Audit Technique Guide For Public Charities

Introduction

This guide

- outlines the procedures IRS auditors use to correctly determine the proper foundation status for organizations described in IRC Section 501(c)(3);
- provides guidance to auditors on determining and addressing the presence of inurement, private benefit, and excess benefit transactions; and
- discusses political and legislative activities, how auditors determine if they are present, and their effect on charities.

For an organization to be described as exempt under IRC Section 501(c)(3), it must:

- meet both the organizational and operational tests,
- not permit earnings to inure to the benefit of private individuals,
- not engage substantially in legislative activities, and
- not engage in any political activity.

Therefore, during an examination, we conduct procedures designed to verify compliance with these requirements.

Private Foundation vs. "Public Charity" Status

IRC Section 509(a) notes that all organizations, foreign and domestic, described in IRC Section 501(c)(3) are private foundations except for those described in IRC Section 509(a)(1), (2), (3), or (4). "Public charity" is the generic term given to the excepted organizations in the above listed Code sections.

Therefore, all IRC Section 501(c)(3) organizations are either private foundations or public charities. All IRC Section 501(c)(3) organizations are presumed to be private foundations unless they are described in IRC Section 509(a)(1), (2), (3), or (4).

Organizations described in	Characteristics/requirements
IRC Sections 509(a)(1) and 170(b)(1)(A)(i), (ii), (iii), and (v)	• Deemed public charities • Don't have to meet public or government financial support tests to establish their status as public charities
IRC Sections 509(a)(1) and 170(b)(1)(A)(iv)	• Must meet a public support test See Rev. Rul. 82-132, 1982-2 C.B. 107.
IRC Sections 509(a)(3) and (4)	• Must show that they are organized and operated for the purposes per their respective code sections • Must meet public support tests
IRC Sections 170(b)(1)(A)(vi) or IRC 509(a)(2)	• Must show they meet the prescribed public support tests to be excluded from private foundation classification

Foundation Status Under IRC Sections 509(a)(1), 509(a)(2), 509(a)(3) or 509(a)(4)

IRC Section 509(a)(1) excludes from private foundation classification those organizations described in IRC Section 170(b)(1)(A)(i)-(vi):

- IRC Section 170(b)(1)(A)(i) - Churches
- IRC Section 170(b)(1)(A)(ii) - Schools
- IRC Section 170(b)(1)(A)(iii) - Hospitals
- IRC Section 170(b)(1)(A)(iv) - Endowment funds for a state university's library
- IRC Section 170(b)(1)(A)(v) - Governmental entities
- IRC Section 170(b)(1)(A)(vi) - Publicly supported charities, such as, United Way

Note: IRC Section 509 (a)(1) organizations engage in inherently public activities.

IRC Section 509 (a)(2) excludes from private foundation classification those publicly supported organizations that receive more than one-third of their support from gifts, grants, contributions, membership fees, and certain gross receipts but not more than one-third from gross investment income and net unrelated business taxable income (UBI).

Note: IRC Section 509 (a)(2) organizations are supported primarily by exempt function income. Exempt function income comes from an activity that is not an unrelated trade or business.

IRC Section 509(a)(3) excludes from private foundation classification those organizations that, in general, support organizations described in IRC Section 509(a)(1) or (2), although they themselves are not publicly supported.

IRC Section 509(a)(4) excludes from private foundation classification those organizations that are organized and operated for the purpose of testing products for public safety. An example is an organization that performs safety tests for pleasure boats and boating equipment. Rev. Rul. 65-61, 1965-1 C.B. 234.

Non-Private Foundation Classification

Generally, IRS gives an organization the "highest" foundation classification status for which it qualifies. The following list shows the hierarchy of code sections describing an organization exempt from private foundation classification and federal income tax, ranked in order of most advantageous classification to the least.

- IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(i) – Not required to apply to the IRS for recognition of exempt status and not required to file Form 990 /990-EZ.
- IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(ii), (iii), (v) – Exempt from some excise taxes, however unrelated business income tax (UBIT) is applicable. No requirement to meet a public support test.
- IRC Section 509 (a)(1) and IRC Section 170(b)(1)(A)(iv), (vi) - A private foundation can terminate its exempt status without taxable consequences by distributing its net assets to an entity described in these code sections. Higher dollar limitations apply to contributions made by individuals and corporations. These organizations can have an organization described in IRC 509(a)(3) supporting it.
- IRC Section 509(a)(2) - These organizations can have an organization described in IRC 509(a)(3) supporting it.
- IRC Section 509(a)(3) - Not a private foundation. No public support test required but required to meet certain organizational and operational tests related to the organization it supports. It can

also be an organization exempt under IRC 501(c)(4), (5), or (6) if it also would be described in IRC Sections 501(c)(3) and IRC 509(a)(2).

- IRC Section 509(a)(4) - Not a private foundation. Its purpose is to conduct tests for public safety.

Guidelines for Determining Classification under IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(vi)

An organization described in IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(vi) is one that:

- Is referred to in IRC Section 170(c)(2) and
- Normally receives a substantial part of its support from governmental units, direct or indirect contributions from the general public, public or a combination of these sources.

Normally, the organization meets the support computation test for the aggregate of the four taxable years before the year under audit and the current and next taxable year. Treas. Reg. 1.170A-9(e)(4)(i).

The terms “gifts” and “contributions” in the context of the public support test have the same meaning as they have under IRC Section 170(c). Any payment of money or transfer of property without adequate consideration is a gift or contribution. Where payment is made in exchange for admissions, merchandise sales, services performed or facilities furnished to the donor, payment is considered a gift or contribution only to the extent it exceeds the value of the exchange.

Where property constitutes the gift or contribution, the amount includible in computing public support is the property's fair market value or rental value on the date the donor makes the gift. Treas. Reg. 1.509(a)-3(f)(2).

The public support test is satisfied by meeting either a 33 1/3 percent test or a facts and circumstances 10 percent test. The amount of public support includible for purposes of the test(s) is modified by limiting contributions, gifts and grants from certain individuals, corporations, trusts and organizations to two percent of total support.

To verify during an audit, use the mechanical test to compute the organization's public support and total support based upon its four preceding taxable years' income. Treas. Reg. 1.170A-9(e)(4)(i), (ii), (iii). See Exhibit 1 for ramifications of the “normally meets” rule.

The mechanical test is a fractional computation:

The organization's public support (subject to certain limitations and exclusions), as defined in the Code and Treasury Regulations. Treas. Reg. 170A-9(e).

----------------Divided by----------------

The organization's total support (also subject to some exclusions.)

Public Support (numerator)

Public support includible in the numerator:

a. Contributions, gifts, bequests (direct or indirect) from the general public (individuals, corporations, trusts)[1]
b. Contributions from organizations described in IRC Section 170(b)(1)(A) (other than clauses (vii) and (viii)) if organization would also qualify under IRC Section 170(b)(1)(A)(vi)[1]
c. Contributions, gifts, grants from organizations described in IRC Section 170(b)(1)(A)(vi)
d. Contributions, gifts, grants from organizations described in IRC Section 509 (a)(2)[2]
e. Contributions, gifts, grants from organizations described in IRC Section 509 (a)(3)[2]
f. Contributions, gifts, grants from private foundations described in IRC Section 509(a)[2]

g. Contributions, gifts, grants from other organizations described in IRC Section 501(c) (such as civic organization, union, business league)[2]
h. Support from governmental units[1]
i. Tax revenues levied for the benefit of the organization
j. Membership fees (for purposes of organization's support only)[2]

[1] See "Two Percent Limitation" discussion below. Otherwise, include in full.
[2] Two percent limit applies.

Items **not** includible in the numerator:

a. Contribution of services for which no deduction is allowed
b. Membership fees from related activities (such as admission fees)
c. Income from an unrelated trade or business (whether or not taxable per IRC Section 513)
d. Investment income, interest, dividends, rents, royalties
e. Capital gains
f. Value of any exemptions from tax (federal, state, local)
g. Loan repayments
h. Unusual grants

Total Support (denominator)
Total support to calculate the denominator includes:

a. 100 percent of contributions, gifts, bequests (direct or indirect) from the general public (individuals, corporations, trusts)
b. 100 percent of contributions from organizations described in IRC Section 170(b)(1)(A) organizations (other than clauses (vii) and (viii)) if organization would also qualify under IRC Section 170(b)(1)(A)(vi)
c. 100 percent of contributions, gifts, grants from organizations described in IRC Section 170(b)(1)(A)(vi)
d. 100 percent of contributions, gifts, grants from organizations described in IRC Section 509 (a)(2)
e. 100 percent of contributions, gifts, grants from organizations described in IRC Section 509 (a)(3)
f. 100 percent of contributions, gifts, grants from private foundations described in IRC Section 509(a)
g. 100 percent of contributions, gifts, grants from other IRC Section 501(c) organizations (e.g., civic organization, union, business league)
h. All support from governmental units
i. Tax revenues levied for the benefit of the organization
j. 100 percent of membership fees (if made for organization's support only)
k. Net income from unrelated activities, whether taxable or not under IRC Section 513
l. Gross investment income, interest, dividends, rents, royalties
m. Value of services or facilities furnished by a governmental unit without charge

Items **not** includible in the denominator:

a. Contribution of services for which no deduction is allowed
b. Unusual grants
c. Income from organization's activities constituting its basis for exemption (e.g., theater admissions of an exempt performing arts organization)
d. Government support for carrying out a related activity

e. Capital gains
f. Contributions of non-deductible services
g. Value of any exemptions from tax (federal, state, local)
h. Loan proceeds or repayments

Two Percent Limitation

a. If a single donor's contribution exceeds two percent of an organization's total support, the excess is:
    - excluded from the numerator of the public support fraction
    - included (entire amount of the contribution) in the denominator (Treas. Reg. 1.170A-9(e)(6)(i)).
b. The two percent limitation also applies to any person(s) or entity related to the donor as described in IRC Section 4946(a)(1)(C) through (G) as if made by the donor. For example, a husband and wife are treated as one person for the two percent limitation.
c. In general, the two percent limitation doesn't apply to the following support:
    - Other IRC Section 170(b)(1)(A)(vi) organizations
    - Governmental units per IRC Section 170(c)(1)
    - Organizations that: normally receive substantially all support from direct or indirect general public contributions, are described in IRC Section 170(c)(2), and would qualify for IRC Section 170(b)(1)(A)(vi). See Rev. Rul. 78-95, 1978-1 C.B. 71.

d. **Exception**: If a contribution, gift or grant from a governmental unit, another IRC Section 170(b)(1)(A)(vi) organization, or a IRC Section 170(c)(2) organization is earmarked for the recipient organization (commonly referred to as a "pass-through"), it is also subject to the two percent limitation.

Facts and Circumstances Test

When an organization fails to meet the 33 and 1/3 percent publicly supported test, evaluate its IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(vi) status based on the facts and circumstances test in Treas. Reg. 1.170A-9(e)(3). The organization, however, first must meet the 10 percent or more public support test.

If an organization receives at least 10 percent but less than 33 1/3 percent of its total support from contributions made directly or indirectly by the general public or from governmental units, then look to the facts and circumstances test to determine if the requisite public support characteristics are present.

Once the organization satisfies the 10 percent test, consider these factors when analyzing whether the organization meets the facts and circumstances test:

- Ability to attract public support
- Percentage of public support above the 10 percent threshold
- Sources of support
- Representative governing body
- Availability of facilities or services

Expand on these concepts by weighing factors listed in Exhibit 2 (below) and consider the following:

- Does the organization receive support from a representative number of people or members of a single family?

- Are its activities limited to a particular region or a specialized field that would limit the sources of support?
- Does the organization’s governing body represent broad interests of the general public rather than private interests of a limited number of donors?
- Does the organization disseminate its programs, seminars, benefits, etc. to the general public? Is the general public familiar with the organization's specific mission?
- Are facilities and services provided directly to the general public on a continual basis?
- Does the organization receive a significant part of its funding from a public charity or governmental agency that holds the organization accountable as a condition of its funding?

There are no set procedures for the compilation of facts and circumstances. Here are some suggestions to you make a determination under the facts and circumstances test:

- Interview the organization's officials. Do they have plans to expand the organization's support base? If so, how do they expect to accomplish the expansion?
- Interview officials and review board of director or committee meeting minutes. Does the organization have a long-range plan to broaden the field to which it appeals?
- Find out whether the board includes public officials or people employed by public officials, experts in the organization’s field of operations, community leaders or officers voted in by a broad-based membership.
- Read the organization's publications and consider how it makes itself and its mission known to the public.
- Interview those responsible for the accounting functions within the organization. Which individuals are provided financial statements and reports?

An interview of the organization's officials can suffice if it’s close to meeting the 33 1/3 percent public support test and in the your judgment, the organization is likely to qualify for the higher status. In more ambiguous circumstances, secure written statements from the organization supplemented by any copies of fund-raising literature as substantiation if you reach an adverse determination of exempt status.

