also exists when two organizations share facilities, equipment, or paid personnel during the year, regardless of the manner in which the arrangement is in effect.

Line 51. Reporting of certain transfers and transactions. (a) Listed below, report on line 51 any transfer or transaction with a noncharitable exempt organization even if the transfer or transaction constitutes the only connection with the noncharitable exempt organization.

Related organizations. If the noncharitable exempt organization is related to or affiliated with the reporting organization, report all direct and indirect transfers and transactions except for contributions and grants received by the reporting organization.

Unrelated organizations. All transfers from the reporting organization to an unrelated noncharitable exempt organization must be reported on line 51a. All transactions between the reporting organization and an unrelated noncharitable exempt organization must be shown on line 51b unless they meet the exception in the specific instructions for that line.

Line 51a. Transfers. Answer “Yes” to lines 51a(i) and 51a(ii) if the reporting organization made any direct or indirect transfers of any value to a noncharitable exempt organization.

A “transfer” is any transaction or arrangement whereby one organization transfers something of value (cash, other assets, services, use of property, etc.) to another organization without receiving something of more than nominal value in return. Contributions, gifts, and grants are examples of transfers.

If the only transfers between the two organizations are contributions and grants made by the noncharitable exempt organization to the reporting organization, answer “No.”

Line 51b. Other transactions. Answer “Yes” for any transaction described in lines 51b(i) through (vi), regardless of its amount, if it is with a related or affiliated organization.

Unrelated organizations. Answer “Yes” for any transaction between the reporting organization and an unrelated noncharitable exempt organization, regardless of its amount, if the reporting organization received less than adequate consideration.

Answer “Yes” for any transaction, including transfers for adequate consideration, between the reporting organization and an unrelated noncharitable exempt organization if the amount involved is more than $500. The “amount involved” is the fair market value of the goods, services, or other assets furnished by the reporting organization.

Exception. If a transaction with an unrelated noncharitable exempt organization was for adequate consideration and the amount involved was $500 or less, it is not necessary to answer “Yes” for that transaction.

Line 51b(iii). Answer “Yes” for transactions in which the reporting organization was either the lessor or the lessee.

Line 51b(iv). Answer “Yes” if either organization reimbursed expenses incurred by the other.

Line 51b(v). Answer “Yes” if either organization made loans to the other or if the reporting organization guaranteed the other’s loans.

Line 51b(vi). Answer “Yes” if either organization performed services or membership or fundraising solicitations for the other.

Line 51c. Complete line 51c regardless of whether the noncharitable exempt organization was related to or closely affiliated with the reporting organization. For the purposes of this line, “facilities” includes office space and any property (e.g., buildings, or equipment) owned or leased by, or provided free of change to, the reporting organization or the noncharitable exempt organization.

Line 51d. Use this schedule to describe the transfers and transactions for which you answered “Yes” on lines 51a through 51c above.

You must describe each transfer or transaction for which you answered “Yes.” You may combine all of the cash transfers (line 51a(i)) to each organization into a single entry. Otherwise, make a separate entry for each transaction.

Column (a). For each entry, enter the line number from lines 51a through 51c. For example, if you answered “Yes” to line 51b(iii), enter “b(iii)” in column (a).

Column (d). If you need more space, write “see attached” in column (d) and use a separate sheet to describe the relationship. If you are making more than one entry on line 51d, specify, on the attached sheet, which transfer or transaction you are describing.

Line 52. Reporting of certain relationships. Enter on line 52 each noncharitable exempt organization to which the reporting organization is related, or affiliated, as defined above. If the control factor or the historic and continuing relationship factor (or both) is present at any time during the year, you must identify the organization on line 52 even if neither factor is present at the end of the year.

Do not enter unrelated noncharitable exempt organizations on line 52 even if you report transfers to or transactions with those organizations on line 51. For example, if you reported a one-time transfer to an unrelated noncharitable exempt organization on line 51a(iii), you should not list the organization on line 52.

Column (b). Enter the exempt category of the organization; for example, “501(c)(4).”

Column (c). In most cases, a simple description, such as “common directors” or “auxiliary of reporting organization” will be sufficient. If you need more space, write “see attached” in column (c) and use a separate sheet to describe the relationship. If you list more than one organization on line 52, identify which organization you are describing on the attached sheet.

Instructions for Schedule A (Form 990)
Form 5768

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

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

For IRS Use Only □

Name of organization:

Employer identification number:

Number and street (or P.O. box no., if mail is not delivered to street address):

City, town or post office, and state: ZIP + 4

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

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

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

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

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

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

General Instructions

Section references are to the Internal Revenue Code.

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

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

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

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

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

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

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

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

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

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

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

Where To File. — Mail Form 5768 to the Internal Revenue Service Center, Ogden, UT 84201-0027.
CHAPTER 5

TAX EXEMPTION OF HOSPITALS AND HEALTH-CARE PROVIDERS

INTRODUCTION

Collectively, tax-exempt hospitals represent one of the two largest groups of organizations described in §501(c)(3). The other group is made up of churches and church-related groups. Data are unavailable, for the most part, on churches because they are currently exempt from reporting requirements. According to statistical data for 1989 provided by the IRS, tax-exempt hospitals had annual revenues of $179.7 billion and assets of $189.7 billion. These figures represent a significant percentage of total revenues of all organizations exempt under §501(c)(3) other than churches.

Until recently, most hospitals and related facilities have enjoyed a relatively quiet existence because the notion was that most facilities were operated exclusively for the public good or at least in the public interest. This laissez faire attitude has been manifested in various procedural policies for hospitals which, for example, require them to provide medical care without regard to the patients’ ability to pay for services. Public charities are often perceived as organizations depending entirely on philanthropy. Hospitals and related health-care groups are allowed to make one step beyond, to embrace a concept of “fee for services.”

The IRS, over the past several years, has begun to target health-care organizations in its comprehensive audit program. The IRS implemented a coordinated examination program for auditing tax-exempt organizations. Specifically targeted in this group would be hospitals and health-care organizations operating on a multistructural basis. The IRS has released Introduction to the Health Care Industry, a 500-page training manual on hospitals and related facilities.

PURPOSE OF EXEMPTION FOR HEALTH-CARE PROVIDERS

Continued exemption for health-related facilities is being challenged from several directions. As is the case for all tax-exempt organizations, operations are being scrutinized in regard to the emphasis on unrelated business income (Chapter 2). In addition, hospitals are being attacked on two other fronts:

■ Physician recruitment incentives, and

■ Hospital-physician joint ventures.
These areas of concern have placed hospitals, health maintenance organizations, and other health-care providers in direct jeopardy of losing their exempt status. In fact, the majority of the issues that the IRS is currently addressing in the area of exemption involves these types of activities. This high visibility relates to the nature of the activities these organizations undertake. For the most part, differentiating exempt activity from its nonexempt counterpart is becoming increasingly more difficult. If the operations of an exempt and nonexempt hospital were evaluated side by side, it would be almost impossible to differentiate their operations. Substantive differences would be more obvious in sources of revenues rather than in use of funds. Some of these funding sources more commonly found in exempt organizations might include:

- Medicare,
- Medicaid,
- Indigent health-care services, and
- Research and special study grants.

One other significant change over the past several years has affected the status of many exempt facilities. Traditionally, tax-exempt hospitals were developed on a community basis and generally stood alone, particularly in rural America where local hospitals were a matter of pride. Today, these hospitals are most often a part of a large institutional health-care complex having little if any resemblance to the facility from which they evolved.

**Operating Structure of Health-Care Organization**

In general, §501(c)(3) limits exemption to:

- Corporations,
- Community chests,
- Trust funds, and
- Foundations.

Because the Code specifically limits exemption to one of these types of activities, other types of entities, such as partnerships, will not qualify for exemption. As discussed later, however, it is possible for a group of exempt organizations to form either a partnership or a limited liability company from which to operate a joint venture.
The Regulations under §301.7701-1(b) classify organizations for tax purposes and provide that the Code prescribe certain categories, or classes, into which the various organizations fall for purposes of taxation. The standards are used to determine which classes are subdivided into associations (including corporations), partnerships, and trusts, but local law governs in determining whether the legal relationships that have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.

These forms of doing business have broad definitions with widespread application, but they each have specific application to the health-care field.

** Corporations **

In some cases, medical groups are prohibited under state law from incorporating as tax-exempt organizations. In this situation, they will most often incorporate as either a professional corporation or professional association because of limitations placed on the group by state law. It is assumed that they will function in much the same way as their for-profit counterparts. In *University of Maryland Physicians, P.A., v. Commissioner*, 41 TCM 732 (1981), it was shown that to maintain exemption, the articles of incorporation required specific language concerning purpose and ability to receive dividends, for example. The Articles of Incorporation provided the following guidance.

The purpose for which the corporation is formed is as follows:

- To engage in the general practice of medicine for patients of the University of Maryland Hospital.

- To provide medical care to all the sick and injured who may come to them...without regard to race, color, creed, sex, age, or ability to pay for services....

- To engage in medical research as a means of seeking to alleviate human suffering.

- To provide teaching services...

  - Notwithstanding any other provisions contained in these Articles of Incorporation, the corporation shall not conduct or carry on any activities not permitted to be conducted or carried on, nor make any grant not permitted to be made, by an organization exempt under §501(c)(3)...

  - The holders of the common stock shall have no right to receive dividends or other distributions of profits, property, money, or other assets of the corporation, except in case of dissolution of the corporation in which event each stockholder shall, to the extent of available net assets in excess of liabilities, be entitled to receive the par value of the shares held ($1).
In the Maryland case, the Court found that the groups of physicians were organized and operated exclusively for charitable, scientific, and educational purposes as used in §501(c)(3). Not only did the Articles of Incorporation contain satisfactory limitations on private inurement but also sufficiently limited the nature of the group’s activities.

This case goes to show the importance of proper drafting of documents.

Community Chest

A community chest is not a type of legal entity. It is a descriptive form of organization that fund-raises, coordinates activities, and distributes benefits.

Trust Fund

Even though no formal definition of “fund” is given in the IRC, Revenue Ruling 57-151, 1957-1 CB 64, is an example of an arrangement meeting the prerequisite requirements and limitations to qualify for exemption.

Foundation

The Code contains no formal definition of “foundation,” and it is generally associated with the corporate form.

With the exception of the corporate format required in some cases by state law, most exempt health-care facilities face the same organizational requirements as other activities. The main emphasis on exempt organizations by the IRS appears to be on the correct application of operational requirements.

HEALTH-CARE FACILITY USE OF PARTNERSHIPS AND JOINT VENTURES

Over the past several years, tax-exempt organizations have grown from mostly small, single-unit operations to large conglomerations of exempt- and nonexempt-related activities. In this group, tax-exempt health-care facilities have been in the forefront, having involvement in a variety of activities. In some cases, these multiple entities have evolved out of necessity to maintain tax exemption or to enhance management’s ability to provide services. Without the need for continued exemption or alternative ways to finance growth and share risk, most of the combined operations could be conducted through a single facility.

Health-care organizations are generally involved in a large variety of multistructural ventures. These ventures are carried out most often in the form of a partnership, joint venture or through a limited liability company. The latter functions much in the same way as a partnership while enjoying much of the limited liability of a corporation.
CONCEPTUAL DESIGN OF PARTNERSHIPS AND JOINT VENTURES

Section 7701(a)(2) defines a partnership to include "...syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not...a trust or estate or a corporation." For the most part, it is assumed that the parties have entered into a working arrangement for some type of financial gain.

The concept of a joint venture is usually synonymous with a partnership. Some fine differences, however, should be noted. In Whiteford v. U. S. et al., 61-1 USTC 9301, it is noted that a partnership has been defined as a contract of two or more persons to place their money, effects, labor, and skill, or some or all of them, in lawful commerce or business, and to divide the profit and bear the loss in definite proportions. Similarly, a joint venture has been defined as an association of two or more persons with intent to carry out a single business venture for joint profit, for which purpose they combine their efforts, property, money, skill, and knowledge, but they do so without creating a formal partnership or corporation. In this regard, two distinct differences between the entities are evident. First, the joint venture appears to have a much narrower focus than does the partnership, and second, the partnership arrangement is normally considerably less formal.

LIMITED PARTNERSHIP/LIMITED LIABILITY COMPANY VS. GENERAL PARTNER

Although this is not a partnership course, some brief comments on partnership operations would be in order because of their relevance to the health-care industry. The following briefly covers the alternative structures within the framework of the partnership environment.

- **General Partnership** — is a conduit through which various items of partnership income, gains, losses, deductions, and credits are passed to the respective partners. The impact of these items are felt at the partner level because the partnership serves as a pass-through entity that is in itself tax-exempt insofar as no taxes are paid at the partnership level. The most notable disadvantage to conducting business through a general partnership is that it subjects all the general partners to joint and several liability for the debts of the partnership. This is a relative issue and will be examined later in greater detail.

- **Limited Partnership** — is a conduit that provides investors protection normally offered through the corporate form. This form offers the same basic advantages of pass-through that the general partnership offers while limiting the liability for debts. The potential for loss is limited to the partner's investment, guarantees, or any additional amounts obligated under the terms of the partnership agreement.

- **Limited Liability Company (LLC)** — is considered a cross between a corporation and a limited partnership. All states have adopted some form of an LLC act. For the most part, these acts mirror the state's corporate act. The biggest advantage to the LLC is that all of the members have limited liability. This is differentiated from the limited partnership where at least one member must be a general partner with unlimited liability. For tax purposes, the LLC resembles a limited partnership in its filing requirements.
A tax-exempt health-care organization, in the present text, can operate in any of the three forms referred to above. Most arrangements, however, are conducted either through general partnerships or joint ventures as noted above.

One very strong word of caution must be noted for tax-exempt organizations that enter into either a partnership or joint venture agreement: the IRS is increasingly viewing joint ventures and partnership arrangements as a method of tax avoidance. The issue expands well beyond one of unrelated business income to one of potential loss of tax exemption.

One common characteristic to all partnerships is the need for a general partner. Further, normally one or more limited partners assume limited amounts of risk. All other liabilities fall on the general partner. This structure can place the exempt organization at risk if it is serving as the general partner because that general partnership can raise the question of the board's placing the organization's assets in jeopardy.

The IRS has taken the position for some time that when an exempt organization is a partner in a joint venture, it has to include its share of income in its unrelated business income. Income from the sale of an exempt organization's interest in a publicly traded partnership is unrelated business income. Both the Courts and the IRS have rejected the argument that as a limited partner the exempt organization does not have the ability to actively enter into the management of the partnership, allowing for passive income. In the Tax Court decision on Service Bolt and Nut Company Profit-Sharing Trust [78 TC 812 (1982) aff'd 724 F.2d 519 (6th Cir. 1984)], the Court noted that "While...a 'silent partner' is not necessarily the same thing as a 'limited partner,' we think...Congress intended to include exempt organizations' distributive shares of partnership income...regardless of whether, as partners, they behaved in an active or passive manner with regard to the management of the partnership's unrelated trades or businesses." In the text of the case, the Court used the following example:

If an exempt educational institution is a silent partner in a partnership which runs a barrel factory and such partnership also holds stock in a pottery manufacturing corporation, the exempt organization would include in its unrelated business income its share of the barrel factory income, but not its proportionate share of any dividends received by the partnership from the pottery corporation.

The IRS has noted a formidable exception to the aforementioned rule, however. This exception applies to a partnership or joint venture whose activity is substantially related to the exempt purpose of a limited partner. A private exempt university and a for-profit hospital entered into a partnership to build and operate an eighty-eight-bed hospital. The university was in need of the facility as part of its medical school program. The IRS noted that the tax-exempt organization was a limited partner with the general partner bearing the risk of loss. As noted in PLR 8432014, the IRS concluded that the joint venture did not endanger the exempt organization's tax status and that the income to the tax-exempt organization was substantially related and not taxable.
TAX EXEMPTION OF HOSPITALS AND HEALTH-CARE PROVIDERS

When a tax-exempt organization is the general partner in a taxable venture, the IRS takes the position that the organization is giving up its exemption by default. The single exception is when the joint venture furthers the organization's exempt purpose. An organization will lose its tax-exempt status if the charitable organization/general partner is not adequately insulated from the day-to-day management responsibilities of the partnership and/or if the limited partners are to receive any form of private inurement.

In GCM 39005, the issue was whether a nonprofit organization that enters into a limited partnership as one of several general partners for the purpose of constructing, owning, and operating a federally assisted apartment complex for handicapped and elderly individuals of limited income may qualify as an organization described in §501(c)(3).

The GCM concluded that an exempt organization may qualify under §501(c)(3), notwithstanding its participation in a limited partnership as one of several general partners, if the partnership arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted. In this case, the IRS believed that both the federally imposed restrictions and the structure of the partnership agreement are sufficient to protect the nonprofit organization from any potential conflict between its partnership obligations as a general partner and its exempt goals.

It was noted in the GCM that an organization may meet the requirements of §501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in §513 (discussed in Chapter 2). In determining the existence or nonexistence of a primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities that are in furtherance of one or more exempt purposes.

As noted above, an exempt organization's participation in a partnership arrangement as a general partner should not in itself result in a denial of exempt status. The partnership arrangement, however, should be closely scrutinized to ensure that the statutory-imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable goals. In all partnership cases, initial focus should be on whether the organization is serving a charitable purpose. Once charity has been established, the partnership arrangement itself should be examined to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of a limited partner.

In contrast, an organization described in another GCM (GCM 36293) could not establish that its participation in the government-sponsored housing project actually would have served a recognizable purpose. In this case, only a small portion of the housing project was designated for low-income individuals. As such, the organization would be hard put to claim that the project was designed to relieve the poor or distressed. Additionally, the project was to be located in an affluent, predominately white suburb consisting exclusively of single-family dwellings with no indication of decay or community tension. Therefore, the project could not have been characterized as charitable on the basis of combating community deterioration or relieving neighborhood tensions. The organization failed, in this case, to demonstrate any charitable purpose for their involvement in the partnership aside from making a profit.
Meeting a charitable purpose alone is not an end-all answer to the issue. Notwithstanding an established charitable purpose, however, conflicts with charitable goals can nevertheless arise in a limited partnership situation because certain statutory obligations are imposed upon a general partner. These obligations include an assumption of all liabilities by the general partner and a basic profit orientation in the interest of the limited partners. Unless an exempt organization, acting as general partner, can insulate itself from these obligations, conflicts that will preclude exemption exist.

In GCM 36293, the organization failed to demonstrate that it was so insulated. The organization was to serve as the sole general partner in the project, and no evidence indicated that its obligations were in any way limited or restricted in the agreement. According to the GCM:

By agreeing to serve as the general partner of the proposed housing project, the Corporation would take on an obligation to further the private financial interests of the limited partners. Since the promotion of those private interests would tend to foster operating and maintenance practices favoring the equity holdings of the limited partners to a greater extent than would otherwise be justifiable on the basis of reasonable financial solvency, the Corporation's assumption of a duty to promote such interests in its capacity as general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes.

By design, a partnership agreement can go a long way toward resolving the conflict between a nonprofit general partner and its exempt purpose. Some suggested inclusions might be the following:

- Make sure that the agreement recognizes the obligations and responsibilities of the exempt general partner and that they remain as limited as possible.
- Try to arrange for at least one nonexempt general partner.
- Make sure the exempt organization has the first right of refusal should the property be offered for sale.
- Keep the exempt organization from obligating itself on mortgages whenever possible.
- Establish some limit on profitability beyond the need to recover direct and indirect cost.

One final note regarding profit motive: percentage compensation arrangements are not, in themselves, a bar to exemption. In OM 19255, the IRS stated that "...a reasonable percentage compensation agreement is not inconsistent with the pursuit of exempt purposes." This form of compensation can appear to be reasonable when it relates to the services being rendered.
THE USE OF PARTNERSHIPS BY TAX-EXEMPT HEALTH-CARE FACILITIES

The primary reason that health-care facilities pool resources and form partnerships is to allow for the acquisition and use of one or more facilities, major equipment or any other significant piece of tangible personal or real property. Modern technology has a price tag attached to it. When a partnership or joint venture is formed out of economic reality, possibilities are fairly good that the IRS will honor the relationship and allow for continued existence. When a profit motive is present, however, a variety of new issues, such as private increment, which is discussed below, arise.

It is becoming more commonplace for tax-exempt organizations to own the facilities out of which they operate. Some of the reasons more commonly found are that:

• Fixed occupancy cost associated with ownership of the facility can be ensured.
• From a bank’s perspective, organizations with real estate holdings are generally considered more solid.
• Many organizations operating out of their own facilities are in a better position to offer special programs, especially in the medical field where major modifications to a facility are often needed to permit proper patient treatment.
• Buildings often represent good investments. They often allow for appreciation and provide for a nontaxable gain when the property sells.

The IRS has reviewed many such arrangements and, for the most part, has looked favorably on them, especially when they represent sound business practices. In many cases, this is the only means an organization may have at its disposal to acquire property.

PLR 9105029 reflects the rationale of both the IRS and the medical group in one such partnership arrangement. In this case, the IRS ruled that the participation in the proposed real estate venture would not jeopardize the partners’ tax-exempt status under §501(c)(3). In addition, the IRS ruled that any income received by the partners by reason of their participation in the proposed transaction would not be unrelated business income. The ruling is a good example of the types of entities that enter into working arrangements. In PLR 9105029, the following made up the co-venture partners:

• M — An acute-care hospital exempt under §501(c)(3). The hospital was also classified as a public charity described under §§509(a)(1) and 170(b)(1)(A)(iii).
• N — An acute-care hospital exempt under §501(c)(3) and associated with a religious organization.
• O — The parent health-care organization associated with the church.
• P — A wholly owned, for-profit subsidiary of M. In addition, P leases medical office buildings it owns to practicing physicians and manages medical office buildings and clinics for practicing physicians.
• Q — A wholly owned, for-profit subsidiary of O. Q’s primary business activity is the management of medical office buildings and clinics.