For membership organizations, consider the following:

- Does the organization solicit dues to enroll a substantial number of persons in only a narrow community/area or a particular profession or field of interest?
- Is the organization’s membership fee structure designed to make membership available to a broad cross-section of the interested public?
- Are the organization’s activities likely to appeal to a broad cross section of the public?

Document the facts and circumstances as part of the public support test in your case file workpapers.

Other 501(a)(1) and 170(b)(1)(A)(vi) Classification Issues

Unusual Grants Exclusion

An unusual grant may be excluded from both the numerator and denominator of the applicable support test under IRC Section 170(b)(1)(A)(vi). The intent of the unusual grant exclusion is to exclude substantial contributions and bequests from disinterested parties that are attracted because of the publicly supported nature of the organization. If significant in amount, it may make the difference between a public charity or private foundation determination. Therefore, it's important to properly identify the grant's classification.

See Exhibit 3 (below) for factors that weigh in favor of or against the income being classified as an unusual grant. To help you determine a questionable grant classification:

- Ask whether the organization has received a private letter ruling for the unusual grant. (Representatives frequently request rulings in this area.)
- Secure any correspondence or documentation that accompanied the grant. Was the contribution a bequest or an inter vivos transfer? A bequest is more indicative that the amount met the requirement of "unusual" or unexpected. Documentation should disclose whether the transfer of the gift or grant has imposed material restrictions or conditions.
- Review organizing documents and the organization's minutes to determine the relationship of the donor to the organization. Did the grant come from a truly disinterested party? Non-related party contributions are more favorable than those from individuals with prior and/or close involvement with the organization.
- Review the minutes and the cash receipts journal to determine if the contributor directly or indirectly exercises control over the organization.
- Review any notes to the organization's audited financial statements and lists of contributors to determine whether the organization continually relies on unusual grants to fund an organization's operating expenses. Determine the organization's ability to attract future support from the general public.

Related vs. Unrelated Gross Receipts

When calculating the public support test for IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(vi), gross receipts derived from a/an:

- **related** trade or business (for example, admissions to performances) are excluded from the numerator and the denominator.
- **unrelated** trade or business is excluded from the numerator, but included in the denominator.

Apply the rules of IRC Section 513 and Treas. Reg.1.513-1(d) to determine whether the support is/is not related to the organization's exempt purpose.

Payments from a Government Contract

Generally, governmental support isn't subject to the two percent limitation and is fully includible in both the numerator and the denominator for the public support test, but there is an exception. If a donor makes an indirect contribution (one earmarked for the benefit of a particular recipient) through a governmental unit, the contribution is subject to the two percent limitation. In that case, the publicly supported organization or governmental unit is acting as a conduit, so the contribution is treated as having been made by the original donor. Consider whether the government grant is given to the organization for the purpose of carrying out the organization's exempt purposes. If that is the case, the grant amount should be entirely excluded from the numerator and the denominator.

Public Support and Assignment of Income in Old Age Homes

There has been considerable litigation involving old age homes and public support. See *Williams Home, Inc. v. United States and Miller Home, Inc. v. United States*, 540 F. Supp. 310 (W.D. Va.1982). The courts ultimately concluded that assets assigned to the homes by the applicants were exempt function income and didn't represent public support. Significant points raised in the issue were:

- The transfer of assets was due to the home's insistence rather than any disinterested generosity from the applicants.
- Treas. Reg.1.170A-9(e)(3)(i) (facts and circumstances test requiring that an organization receive at least 10 percent of its income from public contributions) was valid; although the court did note even though the regulations weren't contemporaneous with the enactment of IRC Section 170, they were contemporaneous with and necessary to the enactment and purposes of IRC 509.
- Treatment of Gaming Income In Public Support Determinations - In determining if an organization is described in IRC Section 170(b)(1)(A)(vi), gross receipts not from an unrelated trade or business, including, for example, bingo receipts which are nontaxable under IRC Section 513(f) are generally excluded from public support computations.

IRC Section 513(i) and Sponsorship.
Treas. Reg. 170A-9(e)(6)(i) was amended in 2002 for the final regulations on corporate sponsorship payments to exempt organizations. It states that the term "contributions" includes qualified sponsorship payments (as defined in Treas. Reg. 1.513-4) in the form of money or property but not services.

- Treas. Reg. 1.513-4 provides that a qualified sponsorship payment is one made by anyone engaged in a trade or business and one for which there is no arrangement or expectation that a substantial benefit will be received in return for the payment. It doesn't matter whether the sponsored activity is related to the organization's exempt activity, or whether the activity is temporary or permanent. Payment means money, transfer of property, or performance of services.
- Qualified sponsorship payment per Treas. Reg. 1.513-4 includes the value of services performed, but public support does not include such value per IRC Section 170A-9(e)(6)(i).
- "Substantial benefit" means other than the use or acknowledgment of the sponsor's name or logo in connection with the activity and other than certain goods or services that have an insubstantial value.
- "Benefits" include:
    1. advertising
    2. exclusive provider arrangements (as defined in Treas. Reg. 1.513-4(c)(2)(vi)(B))
    3. goods, facilities, services or other privileges
    4. exclusive or nonexclusive rights to use an intangible asset (such as trademark, patent, logo, or designation)
- Treas. Reg. 1.513-4(c)(2) describes a "substantial return benefit" that can be disregarded. However, if the aggregate "fair market value" of all benefits provided to the sponsor (payor) in the exempt organization's taxable year equals two percent or more of the total amount of the payment, the entire payment amount is considered a substantial benefit, not just the excess of the two percent.

The final regulations state that in determining whether the two percent threshold has been exceeded in any year, consider all return benefits (other than use or acknowledgment). Therefore, when you review sources of income relative to the public support test for IRC Section 170(b)(1)(A)(vi), look at any corporate sponsorship payments the organization received during the pertinent taxable year(s) and consider whether there were any return benefits.

> ***Example:*** An exempt organization received $100,000 in a qualified sponsorship payment during its fiscal year ending 12/31/17. Certain return benefits to the payor were included in that

amount. The agent determined $900 was the fair market value for advertising (as defined in Treas. Reg. 1.513-4(c)(2)(v)), and $500 was the fair market value for a license (as defined in Treas. Reg.1.513-4(c)(2)(vi)(B)). The aggregate fair market value of return benefits to the payor in FY 17 was $1,400, which was less than two percent of the $100,000 payment received ($2,000). Therefore, $1,400 is considered a disregarded benefit amount for purposes of Treas. Reg. § 1.513-4(c)(2)(ii). The total payment amount of $100,000 is included in the public support test for IRC Section 170(b)(1)(A)(vi).

Example: The same facts as in the previous example, except the agent determined the advertising's fair market value was $5,000, and the license's was $10,000. Since the aggregate fair market value of return benefits to the payor was $15,000, they exceeded two percent of the $100,000 ($2,000) and are not considered disregarded benefits. Therefore, the qualified corporate sponsorship payment for purposes of the public support test for IRC Section 170(b)(1)(A)(vi) is $85,000 ($100,000 total payment less $15,000 substantial benefits).

See Exhibit 4 (below) for a summary of these rules.

Examining Books and Records to Determine Public Support for IRC Sections 509(a)(1) and 170(b)(1)(A)(vi)

When examining the books and records to determine public support:

- Verify the correct classification of gifts, grants and contributions on the organization's financial statements.
- Note any exceptions to gross receipts classification on the IRC Section 509(a)(1) workpapers for possible further consideration. For example, if the organization's financial statements and contracts reveal the contributions are really gross receipts (such as admissions to performances), the organization may then only be eligible for public foundation status under IRC Section 509(a)(2).
- Audit the cash receipts journal and review member correspondence to confirm that membership fees were without consideration, in other words, thank-you letters indicating income from admissions, merchandise, services or the use of facilities, which may indicate gross receipts versus contributions.
- Review all correspondence files that accompany contributions made by publicly supported organizations. The organization must not reserve contributions for the recipient.
- Include tax revenues levied for the benefit of the organization or expended on behalf of the organization as well as the value of in-kind services or facilities from a governmental entity. (Note:, this is commonly found in volunteer fire and rescue organizations.)
- Use contributors' correspondence and consult Publication 78 for which contributors hold a public charity status to determine if certain gifts, grants and contributions from governmental and public charity sources are exempt from the two percent limitation in the public support test.

See Exhibit 5, below, for a sample support test computation worksheet.

Guidelines for Determining Classification under Section IRC Section 509(a)(2)

An organization described in IRC Section 509(a)(2) has a similar basis for public charity status as one described in IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(vi). Many of the same factors apply to an

IRC Section 509(a)(2) public charity such as the definition of “normally,” the treatment of unusual grants, and use of the cash basis of accounting to calculate the public support test. The public support tests in IRC Section 509(a)(2) are designed to ensure the organization is responsive to the general public rather than a limited number of donors or other persons.

An organization described in IRC Section 509(a)(2) is one that typically derives most of its gross receipts from an activity related to its exempt function and receives less than 33 1/3 percent of its total support from investment income and unrelated business income.

While organizations claiming IRC Section 509(a)(1) and IRC Section 170(b)(1)(A)(vi) status only have to satisfy one test, organizations claiming IRC Section 509(a)(2) status must satisfy two tests. The organization must:

- Normally receive more than one-third of its support from any combination of gifts, grants, contributions, membership fees, and gross receipts from permitted sources;
- Not receive more than one-third of its support from gross investment income, in addition to unrelated business income (UBI) less tax imposed by IRC Section 511.

“Normally” means the organization meets the support test in the aggregate for the four taxable years before the year under audit. If it does, it’s considered to meet it for the current and succeeding taxable year. Treas. Reg. 1.509(a)-3(c).

The terms “gifts” and “contributions” in the context of the public support test have the same meaning as under IRC Section 170(c). Any payment of money or transfer of property without adequate consideration is defined as a gift or contribution. Where payment is made in exchange for admissions, merchandise sales, services performed or facilities furnished to the donor, payment is considered a gift or contribution only to the extent it exceeds the value of the exchange.

Where property constitutes the gift or contribution, the amount includible in computing public support is the property's fair market value or rental value on the date the donor makes the gift. Treas. Reg. 1.509(a)-3(f)(2).

Verify the organization's foundation status by using the mechanical test to compute the organization's public support and total support based on its current and four preceding taxable years' income. See Exhibit 6 for ramifications of the “normally meets” rule.

The mechanical test is a fractional computation:

The organization's public support (subject to certain limitations and exclusions), as defined in the Code and Treasury Regulations. Treas. Reg. 1.509(a)-3(a)(2) and (3)

----------------Divided by----------------

The organization's total support (also subject to some exclusions)

Public Support (numerator)

The organization must normally receive more than one-third of its support in each taxable year from any combination of “permitted sources” per Treas. Reg. 1.509(a)-3(2). Include these in the numerator of the support calculation:

a. Contributions, gifts, bequests (direct or indirect) from the general public (individuals, corporations, trusts)[1]

b. Contributions from organizations described in IRC Section 170(b)(1)(A) (other than clauses (vii) and (viii)) and governmental units (for public benefit)
c. Contributions, gifts, grants from organizations described in IRC Section 509(a)(2) or (3)[1]
d. Contributions, gifts, grants from private foundations described in IRC Section 509(a)[1]
e. Contributions, gifts, grants from other organizations described in IRC Section 501(c) (e.g., civic organization, union, business league) [1]
f. Governmental unit support from contracts or grants (for government's benefit or to carry out related activity)[1 2]
g. Membership fees (for admissions, merchandise, etc.) [1 2]
h. Membership fees (to provide support only)
i. Gross receipts from a related activity (e.g., admission fees, merchandise sales, services performed, furnishing facilities)[1 2]
j. Rents (related activity or other) [1 2]
k. Taxes levied for benefit of the organization

[1] Does not include amounts received from disqualified persons defined in IRC Section 4946(a)(1).
[2] See $5000/1 percent limitation discussion below.

Don't include these in the numerator of the public support test:

a. Dividends and interest
b. Unusual grants
c. Unrelated business income (net)
d. Capital gains
e. Loan proceeds
f. Amounts from disqualified persons

Treas. Reg. 509(a)-3(a)(2) excludes disqualified persons (with respect to the organization) from "permitted sources" that go into the public support calculation:

- IRC Section 4946(a)(1) defines disqualified person.
- Among other terms, the definition includes a substantial contributor.
- IRC Section 507(d)(2) defines a substantial contributor as an individual, trust, estate, partnership, association, company or corporation who contributed or bequeathed an aggregate of $5,000 (as long as the $5,000 is more than two percent of cumulative contributions the organization received before its taxable year-end in which the contribution is received).
- From the date a person first meets the $5,000 and two percent test, he remains a substantial contributor, even if his contributions become less than two percent of total contributions in future years. Treas. Reg. 1.507-6(b)(1).
- An organization described in IRC Section 509(a)(1), (2) or (3) isn't a substantial contributor. Treas. Reg. 1.507-6(a)(2).

Example: Individual A makes a $3,500 contribution to Organization B on September 30, 2015. Individual A makes another $3,500 contribution to Organization B on March 31, 2017. During its existence through December 31, 2017, Organization B has received a total of $250,000 in contributions from all sources. Individual A is a substantial contributor to Organization B as of March 31, 2017, the first date on which his contributions met the $5,000 and two percent test. A's $3,500 contribution is excluded entirely from the numerator of B's public support test for taxable year ending December 31, 2017 because A is now a substantial contributor and thus, a disqualified person. However, A's $3,500 contribution on March 31, 2017 is included in B's denominator as part of total support for taxable year December 31, 2017.

Note: Don't confuse the $5,000/ two percent test for substantial contributor with the $5,000/one percent test (see below) for gross receipts from related activities.

Total Support (denominator):

Include these in the denominator of the support calculation:

a. 100 percent of contributions, gifts, bequests (direct or indirect) from the general public (individuals, corporations, trusts)
b. 100 percent of contributions from organizations described in IRC Section 170(b)(1)(A) (other than clauses (vii) and (viii)) and governmental units (for public benefit)
c. 100 percent of contributions, gifts, grants from organizations described in IRC Section 509(a)(2) or (3)
d. 100 percent of contributions, gifts, grants from private foundations described in IRC Section 509(a)
e. 100 percent of contributions, gifts, grants from other organizations described in IRC Section 501(c) (such as civic organization, union, business league)
f. All governmental unit support
g. All membership fees
h. Gross receipts from all related activities
i. All rents (related activity or other)
j. Taxes levied for benefit of the organization
k. Total amounts received from disqualified persons

Don't include these in the total support denominator:

a. Unusual grants
b. Dividends and interest
c. Capital gains
d. Loan proceeds

$5,000 or One Percent Limitation

If related activities generate receipts from one person, bureau, or similar agency of an IRC Section 170(c)(1) governmental unit, only count the greater of: $5,000 or one percent of the organization's total support in any taxable year as public support in the numerator for the 33 1/3 percent test of IRC 509(a)(2). The limitation is applied on a year-to-year basis and is not cumulative. Include the entire amount in the total support, or denominator. IRC Section 509(a)(2)(A)(ii).

One-third Limit on Gross Investment Income and Unrelated Business Income

The second test an organization must meet to be described in IRC Section 509(a)(2) is the gross investment income and UBI test. IRC Section 509(a)(2)(B). It meets this test only if it doesn't normally receive more than one-third of its total support from gross investment income and UBI (less applicable IRC Section 511 tax).

Gross investment income is defined in IRC Section 509(e) as income from interest, dividends, rents and royalties but net of any tax imposed by IRC Section 511. UBI is defined in IRC Section 512 as gross income from a trade or business that is not substantially related to the organization's exempt purposes.

Verify that the organization meets this test by calculating the total gross investment income plus UBI (less IRC Section 511 tax imposed on either) as the numerator divided by the organization's total support as the denominator. If the result is not more than one-third of total support, the organization meets the second test for IRC Section 509(a)(2) classification.

Other IRC Section 509(a)(2) classification issues

Contributions or Gifts vs. Gross Receipts
A payment may sometimes be part gift and part payment for merchandise, admissions, services, or use of facilities. The payment is classified as a gift or contribution if it exceeds the value of what is received, and the remainder is classified as support from gross receipts under IRC Section 509(a)(2)(A)(ii).

Grants vs. Gross Receipts
The distinction between a grant and gross receipts is important because a grant is considered a permitted source for purposes of public support, and as such, is fully included in the public support fraction's numerator. On the other hand, gross receipts are subject to the $5,000/one percent limitation. Typically, a grant is paid to encourage the recipient organization to carry on its exempt activities. The payor imposes terms and conditions on its use of funds. The organization uses the funds in a manner compatible with the payor's own programs and makes sure it results in public benefit.

Be alert to misclassifications of grants and gross receipts; it's difficult to distinguish between the two. For instance, payor restrictions on the grant don't automatically disqualify the payment as public support. Look at whether the organization must provide some sort of service or facility in exchange for the payment; if so, the payment is considered gross receipts and not a grant. See Treas. Reg. 1.509(a)-3.

> ***Example:*** An organization that provides medical care receives $10,000 income in Medicare payments based on individual patients. The Medicare payments constitute gross receipts because the individual patients receive a benefit from services the organization provided. Thus, the $10,000 is includible in the public support test numerator only if it doesn't exceed the greater of $5,000 or one percent of the organization's total support for that year. By contrast, if the same organization receives $10,000 from a governmental agency to refurbish the patients' rooms, the income is fully includible for the public support test numerator because it is for the organization's general exempt activities. See Rev. Rul. 83–153, 1983-2 C.B. 48.

Membership Fees vs. Gross Receipts
The fact that a membership organization provides services, admissions, facilities, or merchandise to its members, as part of its overall activities by itself, doesn't result in classifying fees received from members as gross receipts subject to the $5,000 or one percent limit.

Treas. Reg. 1.509(a)-3(h)(1) defines membership fees as gross receipts if the fees are a way to sell admissions, merchandise, services, or the use of facilities (in the course of a related activity) to people who have no common interest in the organization except the benefit they receive in return for the fee. On the other hand, if the basic purpose for making the payment is to provide support for the organization, rather than to purchase admissions, merchandise, services, or use facilities, the income received from the payment constitutes membership fees. Treas. Reg. 1.509(a)-3(h).

Gross Receipts from Thrift Shops
Gross receipts from IRC Section 513(a)(1), (2), or (3) activities are treated as gross receipts from related activities and therefore, subject to a $5,000 or one percent limitation. In general, these activities relate

to thrift shops, university or hospital convenience shops, and businesses operated by charitable organizations where volunteers perform substantially work. Treas. Reg. 1.509(a)-3(1).

Gross Receipts from a Governmental Unit's Bureau or Agency
The $5,000 or one percent limitation under IRC Section 509(a)(2)(A)(ii) applies separately to gross receipts an organization receives from each bureau or similar agency of a governmental unit. Therefore, the definition of what constitutes a bureau or similar agency of a governmental unit is important.

A governmental unit described in IRC Section 170(c)(1) includes a state, a possession of the United States, or any political subdivision of any of the above-mentioned, or the United States or the District of Columbia.
Under Treas. Reg. 1.509(a)-3(i)(1), the term bureau means a unit functioning at the operating level of government. A bureau is descriptive of a subdivision of a department of government. The term doesn't usually include a level of government that is basically policymaking or administrative.

Example: In State X, the Department of Mental Health is an operational state agency under the Department of Public Health. Because it is a subdivision of a department of government, it is considered a bureau. Gross receipts from the Department of Mental Health, as a bureau, are subject to the $5,000 or one percent limit.

Payments Under CACFP
"Sponsoring organizations" under the United States Department of Agriculture's Child and Adult Care Food Program (CACFP) receive the following payments:

a. payments for meals
b. administrative payments
c. one time start-up payments to develop or expand successful CACFP operations in day care homes

All these CACFP payments are support to the payee organization to carry out its exempt purposes.
For the public support under IRC Section 509(a)(2), meal payments are gross receipts and calculated as public support similar to Medicare payments. As such, they are subject to the $5,000/one percent limitation. By contrast, treat administrative expense reimbursements and start-up payments as government grants. See Treas. Reg. 1.509(a)-3(g)(2) and Treas. Reg. 1.170A-9(e)(8).

Gross Investment Income or Unrelated Business Taxable Income vs. Gross Receipts
Sometimes, you may need to distinguish gross investment income or UBI from a related activity's gross receipts. For example, if an IRC Section 501(c)(3) organization's exempt purpose is to furnish facilities for a rental fee or to provide loans to a particular class of persons (for example, aged, sick, or needy persons), then the income it receives from those persons is considered gross receipts from a related exempt activity, rather than from gross investment income or unrelated business taxable activity.

Earmarked Funds From IRC Section 509(a)(1) Organizations
A grant received from a public charity described in IRC Section 509(a)(1) is fully includible in the 33 1/3 percent support test public support numerator (IRC Section 509(a)(2)(A)). However, an indirect contribution (one earmarked by the donor for a particular recipient's benefit) to the public charity retains its character. Therefore, if a donor who is a substantial contributor (as defined in IRC Section 507(d)(2)) with respect to the ultimate recipient, makes an indirect contribution through a public charity, exclude the amount from the numerator of the support fraction. Treas. Reg. 1.509(a)-3(j).

Treatment of Gaming Income In Public Support Determinations
In verifying whether or not an organization is still described in IRC Section 509(a)(2), include gross receipts from gaming activities in both the denominator and numerator of the support test, if the activity is not an unrelated trade or business.

Examining Books and Records to Determine Public Support for IRC Section 509(a)(2)

Include questions in your initial interview with a membership organization designed to review reasons organizations receive membership fees so you can properly classify the receipts. Likewise, review the organization's minutes because it may reveal whether the membership fees go toward general support of the organization or to purchase a benefit.

Check gross receipts and grants to ensure the organization hasn't erroneously reported them together on the same line of Form 990 or Form 990-EZ.

Keeping in mind the importance of distinguishing between grants and gross receipts, be aware that the organization would avoid the $5,000 and one percent limitation on support if payments are misclassified as grants rather than gross receipts. Review the organization's correspondence as one way to properly identify the receipts.

Review and analyze contracts that generate gross receipts to the organization. In the IRC Section 509 (a)(2) support test, an organization can include related activity gross receipts received from any one individual, corporation or governmental unit up to and including the greater of: $5,000 or one percent of its total support. The gross receipts $5,000 and one percent limitation is applied on a year-to-year basis and isn't cumulative. Be aware that some contracts with government agencies provide payments on behalf of an individual rather than to the general public as a whole and are subject to the $5,000/one percent limitation. For example, if a contract provides Medicare receipts for each patient, request from the organization a list of patients who received $5,000 or the applicable one percent amount to test the public support limitation.

See Exhibit 7 for a sample support test computation worksheet.

IRC Section 509(a)(1) vs. IRC Section 509 (a)(2), If Both Classifications Are Met

If an organization meets the public support tests for IRC Section 509(a)(1) (as an organization described in IRC Section 170(b)(1)(A)(vi)) and IRC Section 509 (a)(2), it is treated as described in IRC Section 509(a)(1). Treas. Reg. 1.509(a)-6.

IRC Section 509 (a)(2) classification has the following disadvantages:

- Under IRC Section 507(b)(1)(A), a private foundation may terminate its status without incurring the IRC Section 507(c) tax if:
    - it distributes all of its net assets to one or more organizations under IRC Section 170(b)(1)(A)(i) through IRC Section 170(b)(1)(A)(vi) and
    - the organization(s) has continually existed with the same foundation status for at least 60 calendar months immediately before the distribution. See Treas. Reg. 1.507-2(a)(1).
- If an IRC Section 509 (a) organization makes a contribution or grant to an organization claiming non-private foundation status under IRC Section 509 (a)(2), it must be considered for the $5,000

or two percent limitation. Under this circumstance, their contributions or grants generally wouldn't constitute support from permitted sources to the organization claiming non-private foundation status for the support test under IRC Section 509 (a)(2).

- An IRC Section 509(a)(2) organization is limited to a deduction of 30 percent of adjusted gross income for donations of capital gain property to another IRC 509(a)(2) organization. See IRC Section 170(b)(1)(B) and IRC Section 170(b)(1)(c).

See Exhibit 8 for a summary and comparison of public support, total support, and limitations for each test under IRC Section 509(a)(1)/170(b)(1)(A)(iv) and IRC Section 509(a)(2).

Guidelines for Determining Classification under IRC Section 509(a)(3)

An IRC 501(c)(3) organization that can't meet the public support tests of IRC Section 509(a)(1) or IRC Section 509(a)(2) but wishes to be classified as other than a private foundation may meet one of the three relationship tests as a supporting organization under IRC Section 509(a)(3). Also, it must meet an organizational, operational, and control test. See Exhibit 9. The three possible relationships are:

- Operated, supervised or controlled by (Treas. Reg. 1.509(a)-4(g)) (Type I)
- Supervised or controlled in connection with (Treas. Reg. 1.509(a)-4(h)) (Type II)
- Operated in connection with (Treas. Reg. 1.509(a)-4(i)) (Type III)

IRC Section 509(a)(3) Relationship Test Guidelines

1. Type I, operated, supervised or controlled by - The first relationship (also known as the "parent-subsidiary relationship") requires the members of an IRC Section 509(a)(1) or (2) organization's body acting in their official capacity to appoint or elect a majority of the IRC Section 509(a)(3) organization's governing body. Therefore, you must interview the organization to verify that a majority of the organization's board of directors has been elected or appointed by properly authorized officials of the supported organization. Then review the governing documents. The supported organization's ability to yield such control should always be documented within the governing documents or official minutes.
2. Type II, supervised or controlled in connection with - The second relationship (also known as the "brother-sister relationship") requires a common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organization. Review the board meeting minute notes or request a list of the current board members for the supporting organization and the supported organization. Review the organization to verify that a majority of the board members of the IRC Section 509(a)(3) supporting organization are also on the supported organization's board. This ensures that the supporting organization will be responsive to the publicly supported organization's needs and requirements.
3. Type III, operated in connection with – The third relationship type was revised by the Pension Protection Act (PPA) of 2006, which made significant changes in Type III requirements to ensure that supporting organizations are responsive to supported organizations. (Pension Protection Act of 2006, P.L. 109-280). There are two types of Type III supporting organizations:

    1. Functionally integrated supporting organizations (FISO)
    2. Non-functionally integrated supporting organizations (Non-FISO)

Functionally integrated Type III supporting organizations are described in Treas. Reg. 1.509(a)-4(i)(4), and are characterized by the performance of *activities* that directly further the exempt purpose of the supported organization(s).