• R — A for-profit professional corporation made up of licensed physicians. R has an agreement with M and N to provide all radiology services for hospital facilities operated by M and N.

• S — A subchapter S corporation owned by the same licensed physicians who own R.

• W — A for-profit professional corporation whose shareholders are licensed physicians.

• X — A newly formed subchapter S corporation owned by the shareholders of W. X owns real estate that is leased to W.

T is the general partnership formed by the subsidiaries of M, N, and S. T currently owns and operates a mobile magnetic resonance scanner, a piece of imaging and diagnostic equipment which is vital in diagnosing and treating disorders common to patients of M and N. The subsidiaries of M and N currently hold a 66⅔% interest in T; S currently holds a 33⅓% interest in T.

In this ruling, the facts stipulate that T proposes to acquire a second magnetic resonance scanner. M represents that before a scanner can be acquired by a health-care facility within the State of V, Y must establish that a need for the equipment exists. T receives approval of a certificate of need from Y for the acquisition of the second scanner.

The most important element of the proposed transaction in regard to M and N’s exempt status is the need to show a causal relationship between the investment in the partnership and their exemption. In this regard, M stated that the current scanner was often heavily booked and patients at M and N frequently have to wait several days to have a scan performed. M also represented that the old scanner, because it is mobile and also serves other community hospitals, is often not available to the City of U. Therefore, M states that the acquisition of the second scanner will give patients at M and N better access to scanner technology.

The facts surrounding this ruling are quite complicated and much broader than just the issue of M and N’s continued exemption. The focus of this chapter, however, concerns only the continued exempt status. In that regard, we are focusing on only the part of the ruling that directly relates to the continued exempt status of M and N.

Section 1.501(c)(3)–1(e) of the Regulations provides that an organization may meet the requirements of §501(c)(3), although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in §513. To determine the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities that are in furtherance of one or more exempt purposes.

134
Additionally, §1.501(c)(3)-1(d)(1)(ii) of the Regulations provides that an organization is not organized or operated exclusively for any of the purposes specified in §501(c)(3) unless it serves a public rather than a private interest. To qualify under §501(c)(3), an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or the creator’s family, shareholders of the organization, or persons controlled directly or indirectly by any related private interests.

As discussed in Chapter 2, the Regulations under §1.513-1(d)(2) provide that a trade or business is “related” to the exempt purpose of the organization when the conduct of the business activity has a causal relationship to the achievements of the organization’s exempt purpose and is “substantially related,” for purposes of §513, only when the causal relationship is a substantial one. In other words, the production of goods or the performance of services from which gross income is derived must contribute importantly to the accomplishment of the organization’s exempt purpose.

When dealing with partnerships, form is virtually everything. Whether participation in a joint venture with nonexempt entities to provide certain outpatient medical services will conflict with an exempt health-care facility’s ability to continue with its charitable purpose depends a great deal on the specific structuring of the partnership or joint venture agreement.

Participation by a charitable organization, as a general partner, in a limited partnership does not per se endanger the organization’s exempt status. It is necessary, however, to ensure that the obligations of the exempt organization as general partner do not conflict with the organization’s ability to pursue exclusively charitable goals. The initial focus should be on whether the exempt organization is serving an exempt purpose. Once a charitable purpose has been established, the partnership arrangement itself should be examined to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the exempt purpose and not for the benefit of the limited partners.

There is nothing per se objectionable about an exempt organization entering into a partnership arrangement when it either lacks or does not wish to expend all of the funds necessary to build or purchase a facility that will further its exempt purposes.

The same standard applicable to a determination of private benefit in other exempt organization contexts should be applied in partnership situations. The question to be determined in each case is whether the benefits available to the partners, both quantitatively and qualitatively, are incidental to the public purposes served by the exempt organizations. Exempt organizations will not violate the requirements of exemption by adopting a plan in which profits are a factor in the compensation formula if the plan is adequately limited and safeguarded.

PLR 9105029, which was previously discussed, is very clear in its interpretation of what role M and N are to perform. According to the ruling, M and N’s exempt purpose is to provide medical care to persons in the communities they serve. This is accomplished by operating hospital facilities where physicians provide medical care. M and N’s participation in the partnership enhances the medical care currently being provided by supplying access, in an economic and efficient manner, to diagnostic imaging medical services provided by licensed physicians. M and N represented successfully to the IRS that their reasons for entering into the partnership were to provide better medical services to the public in their service.
area. The promotion of health for the benefit of the community is an established charitable purpose. As such, the IRS concluded that M and N's participation in the partnership was related to their exempt purpose.

In another ruling (PLR 9029034), the IRS noted in their review of a proposed transaction that the exempt organization's participation served an important charitable purpose of maintaining the access to primary acute-care hospital services for the community. No provision in the arrangement conferred a private benefit to any of the partners. Any private benefit received by any of the limited partners was in the form of reasonable compensation for services rendered and the fair market value on return of capital investments. Additionally, within the agreement, the exempt organization, as general partner had:

- Limited contractual liability,
- An option to continue the business of the partnership on dissolution,
- No obligation to return capital to the limited partners, and
- Profits and losses that were determined in proportionate allocations.

The IRS ruled that the organization's participation in the partnership was consistent with its charitable purposes and would not adversely affect the organization and its exempt status.

In Revenue Ruling 69-545, 1969-2 C.B. 117, the IRS provides detailed illustrations concerning what is required for a medical facility to maintain exemption. All of the organizational requirements were met by the facilities under review. The question of exemption rested solely on operational analysis of the hospitals under review.

**Situation 1** — Hospital A is a 250-bed community hospital. Its board of trustees is composed of prominent citizens in the community. Medical staff privileges in the hospital are available to all qualified physicians in the area, consistent with the size and nature of its facilities. The hospital has 150 physicians on its active staff and 200 physicians on its courtesy staff. It also owns a medical office building on its premises with space for sixty physicians. The hospital operates a full-time emergency room where no one is denied treatment. Patients are billed on a fee-for-services basis, and indigent patients are referred elsewhere. The hospital normally operates at a profit. All profits are recycled into the operations.

**Situation 2** — Hospital B is a sixty-bed general hospital, which was originally owned by five physicians. The owners formed a nonprofit organization and sold their interest in the hospital to the organization at fair market value. The board of trustees of the organization consists of the five physicians, their accountant, and their lawyer. The five physicians also constitute the hospital's medical committee and thereby control the selection and the admission of other physicians to the medical staff. During its first five years of operation, only four other physicians have been granted staff privileges at the hospital. The applications of a number of qualified physicians in the community have been rejected. Hospital admission is restricted to patients of physicians holding staff privileges. The hospital maintains an inactive emergency room. Admissions are limited to those who can pay the cost of the services rendered. Office rental for the original five physicians is below fair market value. No office space is available for any of the other staff members.
The IRS ruled that Hospital A was exempt from federal income tax under §501(c)(3). This was based on its opinion that Hospital A was promoting the health of a class of persons that is broad enough to benefit the community. Furthermore, it determined that:

- Hospital A was operated to serve a public rather than a private interest.
- Control of the hospital rested with its board of trustees, which is composed of independent civic leaders.
- The hospital maintained an open medical staff and made privileges available to all qualified physicians.
- All members of the active medical staff have leasing privileges in the medical building.
- An active and generally accessible emergency room is in operation.

Collectively, these factors indicate that the use and control of the hospital are for the benefit of the public and that no part of the income of the organization is inuring to the benefit of any private individual nor is any private interest being served.

Hospital B is also providing hospital care. To qualify under §501(c)(3), however, an organization must be organized and operated exclusively for one or more of the purposes set out in that Section. The following support the IRS's contention of private inurement:

- Hospital B was established and operated for the benefit of the five original physicians.
- Although its ownership has been transferred to a nonprofit organization, the hospital has continued to operate for the private benefit of its original owners who exercise control over every aspect of the operations.
- The five original physicians have used their control to restrict the number of physicians admitted to the medical staff.
- The physicians entered into favorable rental agreements with the hospital.
- The physicians limited emergency room care and hospital admission substantially to their own patients.

These facts indicate that the hospital is operated for the private benefit of the original owners, rather than for the exclusive benefit of the public [see Sonora Community Hospital v. Commissioner, 46 T.C. 519 (1966), aff'd 397 F.2d 814 (1968)].

In the second case, the IRS held that Hospital B did not qualify for exemption from federal income tax under §501(c)(3).
Rev. Rul. 69-545, in closing, noted that "In considering whether a nonprofit hospital claiming such exemption is operated to serve all of the relevant facts and circumstances in each case." The absence of particular factors set forth above or the presence of other factors will not necessarily be determinative.

According to The Law of Tax-Exempt Healthcare Organizations by Bruce Hopkins and Thomas Hyatt (1995), published by John Wiley and Sons, Inc., p. 316, the following constitute the best form of insulation in an appropriate partnership agreement if the organization maintains any hope of retaining exemption. These include:

- A requirement of income distributions to the organization at least in proportion to its capital contribution;
- A ceiling on losses allocable to the organization equal to its share of total capital;
- A requirement that all transactions between the partnership and other parties be at fair market value;
- A limit on the exposure of the organization to liabilities of the joint venture and corresponding indemnification;
- Exoneration of the organization from repayments of amounts invested by the other partners;
- A prohibition against loans by the organization to the partnership to finance operations or to the nonexempt partners for financial contributions;
- Options (puts, calls, or rights of first refusal) granted to the organization upon disposition of the partnership property or interest;
- No such options in the nonexempt partners unless the exempt organization is to receive at least fair market value; and
- Powers in the organization to appoint a majority of the governing body of the partnership.

PARTNERSHIPS AND THE ISSUE OF PRIVATE INUREMENT

As previously stated, hospitals and medical facilities are entering into an ever-increasing number of joint ventures because of significant changes in their operating environment. Many medical and surgical procedures once requiring inpatient care, still the mainstay of hospital operations, now are performed on an outpatient basis, making every private physician a potential competitor. In addition, the shift in governmental and private carrier coverage policy cost controls to one of competition has fundamentally changed the way in which all hospitals, both for-profit and not-for-profit, do business.

One of the driving forces behind this new operating environment was the Federal Medicare Program's 1983 shift from cost-based reimbursement for covered inpatient hospital services to fixed, per-case, prospective payments. This change to a diagnosis-related prospective payment system (PPS) dramatically
altered hospital financial incentives. PPS severed the link between longer hospital stays with more services provided each patient and higher reimbursement. It substituted strong incentives to control the costs of each individual inpatient's care while attracting a greater number of admissions. Medicare policies are highly influential; the program accounts for nearly 40% of the average hospital's revenues.

The need to increase admission volume was accompanied by a perceived need to influence physician treatment decisions which, by and large, were unaffected by the change to PPS. Hospitals realized that, in addition to attracting more patients, they needed to control use of ancillary hospital services, discharge Medicare beneficiaries as quickly as is medically appropriate, and operate more efficiently. Traditionally, physicians treating their private patients at a hospital had enjoyed nearly complete independence of professional judgment. Because they are paid separately by Medicare and other third-party payers on the basis of billed charges, physicians still have an incentive to render more services to each patient over a longer period to enhance their own revenues. Once hospital and physician economic incentives diverged, hospitals began seeking ways to stimulate loyalty among members of their medical staffs and to encourage or reward physicians who cooperate with their objectives.

Entering into joint venture arrangements with physicians benefits hospitals for many reasons. In seeking IRS approval for transactions, hospitals often cite the need to raise capital and to give physicians a stake in the success of a new enterprise or service. Other reasons may be less readily apparent but, typically, are no less important. In addition to hoping for or expecting additional admissions and referrals, hospitals may operate out of fear that a physician will send patients to another facility. These hopes and fears are a reaction to the competition many hospitals now face from other hospitals, both for-profit and not-for-profit, and, increasingly, from free-standing health providers owned or controlled by physicians.


Whenever a tax-exempt organization gets involved with an unusual or noncharitable venture, the arrangements must be evaluated based on the facts and circumstances in light of the applicable requirements affecting exempt organizations. As with any hospital-physician joint venture, the sale of the income-producing capacity must be carefully examined to determine if benefits are being unjustly transferred to a nonexempt entity. In the event a transaction is deemed inappropriate for an exempt organization, it is usually for one of three reasons:

- The transaction allows for private inurement of part of the exempt organization's net earnings to benefit one or more nonexempt private individuals;

- The transaction confers more than incidental benefits on private interests; or

- The transaction may possibly violate federal law.
USE OF JOINT VENTURES—REVENUE RULING 98-15

On March 4, 1998, the IRS issued a long-awaited Revenue Ruling concerning whole hospital joint ventures and the impact on loss of exemption. While the Ruling is specifically addressed to hospital joint ventures, it very clearly lays out the IRS' position regarding tax-exempt organizations and their participation in joint ventures. In the Ruling, the IRS takes the position that a management contract is permissible as long as the exempt organization has "ultimate control" over the assets and activities and that the terms are reasonable. What is most interesting is the thought process that led them to that conclusion.

The Ruling methodically lays out IRS thinking. While they are specifically addressing the issue of joint ventures and their relationship to healthcare, the same analysis applies in virtually every case where a not-for-profit organization enters into a joint venture with a for-profit entity.

BASICS

The Ruling begins with the basics of the Code and Regulations—"Section 5012(c)(3) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational... Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."

The Ruling cited a number of cases, including Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279,283 (1945), where the court stated that "the presence of a single... [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly... [exempt] purposes." This points out that exempt organizations must be both organized and operated exclusively for exempt purposes with the intent of serving a public good. The fact that there is "goodness" in an organization cannot in and of itself surface if the unrelated activity becomes the central focus of the organization. This is the entire premise for setting up significant unrelated activities as independent business ventures more often than not in corporate form.

ANALYSIS

The IRS relied on its analysis of Revenue Ruling 69-545 (previously discussed) and noted that, in considering whether a nonprofit is operated to serve a private benefit, the IRS will weigh all the facts and circumstances in each case, including but not limited to use and control. Even though the venture appears to be operated for a public good, the IRS will look through the entity in search of enurement.

Specifically regarding partnerships, §512(c) provides that an exempt organization that is a member of a partnership conducting an unrelated trade or business with respect to the exempt organization must include its share of the partnership income and deductions attributable to that business [subject to the exceptions, additions, and limitations in §512(b)] in computing its unrelated business income.
In Butler v. Commissioner, 36 T.C. 1097 (1961, acq. 1962-2 C.B. 4), the court examined the relationship between a partner and a partnership for purposes of determining whether the partner was entitled to a business bad debt deduction for a loan he had made to the partnership that it could not repay. In holding that the partner was entitled to the bad debt deduction, the court noted that "by reason of being a partner in a business, petitioner was individually engaged in business." [Butler, 36 T.C. at 1106 citing Dwight A. Ward v. Commissioner, 20 T.C. 332 (1953, aff'd 224 F.2d 547 (9th Cir. 1955)].

In Plumstead Theatre Society (previously discussed), the Tax Court held that a charitable organization’s participation as a general partner in a limited partnership did not jeopardize its exempt status. The organization co-produced a play as one of its charitable activities. One of the significant factors in that case supporting the Tax Court’s holding was its finding that the limited partners had no control over the organization’s operations.

In Broadway Theatre League of Lynchburg, Virginia, Inc. v. U.S., 293 F. Supp. 346 (W.D. Va. 1968), the court held that an organization that promoted an interest in theatrical arts did not jeopardize its exempt status when it hired a booking organization to arrange for a series of theatrical performances, promote the series, and sell season tickets to the series because the contract was for a reasonable term and provided for reasonable compensation and the organization retained ultimate authority over the activities being managed.

In Housing Pioneers v. Commissioner, 65 T.C.M. (CCH) 2191 (1993), aff’d, 49 F.3d 1395 (9th Cir. 1995), amended 58 F.3d 401 (9th Cir. 1995), the Tax Court concluded that an organization did not qualify as a §501(c)(3) organization because its activities performed as co-general partner in for-profit limited partnerships substantially furthered a non-exempt purpose, and serving that purpose caused the organization to serve private interests. The organization entered into partnerships as a 1% co-general partner of existing limited partnerships for the purpose of splitting the tax benefits with the for-profit partners. Under the management agreement, the organization’s authority as co-general partner was narrowly circumscribed. It had no management responsibilities and could describe only a vague charitable function of surveying tenant needs.

In est of Hawaii v. Commissioner, 71 T.C. 1067 (1979) aff’d in unpublished opinion 647 F.2d 170 (9th Cir. 1981), several for-profit est organizations exerted significant indirect control over est of Hawaii, a non-profit entity, through contractual arrangements. The Tax Court concluded that the for-profits were able to use the non-profit as an "instrument" to further their for-profit purposes. Neither the fact that the for-profits lacked structural control over the organizations, nor the fact that amounts paid to the for-profit organizations under the contracts were reasonable affected the court’s conclusion. Consequently, est of Hawaii did not qualify as an organization described in §501(c)(3).

In Harding Hospital, Inc. v. U.S., a non-profit hospital with an independent board of directors executed a contract with a medical partnership composed of seven physicians. The contract gave the physicians control over care of the hospital’s patients and the stream of income generated by the patients, while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The court held that the benefits derived form the contract constituted sufficient private benefit to preclude exemption.
SALE OR TRANSFER OF A REVENUE STREAM FROM A NONEXEMPT ENTITY

One of the most rudimentary foundations of exempt organizations is to ensure that all activities are designed to use charitable assets exclusively to further the organization's exempt purpose. Section 501(c)(3) describes a charitable organization as one where "...no part of the net earnings of which inures to the benefit of any private shareholder or individual." Similarly, Regulations under §1.501(c)(3)–1(c)(2) provide that:

An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

At any point this occurs, private inurement (inurement) occurs.

Note that GCM 39862 states the following: “Protecting charitable organizations against private inurement serves important purposes. A charitable organization is viewed under the common law and the IRC as a trust whose assets must irrevocably be dedicated to achieving charitable purposes. The inurement prohibition serves to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use."

The concept of inurement and its related applications are very narrow in focus. The concept does not generally apply to a large group of people receiving a benefit under the terms and conditions of exemption such as individuals in a community receiving free medical care. Normally, inurement applies to a specific class of individuals who, because of their relationship to the organization, are in a unique position to control, direct, or influence the organization. In this regard, the Regulations under §1.501(a)–1(c) refer to shareholders and individuals as persons who have a personal and private interest in the activities of the organization. These individuals are often referred to as “insiders” [American Campaign Academy v. Commissioner, 92 T.C. 1053, 1066 (1989)].

The concept of “insider” does not necessarily mean a small group. In GCM 39498, the IRS issued a memorandum stating that all physicians of the medical staff of a hospital, as employees or persons with a close professional working association with the hospital, are persons who have a personal and private interest in the activities of the hospital and as such are subject to the rules covering private inurement. Additionally, in GCM 39670, the IRS stated that all persons performing services for an organization have a personal and private interest in it and, therefore, possess the requisite relationship to find inurement.

It would be unduly restrictive to take the position that hospital physicians, even though subject to inurement, cannot have any economic dealings between themselves and the hospital. The prohibition against inurement will not prevent payment of reasonable compensation for goods and services. The purpose of the rules is to prevent dividend-like distributions of a charity's assets or expenditures to benefit a private interest. The IRS has stated that “...inurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual’s relationship with the organization, and without regard to the accomplishment of exempt purposes” (GCM 38459).
If hospital-based physicians were employees, any reasonable payment to them for services would not normally give rise to inurement [Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953); Birmingham Business College, Inc. v. Commissioner, 276 F.2d 476 (5th Cir. 1960)]. In addition, if physicians were working as independent contractors for a hospital, payment of reasonable compensation for services would not generate inurement. This position is essentially the finding in Revenue Ruling 69-383, 1969-2 C.B. 113. In that ruling, the IRS allowed a physician who was running a radiology department to receive a percentage of the adjusted gross revenues from his department. Although this would normally be considered inurement, the IRS allowed it based on the arrangements that the radiologist worked out with the hospital. In this case:

- The arrangements were negotiated at arm's length;
- The physician had no control over, or management authority with respect to, the hospital; and
- The amount received did not represent excessive or unreasonable compensation for the services actually performed.

Even though the IRS approved the specific circumstances of Revenue Ruling 69-383, they warned that the presence of a percentage compensation arrangement will destroy the organization's exemption when it transforms the principal activity of the organization into a joint venture between it and a group of physicians or if it is merely a device for distributing profits to persons in control. Without question, if salaries or any other form of compensation are unreasonable, inurement exists.

Inurement is not just a question of redirection of earnings. It can also include a redirection of assets. One important fact should be noted: it is possible to find inurement even when the amounts are small. According to Spokane Motorcycle Club v. United States, 222 F.Supp. 151 (E.D. Wash. 1963), no de minimis exception to the inurement prohibition is allowed.

In another example, the net earnings of a psychiatric hospital were found to inure to the benefit of its medical staff [Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974)]. In that case, even though control of the hospital was in the hands of an independent board of trustees, the Court found a pattern of facts showing that one group of physicians received substantial benefits from its dealings with the hospital. The facts showed that seven physicians who were members of one professional association totally monopolized the hospital, treating between 90 and 95% of the patients admitted to the hospital, and rented office space and obtained services from the hospital at less than fair market value.