Non-functionally integrated Type III supporting organizations are described in Treas. Reg. 1.509(a)-4(i)(5), and are characterized by making *payments*, such as grants, to the supported organization(s). Non-FISOs are also subject to more restrictions and requirements than FISOs.

In addition to the tests that all supporting organizations must pass (organizational, operational, control, and relationship), all Type III supporting organizations must satisfy the following:

- Notification requirement
- Responsiveness test
- Integral part test

Treas. Reg. 1.509(a)-4(i) (10) states that a supporting organization is not operated in connection with one or more supported organizations if it supports any supported organization organized outside of the United States. Type III supporting organizations, including both FISOs and non-FISOs, are prohibited from supporting any organization which isn't organized in the U.S.

- The Responsiveness Test - The supporting organization must be responsive to the supported organization's needs or demands. This test itself has two parts:
    1. Relationship of officers, directors, or trustees – Treas. Reg. 1.509(a)-4(i)(3)(ii).
    2. Significant voice – Treas. Reg. 1.509(a)-4(i)(3)(iii).
- The Integral Part Test - The supporting organization maintains a significant involvement in the publicly supported organization's operation, which in turn depends on the supporting organization for the type of support it provides. Treas. Reg. 1.509(a)-4(i)((4) and (5)).

4. Type III also has a notification requirement that applies to both FISOs and non-FISOs. For each taxable year, a Type III Supporting Organization must provide the following documents to each of its supported organizations:
    - A written notice addressed to a principal officer of the supported organization describing the type and amount of all of the support the supporting organization provided to them during the supporting organization's taxable year immediately before the taxable year in which the written notice is provided (and any during any other of the supporting organization's taxable year ending after December 28, 2012, for which such support information has not previously been provided);
    - A copy of the supporting organization's Form 990, Return of Organization Exempt from Income Tax; and
    - A copy of the supporting organization's governing documents in effect on the date of the notification is provided, including its articles of organization and bylaws (if any) and any amendments to those documents, unless the documents have been previously provided and not subsequently amended. Treas. Reg. 1.509(a)-4(i)(2).

Examining the Responsiveness and Integral Part Tests

- Responsiveness Test – (Treas. Reg. 1.509(a)-(4)(i)(3))[1]

- Verify that 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, OR
- Verify that 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 organization, OR
- Document the extent to which the officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the publicly supported organization(s).

Based on the three elements above, you can document that the officers, directors or trustees of the publicly supported organization have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and in otherwise directing its income or assets' use.

[1] Treas. Reg. 1.509(a)-(4)(i)(3)(v) allows an organization that was supporting or benefiting a supported organization before November 20, 1970, to take additional facts and circumstances (such as a historic and continuing relationship with the supported organization), into account to establish compliance with the responsiveness test.

- Integral Part Test – Although both the notification requirement and the responsiveness test are the same for FISOs and non-FISOs, the integral part test is different for FISOs and non-FISOs.

  FISO:

  The integral part test for a FISO is in Treas. Reg. 1.509(a)-4(i)(4). A FISO meets the integral part test and is considered functionally integrated if it-
  - Engages in *activities* substantially all of which directly further the exempt purposes of one or more supported organizations and meets the requirements of Treas. Reg. 1.509(a)-4(i)(4)(ii);
  - Is the parent of each of each of its supported organizations; or
  - Supports a governmental supported organization. (Notice 2014-4, 2014-2 IRB 274)

  Non-FISO:

  The integral part test for a Non-FISO is in Treas. Reg. 1.509(a)-4(i)(5). In general, a non-FISO must satisfy both a distribution requirement (Treas. Reg. 1.509(a)-4(i)(5)(ii)(A)), and an attentiveness requirement (Treas. Reg. 1.509(a)-4(i)(5)(iii)).[1]

  [1] Treas. Reg. 1.509(a)-4(i)(5)(ii)(B) provides a special rule for a non-FISO formed as a trust that, on November 20, 1970, met and continues to meet the requirements of Treas. Reg. 1.509(a)-4(i)(9)(i) through (v).

  - Distribution requirement – Treasury issued final regulations on the distribution requirement for non-FISOs, effective December 21, 2015. A Type III non-FISO must distribute its "distributable amount" each taxable year to or for the use of one or more supported organizations. The distributable amount for a taxable year is an amount equal to the greater of:

1. Distributable amount: 85% of the supporting organization's adjusted net income for the prior taxable year.
2. Minimum asset amount: 3.5% of the excess of the aggregate fair market value of the supporting organization's non-exempt-use assets in the taxable year immediately before the taxable year of the required distribution, over the acquisition indebtedness for the non-exempt-use assets, with certain adjustments. (See T.D. 9746; 2016-14 I.R.B. 515, for further details.)

- Attentiveness requirement – A non-FISO must distribute one-third or more of the organization's distributable amount to one or more supported organizations that are *attentive* to the operations of the supporting organization. A supported organization is attentive to the operations of the supporting organization during a taxable year if at least one of the following requirements is satisfied:

    - The supporting organization distributes to the supported organization amounts equaling or exceeding 10% of the supported organization's total support for the prior taxable year. (Treas. Reg. 1.509(a)-4(i)(5)(iii)(B)(1)); or
    - The amount of support received from the supporting organization is necessary to avoid interruption of a particular function or activity of the supported organization. The support is considered necessary if it is earmarked for a particular program or activity, as long as it is a substantial one. (Treas. Reg. 1.509(a)-4(i)(5)(iii)(B)(2)); or
    - Based on all facts and circumstances, the amount of support received is a sufficient part of a supported organization's total support to ensure attentiveness. Pertinent factors include the number of supported organizations, the length and nature of relationships and the purpose to which funds are applied. (Treas. Reg. 1.509(a)-4(i)(5)(iii)(B)(3)).

IRC Section 509(a)(3) Organizational Test Guidelines

Assuming that one of the three relationship tests has been met, document the fact that the organization's governing instrument meets the general requirements. Treas. Reg. 1.509(a)-4(c) and (d) list four requirements, two positive and two negative:

1. The first requirement limits the organization's purposes to one or more of those in IRC Section 509(a)(3)(A). Ensure the organization has a statement that it is organized and operated exclusively for the benefit of a publicly supported organization.
2. The second requirement calls for the supporting organization to specify the publicly supported organizations they are supporting.

    Note: If no actual organizations are named, you may consider an exception that satisfies the requirement by allowing supporting organizations to specify the publicly supported organization by class or purpose. For example, if the organization states it is organized to support animal rescue organizations within Chenango County, the requirement is satisfied.

3. The third requirement is a negative one which states that the organization can't empower itself to engage in activities not in furtherance of its stated purposes. Review the organization's governing document to verify that the purposes in the organization's governing instrument are no broader than those in the supported organization's articles of incorporation. (If the supported organization is exempt under IRC Sections 501(c)(4), (5) or (6), the supporting organization's purposes must merely have articles requiring it to carry on charitable activities within the meaning of IRC Section 170(c)(2)).
4. The fourth and final requirement is a restriction. The organization must not be empowered to support or benefit any organization other than those publicly supported organizations already specified.

IRC Section 509(a)(3) Operational Test Guidelines

After establishing the fact that the supporting organization is properly organized, ensure it meets the operational test in Treas. Reg. 1.509(a)-4(e). The operational test is concerned with two areas:

- Permissible Beneficiaries - Treas. Reg. 1.509(a)-4(e)(1) allows payments to be made to organizations other than the specified publicly supported organization if the payment is made to:
    1. A member of a charitable class benefited by the specified publicly supported organization via a grant
    2. Another organization meeting one of the three relationship tests
    3. A college or university that is an instrumentality or a government agency.

To verify that payments were made only to permissible beneficiaries, ask pertinent questions and review documentation, such as meeting minutes and cash disbursements.

- Permissible Activities - Treas. Reg. 1.509(a)-4(e)(3) describes permissible independent programs. The supporting organization may carry on its own programs designed to support or benefit the specified publicly supported organization. Conduct an operational survey to determine if the activities actually serve the exempt purposes of its beneficiary. Supporting organizations may also engage in fund raising activities, such as solicitations, fund raising dinners and unrelated trade or business to raise funds for the publicly supported organizations or their permissible beneficiaries.

IRC Section 509(a)(3) Control Test Guidelines

To qualify for IRC Section 509(a)(3) classification, Treas. Reg. 1.509(a)-4(j) requires the organization to satisfy a final test, called the control test. It's designed to preclude the supporting organization's being controlled, directly or indirectly, by disqualified persons as defined in IRC Section 4946. Disqualified persons include the following:

- Substantial contributor
- Foundation manager of a private foundation
- Certain 20 percent owners
- Family members
- Corporations, partnerships, etc.

Look at whether disqualified persons may, by combining their voting powers and their positions of authority, require the supporting organization to engage, or decline to engage, in an act that significantly affects the operations of the supporting organization. Using documents such as the board minutes, look for situations in which the disqualified persons have either 50 percent of the voting power or the veto power over the supporting organization’s activities. Treas. Reg. 1.509(a)-4(j)(2).

Note that the Code not only forbids direct control but indirect control as well. Consider all pertinent facts and circumstances to determine if a disqualified person does, in fact indirectly control an organization. This includes considering the nature, diversity, and income yield of the organization’s holdings, the length of time particular stocks, securities and other assets held, and the manner of exercising voting rights for stocks in which members of its governing body have some interest. Treas. Reg. 1.509(a)-4(j)(1). (See Rev. Rul. 80-207, 1980-2 C.B. 193 for a more detailed discussion.)

Guidelines for Determining Classification under IRC Section 509(a)(4)

IRC Section 509(a)(4) excludes from private foundation classification an organization that is organized and operated exclusively for public safety. The definition of “testing for public safety” includes testing of consumer products, such as electrical products, to determine if they are safe for the general public's use. Few of these organizations are recognized as exempt because they are described in IRC Section 509(a)(4). Many have been denied exemption based on their activities actually serving private interests such as manufacturers and shippers. Certain clinical drug testers also have sought exemption recognition but have been denied on the basis that a drug is not a “consumer product” until it is approved for marketing by the FDA.

Foundation Status – Workpaper Documentation

Document your audit steps in your workpapers:

1. If it’s obvious the organization is publicly supported (such as a United Way organization or community orchestra), you normally don’t need to make an in-depth public support verification. An error in this type of organization's calculation is unlikely to result in a foundation status change. However, create a workpaper for the file showing you considered the foundation status and the reason you reached your stated conclusion.

2. Consider any change or modification from the current classification you propose adverse and treat as an unagreed case. Attempt to obtain a signed Form 6018, Consent to Proposed Adverse Action, for the proposed change or modification. A signed form is not binding, but it does indicate the taxpayer's position. Refer to Publication 557, Tax Exempt Status for Your Organization, to explain the proposal to the taxpayer.

3. Consider foundation status for more than just the year under audit to avoid reaching an incorrect conclusion. If the organization satisfies the aggregate support test for the four prior years, it’s considered “normally publicly supported” in the current and subsequent years. However, if it fails the four-year test, you must look to special rules designed to give the organization public charity status if it met the computation in past years and may meet the test again in a subsequent year. Treas. Reg. 1.170A-9(e)(4)(iii), Treas. Reg. 1.509(a)-3(c)(ii), Exhibits 1 and 6. If the organization does not meet the public support test of either IRC Section 170(b)(1)(A)(vi) or IRC Section 509(a)(2), consider sections IRC 509(a)(3), IRC 509(a)(4), and all other sections of IRC 170(b), and note this in your workpapers.

4. Document all computations, considerations and conclusions in the workpapers whether you determine that the existing status is correct or propose a change.

5. Reflect in your workpapers and any report that the IRS has granted the organization the most advantageous foundation classification for which it qualifies.

Inurement, Private Benefit and Excess Benefit Transactions (IRC Section 4958)

An entity doesn’t qualify as a charitable organization exempt from federal income tax under IRC Section 501(c)(3) unless, among the other requirements, it meets the operational test.

IRC Section 501(c)(3) exempts corporations and any community chest, fund, or foundation, organized and operated exclusively for religious purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Treas. Reg. 1.501(c)(3)-1(c)(2) states 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. Inurement is concerned with the direct transfer of income or provision of services unrelated to exempt purposes.

Treas. Reg. 1.501(a)-1(c) defines a private shareholder or individual as those persons having a personal and private interest in the activities of an organization. In general, a private shareholder or individual is considered an “insider” with respect to the exempt organization.

The prohibition of private benefit is in part in Treas. Reg. 1.501(c)(3)-1(d)(1)(ii), which states that an organization isn’t organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. The burden is on the organization to establish that it isn’t organized and 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 private interests. The organization's activities must be broad enough in scope to confer a public benefit versus serving to benefit only a few.

IRC Section 4958 addresses inurement. It imposes an excise tax, commonly known as “intermediate sanctions,” on excess benefit transactions between a “disqualified person” and a tax-exempt organization in IRC Section 501(c)(3) or IRC Section 501(c)(4). On January 22, 2002, the Treasury Department issued final regulations under IRC Section 4958. Although IRC Section 501(c)(3) still provides for loss of exemption in the case of any private inurement, the legislative history shows that IRC Section 4958 was enacted to impose a sanction in cases where an excess benefit doesn’t rise to a level where it questions the organization's tax exempt organization status. Revocation of exempt status would still occur when the organization no longer meets the operational test as a charitable organization. H. Rep. No. 506, 104th Congress, 2d Sess. 53, 59 note 15(1996).

A disqualified person is defined in Treas. Reg. 53.4958-3 as a person in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period before the benefit transaction in question occurred. Family members and entities controlled by the disqualified person are also considered disqualified persons.

An “excess benefit transaction” is one in which the organization provides an economic benefit, directly or indirectly, to or for the use of the disqualified person, and the value of the benefit provided exceeds the value of the consideration received in return. Treas. Reg. 53.4958-4.

Inurement vs. Private Benefit

It’s important to differentiate between “inurement” and “private benefit.” The two terms are closely related and often used interchangeably. However, they are two separate issues; not treating them as separate issues can lead to incorrect conclusions. Since the enactment of IRC Section 4958, it’s even more crucial to know the difference between them. The first key is that inurement applies to those who are “inside,” or in control, of the organization, whereas private benefit applies to a broader base. Private benefit encompasses those who are not only inside but also “outside” the organization. So, all inurement is private benefit, but not all private benefit is inurement.

The second key you must understand is that inurement means an insider (whether an individual or an entity) takes from the exempt organization's profits in some manner that benefits him or her. However, the private benefit doctrine focuses on the organization's primary activities and how charitable they are. What are the activities? How broad is the class of persons they benefit? Does the class represent the community at large, or is there private benefit to certain individuals or entities? If private benefit exists, is it merely incidental, or does it preclude the public at large?

The third key in comparing inurement and private benefit is the consequence of each. For inurement, any taking of the profits (net earnings) is fatal to exemption; you don’t need to even look at the quality of the organization's charitable activities. By contrast, in considering private benefit, ask questions about activities, whom they benefit, and how representative of the public the beneficiaries are to address the charitable aspects of activities and thus, how substantial any private benefit is. If insubstantial, the private benefit may not be fatal to exemption.

See the table below which lists the distinguishing factors.

Inurement	Private Benefit
Insider (private shareholder or individual in a position to control) benefit is prohibited.	Private benefit may also accrue to anyone outside the charitable class.
Net earnings can’t benefit a private shareholder or individual.	Substantial benefits can be conferred upon a private individual or class of individuals.
IRC Section 501(c)(3) prohibits any inurement.	Private benefit can’t be substantial.

Example: In *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989), the court distinguished between inurement and private benefit in denying declaratory judgment to a school that trained individuals to fill positions in political campaigns. The IRS contended the entity didn’t meet the operational test for IRC Section 501(c)(3) because it engaged in activities that served private interests versus a public purpose. The organization argued the IRS incorrectly applied the private benefit analysis, that the Republican party and candidates couldn’t be construed as insiders of its organization. The court said the entity was incorrectly merging the language of Treas. Reg. 1.501(c)(3)-1(d)(1)(ii), which limits private benefit, with the statutory and regulatory language in IRC Section 501(c)(3), which prohibits inurement of net earnings to private shareholders and individuals. “Petitioner misconstrues the overlapping characteristics of the private benefit and private inurement prohibitions [which do not target the same class]. We have consistently recognized that while [the two] share common and often overlapping elements, the two are distinct requirements which must independently be satisfied." The court also stated the presence of private inurement violates both prohibitions, but the absence of inurement does not mean the absence of private benefit. Ultimately, the court ruled the organization wasn't entitled to exemption under IRC Section 501(a) because it was operated for the benefit of private interests and more than an insubstantial part of its activities furthered a nonexempt purpose.

Inurement

Despite the explicit prohibition of inurement, neither the Code nor the Treasury Regulations defines it. The prohibition of inurement wasn't in the original act that recognized certain corporations as exempt from federal income tax (Tariff Act of 1894, ch. 349, section 32, 28 Stat. 509, 556 (1894)), indicating that perhaps it was a concept so obvious it didn't need to be mentioned. The Tariff Act of 1909, referenced inurement, and the Revenue Act of 1918 changed net income to net earnings. Otherwise, the phrase has remained unchanged.

The concept of inurement contemplates a transaction between the exempt organization and an individual who is an insider. An insider, by virtue of his position within the organization, has the ability to influence or control application of the organization's net earnings. Although the Code and Treasury Regulations don't specify or define insider relative to inurement, the IRS views the prohibition relates only to insider-controlled benefits. Rev. Rul. 69-283, 1969-2CB 113. The IRS found no inurement where an exempt hospital compensated a hospital-based radiologist based on a fixed percentage of the radiology department's income. The conclusion was reached, in pertinent part, because the radiologist didn't control the organization.

There is nothing in IRC Section 501(c)(3) to prohibit dealings between a charitable organization and its insiders (those in controlling positions) as long as those dealings are at arm's length, in good faith, and reasonable. For example, if an organization pays a reasonable compensation to its founder for services rendered, that is not inurement. However, when the interests of the charity are sacrificed to the private interests of the founder or those in control, exemption is precluded because the organization is serving private interests.

The courts have broadly construed the term net earnings to include more than gross receipts minus disbursements as shown on the organization's books and records. Consider the following:

- Excessive compensation - *Church of Scientology*, 823 F.2d 1310 (9th Cir. 1987)
- Interest-free, unsecured loans and payment of personal expenses - *John Marshall Law School v. U.S.*, 228 Ct. Cl. 902 (1981)
- Excessive rents and improvements made on real estate owned by insiders - *Texas Trade School v. Commissioner*, 272 F.2d 168 (5th Cir. 1959)
- Reports and surveys furnished to members - *General Contractors' Ass'n v. U.S.*, 202 F.2d 633 (7th Cir. 1953)
- Services to members - *Chattanooga Auto Club v. Commissioner*, 182 F.2d 551 (6th Cir. 1950)

The IRS has mostly relied on revenue rulings and case law to interpret the meaning of inurement within the context of specific cases. Even though the issue seems to be a "facts and circumstances" test, we can identify certain common principles. Court renderings have generally fallen into several broad categories of inurement.

One category is easy to identify. Inurement can take the form of questionable transactions that have no causal relationship to the organization's exempt purposes but result in some benefit to an insider, whether or not the insider provides goods and services of commensurate value to the entity. The insider is in a position to exercise control over the organization's net earnings as if they were his own by using them at will rather than within limitations of an employer-employee or fiduciary capacity. In effect, the insider is using the public's "net earnings" for her own benefit. You can usually recognize this type of inurement issue by its qualities.

Example: *John Marshall Law School and John Marshall University v. United States*, 228 Ct. Cl. 902 (1981). The court held that personal expenses paid on behalf of the family controlling a law school were not part of reasonable compensation. The plaintiff argued that if these payments had been included in salary, the salary still would be reasonable. However, the court said the corporation didn't pay expenses as additional salary or treat them as compensation on its books. Instead, the corporation paid them at the insider's discretion. He was free to make personal use of the corporate funds for himself and family when and if he chose to do so. The court upheld the Commissioner in the revocation of the school's exempt status based on inurement.

Example: *The Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969). The court reasoned that even if the salary paid to the organization's founder was reasonable, absent a suitable explanation for other payments made to and for his family and him disqualified the organization for tax-exempt status. "If in fact a loan or other payment in addition to salary is a disguised distribution or benefit from the net earnings, the character of the payment is not changed by the fact that the recipient's salary, if increased by the amount of the distribution or benefit, would still have been reasonable." The court ruled the plaintiff was not entitled to recover payment of deficiency.

A second category of inurement is straightforward. Inurement exists when an insider receives a return benefit from the exempt organization that is greater than the value of the goods and services provided to it. A private shareholder or individual benefits from the expenditure of the organization's funds ("net earnings") in some manner when a payment is not reasonable for what the organization gets in exchange, meaning the organization either has paid too much or charged too little. In either case, monies that should have been expended for exempt ("public") purposes went to inurement Although difficult to measure, establish what is reasonable. "Reasonableness" is an issue that has posed problems for the courts, because it is not a concept that easily lends itself to preciseness or measurement.

Example: *Anclote Psychiatric Center, Inc. v. Commissioner*, T.C. Memo 1998-273. An exempt psychiatric hospital's officers and directors sought to convert the organization to a for-profit and sell it to an entity the board created. The question before the court was whether the sale price was close enough to fair market value to conclude there was no inurement. "...recognizing what is fair market value presents an inherently imprecise issue, we see our task as one of determining whether the sale price was within a reasonable range...Our task is not unlike that which we face when inurement depends upon a determination whether payments of compensation are excessive or reasonable." The court said while fair market value is important, it's not a definite figure that you can compare to a sale price and thus, automatically measure inurement. Even two appraisers can disagree on what is "fair market value." Among other factors, inadequate arm's length negotiations could affect the sale price and give rise to inurement if the value received isn't "reasonably" within range of the value transferred. In this case, the organization's sale price to the insiders was more than $1 million under a fair market value and outside any “reasonable” range. The court ruled that tax-exempt status was properly revoked based on inurement.

A third category of inurement doesn’t hinge upon the reasonableness of expenditure amounts or whether they were made for the organization's exempt purposes. Inurement also can occur where an exempt organization and a taxable entity are structured so closely that an insider benefits financially from the arrangement. This type of inurement isn’t always obvious because the exempt organization may be paying a reasonable amount for services provided and carrying on exempt activities. Therefore, you must analyze carefully the actual substance of transactions between the entities to determine where the true benefit lies and if the exempt organization's net earnings are reduced in a way that benefits a private individual or entity that can be considered an insider.

Example: *Housing Pioneers, Inc. v. Commissioner*, 58 F.3d 401 (9th Cir. 1995). The organization's purpose was to provide affordable housing for low income and handicapped persons. The organization entered into an agreement with a for-profit partnership to participate in a project in which the for-profit's property would be exempt from property tax. As part of the agreement, the for-profit loaned money to the exempt to buy an interest in and become a general partner. Part of the property tax savings was to go to the general partnership to keep rents low and part to the exempt organization for its charitable purposes. The court ruled that even though the tax reductions were to be used exclusively to make rents affordable, inurement was present. Federal income tax advantages and property tax reductions resulted in inurement at least indirectly to the benefit of the non-exempt partners (two of whom were insiders with respect to the exempt entity) because their partnerships were relieved of maintaining rents at a level sufficient to cover operating expenses that would otherwise have to be paid out of partnership capital.

Private Benefit

The private benefit standard doesn’t derive its authority from the part of the statute prohibiting inurement of net earnings. Rather, it is based on the operational test in IRC Section 501(c)(3) which requires an organization to operate exclusively for exempt purposes. However, “operated exclusively” has two meanings, both of which are in Treas. Reg. 1.501(c)(3)-1(c)(1). An organization is considered as operated exclusively only if it engages “primarily” in activities that accomplish one or more exempt purposes such as those specified in IRC Section 501(c)(3). it’s not considered “operated exclusively” if more than an “insubstantial” part of its activities doesn’t further an exempt purpose.

Furthermore, Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) holds that an organization isn’t organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Therefore, activities of an organization exempt under IRC Section 501(c)(3) must benefit the general public in a way that distinguishes it from a for-profit corporation, which serves shareholders (private interests). Serving the public is a basic tenet of the law of charity whose purpose is to ensure that those who constitute the “public” benefit equally. Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) goes on to specify the organization must establish 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 interests.”

Example: *United Cancer Council v. Commissioner*, 165 F.3d 1173 (7th Cir. 1999). The court reversed and remanded the Tax Court's ruling to uphold revocation of an organization exempt under IRC Section 501(c)(3) based on inurement. It found nothing in the facts to support the fundraisers seizing control of the exempt organization, thereby becoming an insider, triggering the inurement provision, and destroying exemption. The court stated there was no diversion of charitable earnings to board members or other insiders. The court pondered a different argument: suppose the exempt organization paid the fundraiser twice as much as it actually charged for its services, so half of the annual fund-raising expense was like a gift to the fund-raiser. Then, it could be argued the organization was operated substantially for the private benefit of the fund-raiser. The court suggested enforcing the tax law in this way could address the problem of a charitable organization's expenditures that are extravagant but don't inure to the benefit of insiders. "That, in fact is the IRS's alternative ground for revoking the exemption."