In May 1995, T.J. Sullivan, special assistant to the IRS assistant commissioner (employee plans and exempt organizations), speaking to the American Group Practice Association, stated that a physician may not share in the equity base of a tax-exempt hospital if the hospital does not want to endanger its tax-exempt status. Sullivan cited as being impermissible an arrangement in which an exempt hospital agrees to compensate a physician with a portion of its net income stream. Of interest when comparing for-profit and not-for-profit organizations, Sullivan also pointed out that using the revenue stream as a compensation vehicle is not allowed in the tax-exempt context, although such arrangements are prevalent among for-profit hospitals.
SALE OF THE REVENUE STREAMS THAT BENEFIT RECIPIENTS

Another one of the key requirements regarding exemption is that an entity must serve a public rather than a private interest to be exempt. Regulation §1.501(c)(3)–1(d)(1)(ii) states:

An organization is not organized or operated exclusively for one or more of the purposes specified unless it serves a public rather than a private interest...It is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interest.

According to GCM 39862, the relationship between inurement and private benefit was clarified by the Tax Court in American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989). In that case, the court explained that "...while the prohibitions against private benefit and private inurement share common and overlapping elements, the two are distinct requirements which must independently be satisfied." The Tax Court, in its decision, stated that the presence of private inurement violates both prohibitions, but the absence of inurement does not mean the absence of private benefit. As such, inurement may be taken as a subdivision of private benefit.

GCM 39862 also pointed out that the presence of a single noncharitable purpose, if substantial in nature, would destroy an organization's exemption regardless of the number or importance of the charitable purposes. Whether undue benefit is flowing to an individual often requires detailed analysis and is normally based on the facts and circumstances.

In GCM 37789, the IRS outlined the standard used in balancing private benefit against public benefit. If the organization is to remain exempt, any private benefit arising from a particular activity must be "incidental" in both a qualitative and quantitative sense to the overall public benefit achieved by the activity. To be qualitatively incidental, a private benefit must occur as a necessary concomitant of the activity that benefits the public at large. Stated another way, the benefit to the public cannot be achieved without necessarily benefiting private individuals. To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity. It bears emphasis that, even though exemption of the entire organization may be at stake, the private benefit conferred by an activity or arrangement is balanced only against the public benefit conferred by that activity or arrangement, not against the overall good accomplished by the organization.

In the situation where the physician investor receives an immediate income stream as a direct benefit of the relationship with the hospital, there is no question of inurement. The IRS's position has repeatedly been that, even in cases where there may not necessarily be a question of inurement, clearly a question of private benefit arises. This benefit is conferred whether:

- The physician receives a substantial share in the profits of the hospital; or
- The physician receives an extremely profitable investment in which to participate.

It is very difficult to see where these arrangements promote the health of the community.
SALE OF THE REVENUE STREAM FROM A HOSPITAL ACTIVITY IN VIOLATION OF FEDERAL LAW

Virtually every hospital that is exempt as an organization described in §501(c)(3) participates in the Medicare and Medicaid programs. For the most part, this participation is a requirement for exemption. As such, these hospitals are subject to a comprehensive body of law found in the Social Security Act. In this area, emphasis is on Medicare and Medicaid Anti-Fraud and Abuse Law, referred to as the “Anti-Kickback Statute.” This law prohibits the offer, solicitation, payment, or receipt of any remuneration, in cash or in kind, in return for, or to induce, the referral of a patient for any service that may be paid for by Medicare or Medicaid. When a tax-exempt hospital engages in activities or arrangements that violate the anti-kickback statute, they face the loss of exemption.

The following covers some of the key issues from the anti-kickback provisions.

Part (b) Illegal Remuneration

(1) Whoever knowingly and willfully solicits or receives any remuneration (including any kickback, bribe, or rebate) directly or indirectly, overtly or covertly, in cash or in kind

(A) In return for referring an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in part under [Medicare or Medicaid], or

(B) In return for purchasing, leasing, ordering, arranging for or recommending purchasing, leasing, or ordering any good, facility, service, or item for which payment may be made in whole or in part under [Medicare or Medicaid],

shall be guilty of a felony and upon conviction thereof, shall be fined not more than $25,000 or imprisoned for not more than five years, or both.

(2) Whoever knowingly and willfully offers or pays any remuneration (including any kickback, bribe, or rebate) directly or indirectly, overtly or covertly, in cash or in kind to any person to induce such person

(A) To refer an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in part under [Medicare or Medicaid], or

(B) To purchase, lease, order or arrange for or recommend purchasing, leasing, or ordering any good, facility, service, or item for which payment may be made in whole or in part under [Medicare or Medicaid],

shall be guilty of a felony and upon conviction thereof, shall be fined not more than $25,000 or imprisoned for not more than five years, or both.
Paragraphs (1) and (2) shall not apply to

(A) A discount or other reduction in price obtained by a provider of services or other entity under [Medicare or Medicaid] if the reduction in price is properly disclosed and appropriately reflected in the costs claimed or the charges made by the provider or entity under [Medicare or Medicaid];

(B) Any amount paid by an employer to an employee (who has a bona fide employment relationship with such employer) for employment in the provision of covered items or services.

The provision clearly prohibits giving anything of value in return for, or to induce referral of, patients. It clearly prohibits a hospital from paying its medical staff physicians, directly or indirectly, to admit or refer Medicare or Medicaid patients to the facility.

Office of Inspector General’s Position on Hospital Incentives to Physicians

The Office of Inspector General (OIG) of the Department of Health and Human Services issued a “Special Fraud Alert,” Hospital Incentive to Physicians. The alert illustrates OIG’s opinion on the application of the Medicare and Medicaid anti-kickback statute to various situations, and it addresses various relationships commonly used between hospitals and physicians. The document lists ten areas which are to be considered questionable. The list, which is not all-inclusive, enumerates the most commonly found potentially unlawful activities:

- Payment of any sort of incentive by the hospital each time a physician refers a patient to the hospital.
- The use of free or significantly discounted office space or equipment (in facilities usually located close to the hospital).
- Provision of free or significantly discounted billing, nursing, or other staff services.
- Free training for a physician’s office staff in areas such as management techniques, CPT coding, and laboratory techniques.
- Guarantees providing that, if the physician’s income fails to reach a predetermined level, the hospital will supplement the remainder up to a certain amount.
- Low-interest or interest-free loans, or loans that may be “forgiven” if a physician refers patients (or some number of patients) to the hospital.
- Payment of the cost of a physician’s travel and expenses for conferences.
- Payment for a physician’s continuing education courses.
Coverage on hospitals' group health insurance plans at an inappropriately low cost to the physician.

Payment for services (which may include consultations at the hospital) that require few, if any, substantive duties by the physician or payment for services in excess of the fair market value of services rendered.

Financial incentive packages that incorporate these or similar features may be subject to prosecution under the Medicare and Medicaid anti-kickback statute, if one of the purposes of the incentive is to influence the physician's medical decision concerning where to refer a patient for treatment.

In and of itself, this analysis by the OIG has little relevance to the issue of exemption and, in fact, does not have the force of law behind it. This list does become a concern, however, when combined with GCM 39862 discussed above. The GCM points out that a violation of the anti-kickback statute would, in itself, serve as a sufficient reason to revoke a tax-exempt status.

We believe that engaging in conduct or arrangements that violate the anti-kickback statute is inconsistent with continued exemption as a charitable hospital. No matter how economically rewarding, such activities cannot be viewed as furthering exempt purposes. A §501(c)(3) hospital is a charitable trust. All charitable trusts (and, by implication, all charitable organizations, regardless of their form) are subject to the requirement that their purposes or activities may not be illegal or contrary to public policy.

A series of safe-harbor regulations defines certain situations that would not be defined as abusive and, as such, would not activate the anti-kickback provisions. Discussion of these safe harbors, however, is beyond the scope of this chapter.

PHYSICIAN RECRUITMENT INCENTIVES' IMPACT ON EXEMPTION

Problems arising out of recruiting benefits are receiving an ever-increasing amount of publicity, especially in light of Hermann Hospital's closing agreement and Announcement 95-25. The concept of recruiting benefits and related rhetoric, however, are neither new nor necessarily only related to the medical field. Several Revenue Rulings discussed below have affected this area for some time.

In Revenue Ruling 72-559, 1972-2 C.B. 247, the IRS held that an organization that provides subsidies to recent law school graduates during the first three years of their practice to enable them to establish legal practices in economically depressed communities that have a shortage of available legal services and to provide free legal service to needy members of the community may qualify as an organization described in §501(c)(3).

In regard to the medical field, Revenue Ruling 72-313, 1973-2 C.B. 174, held that attracting a physician to a community that had no available medical services furthered the charitable purpose of promoting the health of the community. In Revenue Ruling 73-313, residents of an isolated rural community had to travel a considerable distance to obtain care. Faced with the total lack of local services, the community formed an organization to raise funds and build a medical office building to attract a physician to the locality. The ruling states that certain facts are particularly relevant:
The demonstrated need for the physician to avert a real and substantial threat to the community;

- Evidence that the lack of a suitable office had impeded efforts to attract a physician;

- Evidence that the arrangements were completely at arm's length; and

- Evidence that no relationship existed between any person connected with the organization and the recruited physician.

The ruling states that, under all the circumstances, the arrangement used to induce the physician to locate a practice in the area "...bears a reasonable relationship to promotion and protection of the health of the community" and any private benefit to the physician is incidental to the public purpose achieved. It concludes that the activity furthers a charitable purpose and the organization qualifies for exemption as an organization described in §501(c)(3).

In 1994, Hermann Hospital, a 560-bed hospital located in Houston, Texas, entered into a closing agreement with the IRS. The closing agreement was picked up by BNA Daily Tax Report, October 1, 1994, p. L-1, as one of the conditions set by the IRS. The agreement outlined actions that were to be required on the part of Hermann in addition to certain payments to be made. The settlement was a direct result of Hermann's recruiting arrangements and dealings with various persons associated with the hospital.

The agreement required Hermann to adopt specific guidelines—"Hospital Physician Recruitment Guidelines"—that had been developed by the national office. The guidelines set out a comprehensive list of permissible and impermissible activities.

The guidelines identify both the physicians to whom the guidelines apply as well as the types of incentives to be offered. The guidelines define two types of recipients and one class of "permissible recruit." In the narrative, an "existing physician" is defined as a nonemployee physician who has medical staff privileges at the hospital. On the other hand, "newly recruited physicians" are defined as nonemployee physicians who have not as yet received hospital privileges. The guidelines also define who is a "permissible recruit." A permissible recruit is a physician who either:

(i) Is a recent graduate of a residency or fellowship program, whether or not in the Hospital's community, or

(ii) Has not previously practiced in the hospital's community or been affiliated with another hospital servicing all or part of the hospital's community.

Incentives included in the guidelines are cash, credit, goods, services, or other valuable rights to a physician in exchange for the physician's agreement to relocate into or remain with the hospital's community. Permissible incentives are allowed if provided in an amount and manner that does not confer prohibited inurement or more than incidental private benefit upon the physicians. In addition, incentives are considered prohibited inurement or more than incidental private benefits if they fall outside the scope of the guidelines. In summary, the guidelines specifically state that the hospital can provide no incentives to physicians that are not permissible incentives. The guidelines make the unqualified statement that any
incentives provided to existing physicians are not permissible incentives by default. In contrast, permissible incentives, including recruitment or retention incentives, are allowable as long as they are given to permissible recruits.

**DEMONSTRABLE COMMUNITY NEED**

Recruitment incentives offered to a permissible recruit will not be considered permissible incentives unless there is a “demonstrable community need” for the physician. Demonstrable community need consists of the following:

- A population-to-physician ratio in the community that is deficient in the particular specialty of the physician being recruited;

- Demand for a particular medical service in the community coupled with a documented lack of availability of the service or long waiting periods for the service, if the physician is being recruited to increase availability of that service;

- Designation of the community at the time the recruitment agreement is executed as a “Health Professional Shortage Area”;

- A demonstrated reluctance of physicians to relocate at the hospital because of the hospital’s physical location;

- A reasonably expected reduction in the number of physicians of that specialty serving in the hospital’s service area because of the anticipated retirement, within the next three-year period, of physicians presently in the community; or

- A documented lack of physicians serving indigent or Medicaid patients within the hospital’s service area, provided that newly recruited physicians commit to serving a substantial number of Medicaid and charity care patients.

**DUTIES AND RESPONSIBILITIES**

In a situation where a hospital is providing permissible incentives to physicians, the guidelines provide that a hospital could obligate the physician to fulfill a variety of duties or stipulations including:

- Relocation to the service area of the hospital;

- Establishment of a full-time private practice;

- Continued presence in the community for a specified period;

- Maintenance of license to practice;
Acceptance of Medicaid and charity patients;
 Assignment to emergency room duty or other rotations;
 Performance of community or medical teaching;
 Performance of necessary administrative duties;
 Maintenance of staff privileges; and
 Maintenance of a practice in the specialty for which he or she was recruited.

PERMISSIBLE INCENTIVES

The guidelines point out that incentives may not be conditioned on a requirement or understanding that the physician admit or refer patients to the hospital or on any prohibition or restriction upon the ability of the physician to obtain or maintain staff privileges at other hospitals or to treat patients at or admit patients to other hospitals.

For incentives such as loans, lines of credit, or loan guarantees to qualify, they must be:

- Documented and evidenced by an executed promissory note;
- Adequately secured; and
- Bear interest at a reasonable rate reflecting market conditions.

At the same time, any loan-forgiveness component will be contingent upon the continued presence of the physician in practice in the community and will be ratable for a period of not less than four years, and the time period must be specified by contract at the time the loan or loan guarantee is made. The guidelines require that a demonstrable need for the particular physician and the amount of the particular incentive shall be evidenced when provision is made for forgiveness of the loan.

INCOME GUARANTEES

The guidelines provide that the hospital can make income guarantees as long as certain conditions are met. Included in these conditions are the following:

- Income guarantees are limited to two years or less.
- No off-agreement benefits are offered or provided.
- All of the terms are agreed to in advance in writing and are not modified over the life of the agreement.
TAX EXEMPTION OF HOSPITALS AND HEALTH-CARE PROVIDERS

- In the event that periodic income guarantee advances are made to the physician, they will be structured as a loan or loans bearing a reasonable rate of interest and will have any long terms or loan forgiveness in compliance with the guidelines.

- When the income guarantee is for a net income amount, a reasonable fixed ceiling amount must be placed on allowable expenses and amounts for which advances may be made.

- The guarantee represents all or part of a compensation package that is reasonable in its entirety.

ADDITIONAL INCENTIVES

The guidelines have created a mutually exclusive set of incentives, which can be provided only if income guarantees or forgiveness of debt is not applicable. This application of permissible incentives includes the following:

- Reasonable subsidies may be paid or provided, or similar financing arranged, for medical office space rent, overhead expenses (such as utilities), or rental of equipment for a permissible recruit. No such subsidy may be provided, however, unless the rental amount is at fair rental value, and in no event may a subsidy be provided for more than two years.

- Reasonable subsidized equipment purchases or other assistance in acquiring equipment may be provided on behalf of a permissible recruit. Again, this incentive is permissible only if free or reduced cost used by the physician does not exceed two years. If title is transferred to the physician at the end of the period of free or reduced cost use, the hospital will receive reimbursement of the equipment's fair market value from the physician.

- No assistance in acquiring equipment or space may be provided if it entails a conveyance or lease of such equipment or office space with a leaseback to the hospital.

In addition to the aforementioned permissible incentives, reasonable interview travel expenses may be reimbursed to permissible recruits.

Incentives are normally discussed within the area of physicians, but in the area of travel the guidelines provide that permissible incentives include educational and related expense reimbursements, in the case of nurses and nurse anesthetists, in exchange for future employment commitments, especially if the hospital service area is experiencing a documented nursing shortage.

IMPERMISSIBLE INCENTIVES

Leaving nothing to chance, the guidelines outline specific impermissible incentives. Impermissible incentives include the following:
Travel and continuing education expenses for any nonemployee physician when the expense is primarily related to the physician's private practice of medicine;

- Payment or subsidized provision of private practice start-up or maintenance assistance, if an income guarantee has been or will be provided to the same physician;

- Hospital subsidization of salary and benefit costs for the support personnel of a nonemployee physician in his or her private practice;

- Payment or provision, directly or indirectly, of malpractice insurance for the current private practice of a nonemployee physician;

- Subsidized parking, telephone allowances including cellular car phones, car allowances, health insurance, or payment of medical society dues or licensing fees;

- Signing bonuses or other bonus payments;

- When a permissible recruit is recruited to enter an existing physician's established medical practice, the hospital is not allowed to pay more than 50% of the recruiting fees or costs associated with that physician;

- Conveyance or promise of a future conveyance of the hospital's outpatient department to a physician; and

- Recruiting fees paid to existing physicians. (Fees may be paid to an outside search consultant.)

**Reporting and Recordkeeping Requirements**

The following reporting requirements must be met to comply with the requirements of the guidelines:

- All incentives provided to physicians are to be reported on Form W-2 or Form 1099.

- The hospital is to maintain complete and accurate records documenting amounts paid and other incentives provided to permissible recruits and documenting community need to ensure compliance with the guidelines.

- The hospital is required to maintain proper records of fees due it for patient use of outpatient departments, as well as other overview safeguards.

- All physicians to whom incentives are provided must agree to a periodic accounting to the hospital and must allow the hospital to inspect the physician's financial books and records.
One final note of importance is included in the guidelines: "While management may negotiate recruitment agreements within these guidelines, Hospital Board approval and review by Hospital's legal counsel or tax advisor shall be obtained prior to execution for each specific financial package provided to each individual recruited physician."

Professionals should exercise considerable caution when assisting exempt health-care providers. For the most part, the recruiting issues discussed above are more administrative than financial. Any failure to comply with any of the provisions in the "Physician Recruitment Guidelines," however, may be found to constitute prohibited inurement and excessive private benefits that are inconsistent with an exempt hospital's continued status as an organization described in §501(c)(3). It is not intended, however, that any such failure would automatically constitute a prohibited inurement or excessive private benefit other than as determined under the federal tax laws in effect at the time of the failure.

**ANNOUNCEMENT 95-25**

On March 15, 1995, the IRS issued Announcement 95-25 (1995-14 IRB, 03/15/95), the text of a proposed Revenue Ruling, regarding the issue of physician recruitment. The proposed Revenue Ruling dealt with whether hospitals violate §501(c)(3) rules for exemption by recruiting physicians either to join nonemployee medical staff or provide services for the hospital. This proposed Revenue Ruling comes on the heels of the Hermann Hospital Physician Recruiting Guidelines discussed above and brings together what has become a growing body of literature on a fairly narrow topic.

The proposed Revenue Ruling (the Ruling) outlines the general analysis that the IRS applies to physician recruitment activities. It describes specific situations in which tax-exempt hospitals are considered to either meet the requirement of §501(c)(3) or fail to meet those requirements. The Ruling clearly does not cover all of the possible situations and, clearly, any alteration of the listed situations would possibly change the outcome.

Strictly for the purpose of this Ruling, Situations 1, 2, 3, and 4 are assumed to be legal. These examples are for information purposes only and, although considered lawful, are not evaluated in regard to the Medicare and Medicaid Anti-Kickback Statute, 42 U.S.C. §1320a-7b(b).

**Situation 1**

**Facts:**

Hospital A is in County V, a rural area, and is the only hospital within a 100-mile radius. County V has been designated by the U.S. Public Health IRS as a Health Professional Shortage Area for primary medical care professionals (which includes obstetricians and gynecologists). Physician M recently completed an ob/gyn residency and is not on Hospital A's medical staff. Hospital A recruits Physician M to establish and maintain a full-time private ob/gyn practice in its service area and become a nonemployee member of its medical staff. Hospital A provides Physician M a recruitment incentive package pursuant to a written agreement negotiated at arm's length and approved by Hospital A's Board of Directors or its designees. Hospital A does not provide any recruiting incentives to Physician M other than those set forth in the written agreement.
In accordance with the agreement, Hospital A pays Physician M a one-time bonus of $5,000, pays Physician M's malpractice insurance premium for one year, provides office space in a building owned by Hospital A for three years at a below-market rent (after which the rental will be at fair market value), and guarantees Physician M's mortgage on a residence in County V. Hospital A also provides Physician M's practice with start-up financial assistance pursuant to an agreement that is properly documented and bears commercially reasonable terms.

**Analysis and Resolution**

As in the case of the organization described in Revenue Ruling 73-313, Hospital A has objective evidence demonstrating a need for obstetricians and gynecologists in its service area and has engaged in physician recruitment activity bearing a reasonable relationship to promoting and protecting the health of the community in accordance with Revenue Ruling 69-545. As with the subsidies provided to the recent law school graduates in Revenue Ruling 72-559, the payment of a bonus, the guarantee of a mortgage, the reimbursement of malpractice insurance, the provision of subsidized office space for a limited time, and the provision of start-up financial assistance as recruitment incentives are reasonably related to causing Physician M to establish and maintain a full-time private ob/gyn practice in Hospital A's service area. The provision of the incentives under the circumstances described furthers the charitable purposes served by the hospital and is consistent with the requirements for exemption as an organization described in §501(c)(3).

**Situation 2**

**Facts:**

Hospital B is located in an economically depressed inner city area of City W. Hospital B has conducted a community needs assessment which indicates not only a shortage of pediatricians in hospital B's service area but also that Medicaid patients are having particular difficulty obtaining pediatricians' services. Physician N is a pediatrician currently practicing outside of Hospital B's service area and is not on Hospital B's medical staff. Hospital B recruits Physician N to relocate to City W, establish and maintain a full-time pediatric practice in Hospital B's service area, become a nonemployee member of Hospital B's medical staff, and treat a reasonable number of Medicaid patients. Hospital B offers Physician N a recruitment incentive package pursuant to a written agreement negotiated at arm's length and approved by Hospital B's Board of Directors or its designees. Hospital B does not provide any recruiting incentives to physician N other than those set forth in the written agreement.

Under the agreement, Hospital B reimburses Physician N for moving expenses as defined in §217(b), reimburses Physician N for professional liability "tail" coverage for Physician N's former practice, and guarantees Physician N's private practice income for the first three years. Under a private practice income guarantee, which is properly documented and bears commercially reasonable terms, Hospital B guarantees that during the first three years that Physician N practices full-time in its service area, Physician N's private practice will generate a certain level of net income (after reasonable expenses of the
practice) and that Hospital B will make up the difference to the extent the private practice does not generate that level of net income. The amount guaranteed falls within the range reflected in regional or national surveys regarding income earned by physicians in the same specialty.

**Analysis and Resolution**

As with Hospital A in Situation 1, Hospital B has objective evidence demonstrating a need for pediatricians in its service area and has engaged in physician recruitment activity bearing a reasonable relationship to promoting and protecting the health of the community in much the same manner as the organization described in Revenue Ruling 73-313. As with the recruitment incentive package provided by Hospital A, the payment of moving expenses, the reimbursement of malpractice "tail" coverage, and the provision of a reasonable private practice income guarantee as recruitment incentives are reasonably related to causing Physician N to establish and maintain a full-time private pediatric practice in Hospital B's service area. Hence, the recruitment activity described furthers the charitable purposes served by the hospital and is consistent with the requirements for exemption as an organization described in §501(c)(3).

**Situation 3**

**Facts:**

Hospital C is located in an economically depressed inner city area of City X. Hospital C has conducted a community needs assessment that indicates that indigent patients are having difficulty getting access to care because of a shortage of obstetricians in Hospital C's service area willing to treat Medicaid and charity care patients. Hospital C recruits Physician O, an obstetrician currently on its medical staff, to provide these services and enters into a written agreement with Physician O that was approved by Hospital C's Board of Directors or its designees. Hospital C does not provide any recruiting incentives to Physician O other than those set forth in the written agreement. Pursuant to the agreement, Hospital C agrees to reimburse Physician O for the cost of one year's malpractice insurance in return for an agreement by Physician O to treat a reasonable number of Medicaid and charity care patients for that year.

**Analysis and Resolution**

In accordance with the standards for exemption set forth in Revenue Ruling 69-545, Hospital C admits and treats Medicaid patients on a nondiscriminatory basis. Hospital C has identified a shortage of obstetricians willing to treat Medicaid patients. The payment of Physician O's malpractice insurance premiums in return for physician O's agreement to treat a reasonable number of Medicaid and charity care patients is reasonably related to the accomplishment of Hospital C's exempt purposes. Because the amount paid by Hospital C is reasonable and any private benefit to Physician O is outweighed by the public purpose served by the agreement, the recruitment activity described is consistent with the requirements for exemption as an organization described in §501(c)(3).
Situation 4

Facts:

Hospital D is located in City Y, a medium- to large-sized metropolitan area. Hospital D operates a neonatal intensive care unit that requires a minimum of four perinatologists to ensure adequate coverage and a high quality of care in the unit. Two of the four perinatologists currently providing coverage for Hospital D's neonatal intensive care unit are relocating to other areas. Hospital D initiates a search for perinatologists and determines that one of the two top candidates is Physician P.

Physician P currently is practicing in City Y, is a member of the medical staff of Hospital E (which is also located in City Y), and provides coverage for the neonatal intensive care unit at Hospital E. Physician P is not on Hospital D's medical staff. Hospital D recruits Physician P to join its nonemployee medical staff and to provide coverage for its neonatal intensive care unit. Hospital D offers Physician P a recruitment incentive package pursuant to a written agreement, negotiated at arm's length and approved by Hospital D's Board of Directors or its designees. Hospital D does not provide any recruiting incentives to Physician P other than those set forth in the written agreement.

Pursuant to the agreement, Hospital D guarantees Physician P's private practice income for the first three years that Physician P is a member of its medical staff and provides coverage for its neonatal intensive care unit. Under a private practice income guarantee, which is properly documented and bears commercially reasonable terms, Hospital D guarantees that Physician P's private practice will generate a certain level of net income (after reasonable expenses of the practice) and that Hospital D will make up the difference to Physician P to the extent the private practice does not generate that level of net income. The net income amount guaranteed falls within the range reflected in regional or national surveys regarding income earned by physicians in the same specialty.

Analysis and Resolution

Hospital D has objective evidence demonstrating a need for perinatologists to provide coverage for its neonatal intensive care unit so that it can promote the health of the community. The provision of a reasonable private practice income guarantee as a recruitment incentive that is conditioned upon Physician P obtaining medical staff privileges and providing coverage for the neonatal intensive care unit is reasonably related to the accomplishment of the charitable purposes served by the hospital. A significant fact in determining that the community benefit provided by the activity outweighs the private benefit provided to Physician P is the determination by Hospital D that it needs additional perinatologists to cover the neonatal intensive care unit to provide adequate coverage and to ensure a high quality of medical care. The recruitment activity described is consistent with the requirements for exemption as an organization described in §501(c)(3).
Situation 5

Facts:

Hospital F is in City Z, a medium- to large-sized metropolitan area. Because of its physician recruitment practices, Hospital F has been found guilty in a court of law of knowingly and willfully violating the Medicare and Medicaid Anti-Kickback Statute, 42 U.S.C. §1320a-7(b), for providing recruitment incentives that constituted payments for referrals. The activities resulting in the violations were substantial.

Analysis and Resolution

Hospital F has engaged in physician recruiting practices resulting in a criminal conviction. As in Revenue Ruling 75-384, the recruiting activities were intentional and criminal, not isolated or inadvertent violations of a regulatory statute. An organization that engages in substantial unlawful activities, including activities involving the use of the organization's property for an objective that is in violation of criminal law, does not qualify as an organization described in §501(c)(3). Because Hospital F has knowingly and willfully conducted substantial activities that are inconsistent with charitable purposes, it does not comply with the requirements of §501(c)(3) and §1.501(c)(3)-1.

In summary, the hospitals in Situations 1, 2, 3, and 4 have not violated the requirements for exemption from federal income tax as organizations described in §501(c)(3) as a result of the physician recruitment incentive agreements because the transactions further charitable purposes, do not result in inurement, do not result in the hospitals servicing a private rather than a public purpose, and are lawful.

Hospital F in Situation 5 does not qualify as an organization described in §501(c)(3) because its unlawful physician recruitment activities are inconsistent with charitable purposes.

SUMMARY

Tax-exempt health-care facilities have to meet all the same requirements as do other tax-exempt organizations. In addition, they must also deal with various issues not normally addressed by most organizations. In addition to the IRS, exempt health-care providers must also contend with such other controlling authorities as the Social Security Administration and the Department of Health and Human Services.

The IRS along with these other agencies are challenging exemption where physicians and other related entities are entering into joint venture arrangements with tax-exempt health-care facilities. The IRS is concentrating on the sale of revenue streams that appear to be to the detriment of organizations exempt under §501(c)(3).
In addition to the sale of revenue streams, the IRS is also challenging "unfair" recruiting practices. In that regard, the IRS is following unofficial guidance provided through a closing letter. The Hospital Physician Recruitment Guidelines have not been formally published or subjected to any form of public hearing or comment. In fact, they are not even binding on hospitals. They give a very clear indication, however, of how the IRS would view the various issues that may arise on examination.

The proposed Revenue Ruling is a different issue. When adopted, it will give the first official guidance offered by the IRS in many years in regard to physician recruitment. This guidance has an impact on both the physician and the exempt health-care facility.
INTRODUCTION

States have the authority to levy taxes along with the authority to determine which organizations will be subject to those taxes. As part of this process, lawmakers must also specify the circumstances under which an organization will be exempted from tax. In cases where states allow for exemption, they rely for the most part on the use of federal designations for the types of organizations. However, there is no guarantee the states will include all the same types of activities within a given classification. By way of example, the District of Columbia does not recognize §501(c)(10) exempt organizations. At the same time, other jurisdictions grant a partial exemption to the extent an exempt organization might benefit their state.

When it comes to the state's authority to levy taxes, discussion is not limited to income taxes alone. Exempt organizations look to their advisors for help with everything from exemption from real property taxes to the application of sales and use taxes.

Example 6-1:

- There are only five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) that have no sales tax.

- Of those states with a sales and use tax, most grant exemption to qualifying §501(c)(3) organizations.

- Other states allow for a partial exemption. Sales Tax Exemptions for Charitable, Educational and Religious Nonprofit Organizations, 78 Exempt Org. Tax Rev. 431 (1993), points out that Wisconsin provides no sales tax exemption for:
  
  - Literary organizations,
Example 6-1: (continued)

- Organizations that test for public safety, and
- Organizations that foster nationals in international athletic competition.

- But does provide for exemption in the case of religion, education, etc.

Although state laws for exempt organizations are not uniform, overall there tends to be uniformity in certain areas. A basic knowledge of these issues can provide the accountant with a frame of reference to be used in effectively solving problems and anticipating future client needs. While it is not possible to cover the diverse treatment given to the various types of taxes in their entirety, an overview of state structures can give insight into the complexity of state issues.

Because of the wide spectrum of requirements by the various states, an exempt organization would be well advised to contact the state charities division to review the local requirements. While many states have a division or group that handles either charities or other types of exempt organizations, some have farmed out the responsibility to other areas. For example, approximately a dozen states have turned over the responsibility to their respective Departments of Agriculture.

It would be impossible to cover all types of taxes assessed by the states. However, the following taxes and requirements are generally applicable to most states:

- Sales and Use Taxes.
- Real Property Taxes.
- Payroll Taxes.
- Income Taxes.
- Registration and Filing Requirements.

SALES AND USE TAXES

GENERAL

Sales/Use tax legislation can be complex due to lack of uniformity between state laws and the constant revisions being passed by individual states. Because most states are facing substantial revenue shortfalls, they have become reluctant to grant exemptions. An organization which is exempt from state income taxes may not be exempt from sales/use taxes because different qualifying standards are used.
Exemption Factors

In determining exemption from sales/use taxes, the state may consider such factors as:

- Organization’s purpose or main activity.
- Primary goods or services it offers.

Often, there does not appear to be a great deal of rationale to a state’s sales and use tax laws.

Example 6-2:

- In Idaho, businesses owned and operated by Idaho tribes are exempt from sales tax while other federally recognized tribes are exempt in Idaho only for sales made to Idaho Indian Reservations.
- At the same time, sales of meals under programs providing nutritional meals for the aged have been exempted from sales and use taxes while sales of meals are not exempt in the case of nursing homes.

Purchase of Goods and Services

Many states will not grant an exemption from sales/use taxes unless the exempt organization has filed for and obtained an exemption certificate. Certain states, however, will issue this certificate based on evidence that the organization has met federal requirements for exemption from income tax. Still, other states have their own requirements separate from, or in addition to, the federal ones.

Normally, exemptions from sales/use taxes are granted only to §501(c)(3) organizations. Other exempt entities, such as trade associations and social welfare groups, have often been denied exemption.

Example 6-3:

- A Virginia drug and alcohol treatment center located in a hospital lost its Virginia sales tax exemption when it filed for its own exemption.
- Exemption was not allowed because it was no longer considered part of the hospital which enjoyed a blanket exemption from sales/use taxes.
- Similarly, an Ohio credit counseling service was denied an exemption because it did not restrict service to individuals below the poverty line.
SALES OF GOODS AND SERVICES

While many states have not addressed the issue of purchases by exempt organizations, most have enacted legislation dealing specifically with the imposition of sales/use taxes on sales by exempt organizations. Unfortunately, the application of the rules are not uniform among the states, and the laws vary widely.

Example 6-4:

- Compare the sales/use tax laws in Minnesota and New Jersey for amusement admissions charged by exempt organizations.
- Minnesota exempts these charges from sales tax for "isolated or occasional events," with a limit of 24 such events a year.
- New Jersey, on the other hand, exempts all amusement charges without limitation.

Criteria for Sales Tax Exemption

Most states allow for sales tax exemption depending on certain criteria. The following factors appear to be the most consistently applied criteria:

- Type of exempt organization.
- Whether sales of goods and/or services promote the tax-exempt purposes.
- Whether the exempt organization is conducting a resale activity or actually producing the product.

These issues become particularly confusing when the exempt organization is making sales in both charitable and noncharitable functions.

Example 6-5:

- In Maryland, if a charity sells Christmas trees as a fund-raising project, it is required to collect and pay sales tax.
- This is the case even though it is only a once-a-year fund-raising project.
Example 6-6:

- Another example of this inconsistent treatment with sales tax involves North Dakota.
- Admission charges to events are generally subject to North Dakota’s sales tax.
  - However, there are exceptions for nonprofit music and dramatic arts entities.
- The catch is that North Dakota allows these exceptions only for groups giving regularly scheduled performances in publicly owned facilities.

Determining a nonprofit organization’s state sales/use tax exemption status is further complicated by the passage of frequent revisions to existing state laws. This area of sales/use taxes has also been the source of controversy where organizations (both for-profit and nonprofit) claimed violations of their constitutional rights. In Texas Monthly, Inc., v. Bullock, 489 U.S. 1 (1989), it was alleged that a Texas law limiting sales tax exemptions to religious periodicals violated the separation of church and state. Arkansas Writers Project, Inc., v. Ragland, 481 U.S. 221 (1987), addressed claims that the plaintiff’s freedom of speech was violated by an Arkansas statute which imposed a sales tax on some publications but not others. Constitutional questions relating to interstate sales were also raised in National Bellas Hess v. Department of Revenue of the State of Illinois, 386 U.S. 753 (1967) (see section on interstate sales below).

INTERSTATE SALES

The entire issue of sales/use taxes becomes more complicated when an exempt organization becomes involved in interstate sales. This is particularly true in the case of use tax. Even though some states allow exemption from sales tax on items purchased in the state to be delivered and consumed in another state, the other state may require use tax to be collected and paid.

As a result of the interplay of sales and use tax in different states, exempt organizations must consider:

- What, if any, sales and use tax exemptions are available in both the state of the seller and in the state of the purchaser.
- Whether it will be required to collect and remit sales taxes on interstate sales.
- Whether it will be subject to use tax on interstate sales.

Issues relating to this area of law have sparked considerable controversy, particularly where states have imposed a use tax collection requirement for interstate sales. This issue was also discussed in National Bellas Hess, above.
After hearing the *National Bellas Hess* case, the Supreme Court ruled that requiring a mail-order vendor to collect sales tax from its out-of-state clients violated the Commerce Clause of the United States Constitution. Reacting to the *National Bellas Hess* decision, several states revised their sales/use tax law and imposed a use tax collection requirement on out-of-state vendors.

The validity of these requirements was subsequently challenged in such cases as *Quill Corporation v. North Dakota*, 112 S. Ct. 1904 (1992).

**REAL PROPERTY TAXES**

Historically, real property taxes have been an important component of state and local revenues. In recent years, state and local taxing authorities have taken steps to preserve this source of funds, using a variety of methods. Some have even allowed exempt organizations to make negotiated payments in lieu of real property tax payments.

**Example 6-7:**

- This type of negotiation was allowed for Harvard University in the 1991 tax year.
- The reported estimated value of Harvard’s tax-exempt properties was approximately $71 million.
- In lieu of paying taxes based on the assessed amount, Harvard agreed to make payments which equalled the previous tax bills issued for those properties.

Negotiating voluntary payments in this manner is time-consuming and may yield inconsistent results. It is more common for states to take steps limiting the number of real property exemptions granted to exempt organizations.

**TECHNIQUES TO LIMIT EXEMPTIONS**

The following techniques have been used by states to limit exemptions:

- Changing the guidelines for granting real property tax exemptions.
- Restricting exemptions to entities specifically named by state statute.
- Restricting the purposes for which exempt property may be used.
These changes have led to states denying real property tax exemptions even for organizations exempt under §501(c)(3). This has occurred frequently for educational institutions, as witnessed by two recent court cases in Illinois, discussed below. As far as other types of 501(c)(3) exempt organizations are concerned, the real property tax exemption is normally allowed. Non-501(c)(3) exempt organizations, such as trade associations, social clubs, etc., would not be eligible for real property tax exemptions, except by specific exclusion normally granted by state legislation. Real property tax exemption also appears to be an all-or-nothing exemption. Where a property might be exempt from real property taxes under normal circumstances, if any part of the property is used for nonexempt purposes, the entire property normally becomes nonexempt.

**Exemption Denial for Educational Institutions**

In *Winona School of Professional Photography v. Department of Revenue (Ill.)*, 570 NE 2d 523 (Ill. App. Ct.), appeal denied, 580 NE 2d 137 (Ill. 1991), the court held that a photography school did not meet the criteria of "public education" and should not be considered a school for purposes of real property tax exemption.

In a second case, *American College of Chest Physicians v. Department of Revenue (Ill.)*, 559 NE 2d 774 (Ill. App. Ct. 1990), appeal denied, 564 NE 2d 834 (Ill. 1990), the issue involved an organization of physicians (ACCP) which taught courses in continuing medical education. Illinois courts held that because Illinois physicians had no continuing professional education requirement, courses taught by the ACCP were not part of the Illinois public curriculum. Consequently, the ACCP was denied an exemption from real property taxes.

**Activities Unrelated to Purpose**

States may also require that the exempt property can be used only in activities directly related to the organization's tax-exempt purpose. Using the property for other activities, even those activities that would be considered tax-exempt, may cause the organization to lose its real property tax exemption.

**Example 6-8:**

- In a case involving Middlebury College, the Vermont courts ruled that property held by a college as trustee was subject to real property taxes because the property was being used for public recreational purposes.

- In *Christian Church of Ohio v. Limback*, 560 NE 2d 199 (Ohio Ct. of App. 1990), the court denied an exemption for a church's regional headquarters because no public worship services had ever been conducted on the property.

  - It was argued that the regional headquarters were used to support other groups holding public worship ceremonies, but the court ruled that these activities were unrelated to the church's specific tax-exempt purpose.
Other Concerns

Questions have also been raised by the states concerning the tax-exempt nature of the following types of properties owned by exempt organizations:

- Vacant property (including sites of future churches).
- Property leased to or from a for-profit entity.
- Property used for commercial activities.
- Property used on an occasional or sporadic basis.

Possible State Action

The states may take one of the following actions:

- Deny real property tax exemptions altogether.
- Grant a partial exemption based on the percentage of property usage for the organization's exempt purpose.
- Impose statutory limits on the acreage which may be exempt.

PAYROLL TAXES

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

Tax-exempt organizations are not subject to the Federal Unemployment Tax Act (FUTA) and thus are not required to file Form 940 and pay the FUTA tax. However, many states hold tax-exempt organizations liable for state unemployment taxes on wages paid to employees. In this case, the tax-exempt organization is responsible for setting up an account with the state and making all appropriate filings.
INCOME TAXES

Many states automatically exempt an organization from state income tax if it has been exempted from federal income tax. Delaware, for example, extends this to both domestic and foreign nonprofits which have met the requirements of doing business in Delaware. In many cases, corporations that are exempt from federal income tax under §501(a) and described in §501(c) are not required to make a formal filing to the state before the state exemption is granted. However, this limited privilege may be short-lived. In many jurisdictions, such as the District of Columbia, exemption is being denied unless a separate state exemption is granted. Often the criteria for state exemption rests with the amount of benefits extended to the community in that state.

Other states pattern their guidelines for income tax exemption after the federal guidelines but require organizations to obtain a state income tax exemption separately. For taxing authorities such as Florida, California, and the District of Columbia, this process entails filing a specific request for exemption from state income tax. Such exemptions do not extend to other taxes imposed by these jurisdictions unless separately applied for and granted.

ADDITIONAL STATE RESTRICTIONS

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

Restrictions for the District of Columbia center around the issue of whether the organization shares its benefits with D.C. residents. The D.C. Code requires that at least 5% of benefits from an exempt national organization be conferred on D.C. residents (25% for a nonnational organization). To maintain its exemption, the organization must submit an annual statement containing a description of its activities for the year and the percentage of its benefits conferred to D.C. residents.

Similarly, Florida laws specify that exempt organizations must justify the rates they charge for services rendered. Exempt organizations must prove that any fee monies received in excess of costs incurred were either:

- Used for the organization's maintenance and operational expenses.
- Used to provide services for individuals unable to pay.
In general, organizations which are otherwise considered exempt for state income tax purposes will be taxed on their unrelated business income as if they were a commercial enterprise in the state. Income and expenses are normally reported using the same forms and in the same manner as any other commercial activity. State definitions for unrelated business income normally follow or make reference to those used in the Code. In many states, exempt organizations having unrelated business income are required to make quarterly tax deposits similar to for-profit corporations.

REGISTRATION AND FILING REQUIREMENTS

Registration

Practically all states require exempt organizations to complete some type of registration with state governmental agencies. Registration is normally required before an organization can:

■ Conduct business in the state.

■ Hold property in the state.

■ Solicit funds within the state.