Example: *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), aff'd, 242 F.3d 904 (9th Cir. 2001). At issue was whether Redlands Surgical Services should be recognized as exempt from federal income tax based on its activities. The entity was a wholly owned subsidiary of an exempt health care system. It participated as co-general partner with a for-profit corporation, a general partner of a partnership that operated an ambulatory surgery center. The organization argued it met the operational test under IRC Section 501(c)(3) because its surgery center activities furthered exempt purposes by promoting health and providing access to surgical care for the community based on medical need, not the ability to pay. The IRS contended that it was not operated exclusively for charitable purposes because it operated for the benefit of private parties and failed to benefit a broad cross-section of the community. Based on all the facts and circumstances, the court held that the organization had ceded effective control of the partnerships' and the surgery center's activities to for-profit parties, conferring significant private benefits on them. Therefore, it wasn't operated exclusively for charitable purposes within the meaning of IRC Section 501(c)(3).

Example: *Retired Teachers Legal Defense Fund, Inc. v. Commissioner*, 78 T.C. 280 (1982). At issue was whether the organization was organized and operated exclusively for one or more exempt purposes within the meaning of IRC Section 501(c)(3) or served private interests. Membership for a fee was open to any retiree of the New York City Teachers' Retirement System receiving a pension, of whom there were approximately 25,000. The organization argued that "benefit," as used in Treas. Reg. 1.501(c)(3)-1(d)(1)(ii), is vague and contains no guidelines. The court disagreed, citing the Black's Law Dictionary definition as "advantage; profit; fruit; privilege; gain; interest." The court stated the organization ignored "private" as used in conjunction with "benefit" in the Treasury Regulations. The fundamental reason for granting an organization tax exemption is that it serves a public benefit...The [beneficiaries] of petitioner's organization and operation are the retirees of the system. Although approximately one-third of its members are poor and disabled, and although the term "charitable" includes "relief of the poor and distressed," over two-thirds of its members don't fall within this classification. Thus, the organization was denied recognition as exempt under IRC Section 501(c)(3).

The Treasury Regulations on the private benefit doctrine don't speak to net earnings but rather to exempt purposes, which are inferred from the type of activities it carries out and for whom. For example, a common private benefit issue involves a charitable organization's requiring a membership, and only those who pay to become members are granted the rights to its benefits. If it provides benefits only to the members who paid for these privileges, it results in a select group set apart from the public, and private benefit may result. However, if the organization provides the benefits (so long as they are charitable) to anyone without a membership requirement, a special group doesn't exist. The organization's benefits serve the public, and there likely is no private benefit issue.

On the other hand, sometimes a public charity by its very nature benefits particular individuals in order to achieve its charitable purposes. The courts have recognized that a single activity can serve both an exempt and a nonexempt purpose. For example, an educational organization confers primary private benefit by instructing or training an individual for the purpose of improving and developing his or her capabilities. (See *Bob Jones University v. United States*, 103 S. Ct. 2017 and the cases cited in it.) A hospital confers private benefit on an individual patient through the process of health care. This type of private benefit is often referred to as “incidental” or “permissible.” To be incidental, a private benefit must occur as a necessary result of the activity that benefits the public at large. In other words, the benefit to the public can’t be achieved without indirectly or unintentionally benefitting private individuals.

Even if a certain amount of incidental or permissible private benefit is allowed without jeopardizing exempt status, the issue sometimes arises as to how much is too much. If an organization is carrying out its exempt purposes for the benefit of the public yet private benefit is present, the agent must weigh all facts and circumstances.

Private benefit conferred by an activity must be balanced only against the public benefit conferred by that activity or arrangement, not the overall good accomplished by the organization. Therefore, first identify how and to what degree the activity benefits the public. Then, determine if the private benefit is an unavoidable side effect of the activity. If the public benefit outweighs the indirect private benefit, you can consider it permissible. However, if an argument can be made that the activity's public benefit is subordinate to private benefit, then the private benefit can destroy exemption.

Example: *Sonora Community Hosp. v. Commissioner*, 46 T.C. 519 (1966), aff'd, 397 F.2d 814 (9th Cir. 1968). The court considered whether more than incidental private benefit accrued to physicians from a hospital’s activities. Two doctors, who previously owned and founded the hospital facilities in question shared in the fees from the privately operated laboratory and hospital x-ray departments, even though they performed no associated services. The Tax Court ruled this demonstrated that the hospital was operated to a considerable extent for the private benefit of the two founding doctors, rather than exclusively as a charitable organization. The court found it unnecessary to decide whether the arrangement constituted inurement of hospital net earnings to the doctors because the resulting private benefit was enough to prevent exemption.

You must be able to distinguish between private benefit issues and UBI issues. Unlike private benefit, unrelated trade or business doesn’t normally jeopardize exempt status unless it rises to the level of questioning whether the organization is operated primarily for commercial or exempt purposes. As long it is primarily engaged in related activities, the organization's only consequence is its IRC Section 511 UBI tax liability. On the other hand, private benefit can result in revocation regardless of its insubstantiality. Therefore, it is important to properly identify the classification of a questionable activity.

IRC Section 4958 Intermediate Sanctions

An additional tax is imposed on the disqualified person if correction is not made within the taxable period. The primary objective of IRC Section 4958 is to:

- Impose a sanction on the influential person involved rather than punish the organization itself by revoking its exempt status, as long as it’s otherwise properly carrying out its exempt purposes.
- Encourage correction of the excess benefit transaction.

You aren't prevented from proposing excise taxes assessment on the disqualified person under IRC Section 4958 and proposing revocation of the exempt organization.

See the table below for IRC Section 4958 taxes:

IRC Section	Rate	Imposed on…	For…
4958(a)(1)	25%[1]	Disqualified person	Engaging in excess benefit transaction
4958(a)(2)	10%[2]	Organization manager(s)	Knowingly participating in the transaction
4958(b)	200%[3]	Disqualified person	Failure to correct within the taxable period
[1] Percentage of the amount of the excess benefit [2] Limited to $10,000 [3] Percentage of the amount of excess benefit not corrected			

See IRC Section 4961(a), IRC Section 4962(a) and the related Treasury Regulations for rules on "abatement" of taxes on an excess benefit transaction corrected within the correction period (as defined in IRC Section 4963(e)). By permitting abatement, the Code encourages the disqualified person to correct excess benefits.

> ***Note:*** This section isn't meant to be all-inclusive on the issue of IRC Section 4958 application but rather highlights important concepts for an audit. See IRM 7.27.30, Taxes on Excess Benefit Transactions for audit details and safe harbor guidelines for taxes on excess benefit transactions.

IRC 4958 Definitions

As with IRC Section 4941, it's crucial to become familiar with the terminology in IRC Section 4958. Although worded similarly, each section has its own distinctive definitions. Listed below are some of the most important ones in IRC Section 4958.

An excess benefit transaction is any economic benefit a disqualified person receives directly or indirectly from an applicable exempt organization if the value of the economic benefit provided exceeds the value of consideration received. Although IRC Section 4958 does not define "economic," Treas. Reg. 53.4958-4(a)-(1) describes the amount as all consideration and benefits exchanged between a disqualified person and the applicable tax-exempt organization and/or all entities the organization controls. Put simply, excess benefit means the value of the economic benefit the disqualified person received exceeds the value of consideration (cash, property, benefits, or services) the exempt organization received. Only the excess is subject to the IRC Section 4958 initial and additional taxes.

An applicable organization is one described in IRC Section 501(c)(3) or (4) that was exempt any time in the five-year period before the excess benefit transaction occurred. This is called the "Lookback Rule," and the five-year period is called the "Lookback Period." The following are not "applicable tax-exempt organizations":

- A private foundation
- A governmental entity not subject to taxation

- A foreign organization exempt under IRC Section 501(c)(3) or (4) that receives substantially all support from sources outside the United States
- An IRC Section 501(c)(3) or (4) entity whose exemption was never recognized
- An IRC Section 501(c)(3) or (4) entity that was revoked (unless the revocation was based on inurement or private benefit, which could include revocation based on the Lookback Rule).

A disqualified person is any person in a position to exercise substantial influence over the affairs of the organization at any time in the Lookback Period. It's not necessary for the person to actually exercise substantial influence, he only has to be in a position to do so. Per Treas. Reg. 53.4958-3, this includes persons who hold any of the following powers, responsibilities, or interests:

- Family members of the disqualified person;
- Entities controlled by the disqualified person (owning more than 35 percent voting power);
- A voting member of the governing body;
- A person with ultimate responsibility to implement the governing body's decisions, to supervise management, to carry out administration or operation of the organization, i.e., president, chief executive officer, chief operating officer;
- A person with ultimate responsibility for managing the finances of the organization, i.e., treasurer, chief financial officer; or
- Persons with a material financial interest in a provider-sponsored organization.

Other persons may or may not meet the definition of disqualified person. Treas. Reg. 53.4958-3 gives facts and circumstances that are not all inclusive but tend to show a person does have substantial influence over the organization's affairs:

- The organization's founder;
- A substantial contributor
- A person whose compensation is based on revenues from activities of the organization the person controls;
- A person who has or shares authority to control a substantial part of the organization's capital expenditures, operating budget, or employees' compensation;
- A person who manages activities that are a substantial portion of the organization's overall activities, assets, income or expenses;
- A person who owns a controlling interest in a corporation, partnership or trust that is a disqualified person; or
- A person who is a non-stock organization controlled directly or indirectly by one or more disqualified persons.

A disqualified person is **not:**

- An IRC Section 501(c)(3) or (4) organization
- An employee of the organization who receives economic benefit of a specific amount within a taxable year, unless that employee is a family member of the disqualified person, someone who can exercise substantial influence (as described), or a substantial contributor to the organization.

Treas. Reg. 53.4958-3(e)(3) lists facts and circumstances that are not all inclusive but tend to show a person does not have substantial influence over the organization's affairs.

An organization manager is defined in Treas. Reg. 53.4958-1(d)(2) as any officer, director, or trustee of the organization, or any individual having powers or responsibilities similar to such persons, regardless of title. A person is an officer if its organizing documents (articles of incorporation, bylaws, or other) designate him/her, or if the person regularly exercises authority to make administrative or policy decisions for the organization.

An organization manager participates in an excess benefit transaction knowingly if she:

- Has actual knowledge of sufficient facts that the transaction would be an excess benefit transaction;
- Is aware the transaction may constitute an excess benefit transaction and
- Negligently fails to make reasonable attempts to determine if the transaction is an excess benefit transaction or is aware it is one.

There are exceptions to knowing, even if a transaction is later found to be an excess benefit transaction:

- The foundation manager relied on a professional's advice after making full disclosure of all relevant facts
- The foundation manager relied on the fact that the requirements for “rebuttable presumption” of reasonableness have been satisfied.

“Willful” means the participation was voluntary, conscious and intentional. “Reasonable cause” means the organization manager exercised responsibility with ordinary business care and prudence.

If an organization meets three requirements, the transaction is presumed to be reasonable and at fair market value. This is called “rebuttable presumption.” The requirements are:

- Advance approval by an authorized body;
- The authorized body obtained and relied on appropriate comparative data before making the determination; and
- It concurrently documented the basis for its determination.

The taxable period begins when the excess benefit transaction occurred and ends on the earlier of:

- Mailing a notice of deficiency to the disqualified person regarding the 25 percent tax, or
- Assessment of the 25 percent tax on the disqualified person.

IRC Section 4958(f)(6) provides that an excess benefit transaction is “corrected” by undoing it to the extent possible and taking any additional measures necessary to place the organization into a financial position that is not worse than it would be if the disqualified person had acted under the highest fiduciary standards.

IRC Section 4961, IRC Section 4962, and Treas. Reg. 53.4958-1(c)(2)(iii) outline circumstances under which the 25 percent tax may be abated and the 200% tax must be abated. By allowing abatement, the Code encourages the disqualified person to make correction of excess benefits.

IRC Section 4958 Statute of Limitation Considerations

The period of limitations for assessing IRC Section 4958 excise taxes against the disqualified person and foundation manager begins when the organization files its Form 990 for the later of: the period in which the excess benefit transaction occurred or when the Form 990 is due. The period ends either three years or six years from that date.

- **Three Years** - If the organization filed Form 990 for the period in which the excess benefit transaction occurred and adequately reported the excess benefit on the return, the period of limitations ends three years later.
- **Six Years** - If the organization filed Form 990 for the period in which the excess benefit transaction occurred but did not adequately report the excess benefit transaction on the return, the period of limitations ends six years later.

Note: The IRS has the burden of proof as to whether the organization reported the excess benefit on the Form 990 was insufficient to apprise the IRS of the existence and nature of an excess benefit transaction with a disqualified person and participation by an organization manager. Therefore, the agent must consult with Area Counsel on the six-year limitation period.

If the organization didn't file Form 990, the period of limitations hasn't begun and there's no statute date.

The disqualified person or foundation manager, each of whom is deemed a separate taxpayer, is liable for IRC Section 4958 excise tax. Therefore, the IRS and each disqualified person or foundation manager may agree to extend the period of limitations by executing a separate Form 872, Consent to Extend the Time to Assess Tax. Each Form 872 relates to each person's own tax year, not the year of the organization. You must be vigilant in recognizing that the period of limitations begins with the filing of Form 990, which may be a different tax year than that of the disqualified person or foundation manager.