In some states, such as Alabama, the registration requirements for a tax-exempt organization are similar to those for other business entities. The Alabama Nonprofit Corporation Act requires that Articles of Incorporation be prepared, listing specific items of information which must be included. The Articles of Incorporation must be filed with and approved by the probate judge. After its articles have been approved, the organization will receive a certificate of incorporation. At this point, it has met its registration requirements for Alabama. However, depending on the nature of its operations, it may be required to obtain identification numbers and set up tax accounts within the state (see payroll tax section).

Exceptions to Registration Requirement

Other states, such as California, may require only that certain organizations register. Exceptions to the registration requirement vary widely among the states. However, exceptions will usually fall into one of these categories:

■ Religious organizations.

■ Educational institutions, under specified circumstances.

■ Nonprofit hospitals.

■ Organizations soliciting funds exclusively from their own membership.

■ Organizations soliciting and providing funds on behalf of a named beneficiary.
Organizations that do not:

- Receive contributions in excess of a specified limit.
- Receive contributions from more than a specified number of donors.
- Use paid fund-raisers.

(Some states also require that the organization not have paid employees.)

Determining all the state filing requirements for an exempt organization may be quite difficult. The comprehensive state-by-state guide beginning on page 170 contains telephone numbers of the state offices which can provide more guidance in this area.

CHARITABLE SOLICITATION REQUIREMENTS

Most states have enacted strict requirements for exempt organizations soliciting funds, either alone or as part of a commercial co-venture with a for-profit business:

- Article 7-A of New York’s Executive Law includes directives for:
  - Wording of advertisements for sales to benefit a charitable organization.
  - Proper use of another individual’s name when soliciting funds.
  - Information to be expressly stated in contracts between a charitable organization and a professional fund-raiser, fund-raising counselor, or co-venturer.
  - Limitations on professional solicitors in the employ of professional fund-raisers.

In addition, "watchdog" agencies, such as the National Charities Information Bureau and the Council of Better Business Bureaus Philanthropic Advisory Service, monitor the activities of organizations soliciting funds. These agencies routinely release information about nonprofit organizations to help donors make informed decisions regarding contributions.

It cannot be overstressed that managers for exempt organizations must be fully aware of, and in compliance with, charitable solicitation requirements in their state(s) of operation.

FILING REQUIREMENTS

Most exempt organizations registered within a state will make periodic filings, usually once a year, to renew their registration. The most common type of filing is an annual financial report summarizing the exempt organization's financial activity for the year and disclosing the names of key individuals of the
organization. States may also require that any or all of the following documents be completed and submitted:

- State annual report form.
- Copy of federal Form 990 and Schedule A.
- Audited financial statements.

STATE-BY-STATE ANALYSIS OF REGISTRATION AND FILING REQUIREMENTS FOR EXEMPT ORGANIZATIONS

Notes:

- The information that follows is a unique comprehensive guide that summarizes the registration and filing requirements for the various states.
  - The information is up-to-date but subject to change.
- As discussed in the text, states revise their procedures with relatively little notice.
- Use the information provided in this section to contact the states for more specific information in regard to the state requirements.
- Many states accept the uniform registration application. Check with the state before completing the registration.

STATE-BY-STATE SUMMARY OF REGISTRATION AND FILING REQUIREMENTS

Registration and filing requirements are shown in the following order:

1. Registration Requirements.
2. Annual Filing Requirements.
3. Telephone Number/Contact Name (Where Applicable).

Note: Registration filing fees are not shown.
Alabama:

1. Required registration.
   - Organizations are required to complete informal registration statement available from the Attorney General’s office.

2. There is an annual registration requirement.
   Corporate income tax return required for organizations not specifically exempted by Section 40-18-32.

3. Attorney General: (334) 242-7334
   Corporate Income Tax: (334) 242-1212
   (Rhonda Barber) (Phyllis Watson)

Alaska:

1. Corporations must register with the Department of Commerce.
   - Organizations soliciting funds must register with the Department of Law (Fair Business Practices — Charitable Solicitation).

2. Biennial filing requirement for corporations registered in Alaska.
   Laws for Alaska state income tax follow federal guidelines.
   - Organizations should file Form 04-611, attaching a copy of federal forms filed.
   - Income that is federally taxable will also be subject to Alaska corporate tax.

3. Department of Commerce: (907) 465-2530
   Department of Law: (907) 269-5100
   Corporate Income Tax: (907) 465-2322
   (Cliff Doherty)

Arizona:

1. Registration with the Secretary of State required for exempt organizations where the board of directors receives a salary and for exempt organizations soliciting funds.

2. Annual filing required by Secretary of State using Form CS-1 and Form CS-5 (or federal Form 990).
Corporate income tax return (Form 120) required for organizations not exempted by Section 43-1201.

- Most exempt organizations will file Form 99, unless specifically excepted by Section 43-1201.
- Form 990T should be used by exempt organizations reporting unrelated business income.

3. Secretary of State: (602) 542-4086 (Betty Vermillion)

Corporate Income Tax: (602) 255-3381

Arkansas:

1. Registration with Attorney General required for exempt organizations soliciting funds, unless exempted by Act 1177.

2. Annual filing required to renew registration with Attorney General.

Corporate income tax return (Form AR1100CT) required from organizations not exempted under Arkansas Code Annotated section 26-51-303 and exempt organizations which have unrelated business income (defined by Arkansas Code Annotated §26-51-304).

- Exempt organizations which do not have unrelated business income are not required to make any filings to the state.

3. Attorney General: (501) 682-2007

Corporate Income Tax: (501) 682-7255

California:

1. All organizations must register with the Attorney General (Registry of Charitable Trusts), unless exempted by §12583. Registration Form CT-1 must be submitted, accompanied by audited financial statements or federal Form 990.

The Registry of Charitable Trusts requires organizations soliciting funds to register separately using Form CF-1.

- The organization may also need to obtain a license from the appropriate state or county before soliciting funds.
2. General registrations must be renewed annually by filing Form CT-2, accompanied by federal Form 990.

- Registrations for charities soliciting funds are renewed by filing Form CF-2.

All organizations are required to file Form 199 unless specifically exempted under General Instruction C for Form 199.

- Organizations having unrelated business income tax may also be required to file Form 109 (see instructions for Form 199, section B, "Who Must File").

3. Attorney General: (916) 445-2021
   Corporate Income Tax: 1-800-852-5711
   F.A.S.T. Tax Service: 1-800-338-0505

**Colorado:**

1. Registration with Secretary of State required for organizations soliciting funds in the state.

- Registration covers a specific solicitation campaign (typically a fiscal year).

- A solicitation campaign financial report must be filed within 90 days after the campaign ends.

- Where applicable, a copy of federal Form 990 and Schedule A or audited financial statements should be submitted with the solicitation campaign financial report.

2. All organizations must file a biennial report to the Secretary of State through their registered agent.

- Organizations exempt from federal income tax are also exempt from state income tax and filings unless there is unrelated business income.

- Organizations having unrelated business income file Form 112.

3. Secretary of State: (303) 894-2680
   Corporate Income Tax: 1-900-555-1717
   ($1.50/minute) (303) 534-1209

**Connecticut:**

1. Registration with the Attorney General's office (Department of Consumer Protection) required for organizations soliciting funds in the state.
2. All organizations required to file a biennial report with the Secretary of State.
   - Organizations soliciting funds are required to file annual report Form CPC-60.
   - Form CPC-60 should be accompanied by a copy of federal Form 990 and, where gross revenue exceeds $100,000, audited financial statements.
   - Organizations are required to file a state income tax return unless exempted under the general instructions to Form CT-1120.
   - Organizations having unrelated business income are required to file Form CT-990T.
   - If an organization files Form CT-990T, it is not required to file Form CT-1120 for that year.

3. Attorney General: (203) 566-5836
   Secretary of State: (203) 566-7143
   Corporate Income Tax: (203) 566-7033

Delaware:

1. No registration requirements.

2. Organizations are required to file an annual report with the franchise tax department of the Secretary of State's office.

   Organizations not specifically exempt under provisions of Delaware Code §1902(b), Title 30, will be required to file Form 1100.

   - Organizations exempted under §1902(b)(8) must file an Annual Information Return [Division of Revenue Form 1902(b)(8)].

3. Secretary of State: (302) 739-3077
   Attorney General: (302) 577-2500
   Department of Taxation: (302) 577-3300

District of Columbia:

1. Organizations soliciting funds must register with the Department of Consumer and Regulatory Affairs (Business Regulation Administration).

2. Registrations within the District of Columbia—whether to do business or to solicit funds—must be renewed on an annual basis.
In addition, organizations claiming exemption from D.C. franchise tax must apply for a separate D.C. exemption.

- Exemption from D.C. franchise tax does not apply to unrelated business income.

3. Business Regulation:  
   Charitable Solicitation:  (202) 727-7278  
   Department of Taxation:  (202) 727-7280  
   (202) 727-6103

Florida:

1. Organizations soliciting funds must register with the Commissioner of Agriculture, unless exempted under FS Law 496.

- Copies of federal Form 990 and Schedule A or some other financial report are required for initial registrations.

2. Registrations with the Commissioner must be renewed annually.

- Copies of federal Form 990 and Schedule A are required for renewals.

Organizations which are federally tax-exempt must file a Form F-1120 and a copy of their determination letter for the first year of operations in Florida.

- No further state filings are required unless federal tax-exempt status changes or organization has unrelated business income (reported on Form F-1120).

3. Commissioner of Agriculture:  (904) 488-2221  
   Corporate Income Tax:  (904) 488-6000

Georgia:

1. Organization soliciting funds must register with the Secretary of State, unless specifically exempted by O.C.G.A., Title 43, Chapter 17.

- Registration Form C101 should be accompanied by audited financial statements (federal Form 990 if gross revenue is less than $100,000).

2. Registrations are renewed annually by submitting SOS Form C101 and a financial report (audited financial statements and a copy of federal Form 990).

Organizations federally exempt under §§401, 501(c), 501(d), 501(e), or 664 are exempt from Georgia state taxes unless there is unrelated business income (reported on Form 600).
Hawaii:

1. Organizations register with the Department of Commerce and Consumer Affairs (Business Registration Division) to operate as a tax-exempt entity or to solicit funds.
   - Only one type of registration should be submitted.
   - The registration for solicitation of funds should be accompanied by an audited financial statement if annual gross receipts exceed $25,000.

2. Registrations must be renewed annually.
   - Renewals for registrations to solicit funds should be accompanied by audited financial statements and a copy of federal Form 990.

Organizations must file Form N-30 unless specifically exempted under Section 235-9, Hawaii Revised Statutes.

- Organizations having unrelated business income must file Form N-70NP.

Idaho:

1. Organizations soliciting funds may be required to register with the Attorney General’s Office of Consumer Protection.
   - There is no registration specifically for nonprofits; rather, requirements are based on the type of solicitation activity taking place.
   - For example, all organizations soliciting funds by telephone are required to register.
   - Activities requiring prior registration are outlined in the Charitable Solicitations Act, which can be obtained by calling the Office of Consumer Protection.

2. Registrations such as the Telephone Solicitor Registration are renewed annually.
   - Idaho does not require annual financial reports from nonprofits.
Federally exempt organizations are not required to file returns in Idaho unless there is unrelated business income (reported on Form 41).

- The general instructions to Form 41 mention that the State Tax Commission "would appreciate" a copy of federal Form 990, but does not require it.

3. Secretary of State: (208) 334-2301
   Consumer Protection: (208) 334-2424
   Department of Taxation: (208) 334-7660

Illinois:

1. Organizations soliciting funds must register with the Attorney General's office using Form CO-1.

- Religious organizations seeking exemption must also complete a Religious Organization Exemption Form.

2. All charities must file an annual financial report with the Attorney General’s office.

- The following should be submitted:
  - Form AG 990-IL.
  - Copy of federal Form 990.
  - Report of Individual Fund-Raising Campaign (if applicable).
  - Audited financial statements if contributions exceed $100,000 or a professional fund-raiser is used.

Organizations federally exempt under §501(a) are not required to file Illinois state income tax return (Form IL-1120).

- If an exempt organization has unrelated business income, it must file Form IL-990-T.

- All other organizations must file Form IL-1120.

3. Attorney General: (312) 814-2595
   Department of Taxation: 1-800-732-8866
Indiana:

1. Organizations must apply to the Department of Revenue for permission to be treated as a nonprofit organization.
   - There are no registration requirements for organizations soliciting funds.

2. During their first year of operation, organizations should file Form IT-35A to obtain status as a nonprofit in Indiana.
   - State income tax liability and filing requirements will vary according to whether the Indiana Department of Revenue classifies the organization as wholly exempt or partially exempt.

   Partially exempt organizations file Form IT-20NP (including Schedule A) and Form IT-35AR.
   - Unrelated business income must be reported on Schedules B, C, and D of Form IT-20NP.

   Wholly exempt organizations are not required to file Forms IT-20NP or IT-35AR unless there is unrelated business income.

3. Attorney General: (317) 232-6331
   Secretary of State: (317) 232-6531
   Department of Taxation: (317) 232-2188

Iowa:

1. Organizations must apply to the Department of Revenue for permission to be treated as a nonprofit organization.
   - There are no registration requirements for organizations soliciting funds.

2. Organizations exempt under §422.23, Code of Iowa, are not required to file state returns unless there is unrelated business income (reported on Form IA1120).
   - Other organizations are required to file Form IA1120.

3. Attorney General: (515) 281-5926
   Department of Taxation: 1-800-367-3388
   (except Des Moines)
   (515) 281-3114
   (Des Moines and Out-of-State Callers)
Kansas:

1. Organizations soliciting funds must register with the Secretary of State unless exempted under the Charitable Organizations and Solicitations Act (Section 17-1762).
   - Applications for registration should include financial statements or federal Form 990.
   - The organization should submit audited financial statements if it has received contributions in excess of $100,000.

2. Solicitation registration must be renewed annually.

   Organizations required to file a federal return must file a Form K-120 (Kansas corporation income tax return).

   - Any organization which is federally tax-exempt will likewise be exempted from Kansas income tax unless there is unrelated business income (reported on Form K-120).

3. Secretary of State: (913) 296-2235
   Department of Taxation: (913) 296-0222
   (Topeka)
   (913) 788-3445
   (Kansas City)
   (316) 337-6140
   (Wichita)

Kentucky:

1. Organizations must register with the Secretary of State for permission to do business in Kentucky.
   - Organizations soliciting funds are required to register with the Attorney General's office by submitting federal Form 990 or (new organizations) a notice of intent to solicit.

2. All organizations must file an annual verification report with the Secretary of State.
   - Organizations soliciting funds renew their registration by submitting a copy of federal Form 990 (if filed) to the Attorney General's office.
   - Where no federal Form 990 exists and the organization still wishes to solicit funds, a new notice of intent should be submitted.
Kentucky state income tax laws generally follow federal guidelines (see "Who Must File" under the instructions for Form 720).

3. Secretary of State:  (502) 564-2848
   Attorney General:   (502) 573-2200
   Department of Revenue: (502) 564-4580

**Louisiana:**

1. All organizations are required to register with the Secretary of State.
   - Organizations employing a professional fund-raiser should register separately with the Attorney General’s office.
   - Registration applications to the Attorney General’s office should be submitted with the following:
     - Copies of Articles of Incorporation and a copy of IRS letter granting 501(c)(3) status.
     - Financial statement or federal Form 990.
     - Contracts held with professional fund-raisers.
     - List of states in which the organization is registered.

2. An annual report must be submitted to the Secretary of State.
   - Organizations registered with the Attorney General’s office should submit a financial report each year.

   Louisiana Revised Statute 47:287.501 should be consulted to determine whether a given organization is exempt from Louisiana state income taxes.

   - Louisiana Revised Statute 47:608 should be consulted to determine whether a given organization is exempt from Louisiana franchise taxes.

   Organizations generally exempt from Louisiana state income taxes are still taxed on unrelated business income (reported on Form ICFT-620).

   - All organizations must file Form ICFT-620 (Income and Franchise Tax Return) unless exempted from both income and franchise taxes.
Maine:

1. All organizations must register with the Secretary of State to do business in Maine.
   - Organizations soliciting funds must register with the Department of Professional and Financial Regulation unless specifically exempted under §5004 of the Maine Charitable Solicitations Act.

2. Organizations registered with the Secretary of State are required to file an annual report through their registered agents.
   - Organizations registered to solicit funds must renew their registration each year.
   - The request for renewal should be accompanied by a financial report which includes audited financial statements, disclosure of officers/affiliates receiving more than $30,000 per fiscal year, and results of any fund-raising campaigns where professional fund-raisers were used.

Organizations subject to federal income tax as a corporation must file Form 1120ME and pay Maine corporate income tax (see Title 36, Sec. 5162).

Maryland:

1. Organizations soliciting funds or employing a professional fund-raiser must register with the Secretary of State.
   - The following should be submitted with the application:
     - Copies of Articles of Incorporation and IRS letter granting 501(c)(3) status.
     - Copy of federal Form 990.
     - Names and addresses of directors.
A CPA’S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

- Financial statements reviewed by a CPA (where contributions are $100,000 to $199,999).
- Audited financial statements (where contributions are $200,000 or greater).
- Contracts (if any) with professional fund-raisers.

2. Registrations with the Secretary of State must be renewed annually.
   - Organizations should submit a copy of federal Form 990 and audited financial statements with their request for renewal.

Maryland state income laws follow the federal guidelines.

- Organizations federally exempt under §501 are exempt from filing unless there is unrelated business income (reported on Form 500).

3. Secretary of State: (410) 974-5534
   Department of Taxation: (410) 225-1340

Massachusetts:

1. All organizations must register with the Attorney General’s office (Division of Public Charities), except for religious organizations and organizations exempted under Massachusetts General Laws c.12, §8E.

   Organizations wishing to solicit funds must first obtain a Certificate of Solicitation from the Division of Public Charities.

2. Organizations registered with the Attorney General’s office must file an annual report (Form PC).
   - Organizations soliciting funds should complete Schedules A-1 and A-2 of Form PC.
   - When Form PC is filed, the organization should include a copy of federal Form 990 and, if contributions exceed $100,000, audited financial statements.

   Organizations must apply to the Department of Revenue for a ruling on their tax-exempt status in the state of Massachusetts.
   - Nonexempt organizations must file Form 355A.
Michigan:

1. Organizations holding assets within the state of Michigan are required to register with the Attorney General’s office.
   - Financial information (federal Form 990 or financial statements) should be submitted as part of the registration package.

   Organizations wishing to solicit funds must file a charitable trust/solicitation questionnaire with the Attorney General’s office.
   - If this questionnaire is approved, the organization submits an application for a license to solicit funds.
   - Federal Form 990 and audited financial statements should be submitted with the application. In cases where organizations are registering and applying for a license at the same time, financial information need only be submitted once.

2. Registrations and licenses must be renewed annually. Organizations registered in Michigan are required to submit financial information to the Attorney General’s office unless they are also licensed in Michigan.
   - In that case, information shown on the financial summary section of the license renewal form is considered sufficient to satisfy state renewal requirements.

   Generally, organizations exempt from federal income tax will be exempted from Michigan state (single business) tax unless there is unrelated business income (reported on Form C-8000).

Minnesota:

1. Organizations soliciting funds must register with the Attorney General, unless excepted under the Supervision of Charitable Trusts and Trustees Act (Chapter 501B).
• Registration forms should be submitted with the following attachments:
  ▪ Articles of Incorporation and a copy of IRS letter granting 501(c)(3) status.
  ▪ Most recent federal Form 990 or financial statement.
  ▪ Filing fee, if prior year contributions equalled or exceeded $25,000.

2. Registered charities must file an annual report with the Attorney General, including the following:

• Attorney General annual report form.
• Federal Form 990, 990-EZ, or 990-PF (whichever form has been filed with the IRS).
  ▪ If federal Form 990-EZ is used, the organization will need to complete the supplemental expense statement.
• Audited financial statements if contributions equal or exceed $100,000.

Laws for Minnesota state income tax follow federal guidelines.

• Organizations filing a federal Form 990T should file a Form M4-NP with the Department of Revenue.
• The Department of Revenue does not require other forms in the federal Form 990 series (Forms 990, 990-EZ, 990-PF) if these forms have already been filed with the Attorney General’s office.

3. Attorney General: (612) 297-4613
Department of Revenue: 1-800-657-3619 (Mike Bublitz)

**Mississippi:**

1. Organizations soliciting funds must register with the Secretary of State unless exempted by Mississippi Code Annotated Section 79-11-505.

• Initial registration is done using Form C and either Form FS-1 (contributions under $50,000) or Form FS-2 (contributions equal to or greater than $50,000).
• Form FS-1 should be submitted with a copy of federal Form 990 (where applicable); Form FS-2 should be submitted with copies of Form 990 and audited financial statements.
2. The deadline for registration renewal is the anniversary date of the initial registration. Requests for renewal are made using Form C-R.

Within six months of fiscal year-end, each organization must submit an annual summary of financial activities (Form FS-1 or Form FS-2, whichever is applicable).

Mississippi state laws for income tax generally follow the federal guidelines.

- Organizations filing Form FS-1 or Form FS-2 with the Secretary of State are not required to file with the Mississippi Tax Commission unless there is income from unrelated business activities.

- Any organization required to file federal Form 990T would also be required to report its unrelated business income using Mississippi Form 62-301.

3. Secretary of State: (601) 359-1371
   Tax Commission: (601) 359-1142

Missouri:

1. Organizations soliciting funds in Missouri must register with the Attorney General’s office unless exempted by §407.456 of the Missouri Charitable Solicitations Act.

   - Registration Form 1-A is used.

2. Organizations doing business in Missouri must file an annual registration form with the Secretary of State’s office.

   - Filing is done through the organization’s registered agent.

Organizations registered to solicit funds must renew their registration annually by filing Form 2-A ten days prior to the end of their fiscal year.

Laws for Missouri income tax follow federal guidelines.

- Organizations filing federal Form 990T should report unrelated business taxable income on Form MO-1120.

3. Attorney General: (314) 751-4471
   Secretary of State: (314) 751-2379
   Department of Revenue: (314) 751-4450
Montana:

1. All organizations register with the Secretary of State using Form C-4.

2. Annual reports must be filed with the Secretary of State for an organization to remain active.

   Organizations are required to file Form CLT-4 (Montana Corporation License Tax Return) if their unrelated business income creates a tax liability greater than $100. (For further details regarding filing requirements, see Montana Code Annotated §15-31-102 and Regulation §42-23-103.)

3. Attorney General: (406) 444-3665
   Department of Revenue: (406) 444-2441

Nebraska:

1. Organizations soliciting funds must register with the Secretary of State by filing the Uniform Registration Statement — Charitable Organization.

   • A copy of federal Form 990 or audited financial statements should be sent with the registration application.

2. Registrations should be renewed annually by filing the Uniform Registration Statement - Charitable Organization.

   Organizations exempt from federal taxes are also exempt from Nebraska state taxes.

   • If an organization files a federal Form 990T, it will be required to file the Nebraska Corporation Income Tax Return, Form 1120N.

3. Secretary of State: (402) 471-2554
   Department of Revenue: (402) 471-2971

Nevada:

1. All organizations must register with the Secretary of State.

2. Registrations with the Secretary of State must be renewed annually.

   There is no corporate income tax for the state of Nevada.

3. Attorney General: (702) 687-5203
New Hampshire:

1. All domestic charities, foreign charities soliciting funds, and organizations administering restricted funds must register with the Attorney General - Registrar of Charitable Trusts.

   - For initial registration, use Form NHCT-1.

   Organizations employing a professional fund-raiser must also obtain a license by filing Form PFR-5 (Solicitation Notice).

   - This must be filed prior to the start of each solicitation campaign.

2. Organizations registered with the Attorney General's office must file an annual financial report.

   - This contains an annual report certificate signed by an officer and either federal Form 990 or state Form NHCT-2A.

All organizations exempt from federal tax are exempted from filing the New Hampshire Profit Tax Return.

- Organizations exempted from federal tax under IRC sections other than 501(c)(3) are required to file the New Hampshire Business Enterprise Tax Return (for all taxable income, including unrelated business income).

- 501(c)(3) organizations only file the Business Enterprise Tax Return if there is unrelated business income.

3. Attorney General: (603) 271-3591
   Secretary of State: (603) 271-3244
   Department of Revenue: (603) 271-3400

New Jersey:

1. Organizations soliciting funds must first file a questionnaire (Form CRI-100) with the New Jersey Department of Law and Public Safety (Division of Consumer Affairs).

   - After processing the questionnaire, Consumer Affairs will send either a "short form" (Form CRI-200) or "long form" (Form CRI-300) for completion by the organization.

2. Registrations with the Attorney General's office must be renewed by filing an annual report. Federal Form 990 must be submitted with the annual report form.
If the organization has over $100,000 in gross receipts, audited financial statements must also be filed.

Organizations must apply to the New Jersey Division of Taxation for a determination of their status for state income tax.

- Tax-Exempt entities must be organized without stock and operated for a charitable purpose where benefits are not conferred on any one individual.

- In general, organizations must be incorporated under Title 15, 16, or 17 of the Revised Statutes of New Jersey.

If the Division of Taxation rules an organization is exempt, the organization is not required to file state income tax returns (even if there is unrelated business income).

- Nonexempt organizations must file New Jersey Form CBT-100A.

3. Consumer Protection: (201) 504-6262 (Newark)
   Secretary of State: (609) 530-6425 (Trenton)
   Division of Taxation: (609) 588-2200 (Trenton)

New Mexico:

1. Organizations soliciting funds must register with the Attorney General, unless exempted under §57-22-4 of the Charitable Organizations and Solicitations Act.

- For the initial registration, organizations should include Articles of Incorporation, a copy of the IRS letter granting tax-exempt status, and federal Form 990.

2. Registration with the Attorney General should be renewed by filing an annual report and copy of federal Form 990.

Laws for New Mexico state taxes follow federal guidelines.

- Organizations having unrelated business income should file New Mexico Form CIT-1.

3. Attorney General: (505) 827-6000
   Taxation/Revenue: (505) 827-0945 (Santa Fe)
New York:

1. All organizations with contributions over $25,000 or employing a professional fund-raiser must register with the New York State Department of State (Office of Charities Registration).

2. Registration with the Department of State must be renewed by filing an annual financial report (Form DOS-497).
   • This form should be submitted only with a copy of federal Form 990 where total support and revenue are $75,000 or less.
   • Where total support and revenue are $75,001 to $150,000, audited or reviewed financial statements must also be included.
   • Where total support and revenue are greater than $150,000, audited financial statements must be included.

Organizations which are federally exempt under §501(c)(3) are exempt from New York state taxes and filing requirements unless the organization has unrelated business income. In this instance, the organization files New York Form CT13.

Organizations which are federally exempt under IRC sections other than 501(c)(3) must file New York Form CT3.

3. Department of State: (518) 474-3820
   Department of Taxation: 1-800-972-1233

North Carolina:

1. Organizations soliciting funds must register with the State Solicitation Licensing Branch.
   • State regulations changed effective January 1, 1995, and the information given below reflects the new rules. (For rules in effect through December 31, 1994, see Charitable Solicitation Licensure Act, Chapter 131C.)

   Organizations should contact the state to determine whether they are tax-exempt.
   • If a nonexempt organization has raised over $25,000 ($10,000 prior to January 1, 1995) or employs a professional fund-raiser, it must register with the state.

2. Organizations renew their registrations by filing an annual report with the state.
A CPA’S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

- For organizations with less than $100,000 in contributions, filing requirements can be met by submitting either the state forms or federal Form 990.

- Organizations raising between $100,000 and $249,999 must submit compiled financial statements to the state along with federal Form 990.

- Organizations raising $250,000 or more must submit audited financial statements along with federal Form 990.

Organizations should contact the North Carolina Department of Revenue to determine whether they are exempt from state income tax and filing requirements.

- An organization may be exempt from state income tax but still have to file a state return.

- Exempt organizations required to file should use Form CD-427 for related business income and either Form CD-404 (domestic corporations) or Form CD-405 (multistate corporations) for unrelated business income.

Nonexempt organizations should file either Form CD-404 or Form CD-405 for all income.

3. Solicitation Licensing: (919) 733-4510
   Department of Revenue: (919) 733-4644

North Dakota:

1. Before an organization can solicit funds, it must be registered with the Secretary of State and "in good standing."

   - It may not begin a solicitation campaign unless it has also been licensed by the Secretary of State.

   - Application for licensing is done by filing Form SFN 11300.

2. Licenses must be renewed by filing Annual Report SFN 11302.

   - Audited financial statements or federal Form 990 should be sent along with the request for renewal.

Laws for North Dakota state income tax follow federal guidelines.

- Exempt organizations are not required to file state returns unless they have unrelated business income (reported on North Dakota Form 40).
Ohio:

1. Organizations soliciting funds or employing professional fund-raisers must register with the Attorney General unless exempted by §1716.03 of the Revised Code.

2. Registrations with the Attorney General should be renewed by filing an annual report (Form CORS-1).

   • Financial information such as federal Form 990 should accompany this report when submitted.

Laws for Ohio state income tax follow federal guidelines.

   • Exempt organizations are not required to file state returns unless there is unrelated business income (reported on Form FT1120).

3. Attorney General: (614) 466-3180
   Department of Taxation: (614) 433-7617

Oklahoma:

1. Organizations soliciting funds must register with the Attorney General’s office.

2. Registrations with the Attorney General’s office should be renewed by filing an annual report.

   • Copies of federal Form 990 and audited financial statements should be sent with the request for renewal.

Laws for Oklahoma state income tax generally follow federal guidelines.

   • Exempt organizations file Form 512E for all income items, including unrelated business income.

3. Attorney General: (405) 521-3921
   Secretary of State: (405) 521-3911
   Business Tax Registration: (405) 521-4594
   Form 512E Filing Questions: (405) 521-3125
Oregon:

1. All organizations are required to register with the Department of Justice (Charitable Activities Section) unless granted a special exception.

2. Registrations with the Department of Justice are renewed by filing an annual report (Form CT-12).
   - A copy of federal Form 990 should be sent with the annual report.

Laws for Oregon state tax follow federal guidelines.

- There is no filing requirement for an exempt organization unless it has unrelated business income (reported on Form 20).

3. Attorney General: (503) 229-5902
   Department of Revenue: (503) 378-4988

Pennsylvania:

1. Organizations soliciting funds are required to register with the Department of State unless exempted under §6 of Pennsylvania Act No. 1992-92.
   - Organizations listed in §7 of the Act file short Forms BCO-400 (registration form) and BCO-20 (disclosure statement for net contributions); other organizations file long Forms BCO-100 (registration form) and BCO-23 (disclosure statement for net contributions).
   - Copies of federal Form 990, Schedule A, and audited financial statements should be sent with long form submissions.

2. Registration with the Department of State should be renewed annually.
   - The same forms used for the initial registration will also be used for the renewal.

The determination whether or not an organization is subject to Pennsylvania state tax is made by the Pennsylvania Department of State.

- Generally, laws for Pennsylvania state income tax follow federal guidelines.

- Exempt organizations are not required to file a state income tax return unless there is unrelated business income (reported on Form RCT101).
Rhode Island:

1. Organizations soliciting funds must register with the Department of Business Regulations (Charitable Organizations Section) unless exempted under §5-53-3 of the Rhode Island Charitable Solicitation Act.

   - When sending the registration application, organizations should also send along a copy of the financial statements prepared by a certified public accountant (audited statements if organization’s gross budget exceeds $100,000).

2. Registrations with the Department of Business Regulations should be renewed annually by filing Form 115-1-77.

Laws for Rhode Island state taxes follow federal guidelines.

- Exempt organizations are not required to file a state income tax return unless there is unrelated business income (reported on Form I1120).

- Organizations filing Form RI1120 to report unrelated business income will be required to pay a minimum tax ($250 for 1994 and 1995).

South Carolina:

1. All domestic organizations (and nondomestic corporations soliciting funds) must register with the Secretary of State.

2. Registrations with the Department of State must be renewed annually by filing an updated registration statement and either a South Carolina Annual Financial Report form or federal Form 990.

Organizations which are federally exempt under §501(c) are not required to file a state income tax return unless there is unrelated business income (reported on Form SC990T).

- Organizations which are federally exempt under other sections of the IRC must file Form SC1120 for related and unrelated business income.
A CPA’S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

South Dakota:

1. All organizations (for-profit and not-for-profit) soliciting funds by telephone (unless solicitation is done by staff or volunteers) must register with the Attorney General (Division of Consumer Affairs).
   • Organizations employing telephone solicitors are not required to register, but should verify that their solicitors are registered.

2. Organizations registered with the Attorney General are required to file financial reports within 90 days after the close of each charitable campaign.
   • Board members of organizations employing paid solicitors are required to sign off on financial reports filed by the paid solicitors.

South Dakota does not impose a state income tax.

3. Attorney General: (605) 773-4400

Tennessee:

1. Organizations soliciting funds or receiving donations in excess of $5,000 a year must register with the Department of State.
   • The organization should complete the Summary of Financial Activity portion of the registration form but should also send either a copy of federal Form 990 or audited financial statements with its application.

2. Registrations with the Department of State should be renewed by filing Annual Financial Report SS-6001.

Determination of the tax-exempt status for an organization is made by the Secretary of State.

• Exempt organizations are not required to make any state income tax filings, even if there is unrelated business income. Nonexempt organizations file Form RV-0007.

3. Department of State: (615) 741-2555
   Department of Revenue: (615) 741-2482
Texas:

1. Organizations are not required to register beyond their initial application with the Secretary of State.

2. Texas does not impose a corporate income tax.

3. Secretary of State: (512) 463-5555
   Questions About Other Tax Exemptions: (512) 463-4600

Utah:

1. Organizations soliciting funds are required to register with the Department of Commerce (Division of Consumer Protection) unless exempted under §13-22-8 of the Charitable Solicitations Act.

   - When making its initial registration, an organization should send audited financial statements, information about any professional fund-raisers employed, and copies of its Articles of Incorporation along with the registration statement.

2. Registrations with the Department of Commerce should be renewed annually by filing an updated Charitable Organization Permit Application Form.

   Laws for Utah state tax follow federal guidelines.

   - Changes to the laws passed in 1994 require exempt organizations with unrelated business income to file Form TC-20UBI.

3. Department of Commerce: (801) 530-6601
   Tax Commission: (801) 297-6700

Vermont:

1. Organizations soliciting funds are not required to register.


3. Attorney General: (802) 826-3171
   Department of Revenue: (802) 828-2551
Virginia:

1. Organizations soliciting funds are required to register with the Department of Agriculture and Consumer Services unless exempted under §57-60 of the Virginia Solicitation of Contributions Law.

2. Registrations with Consumer Services must be renewed annually by filing an updated registration statement (Form 102).
   - Copies of audited financial statements and federal Form 990 should be submitted with Form 102.

Organizations federally exempted under §501(c) are not required to file Virginia corporate income tax returns unless there is unrelated business income (reported on Form 500).

Organizations federally exempted under other sections of the Code should file Form 500 for related and unrelated business income.

3. Consumer Affairs: (804) 786-1343
   Department of Taxation: (804) 367-8036

Washington:

1. Organizations soliciting funds must register with the Secretary of State by filing Form CHO-1.

2. Organizations registered with the Secretary of State must renew their registration annually by submitting an updated Form CHO-1.

   Washington does not impose a corporate income tax.

3. Secretary of State: (206) 753-7121

West Virginia:

1. Organizations soliciting funds must register with the Secretary of State.
   - Copies of federal Form 990 and audited financial statements should be sent with the registration application.
2. Organizations registered with the Secretary of State must renew their registrations annually by filing an updated registration statement.

Corporations that are exempt for federal income tax purposes are also exempt for purposes of West Virginia corporate income tax.

- Unrelated business income is subject to West Virginia corporate tax (reported on Form WV/CNT-112).

3. Secretary of State: (304) 558-6000
   Department of Revenue: (304) 344-2068

Wisconsin:

1. Organizations soliciting funds must register with the Department of Regulation and Licensing using Form 296.

2. Registrations must be renewed annually by filing Form 308, a copy of federal Form 990, and audited financial statements (where contributions have exceeded $100,000).

Laws for Wisconsin state income tax follow federal guidelines.

- Exempt organizations are not required to file a return unless there is unrelated business income (reported on Wisconsin Form 4T).

3. Department of Licensing: (608) 266-0829 (A-B)
   (608) 267-1132 (C-H)
   (608) 267-7860 (I-Z)
   Department of Revenue: (608) 266-2772

Wyoming:

1. Organizations are not required to register for soliciting funds.

2. Wyoming does not impose a state corporate income tax.

3. Secretary of State: (307) 777-7378
STATE TAX COMPLIANCE

Form 990 (1999) Page 2

### Statement of Functional Expenses

All organizations must complete column (A). Columns (B), (C), and (D) are required for section 501(c)(3) and (4) organizations and 4947(a)(1) nonexempt charitable trusts but optional for others. [See Specific Instructions on page 10.]

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>(A) Total</th>
<th>(B) Program Services</th>
<th>(C) Management and General</th>
<th>(D) Fundraising</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>Grants and allocations (attach schedule)</td>
<td>............</td>
<td>22</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(cash $ ______________ noncash $ ______________)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Specific assistance to individuals (attach schedule)</td>
<td>............</td>
<td>23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Benefits paid to or for members (attach schedule)</td>
<td>............</td>
<td>24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Compensation of officers, directors, etc.</td>
<td>............</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Other salaries and wages</td>
<td>............</td>
<td>26</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Pension plan contributions</td>
<td>............</td>
<td>27</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Other employee benefits</td>
<td>............</td>
<td>28</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Payroll taxes</td>
<td>............</td>
<td>29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Professional fundraising fees</td>
<td>............</td>
<td>30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>Accounting fees</td>
<td>............</td>
<td>31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>Legal fees</td>
<td>............</td>
<td>32</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>Supplies</td>
<td>............</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>Telephone</td>
<td>............</td>
<td>34</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>Postage and shipping</td>
<td>............</td>
<td>35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>36</td>
<td>Occupancy</td>
<td>............</td>
<td>36</td>
<td></td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>Equipment rental and maintenance</td>
<td>............</td>
<td>37</td>
<td></td>
<td></td>
</tr>
<tr>
<td>38</td>
<td>Printing and publications</td>
<td>............</td>
<td>38</td>
<td></td>
<td></td>
</tr>
<tr>
<td>39</td>
<td>Travel</td>
<td>............</td>
<td>39</td>
<td></td>
<td></td>
</tr>
<tr>
<td>40</td>
<td>Conferences, conventions, and meetings</td>
<td>............</td>
<td>40</td>
<td></td>
<td></td>
</tr>
<tr>
<td>41</td>
<td>Interest</td>
<td>............</td>
<td>41</td>
<td></td>
<td></td>
</tr>
<tr>
<td>42</td>
<td>Depreciation, depletion, etc. (attach schedule)</td>
<td>............</td>
<td>42</td>
<td></td>
<td></td>
</tr>
<tr>
<td>43</td>
<td>Other expenses (itemize): a</td>
<td>............</td>
<td>43a</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>b</td>
<td>............</td>
<td>43b</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>c</td>
<td>............</td>
<td>43c</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>d</td>
<td>............</td>
<td>43d</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>e</td>
<td>............</td>
<td>43e</td>
<td></td>
<td></td>
</tr>
<tr>
<td>44</td>
<td>Total functional expenses (add lines 22 through 43). Organizations completing columns (B)-(D), carry these totals to lines 13-15</td>
<td>............</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Reporting of Joint Costs.** Did you report in column (B) (Program services) any joint costs from a combined educational campaign and fundraising solicitation? ◯ Yes ◯ No

If "Yes," enter (i) the aggregate amount of these joint costs $ ___________ (ii) the amount allocated to Program services $ ___________ (iii) the amount allocated to Management and general $ ___________ and (iv) the amount allocated to Fundraising $ ___________.

### Statement of Program Service Accomplishments (See Specific Instructions on page 22.)

What is the organization's primary exempt purpose? ◯ Yes ◯ No

All organizations must describe their exempt purpose achievements in a clear and concise manner. State the number of clients served, publications issued, etc. Discuss achievements that are not measurable. (Section 501(c)(3) and (4) organizations and 4947(a)(1) nonexempt charitable trusts must also enter the amount of grants and allocations to others.)

| Line | Description | Amount | Program Service Expenses
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>(Grants and allocations $ ___________)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>(Grants and allocations $ ___________)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>(Grants and allocations $ ___________)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>(Grants and allocations $ ___________)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>Other program services (attach schedule) (Grants and allocations $ ___________)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td>Total of Program Service Expenses (should equal line 44, column (B), Program services)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Balance Sheets** (See Specific Instructions on page 22.)