Determining the Value of a Potential Excess Benefit Transaction

One of the most difficult audit issues is determining if an excess benefit transaction has occurred. Part of deciding is to know the value of the transaction itself, which will tell you if it's excessive or not. In general, excess benefit transactions involve the transfer of property or payments for services. If the issue is property (including the right to use property), the Treasury Regulations note that the value is fair market value for IRC Section 4958. If the issue is compensation, the value is the amount that would ordinarily be paid for like services by like enterprises under like circumstances, otherwise known as "reasonable compensation." Apply IRC Section 162 standards in determining reasonableness of compensation.

To determine a property's fair market value, you may want to consider a referral to Engineering. Request Engineering help as early in your issue development as possible. See IRM 4.75.13, Issue Development.

To determine if an excess benefit transaction has occurred, take into account all consideration and benefits exchanged between a disqualified person and the applicable exempt organization as well as any entities it controls. However, virtually any economic benefits that are excluded from income under IRC Section 132 also are disregarded for IRC Section 4958. Treas. Reg. 53.4958-4(a)(4).

Examples of economic benefits included in determining the value of services rendered and whether the compensation is reasonable are:

- Cash and non-cash compensation (salary, fees, bonuses, severance payments, deferred compensation)

- Payment of liability insurance premiums
- Other payments on behalf of the disqualified person (penalties, tax expenses, civil proceeding expenses, expenses resulting from an act or failure to act)
- Other compensatory benefits (expense allowances or reimbursements paid under a non-accountable plan, such as travel or auto expenses)
- Foregone or below-market interest on loans

Other IRC Section 4958 Issues

Though certainly not all-inclusive, the list below shows examples of transactions between an applicable exempt organization and disqualified person that could be IRC Section 4958 issues:

- Exempt organization 's payment of a disqualified person's personal expenses
- Disqualified person's use of the exempt organization's vehicles for personal reasons
- Disqualified person's use of the exempt organization's real property for personal reasons
- Disqualified person's lease of property to the exempt organization in exchange for rent
- Whether amounts the disqualified person received from the exempt organization are loans
- Whether amounts the disqualified person received from the exempt organization are loan repayments
- Exempt organization's payment of personal expenses for a disqualified person's family members
- Exempt organization's payment of a for-profit corporation's owned by the disqualified person expenses
- Disqualified person's embezzled amounts from an exempt organization (Treas. Reg. 53.4958-4(c)(1))
- Exempt organization and disqualified person revenue-sharing arrangements
- Exempt organization's transfer of assets from to a for-profit organization controlled by the disqualified person

Hospitals Providing Financial Assistance to Staff Physicians Involving Electronic Health Records

This subsection provides a directive for handling audits and exemption application cases involving hospitals that provide physicians who have staff privileges at those hospitals ("medical staff physicians") with financial assistance to acquire and implement software that is used predominantly for creating, maintaining, transmitting, or receiving electronic health records ("EHR") for their patients.

Many hospitals described in IRC Section 501(c)(3) plan to establish interoperable EHR systems to improve the effectiveness and efficiency of their medical care and to reduce medical errors. Some hospitals believe that their medical staff physicians need a financial incentive to acquire and implement EHR software that would allow the physicians to connect to the hospitals' EHR systems. On August 8, 2006, the U.S. Department of Health and Human Services ("HHS") issued final regulations (see 42 C.F.R. Section 411.357 and 42 C.F.R. Section 1001.952) ("HHS EHR Regulations") that allow hospitals to provide, within specific parameters, EHR software and technical support services ("Health IT Items and Services") to their medical staff physicians without violating the federal anti-kickback law, 42 USC 1320a-7b, and physician self- referral law, 42 USC 1395nn.

We will not treat the benefits a hospital provides to its medical staff physicians as impermissible private benefit or inurement in violation of IRC Section 501(c)(3) if the benefits fall within the range of Health IT

Items and Services permissible under the HHS EHR Regulations and the hospital operates in the manner described below.

A hospital that is otherwise described in section IRC Section 501(c)(3) enters into Health IT Subsidy agreements with its medical staff physicians for the provision of Health IT Items and Services at a discount (“Health IT Subsidy Arrangements”). These Health IT Subsidy Arrangements require both the hospital and the participating physicians to continually comply with the HHS EHR Regulations. The Health IT Subsidy Arrangements provide that, to the extent permitted by law, the hospital may access all of the electronic medical records a physician created using the Health IT Items and Services subsidized by the hospital. The hospital ensures that the Health IT Items and Services are available to all of its medical staff physicians. The hospital provides the same level of subsidy to all of its medical staff physicians or varies the level of subsidy by applying criteria related to meeting the health care needs of the community.

These procedures don’t apply to a hospital that allows its earnings to inure to the benefit of one or more medical staff physicians through arrangements that are other than Health IT Subsidy Arrangements, because the hospital wouldn’t be considered to be described in IRC Section 501(c)(3).

See Exhibit 12 - Q&A on Hospitals' Health IT Subsidy Arrangements with Medical Staff Physicians for further information.

Audit of Books and Records – Steps to Identify and Develop Inurement, Private Benefit or IRC Section 4958 Issues

Follow these audit steps to identify and develop issues of inurement, private benefit, and IRC Section 4958 issues leading to intermediate sanctions:

- Review Form 990 carefully for items that could indicate issues. See Exhibit 10 (below).
- Review salaries paid to those controlling the organization and to other key employees. To determine if they are reasonable consider factors such as:
  - Duties performed
  - Amount and type of responsibility
  - Time devoted to duties
  - Special knowledge and experience
  - Individual ability
  - Previous training
  - Compensation paid in prior years
  - Prevailing economic conditions
  - Living conditions of the particular locality
  - The type of activities carried out by the organization and its size.
- Reconcile salaries the organization paid to wages on Forms W-2, Wage and Tax Statement of the employees. What was included in taxable income?
- Request copies of employment contracts or compensation packages as deemed pertinent. Check the date and the specific compensation the organization intended to pay.
- Review disbursements. Look for exempt organization payment of expenses to or for the benefit of an officer or employee that isn’t reported as wages on Forms W-2.
- Consider the status of the recipients to determine who meets the various criteria of an **insider**, an **outsider**, or a disqualified person with respect to the organization.

- Review other compensation amounts, including fringe benefits. Determine if they're excludable from the recipient's gross income under IRC Section 132 or includible under IRC Section 61. Look closely at reimbursements such as travel expenses. Was the payment made under a non-accountable plan? If so, determine if the amounts paid meet the ordinary and necessary requirements of IRC Section 162. Was the amount included on Forms W-2?
- Determine if there were any sales or exchanges of property. If so, were there any insiders, disqualified persons, foundation managers involved? Was the sale or exchange at fair market value?
- Analyze the composition of the organization's assets. Did an insider, disqualified person, foundation manager have personal use of any of them? For example, did any of them use a vehicle for both personal and business travel? If used for personal use, was an amount included on the Forms W-2?
- Analyze fund-raising agreements to determine if they are at arm's length. Consider the method of raising funds and whether this income is subject to unrelated business tax. Does the fund-raiser exercise control over the organization in any way?
- Determine if there are entities related to the exempt organization. Analyze the structure of any transactions between the related entities and the exempt organization. Are they at arm's length, at fair market value, exclusive?

See Exhibit 11 (below) for a list of steps to help identify and analyze excess benefit transactions subject to IRC Section 4958 taxes.

Legislative Activities Guidelines

IRC Section 501(c)(3) states that no substantial part of an otherwise qualified organization's activities may be carrying on of propaganda or otherwise attempting to influence legislation. Organizations whose lobbying activities disqualify them from recognition of exemption under IRC Section 501(c)(3) are action organizations. Treas. Reg. 1.501(c)(3)-1(c)(3)(iv) states an organization is an action organization if:

- Its primary objective (as distinguished from an incidental objective) can be attained only by legislation or defeat of proposed legislation and;
- It advocates or campaigns for the attainment of its primary objective as opposed to engaging in nonpartisan analysis, study or research and making the results available to the public.

Example: An organization was formed to help the governor-elect of a state. It screened and selected appointive office applicants, prepared the party platform's legislative message and program for presentation to the legislature. Since the organization could accomplish its main purpose only through legislation, it was ruled an action organization. Rev. Rul.74-117, 1974-117, 1974-1 C.B. 128.

Distinction between "Direct" and "Grass Roots" Lobbying

"Direct lobbying" is the attempt to influence legislation through communication with any member or employee of a legislative body, with a government official or other employee who can participate in formulation of the legislation. The key is that the communication's main purpose must be to influence legislation.

"Grass roots lobbying" involves the organization's urging members of the public to contact legislators to support, oppose, or propose a piece of legislation. Determine if the organization is engaged in grass roots lobbying and if so, to what extent. Interview officers about any activities that further the entity's legislative interests, review official minutes, publications and financial records, and consider the following:

- Have there been paid articles and advertisements in newspapers or magazines that promote the organization's legislative interests?
- Did the organization engage in commentaries through television, cable, radio or other public communications?
- Did it publicize or disseminate its position on certain legislation in articles or publications?
- Has it made direct mailings or internet campaigns that encourage the public to contact legislators regarding its position?

Analyze expenses to determine if the entity made disbursements for any of the following:

- Contributions to organizations engaged in legislative activities.
- Payments to lobbyists or other intermediaries on the organization’s behalf or as a subordinate to a national regional or state parent organization. (***Note:*** Payments may be disguised as charges to legal, professional or advertising fees.)
- Dues to parent, state or national organizations for legislative activities. This activity might be attributed to the subsidiary organization via payment of dues.
-

IRC Section 501(h) Election and the IRC Section 4911 Excise Tax on Excess Lobbying Expenses

When there is strong evidence of legislative activity, determine whether the organization has made a lobbying election under IRC Section 501(h) by filing Form 5768, Election/Revocation of Election by an Eligible Section Section 501(c)(3) Organization To Make Expenditures To Influence Legislation. This election subjects the organization to the lobbying expenditures test of IRC Section 4911. An eligible public charity, through an election, may choose to have its legislative activities measured by an expenditures test that sets relatively specific expenditure limits and makes the uncertain standards of IRC Section 501(c)(3) more concrete. Analyze disbursements to determine if:

- The sliding scale limits for nontaxable lobbying and grassroots expenditures have been exceeded. (The maximum lobbying nontaxable amount is $1,000,000.)
- Affiliated organizations have included their disbursements in the total to determine if the nontaxable amounts have been exceeded.
- Lobbying expenditures over a four year period exceed 150 percent of the lobbying nontaxable amount; or
- Grass roots expenditures over a four year period exceed 150 percent of the grass roots nontaxable amount.
  Note: If either the lobbying or grass roots limits are exceeded, consider revocation. (Note that once revoked, the organization can’t then apply for IRC Section 501(c)(4) status.) There is no determination required, however, for the first, second, or third year of election as long as the expenditures are not over the ceiling amounts. If expenditures exceed the ceiling amount, recompute the determination using prior years, even if they were before an election. (Omit all years in which the organization wasn’t exempt under IRC Section 501(c)(3). See Treas. Reg. 1.501(h)-3(b)(2)).

If the organization exceeds its limits for direct and/or grassroots lobbying expenditures, it’s subject to an excise tax of 25 percent of the excess expenditures, per IRC Section 4911(a). If the organization becomes liable for the IRC Section 4911(a) excise tax, secure a delinquent Form 4720, “Return of Certain Excise

Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code," and collect the tax due.

IRC Section 4911(d)(2) specifies activities which aren't considered to be influencing legislation:

- Available results of nonpartisan analysis, study, or research.
- Technical advice or assistance given to a governmental body, a committee or its other subdivision in response to their written request.
- Appearances before, or communications to, any legislative body with respect to possible decision of the body that might affect the organization's existence, powers, duties, tax exempt status, or the deduction of contributions to the organization.
- Communications between the organization and its bona fide members about legislation or proposed legislation of direct interest to the organization and its members as long as the organization does not encourage the member to take commensurate action.
- Certain communications with members or employees of legislative bodies.

Be aware that the following organizations are ineligible to make an IRC Section 501(h) election:

- Churches or conventions or associations of churches as described in IRC Section 170(b)(1)(A)(i), including integrated auxiliaries, convention or association of churches,
- Organizations described in IRC Section 501(c)(3) that are affiliated with at least one church, convention or association of churches, or an integrated auxiliary (an "affiliated group" within the meaning of IRC Section 4911(f)(2)),
- Organizations that are public charities because they are a supporting organization described in IRC Section 509(a)(3),
- Organizations engaged in testing for public safety described in IRC Section 509(a)(4),
- Private foundations.

The election under IRC Section 501(h) is effective beginning with the organization's taxable year in which it files Form 5768.