<table>
<thead>
<tr>
<th>Note: Where required, attached schedules and amounts within the description column should be for end-of-year amounts only.</th>
<th>(A) Beginning of year</th>
<th>(B) End of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>45 Cash—non-interest-bearing</td>
<td>45</td>
<td></td>
</tr>
<tr>
<td>46 Savings and temporary cash investments</td>
<td>46</td>
<td></td>
</tr>
<tr>
<td>47a Accounts receivable</td>
<td>47a</td>
<td></td>
</tr>
<tr>
<td>b Less: allowance for doubtful accounts</td>
<td>47b</td>
<td></td>
</tr>
<tr>
<td>48a Pledges receivable</td>
<td>48a</td>
<td></td>
</tr>
<tr>
<td>b Less: allowance for doubtful accounts</td>
<td>48b</td>
<td></td>
</tr>
<tr>
<td>49 Grants receivable</td>
<td>49</td>
<td></td>
</tr>
<tr>
<td>50 Receivables from officers, directors, trustees, and key employees (attach schedule)</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>51a Other notes and loans receivable (attach schedule)</td>
<td>51a</td>
<td></td>
</tr>
<tr>
<td>b Less: allowance for doubtful accounts</td>
<td>51b</td>
<td></td>
</tr>
<tr>
<td>52 Inventories for sale or use</td>
<td>52</td>
<td></td>
</tr>
<tr>
<td>53 Prepaid expenses and deferred charges</td>
<td>53</td>
<td></td>
</tr>
<tr>
<td>54 Investments—securities (attach schedule)</td>
<td>54</td>
<td></td>
</tr>
<tr>
<td>55a Investments—land, buildings, and equipment: basis</td>
<td>55a</td>
<td></td>
</tr>
<tr>
<td>b Less: accumulated depreciation (attach schedule)</td>
<td>55b</td>
<td></td>
</tr>
<tr>
<td>56 Investments—other (attach schedule)</td>
<td>56</td>
<td></td>
</tr>
<tr>
<td>57a Land, buildings, and equipment: basis</td>
<td>57a</td>
<td></td>
</tr>
<tr>
<td>b Less: accumulated depreciation (attach schedule)</td>
<td>57b</td>
<td></td>
</tr>
<tr>
<td>58 Other assets (describe ▶)</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td>59 Total assets (add lines 45 through 58) (must equal line 74)</td>
<td>59</td>
<td></td>
</tr>
<tr>
<td>60 Accounts payable and accrued expenses</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>61 Grants payable</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td>62 Deferred revenue</td>
<td>62</td>
<td></td>
</tr>
<tr>
<td>63 Loans from officers, directors, trustees, and key employees (attach schedule)</td>
<td>63</td>
<td></td>
</tr>
<tr>
<td>64a Tax-exempt bond liabilities (attach schedule)</td>
<td>64a</td>
<td></td>
</tr>
<tr>
<td>b Mortgages and other notes payable (attach schedule)</td>
<td>64b</td>
<td></td>
</tr>
<tr>
<td>65 Other liabilities (describe ▶)</td>
<td>65</td>
<td></td>
</tr>
<tr>
<td>66 Total liabilities (add lines 60 through 65)</td>
<td>66</td>
<td></td>
</tr>
<tr>
<td>Organizations that follow SFAS 117, check here ▶ □ and complete lines 67 through 69 and lines 73 and 74.</td>
<td>67</td>
<td></td>
</tr>
<tr>
<td>67 Unrestricted</td>
<td>67</td>
<td></td>
</tr>
<tr>
<td>68 Temporarily restricted</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>69 Permanently restricted</td>
<td>69</td>
<td></td>
</tr>
<tr>
<td>Organizations that do not follow SFAS 117, check here ▶ □ and complete lines 70 through 74.</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>70 Capital stock, trust principal, or current funds</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>71 Paid-in or capital surplus, or land, building, and equipment fund</td>
<td>71</td>
<td></td>
</tr>
<tr>
<td>72 Retained earnings, endowment, accumulated income, or other funds</td>
<td>72</td>
<td></td>
</tr>
<tr>
<td>73 Total net assets or fund balances (add lines 67 through 69 OR lines 70 through 72; column (A) must equal line 19 and column (B) must equal line 21)</td>
<td>73</td>
<td></td>
</tr>
<tr>
<td>74 Total liabilities and net assets / fund balances (add lines 66 and 73)</td>
<td>74</td>
<td></td>
</tr>
</tbody>
</table>

Form 990 is available for public inspection and, for some people, serves as the primary or sole source of information about a particular organization. How the public perceives an organization in such cases may be determined by the information presented on its return. Therefore, please make sure the return is complete and accurate and fully describes, in Part III, the organization’s programs and accomplishments.
### Reconciliation of Revenue per Audited Financial Statements with Revenue per Return

| a | Total revenue, gains, and other support per audited financial statements . . . ► |
| b | Amounts included on line a but not on line 12, Form 990: |
|   | (1) Net unrealized gains on investments . . . $ ▶ |
|   | (2) Donated services and use of facilities $ ▶ |
|   | (3) Recoveries of prior year grants . . . $ ▶ |
|   | (4) Other (specify): $ ▶ |
|   | Add amounts on lines (1) through (4) ▶ |
| c | Line a minus line b . . . . . . ▶ |
| d | Amounts included on line 12, Form 990 but not on line a: |
|   | (1) Investment expenses not included on line 6b, Form 990 . . . $ ▶ |
|   | (2) Other (specify): $ ▶ |
|   | Add amounts on lines (1) and (2) ▶ |
| e | Total revenue per line 12, Form 990 (line c plus line d) . . . . . . ▶ |

### Reconciliation of Expenses per Audited Financial Statements with Expenses per Return

| a | Total expenses and losses per audited financial statements . . . . ▶ |
| b | Amounts included on line a but not on line 17, Form 990: |
|   | (1) Donated services and use of facilities $ ▶ |
|   | (2) Prior year adjustments reported on line 20, Form 990 . . . $ ▶ |
|   | (3) Losses reported on line 20, Form 990 . $ ▶ |
|   | (4) Other (specify): $ ▶ |
|   | Add amounts on lines (1) through (4) ▶ |
| c | Line a minus line b . . . . . . ▶ |
| d | Amounts included on line 17, Form 990 but not on line a: |
|   | (1) Investment expenses not included on line 6b, Form 990 . . . $ ▶ |
|   | (2) Other (specify): $ ▶ |
|   | Add amounts on lines (1) and (2) ▶ |
| e | Total expenses per line 17, Form 990 (line c plus line d) . . . . . . ▶ |

### List of Officers, Directors, Trustees, and Key Employees

<table>
<thead>
<tr>
<th>(A) Name and address</th>
<th>(B) Name and average hours per week devoted to position</th>
<th>(C) Compensation (if not paid, enter ▶) (D) Contributions to employer benefits &amp; related compensation</th>
<th>(E) Expenses account and other allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tr>
</tbody>
</table>

75 Did any officer, director, trustee, or key employee receive aggregate compensation of more than $100,000 from your organization and all related organizations, of which more than $10,000 was provided by the related organizations? ▶ [ ] Yes [ ] No

If "Yes," attach schedule—see Specific Instructions on page 25.

---

201
### Other Information (See Specific Instructions on page 25.)

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>76  Did the organization engage in any activity not previously reported to the IRS? If &quot;Yes,&quot; attach a detailed description of each activity.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>77  Were any changes made in the organizing or governing documents but not reported to the IRS? If &quot;Yes,&quot; attach a conformed copy of the changes.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>78a Did the organization have unrelated business gross income of $1,000 or more during the year covered by this return?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>78b Was there a liquidation, dissolution, termination, or substantial contraction during the year? If &quot;Yes,&quot; attach a statement here.</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>80a Is the organization related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>81a Enter the amount of political expenditures, direct or indirect, as described in the instructions for line 81.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>81b Did the organization file Form 1120-POL for this year?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>82a Did the organization receive donated services or the use of materials, equipment, or facilities at no charge or at substantially less than fair rental value?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>82b Did the organization comply with the public inspection requirements for returns and exemption applications?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>83a Did the organization comply with the disclosure requirements relating to quid pro quo contributions?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>83b Did the organization solicit any contributions or gifts that were not tax deductible?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>84a Did the organization make only in-house lobbying expenditures of $2,000 or less?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>85  501(c)(4), (5), or (6) organizations. a Were substantially all dues nondeductible by members?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>86  At any time during the year, did the organization own a 50% or greater interest in a taxable corporation or partnership, or an entity disregarded as separate from the organization under Regulations sections 301.7701-2 and 301.7701-3? If &quot;Yes,&quot; complete Part IX.</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>88a 501(c)(3) organizations. Enter: Amount of tax imposed on the organization during the year under:</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>88b 501(c)(3) and 501(c)(4) organs. Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year?</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>89  The books are in care of</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>90a List the states with which a copy of this return is filed</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>91  Telephone no.</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>92  Section 4947(a)(1) nonexempt charitable trusts filing Form 990 in lieu of Form 1091—Check here and enter the amount of tax-exempt interest received or accrued during the tax year.</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>
Analysis of Income-Producing Activities (See Specific Instructions on page 29.)

Enter gross amounts unless otherwise indicated.

<table>
<thead>
<tr>
<th>Line No.</th>
<th>Description</th>
<th>Unrelated business income</th>
<th>Excluded by section 512, 513, or 514</th>
<th>Related or exempt function income</th>
</tr>
</thead>
<tbody>
<tr>
<td>93</td>
<td>Program service revenue:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
<td></td>
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</tr>
<tr>
<td>d</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>f Medicare/Medicaid payments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g</td>
<td>Fees and contracts from government agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>94</td>
<td>Membership dues and assessments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>95</td>
<td>Interest on savings and temporary cash investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>96</td>
<td>Dividends and interest from securities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>97</td>
<td>Net rental income or (loss) from real estate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a</td>
<td>debt- financed property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>other debt- financed property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>98</td>
<td>Net rental income or (loss) from personal property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>99</td>
<td>Other investment income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>100</td>
<td>Gain or (loss) from sales of assets other than inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>101</td>
<td>Net income or (loss) from special events</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>102</td>
<td>Gross profit or (loss) from sales of inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>103</td>
<td>Other revenue: a</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>b</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
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<td></td>
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</tr>
<tr>
<td>d</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>104</td>
<td>Subtotal (add columns (B), (D), and (E))</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105</td>
<td>Total (add line 104, columns (B), (D), and (E))</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Line 105 plus line 1d. Part I, should equal the amount on line 12. Part I.

Relationship of Activities to the Accomplishment of Exempt Purposes (See Specific Instructions on page 30.)

Explain how each activity for which income is reported in column (E) of Part VII contributed importantly to the accomplishment of the organization's exempt purposes (other than by providing funds for such purposes).

Information Regarding Taxable Subsidiaries and Disregarded Entities (See Specific Instructions on page 30.)

<table>
<thead>
<tr>
<th>(A) Name, address, and EIN of corporation, partnership, or disregarded entity</th>
<th>(B) Percentage of ownership interest</th>
<th>(C) Nature of activities</th>
<th>(D) Total income</th>
<th>(E) End-of-year assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
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<td></td>
<td>%</td>
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<tr>
<td></td>
<td>%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Please Sign Here

Signature of officer: ____________________________ Date: __________

Type or print name and title: ____________________________

Paid Preparer's Use Only

Preparer's signature: ____________________________ Date: __________

Check if self-employed □

If tax return preparer, enter EIN: ____________________________

ZIP + 4: ____________________________

Form 990 (1999)
## SCHEDULE A (Form 990)

**Organization Exempt Under Section 501(c)(3)**  
(Except Private Foundation) and Section 501(e), 501(f), 501(k), 501(n), or Section 4947(a)(1) Nonexempt Charitable Trust

**Supplementary Information**—(See separate instructions.)

\[ \text{MUST be completed by the above organizations and attached to their Form 990 or 990-EZ} \]

### Compensations of the Five Highest Paid Employees Other Than Officers, Directors, and Trustees

(See page 1 of the instructions. List each one. If there are none, enter "None.")

<table>
<thead>
<tr>
<th>(a) Name and address of each employee paid more than $50,000</th>
<th>(b) Title and average hours per week devoted to position</th>
<th>(c) Compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Total number of other employees paid over $50,000

### Compensations of the Five Highest Paid Independent Contractors for Professional Services

(See page 1 of the instructions. List each one (whether individuals or firms). If there are none, enter "None.")

<table>
<thead>
<tr>
<th>(a) Name and address of each independent contractor paid more than $50,000</th>
<th>(b) Type of service</th>
<th>(c) Compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tr>
</tbody>
</table>

Total number of others receiving over $50,000 for professional services

For Paperwork Reduction Act Notice, see page 1 of the Instructions for Form 990 and Form 990-EZ.
### Schedule A (Form 990) 1999

#### Statements About Activities

<table>
<thead>
<tr>
<th>Statement</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  During the year, has the organization attempted to influence national, state, or local legislation, including any attempt to influence public opinion on a legislative matter or referendum?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>If &quot;Yes,&quot; enter the total expenses paid or incurred in connection with the lobbying activities ▶ $</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Organizations that made an election under section 501(h) by filing Form 5768 must complete Part VI-A. Other organizations checking &quot;Yes,&quot; must complete Part VI-B AND attach a statement giving a detailed description of the lobbying activities.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2  During the year, has the organization, either directly or indirectly, engaged in any of the following acts with any of its trustees, directors, officers, creators, key employees, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a  Sale, exchange, or leasing of property?</td>
<td>2a</td>
<td></td>
</tr>
<tr>
<td>b  Lending of money or other extension of credit?</td>
<td>2b</td>
<td></td>
</tr>
<tr>
<td>c  Furnishing of goods, services, or facilities?</td>
<td>2c</td>
<td></td>
</tr>
<tr>
<td>d  Payment of compensation (or payment or reimbursement of expenses if more than $1,000)?</td>
<td>2d</td>
<td></td>
</tr>
<tr>
<td>e  Transfer of any part of its income or assets?</td>
<td>2e</td>
<td></td>
</tr>
<tr>
<td>If the answer to any question is &quot;Yes,&quot; attach a detailed statement explaining the transactions.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3  Does the organization make grants for scholarships, fellowships, student loans, etc.?</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>4a Do you have a 403(b) annuity plan for your employees?</td>
<td>4a</td>
<td></td>
</tr>
<tr>
<td>b  Attach a statement to explain how the organization determines that individuals or organizations receiving grants or loans from it in furtherance of its charitable programs qualify to receive payments. (See page 2 of the instructions.)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Reason for Non-Private Foundation Status (See pages 2 through 4 of the instructions.)

The organization is not a private foundation because it is: (Please check only ONE applicable box.)

<table>
<thead>
<tr>
<th>Reason</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1 A church, convention of churches, or organization of churches. Section 170(b)(1)(A)(vi).</td>
<td></td>
</tr>
<tr>
<td>2 A school. Section 170(b)(1)(A)(iii). (Also complete Part V, page 4.)</td>
<td></td>
</tr>
<tr>
<td>3 A hospital or a cooperative hospital service organization. Section 170(b)(1)(A)(ii).</td>
<td></td>
</tr>
<tr>
<td>4 A Federal, state, or local government or governmental unit. Section 170(b)(1)(A)(iv).</td>
<td></td>
</tr>
<tr>
<td>5 A medical research organization operated in conjunction with a hospital. Section 170(b)(1)(A)(vi). Enter the hospital's name, city, and state ▶. (Also complete the Support Schedule in Part IV-A.)</td>
<td></td>
</tr>
<tr>
<td>6 An organization operated for the benefit of a college or university owned or operated by a governmental unit. Section 170(b)(1)(A)(iv). (Also complete the Support Schedule in Part IV-A.)</td>
<td></td>
</tr>
<tr>
<td>7 An organization that normally receives a substantial part of its support from a governmental unit or from the general public. Section 170(b)(1)(A)(vi). (Also complete the Support Schedule in Part IV-A.)</td>
<td></td>
</tr>
<tr>
<td>8 A community trust. Section 170(b)(1)(A)(v). (Also complete the Support Schedule in Part IV-A.)</td>
<td></td>
</tr>
<tr>
<td>9 An organization that normally receives: (1) more than 33 1/3% of its support from contributions, membership fees, and gross receipts from activities related to its charitable, educational, etc., functions—subject to certain exceptions, and (2) no more than 33 1/3% of its support from gross investment income and unrelated business taxable income (less section 511 tax) from businesses acquired by the organization after June 30, 1975. See section 509(a)(2). (Also complete the Support Schedule in Part IV-A.)</td>
<td></td>
</tr>
<tr>
<td>10 An organization that is not controlled by any disqualified persons (other than foundation managers) and supports organizations described in: (1) lines 5 through 12 above; or (2) section 501(c)(4), (5), or (6), if they meet the test of section 509(a)(2). (See section 509(a)(3)).</td>
<td></td>
</tr>
</tbody>
</table>

Provide the following information about the supported organizations. (See page 4 of the instructions.)

- **(a) Name(s) of supported organization(s)**
- **(b) Line number from above**

<table>
<thead>
<tr>
<th>Name(s) of supported organization(s)</th>
<th>Line number from above</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

14 An organization organized and operated to test for public safety. Section 509(a)(4). (See page 4 of the instructions.)
A CPA’S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

Schedule A (Form 990) 1999

Support Schedule (Complete only if you checked a box on line 10, 11, or 12.) Use cash method of accounting.

Note: You may use the worksheet in the instructions for converting from the accrual to the cash method of accounting.

<table>
<thead>
<tr>
<th>Calendar year (or fiscal year beginning in)</th>
<th>(a) 1998</th>
<th>(b) 1997</th>
<th>(c) 1996</th>
<th>(d) 1995</th>
<th>(e) Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 Gifts, grants, and contributions received. (Do not include unusual grants. See line 26.)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16 Membership fees received</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17 Gross receipts from admissions, merchandise sold or services performed, or furnishing of facilities in any activity that is not a business unrelated to the organization's charitable, etc., purpose.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18 Gross income from interest, dividends, amounts received from payments on securities loans (section 512(a)(5)), rents, royalties, and unrelated business taxable income (less section 511 taxes) from businesses acquired by the organization after June 30, 1975</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19 Net income from unrelated business activities not included in line 18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 Tax revenues levied for the organization's benefit and either paid to it or expended on its behalf</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 The value of services or facilities furnished to the organization by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22 Other income. Attach a schedule. Do not include gain or (loss) from sale of capital assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23 Total of lines 15 through 22</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 Line 23 minus line 17</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25 Enter 1% of line 23</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26 Organizations described on lines 10 or 11: a Enter 2% of amount in column (e), line 24</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26b Attach a list (which is not open to public inspection) showing the name of and amount contributed by each person (other than a governmental unit or publicly supported organization) whose total gifts for 1999 through 1998 exceeded the amount shown in line 26a. Enter the sum of all these excess amounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26c Total support for section 509(a)(1) test: Enter line 24, column (e)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26d Add: Amounts from column (e) for lines: 18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27d</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26e Enter line 26c minus line 26d total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26f Public support percentage (line 26e (numerator) divided by line 26c (denominator))</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

27 Organizations described on line 12: a For amounts included in lines 15, 16, and 17 that were received from a "disqualified person," attach a list to show the name of, and total amounts received in each year from, each "disqualified person." Enter the sum of such amounts for each year:

(b) For any amount included in line 17 that was received from a non-disqualified person, attach a list to show the name of, and amount received for each year, that was more than the larger of (1) the amount on line 25 for the year or (2) $5,000. (Include in the list organizations described in lines 5 through 11, as well as individuals.) After computing the difference between the amount received and the larger amount described in (1) or (2), enter the sum of these differences (the excess amounts) for each year:

(c) Add: Amounts from column (e) for lines: 15 |  |  |  |  |  |
| 27e  |  |  |  |  |  |
| 26d  |  |  |  |  |  |
| 26e  |  |  |  |  |  |
| 26f  |  |  |  |  |  |
| 26g  |  |  |  |  |  |
| 26h  |  |  |  |  |  |

28 Unusual Grants: For an organization described in line 10, 11, or 12 that received any unusual grants during 1995 through 1998, attach a list (which is not open to public inspection) for each year showing the name of the contributor, the date and amount of the grant, and a brief description of the nature of the grant. Do not include these grants in line 15. (See page 4 of the instructions.)

Schedule A (Form 990) 1999

206
<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>29 Does the organization have a racially nondiscriminatory policy toward students by statement in its charter, bylaws, other governing instrument, or in a resolution of its governing body?</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>30 Does the organization include a statement of its racially nondiscriminatory policy toward students in all its brochures, catalogues, and other written communications with the public dealing with student admissions, programs, and scholarships?</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>31 Has the organization publicized its racially nondiscriminatory policy through newspaper or broadcast media during the period of solicitation for students, or during the registration period if it has no solicitation program, in a way that makes the policy known to all parts of the general community it serves?</td>
<td>31</td>
<td></td>
</tr>
<tr>
<td>If &quot;Yes,&quot; please describe; if &quot;No,&quot; please explain. (If you need more space, attach a separate statement.)</td>
<td>[ ]</td>
<td></td>
</tr>
<tr>
<td>32 Does the organization maintain the following:</td>
<td>32a</td>
<td></td>
</tr>
<tr>
<td>a Records indicating the racial composition of the student body, faculty, and administrative staff?</td>
<td>32a</td>
<td></td>
</tr>
<tr>
<td>b Records documenting that scholarships and other financial assistance are awarded on a racially nondiscriminatory basis?</td>
<td>32b</td>
<td></td>
</tr>
<tr>
<td>c Copies of all catalogues, brochures, announcements, and other written communications to the public dealing with student admissions, programs, and scholarships?</td>
<td>32c</td>
<td></td>
</tr>
<tr>
<td>d Copies of all material used by the organization or on its behalf to solicit contributions?</td>
<td>32d</td>
<td></td>
</tr>
<tr>
<td>If you answered &quot;No&quot; to any of the above, please explain. (If you need more space, attach a separate statement.)</td>
<td>[ ]</td>
<td></td>
</tr>
<tr>
<td>33 Does the organization discriminate by race in any way with respect to:</td>
<td>33a</td>
<td></td>
</tr>
<tr>
<td>a Students' rights or privileges?</td>
<td>33a</td>
<td></td>
</tr>
<tr>
<td>b Admissions policies?</td>
<td>33b</td>
<td></td>
</tr>
<tr>
<td>c Employment of faculty or administrative staff?</td>
<td>33c</td>
<td></td>
</tr>
<tr>
<td>d Scholarships or other financial assistance?</td>
<td>33d</td>
<td></td>
</tr>
<tr>
<td>e Educational policies?</td>
<td>33e</td>
<td></td>
</tr>
<tr>
<td>f Use of facilities?</td>
<td>33f</td>
<td></td>
</tr>
<tr>
<td>g Athletic programs?</td>
<td>33g</td>
<td></td>
</tr>
<tr>
<td>h Other extracurricular activities?</td>
<td>33h</td>
<td></td>
</tr>
<tr>
<td>If you answered &quot;Yes&quot; to any of the above, please explain. (If you need more space, attach a separate statement.)</td>
<td>[ ]</td>
<td></td>
</tr>
<tr>
<td>34a Does the organization receive any financial aid or assistance from a governmental agency?</td>
<td>34a</td>
<td></td>
</tr>
<tr>
<td>b Has the organization's right to such aid ever been revoked or suspended?</td>
<td>34b</td>
<td></td>
</tr>
<tr>
<td>If you answered &quot;Yes&quot; to either 34a or b, please explain using an attached statement.</td>
<td>[ ]</td>
<td></td>
</tr>
<tr>
<td>35 Does the organization certify that it has complied with the applicable requirements of sections 4.01 through 4.05 of Rev. Proc. 75-50, 1975-2 C.B. 587, covering racial nondiscrimination? If &quot;No,&quot; attach an explanation</td>
<td>35</td>
<td></td>
</tr>
</tbody>
</table>
Schedule A (Form 990) 1999

Lobbying Expenditures by Electing Public Charities (See page 6 of the instructions.)
(To be completed ONLY by an eligible organization that filed Form 5768)

Check here ▶ a ☐ if the organization belongs to an affiliated group.
Check here ▶ b ☐ if you checked "a" above and "limited control" provisions apply.

Limits on Lobbying Expenditures
(The term "expenditures" means amounts paid or incurred.)

<table>
<thead>
<tr>
<th>(a) Affiliated group totals</th>
<th>(b) To be completed for ALL electing organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>36 Total lobbying expenditures to influence public opinion (grassroots lobbying)</td>
<td>36</td>
</tr>
<tr>
<td>37 Total lobbying expenditures to influence a legislative body (direct lobbying)</td>
<td>37</td>
</tr>
<tr>
<td>38 Total lobbying expenditures (add lines 36 and 37)</td>
<td>38</td>
</tr>
<tr>
<td>39 Other exempt purpose expenditures</td>
<td>39</td>
</tr>
<tr>
<td>40 Total exempt purpose expenditures (add lines 38 and 39)</td>
<td>40</td>
</tr>
<tr>
<td>41 Lobbying nontaxable amount. Enter the amount from the following table—</td>
<td></td>
</tr>
<tr>
<td>If the amount on line 40 is—</td>
<td>The lobbying nontaxable amount is—</td>
</tr>
<tr>
<td>Not over $500,000</td>
<td>20% of the amount on line 40</td>
</tr>
<tr>
<td>Over $500,000 but not over $1,000,000</td>
<td>$100,000 plus 15% of the excess over $500,000</td>
</tr>
<tr>
<td>Over $1,000,000 but not over $1,500,000</td>
<td>$175,000 plus 10% of the excess over $1,000,000</td>
</tr>
<tr>
<td>Over $1,500,000 but not over $17,000,000</td>
<td>$225,000 plus 5% of the excess over $1,500,000</td>
</tr>
<tr>
<td>Over $17,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>42 Grassroots nontaxable amount (enter 25% of line 41)</td>
<td>42</td>
</tr>
<tr>
<td>43 Subtract line 42 from line 36. Enter -0- if line 42 is more than line 36</td>
<td>43</td>
</tr>
<tr>
<td>44 Subtract line 41 from line 38. Enter -0- if line 41 is more than line 38</td>
<td>44</td>
</tr>
</tbody>
</table>

Caution: If there is an amount on either line 43 or line 44, you must file Form 4720.

4-Year Averaging Period Under Section 501(h)
(Some organizations that made a section 501(h) election do not have to complete all of the five columns below.
See the instructions for lines 45 through 50 on page 7 of the instructions.)

<table>
<thead>
<tr>
<th>Calendar year (or fiscal year beginning in) ▶</th>
<th>(a) 1999</th>
<th>(b) 1998</th>
<th>(c) 1997</th>
<th>(d) 1996</th>
<th>(e) Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>45 Lobbying nontaxable amount.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>46 Lobbying ceiling amount (150% of line 45(e)).</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>47 Total lobbying expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>48 Grassroots nontaxable amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>49 Grassroots ceiling amount (150% of line 48(e))</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50 Grassroots lobbying expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Lobbying Activity by Nonelecting Public Charities
(For reporting only by organizations that did not complete Part VI-A) (See page 8 of the instructions.)

During the year, did the organization attempt to influence national, state or local legislation, including any attempt to influence public opinion on a legislative matter or referendum, through the use of:

a Volunteers: | Yes | No | Amount |
---|-----|----|--------|

b Paid staff or management (Include compensation in expenses reported on lines c through h): | | | |
cc Media advertisements: | | | |
| | | |
d Mailings to members, legislators, or the public | | | |
e Publications, or published or broadcast statements | | | |
f Grants to other organizations for lobbying purposes | | | |
g Direct contact with legislators, their staffs, government officials, or a legislative body | | | |
h Rallies, demonstrations, seminars, conventions, speeches, lectures, or any other means | | | |
i Total lobbying expenditures (add lines c through h): | | | |

If "Yes" to any of the above, also attach a statement giving a detailed description of the lobbying activities.

Schedule A (Form 990) 1999
### Information Regarding Transfers To and Transactions and Relationships With Noncharitable Exempt Organizations

#### Schedule A (Form 990) 1999

**§1** Did the reporting organization directly or indirectly engage in any of the following with any other organization described in section 501(c) of the Code (other than section 501(c)(3) organizations) or in section 527, relating to political organizations?

- **a** Transfers from the reporting organization to a noncharitable exempt organization of:
  - (i) Cash
  - (ii) Other assets

- **b** Other transactions:
  - (i) Sales or exchanges of assets with a noncharitable exempt organization
  - (ii) Purchases of assets from a noncharitable exempt organization
  - (iii) Rental of facilities, equipment, or other assets
  - (iv) Reimbursement arrangements
  - (v) Loans or loan guarantees
  - (vi) Performance of services or membership or fundraising solicitations

- **c** Sharing of facilities, equipment, mailing lists, other assets, or paid employees

- **d** If the answer to any of the above is "Yes," complete the following schedule. Column (b) should always show the fair market value of the goods, other assets, or services given by the reporting organization. If the organization received less than fair market value in any transaction or sharing arrangement, show in column (d) the value of the goods, other assets, or services received:

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Line no.</td>
<td>Amount involved</td>
<td>Name of noncharitable exempt organization</td>
<td>Description of transfers, transactions, and sharing arrangements</td>
</tr>
</tbody>
</table>

**§2a** Is the organization directly or indirectly affiliated with, or related to, one or more tax-exempt organizations described in section 501(c) of the Code (other than section 501(c)(3)) or in section 527?

- **b** If "Yes," complete the following schedule:

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name of organization</td>
<td>Type of organization</td>
<td>Description of relationship</td>
</tr>
</tbody>
</table>
A CPA'S GUIDE TO TACKLING TOUGH TAX ISSUES FOR NONPROFIT ORGANIZATIONS

Form 990-T

Exempt Organization Business Income Tax Return
(and proxy tax under section 6033(e))

For calendar year 1999 or other tax year beginning .......................... and ending ..........................

D Employer identification number
(Enter and see instructions for block D on page 6.)

E NEW unrelated bus. activity codes
(See instructions for block E on page 6.)

F Group exemption number (see instructions for Block F on page 6)

G Check organization type □ 501(c) corporation □ 501(c) trust □ 401(a) trust □ Other trust

H Describe the organization's primary unrelated business activity.

I During the tax year, was the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? □ Yes □ No

J The books are in care of Telephone number

<table>
<thead>
<tr>
<th>Gross receipts or sales</th>
<th>Less returns and allowances</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 Cost of goods sold (Schedule A, line 7)</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>3 Gross profit (subtract line 2 from line 1c)</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>4a Capital gain net income (attach Schedule D)</td>
<td>4a</td>
<td></td>
</tr>
<tr>
<td>4b Net gain (loss) (Form 4797, Part II, line 18) (attach Form 4797)</td>
<td>4b</td>
<td></td>
</tr>
<tr>
<td>4c Capital loss deduction for trusts</td>
<td>4c</td>
<td></td>
</tr>
<tr>
<td>5 Income (loss) from partnerships and S corporations (attach statement)</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>6 Rent income (Schedule C)</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>7 Unrelated debt-financed income (Schedule E)</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>8 Interest, annuities, royalties, and rents from controlled organizations (see page 8 of instructions)</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>9 Investment income of a section 501(c)(7), (9), or (17) organization (Schedule G)</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>10 Exploited exempt activity income (Schedule I)</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>11 Advertising income (Schedule J)</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>12 Other income (see page 8 of the instructions—attach schedule)</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>13 TOTAL (combine lines 3 through 12)</td>
<td>13</td>
<td></td>
</tr>
</tbody>
</table>

Deductions Not Taken Elsewhere (See page 9 of the instructions for limitations on deductions.)
(Except for contributions, deductions must be directly connected with the unrelated business income.)

| Compensation of officers, directors, and trustees (Schedule K) | 14 | |
| Salaries and wages | 15 | |
| Repairs and maintenance | 16 | |
| Bad debts | 17 | |
| Interest (attach schedule) | 18 | |
| Taxes and licenses | 19 | |
| Charitable contributions (see page 10 of the instructions for limitation rules) | 20 | |
| Depreciation (attach Form 4562) | 21 | |
| Less depreciation claimed on Schedule A and elsewhere on return | 22a | |
| 22b | |
| Depletion | 23 | |
| Contributions to deferred compensation plans | 24 | |
| Employee benefit programs | 25 | |
| Excess exempt expenses (Schedule I) | 26 | |
| Excess readership costs (Schedule J) | 27 | |
| Other deductions (attach schedule) | 28 | |
| Total deductions (add lines 14 through 28) | 29 | |
| Unrelated business taxable income before net operating loss deduction (subtract line 29 from line 13) | 30 | |
| Net operating loss deduction | 31 | |
| Unrelated business taxable income before specific deduction (subtract line 31 from line 30) | 32 | |
| Specific deduction (Generally $1,000, but see line 33 instructions for exceptions) | 33 | |
| Unrelated business taxable income (subtract line 33 from line 32) if line 33 is greater than line 32, enter the smaller of zero or line 32 | 34 | |

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11291J

Form 990-T (1999)
### Form 990-T (1999)

#### Page 2

##### Tax Computation

**35** Organizations Taxable as Corporations (see instructions for tax computation on page 12). Controlled group members (sections 1561 and 1563)—check here. **See instructions** and:

**a** Enter your share of the $50,000, $25,000, and $9,925,000 taxable income brackets (in that order):

1. $50,000
2. $25,000
3. $9,925,000

**b** Enter organization's share of:

1. Additional 5% tax (not more than $11,750)
2. Additional 3% tax (not more than $100,000)
3. 

**c** Income tax on the amount on line 34

**36** Trusts Taxable at Trust Rates (see instructions for tax computation on page 12) Income tax on the amount on line 34 from: 

- **Tax rate schedule** or 
- **Schedule D (Form 1041)**

**37** Proxy tax (see page 12 of the instructions)

**38** Total (add line 37 to line 35c or 36, whichever applies)

### Tax and Payments

**39a** Foreign tax credit (corporations attach Form 1118; trusts attach Form 1116)

**b** Other credits. (see page 13 of the instructions)

**c** General business credit—Check if from:

- **Form 3800** or 
- **Form (specify)**

**d** Credit for prior year minimum tax (attach Form 8801 or 8827)

**e** Total credits (add lines 39a through 39d)

**40** Subtract line 39e from line 38

**41** Recapture taxes. Check if from: 

- **Form 4255**
- **Form 8611**

**42** Alternative minimum tax

**43** Total tax (add lines 40, 41, and 42)

**44a** Payments: a 1998 overpayment credited to 1999

**b** 1999 estimated tax payments

**c** Tax deposited with Form 7004 or Form 2758

**d** Foreign organizations—Tax paid or withheld at source (see instructions)

**e** Backup withholding (see instructions)

**f** Other credits and payments (see instructions)

**44f** Total payments (add lines 44a through 44f)

**45** Estimated tax penalty (see page 3 of the instructions). Check if Form 2220 is attached

**46** Tax due—If line 45 is less than the total of lines 43 and 46, enter amount owed

**47** Overpayment—If line 45 is larger than the total of lines 43 and 46, enter amount overpaid

**49** Enter the amount of line 48 you want. Credited to 2000 estimated tax

### Statements Regarding Certain Activities and Other Information

(See instructions on page 14.)

1. At any time during the 1999 calendar year, did the organization have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)?

- **Yes**
- **No**

2. During the tax year, did the organization receive a distribution from, or was it the grantor of, or transferor to, a foreign trust?

- **Yes**
- **No**

3. Enter the amount of tax-exempt interest received or accrued during the tax year


### Schedule A—Cost of Goods Sold

(See instructions on page 15.)

#### Method of inventory valuation (specify)

1. Inventory at beginning of year
2. Purchases
3. Cost of labor
4a. Additional section 263A costs (attach schedule)
4b. Other costs (attach schedule)
5. Total—Add lines 1 through 4b

#### Schedule B

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

<table>
<thead>
<tr>
<th>Sign Here</th>
</tr>
</thead>
<tbody>
<tr>
<td>Signature of officer or fiduciary</td>
</tr>
<tr>
<td>Paid Preparer's Signature</td>
</tr>
</tbody>
</table>

**Use Only**

- Preparer's name (or yours, if self-employed) and address
- ZIP code

Form 990-T (1999)

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211
### SCHEDULE C—RENT INCOME (FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY)

(See instructions on page 15.)

<table>
<thead>
<tr>
<th>1 Description of property</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
</tr>
<tr>
<td>(2)</td>
</tr>
<tr>
<td>(3)</td>
</tr>
<tr>
<td>(4)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2 Rent received or accrued</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) From personal property (if the percentage of rent for personal property is more than 10% but not more than 50%)</td>
</tr>
<tr>
<td>(b) From real and personal property (if the percentage of rent for personal property exceeds 50% or if the rent is based on profit or income)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3 Deductions directly connected with the income in columns (2a) and (2b) (attach schedule)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
</tr>
<tr>
<td>(2)</td>
</tr>
<tr>
<td>(3)</td>
</tr>
<tr>
<td>(4)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

| Total income (Add totals of columns 2a and 2b). Enter here and on line 6, column (A), Part I, page 1. |
|-------------------------------------------------------------------------------------------------

### SCHEDULE E—UNRELATED DEBT-FINANCED INCOME

(See instructions on page 15.)

<table>
<thead>
<tr>
<th>1 Description of debt-financed property</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
</tr>
<tr>
<td>(2)</td>
</tr>
<tr>
<td>(3)</td>
</tr>
<tr>
<td>(4)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2 Gross income from or allocable to debt-financed property</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Straight line depreciation (attach schedule)</td>
</tr>
<tr>
<td>(b) Other deductions (attach schedule)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3 Deductions directly connected with or allocable to debt-financed property</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Straight line depreciation (attach schedule)</td>
</tr>
<tr>
<td>(b) Other deductions (attach schedule)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4 Amount of average acquisition debt on or allocable to debt-financed property (attach schedule)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>5 Average adjusted basis of or allocable to debt-financed property (attach schedule)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>6 Column 4 divided by column 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>7 Gross income reportable (column 2 × column 6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>8 Allocable deductions (column 6 ÷ total of columns 3a and 3b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

Total dividends-received deductions included in column 8.

### SCHEDULE F—INTEREST, ANNUITIES, ROYALTIES, AND RENTS FROM CONTROLLED ORGANIZATIONS

(See instructions on page 16.)

<table>
<thead>
<tr>
<th>1 Name and address of controlled organization(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
</tr>
<tr>
<td>(2)</td>
</tr>
<tr>
<td>(3)</td>
</tr>
<tr>
<td>(4)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2 Gross income from controlled organization(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3 Deductions of controlling organization directly connected with column 2 income (attach schedule)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Unrelated business taxable income</td>
</tr>
<tr>
<td>(b) Taxable income computed as though not exempt under sec. 501(a), or the amount in col. (a), whichever is larger</td>
</tr>
<tr>
<td>(c) Column (a) divided by column (b)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4 Exempt controlled organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Unrelated business taxable income</td>
</tr>
<tr>
<td>(b) Taxable income computed as though not exempt under sec. 501(a), or the amount in col. (a), whichever is larger</td>
</tr>
<tr>
<td>(c) Column (a) divided by column (b)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>5 Nonexempt controlled organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Excess taxable income</td>
</tr>
<tr>
<td>(b) Taxable income, or amount in column (a), whichever is larger</td>
</tr>
<tr>
<td>(c) Column (a) divided by column (b)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>6 Gross income reportable (column 2 × column 4c) or column 5c(i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>7 Allowable deductions (column 3 × column 4c) or column 5c(i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) %</td>
</tr>
<tr>
<td>(2) %</td>
</tr>
<tr>
<td>(3) %</td>
</tr>
<tr>
<td>(4) %</td>
</tr>
</tbody>
</table>

Total dividends-received deductions included in column 8.

Form 990-T (1999)
### SCHEDULE G—INVESTMENT INCOME OF A SECTION 501(c)(7), (9), OR (17) ORGANIZATION

(See instructions on page 17.)

<table>
<thead>
<tr>
<th>Description of income</th>
<th>Amount of income</th>
<th>Deductions directly connected with production of unrelated business income</th>
<th>Set-asides attributable to income from activity that is unrelated business activity (col. 2 minus col. 3)</th>
<th>Total deductions and set-asides (col. 3 plus col. 4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2)</td>
<td></td>
<td></td>
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<tr>
<td>(3)</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>(4)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### SCHEDULE I—EXPLOITED EXEMPT ACTIVITY INCOME, OTHER THAN ADVERTISING INCOME

(See instructions on page 17.)

<table>
<thead>
<tr>
<th>Description of exploited activity</th>
<th>Gross unrelated business income from trade or business</th>
<th>Expenses directly connected with production of unrelated business income</th>
<th>Net income (loss) from unrelated trade or business (column 2 minus column 3). If a gain, compute cols. 5 through 7.</th>
<th>Gross income from activity that is unrelated business activity (column 5)</th>
<th>Expenses attributable to column 5</th>
<th>Excess exempt expenses (column 6 minus column 5, but not more than column 4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2)</td>
<td></td>
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<tr>
<td>(3)</td>
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<tr>
<td>(4)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Column totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### SCHEDULE J—ADVERTISING INCOME

(See instructions on page 18.)

**Income From Periodicals Reported on a Consolidated Basis**

<table>
<thead>
<tr>
<th>Name of periodical</th>
<th>Gross advertising income</th>
<th>Direct advertising costs</th>
<th>Advertising gain or (loss) (col. 2 minus col. 3). If a gain, compute cols. 5 through 7.</th>
<th>Circulation income</th>
<th>Readership costs</th>
<th>Excess reader costs (column 6 minus column 5, but not more than column 4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2)</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>(3)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Column totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Income From Periodicals Reported on a Separate Basis** *(For each periodical listed in Part II, fill in columns 2 through 7 on a line-by-line basis.)*

| (1)                |                          |                          |                                                                                  |                   |                 |                                                                                |
| (2)                |                          |                          |                                                                                  |                   |                 |                                                                                |
| (3)                |                          |                          |                                                                                  |                   |                 |                                                                                |
| (4)                |                          |                          |                                                                                  |                   |                 |                                                                                |
| Totals from Part I |                          |                          |                                                                                  |                   |                 |                                                                                |

### SCHEDULE K—COMPENSATION OF OFFICERS, DIRECTORS, AND TRUSTEES

(See instructions on page 18.)

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Percent of time devoted to business</th>
<th>Compensation attributable to unrelated business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>%</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Form 990-T (1999)
**User Fee for Exempt Organization Determination Letter Request**

Attach this form to the determination letter application. (Form 8718 is NOT a determination letter application.)

<table>
<thead>
<tr>
<th>Name of organization</th>
<th>Employer Identification Number</th>
</tr>
</thead>
</table>

**Caution:** Do not attach Form 8718 to an application for a pension plan determination letter. Use Form 8717 instead.

<table>
<thead>
<tr>
<th>Type of request</th>
<th>Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>a □ Initial request for a determination letter for:</td>
<td></td>
</tr>
<tr>
<td>• An exempt organization that has had annual gross receipts averaging not more than $10,000 during the preceding 4 years, or</td>
<td></td>
</tr>
<tr>
<td>• A new organization that anticipates gross receipts averaging not more than $10,000 during its first 4 years . . . ▶ $150</td>
<td></td>
</tr>
<tr>
<td>Note: If you checked box 3a, you must complete the Certification below:</td>
<td></td>
</tr>
</tbody>
</table>

**Certification**

I certify that the annual gross receipts of ______________________________ have averaged (or are expected to average) not more than $10,000 during the preceding 4 (or the first 4) years of operation.

Signature ▶ Title ▶

<table>
<thead>
<tr>
<th>Type of request</th>
<th>Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>b □ Initial request for a determination letter for:</td>
<td></td>
</tr>
<tr>
<td>• An exempt organization that has had annual gross receipts averaging more than $10,000 during the preceding 4 years, or</td>
<td></td>
</tr>
<tr>
<td>• A new organization that anticipates gross receipts averaging more than $10,000 during its first 4 years . . . ▶ $500</td>
<td></td>
</tr>
<tr>
<td>c □ Group exemption letters ▶ $500</td>
<td></td>
</tr>
</tbody>
</table>

**Instructions**

The law requires payment of a user fee with each application for a determination letter. The user fees are listed on line 3 above. For more information, see Rev. Proc. 98-8, 1998-1, I.R.B. 225.

Check the box on line 3 for the type of application you are submitting. If you check box 3a, you must complete and sign the certification statement that appears under line 3a.

Attach to Form 8718 a check or money order payable to the Internal Revenue Service for the full amount of the user fee. If you do not include the full amount, your application will be returned. Attach Form 8718 to your determination letter application.

Send the determination letter application and Form 8718 to:
- Internal Revenue Service
- P.O. Box 192
- Covington, KY 41012-0192
- If you are using express mail or a delivery service, send the application and Form 8718 to:
  - Internal Revenue Service
  - 201 West Rivercenter Blvd.
  - Attn: Extracting Stop 312
  - Covington, KY 41011
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