> ***Example:*** An eligible organization with a taxable year ending December 31, 2017 files Form 5768, on August 31, 2017, making the IRC Section 501(h) election. The organization's IRC Section 501(h) election is effective for all taxable years beginning January 1, 2017. (A loss of exemption will automatically revoke the election.)

An organization's election may be revoked voluntarily or involuntarily. A voluntary revocation of election is:

- Made by filing a notice with the appropriate Service Center listed on Form 5768.
- Effective beginning with the first taxable year after the taxable year in which the notice is filed, and the organization becomes subject to the "substantial part" test at that time (IRC Section 501(h)).

Organizations Not Making 501(h) Election

If the agent determines that the organization engaged in legislative activity but didn't elect the provisions of IRC Section 501(h), it remains subject to the substantial part test.

Determining whether an organization is substantially engaged in legislative activity is a question of facts and circumstances. (The courts have found that a percentage test is not the only measure of substantiality.)

Substantial is measured not only by the funds spent on the activity but by the time and effort expended as well. Consider:

- The amount of effort the organization's membership expended when urged to act. (Keep in mind that a single article in an organization's publication requesting legislative action might trigger thousands of members to contact their legislators, but the expense may be minimal.)
- The organization's time, effort and money expended on reaching or developing a position on whether to support or oppose particular legislation.

Audit steps:

- Analyze all direct and indirect expenses attributable to legislative activities.
- Find out what the organization's definition of lobbying is and make sure it complies with the law.
- Review time sheets or whatever activity report the organization uses to determine the staff's time spent on lobbying activities (in other words, check the organization's computation to make sure it's reasonable.)
  Note: Just because the dollar limits are high, don't ignore them. The organization may have misclassified disbursements for grass roots activities as exempt activities. Since the grassroots amount is only 25 percent of the lobbying amount, it's easier to exceed the grass roots amount. Solicit Form 4720 if either of the limits were exceeded.

Possible Exceptions to Revocation for Substantial Lobbying

Under IRC Section 501(c)(3), there are certain circumstances where nonpartisan analysis, study, research, or discussion of matters pertaining to legislation, may be educational and don't constitute attempts to influence legislation. Even if you determine the organization is substantially engaged in legislative activity and revocation seems likely, research the following cases and rulings when applicable:

- *League of Women Voters of the United States v. United State*s,180 F. Supp. 379 (Ct. Cl.1960). The court considered their time spent discussing public issues, formulating and agreeing upon positions, and studying them to prepare to adopt a position. Then, they compared it to the other activities to determine the substantiality of the attempts to influence legislation. Research, discussion and other back-up activities may not always be considered part of attempting to influence legislation.
- In Rev. Rul. 72-513, 1972-2 C.B. 246, a school exempt under IRC Section 501(c)(3), whose staff was available to serve on a school newspaper that published opinion on legislative and political matters was not attempting to influence legislation or participate in political activities. The process of gathering news, doing research, analyzing data, writing and editing material for the newspaper dealing with legislative and political topics furthered the education of the students.
- In Rev. Rul. 64-195, 1964-2 C.B. 138, an organization conducted research on legislation and disseminated materials to the public. The ruling concluded, "it is clear that the instant organization does not participate in any way in the presentation of any proposed bills to the State Legislature or advocate either approval or disapproval of the proposed constitutional amendment by the electorate. Its primary activity in connection with court reform is the study, research, and assembling of materials on a nonpartisan basis and the dissemination of such materials to the public." Ask about the purpose of the analysis, study or discussion. Ask if it

furthers a partisan end, and if the organization is involved in advocating adoption or rejection of the legislation.

When a membership organization is involved, you need to determine whether a lobbying activity is attributable to the organization or is merely the act of the individual. As a general rule, don't consider actions of a person in excess of his official authority to be those of the exempt organization (for example, a school or a church). However, if the organization allows an individual's contempt for authority to go unpunished, it implies ratification of the act. When trying to determine if an individual's acts may be attributed to an organization, there are no clear set of rules or guidelines. Relevant indicators include whether statements appear on the organization's official letterhead, whether the board of directors of the organization endorsed a questionable act, what the organization's stated policies and intentions are to support particular acts, and whether the organization tried to explain or disassociated itself from the act.

IRC Section 4912, Excise Tax on Disqualifying Lobbying Expenditures

Effective for tax years beginning after December 22, 1987, IRC Section 4912 imposes a tax of five percent on the lobbying expenditures of an organization whose tax exempt status was revoked due to a substantial amount of lobbying activity. The tax doesn't apply to:

- Charitable organizations which have made the IRC Section 501(h) election
- Churches or certain church-related organizations that ineligible to make the IRC Section 501(h) election
- Private foundations

IRC Section 4912 imposes an excise tax described in IRC Chapter 41 (Public Charities). Organizations and individuals with a tax liability under this section must file Form 4720. (The organizations and persons are jointly and severally liable under the Code.) Penalties for failure to file, failure to pay tax due, negligence and civil fraud may apply.

IRC Section 4912 imposes a similar tax on organization managers (basically, its officers and directors) who permit the expenditure, knowing that it will jeopardize the organization's exempt status.

Political Activity Guidelines

There is an absolute prohibition on all IRC Section 501(c)(3) organizations from participating or intervening in any political campaign. Even an insubstantial amount of an organization's political activity can lead to the revocation of its exempt status. Examples of political activity include:

- Publication of written or printed statements or oral statements made on behalf of, or in opposition to a candidate for public office Treas. Reg. 1.501(c)(3)-1(c)(3)(iii));
- Payments to a political candidate for speeches or other services;
- Travel expenses of a candidate;
- Expenses incurred in conducting polls, surveys, or other studies;
- Preparing papers or other material for use by a candidate;
- Expenses of advertising, publicity, and fund-raising for a candidate; and
- Any other expense that has the primary purpose of promoting public recognition, or otherwise primarily accruing to the benefit of an individual.

A candidate for public office is defined as an individual who offers himself or herself or is proposed by others as a contestant for an elective public national, state, or local office. Treas. Reg. 1.501(c)(3)-1(c)(3)(iii)).

Note: It doesn't matter if the candidate isn't endorsed by or the office isn't contested by a political party. In Rev. Rul. 67-71, 1967-1 CB 125, school board candidates were held to be candidates for public office despite the fact that no candidates were affiliated with any political party.

Attempting to influence the senate confirmation of an individual nominated to serve as a federal judge doesn't constitute intervention or participation in a political campaign per IRC Section 501(c)(3), because a federal judgeship is an appointive office rather than an elective one. Notice 88-76, 1988-27 I.R.B. 34. ***Note:*** However, these expenditures are subject to the IRC Section 527(b) tax on political expenditures.

Political vs. Educational Activities

While some activities and disbursements are obviously political in nature, others may initially appear political but actually are educational. Certain "voter education" activities conducted by an IRC Section 501(c)(3) organization in a non-partisan way may not constitute prohibited political activity. Consider the following:

- Rev. Rul. 86-95, 1986-2 C.B. 73 states that public forums aren't participation or intervention in any political campaign under IRC Section 501(c)(3). An IRC Section 501(c)(3) organization conducted the public forums in a congressional district during a congressional election campaign. They invited all legally qualified congressional candidates were to participate; they discussed topics that covered a broad range of issues of interest to the public. A nonpartisan, independent panel prepared and presented questions; and each candidate received an equal opportunity to present his or her views on each issue discussed. The facts and circumstances established that both the format and content of the forums were presented in a neutral manner.
- Rev. Rul. 78-248, 1978-1 C.B. 154, Situation 1 held an organization was exempt under IRC Section 501(c)(3) that annually prepared and made generally available to the public a compilation of voting records of all members of Congress on major legislative issues involving a wide range of subjects. The publication contained no editorial opinion, and its contents and structure didn't imply approval or disapproval of any Congressional members or their voting records.
- Rev. Rul. 78-248, 1978-1 C.B. 154, Situation 2, an organization distributed a questionnaire to all candidates for governor in a particular state. The ruling held the organization to be exempt under IRC Section 501(c)(3). The questionnaire solicited a brief statement of each candidate's position on a wide variety of issues and was published in a voter's guide made generally available to the public. Neither the questionnaire nor the voter's guide, in content or structure, evidenced a bias or preference towards any candidate or group of candidates' views.
- Rev. Rul. 80-282, 1980-2 C.B. 178 - An IRC Section 501(c)(3) organization which monitored and reported on governmental activities and developments it considered to be of important social interest is not participating or intervening in any political campaign. It published and distributed a non-partisan newsletter to interested members and others, who numbered only a few thousand nationwide. The newsletter was politically non-partisan and consisted of congressional incumbents' voting records on selective issues, along with an expression of the organization's position on the issues. The publication occurred after congressional adjournment and wasn't geared to the timing of any federal election.

On the other hand, other voter education activities may indeed constitute political. Consider the following:

- An organization that sent a questionnaire to candidates for major public offices and used the responses to prepare a voter's guide that was distributed during an election campaign. It was held not to be exempt under IRC Section 501(c)(3) since some of the questions evidenced a bias on certain issues. Rev. Rul. 78-248, 1978-1 C.B. 154, Situation 3.
- An organization that published and distributed to the public a voter's guide containing voting records of members of Congress on the single issue of land conservation was held not to be exempt under IRC Section 501(c)(3) because the emphasis on one area of concern indicated a partisan purpose and constituted a prohibited political activity. Rev. Rul. 78-248, 1978-1 C.B. 154, Situation 4.
- A bar association didn't qualify under IRC Section 501(c)(3) because its practice of rating and publishing candidates for elective judicial office ratings constituted intervention in a political campaign, although it comprised only a small part of the association's total activities, was clearly in the public interest, and was conducted on a nonpartisan basis. The Association of the Bar of the City of New York v. Commissioner, 858 F.2d 876, 881 (1988).

Public Discussion of Political Issues

An organization that conducted public forums, lectures, and debates on controversial social, political, and international questions was held to be educational. Although the speakers were frequently controversial, the organization adopted an unbiased position. Rev. Rul. 66-256, 1966-2 C.B. 210.

An organization that operated a broadcasting station was not participating in political activities by providing reasonable air time equally available to all legally qualified candidates for election to public office in compliance with the Federal Communications Act of 1934. The organization neither endorsed a candidate nor any viewpoint expressed by a candidate. Rev. Rul. 74-574, 1974-2 C.B.161.

An organization formed to elevate the standards of ethics and morality in the conduct of political campaigns disseminated information concerning general campaign practices, furnished teaching aids to political science and civics teachers, and publicized its proposed code of fair campaign practices without soliciting the signing or endorsement of the code by candidates. It qualified as an educational organization under IRC Section 501(c)(3). Rev. Rul.76-456, 1976-2 C.B. 151.

Auditing Procedures for Political Activity

Most organizations are aware of the prohibition. However, during the audit process, if you find evidence of political activity but no overt transactions, you may need to look at more subtle sources to substantiate the evidence. Some suggestions are:

- Read the organization's minutes and newsletters for mention of a political figure or a political event. (Some organizations maintain a publicity file.)
- Review of the cash disbursements journal along with the corresponding cancelled checks to determine possible payments to politicians, political parties, political action committees (PACs), bogus trade associations, legal firms diverted to political trustee accounts as well as other organizations.

- Review agreements and contracts the organization entered into to determine possible lending or sharing of equipment, facilities or employees.

  Example: Upon a review of the organization's minutes, you notice a political figure is featured in the minutes. You note the month that the discussion takes place and review the cash disbursements for that month and the following months. Noting a questionable expenditure, you request the actual check, which was in the amount of $700, to determine the payee and to look at the endorsement. You trace the payment to the general ledger to determine how it was recorded. Since there was an indication the payment was for services of an independent contractor, the agent requests to see the person's contract with the organization and Form 1099.
- Review local newspapers for announcements on political events sponsored by the organization.
- Test expense reimbursements for any political contributions.
- Check supplier invoices for any evidence of overbilling (an excess may be used for political purposes).
- Test payroll accounts for evidence of any employees who may have worked on political campaigns on company time.

Although an organization may not be directly conducting any political activities themselves, you may discover evidence of support for a political campaign through an affiliated organization. Typical conduits are organizations described in IRC Section 501(c)(4), (5), or (6) because they're permitted to engage in some political activity. The organization may be making grants, lending equipment, facilities, employees, or members to these affiliates for political endeavors.

Any organization (except for churches, conventions of churches, etc.) that ceases to qualify under IRC Section 501(c)(3) by reason of participating in, or intervening in, any political campaign on behalf of, or in opposition to, any candidate for public office can't be recognized as exempt under IRC Section 501(c)(4).

IRC Section 527 Organizations

IRC Section 527 enables an IRC Section 501(c) organization to set up a separately segregated fund to carry out the political activities of the IRC Section 501(c) organization. The IRC Section 501(c) organization is subject to tax on any amount that it spends on the selection, nomination, election or appointment of a candidate for public office but only to the extent of its net investment income. IRC Section 527(f)(3).

> ***Note:*** IRC Section 527 was not intended to negate the prohibition against IRC Section 501(c)(3) organizations engaging in political activities. So, without considering IRC Section 527, charities may not engage in political activities on behalf of, or in opposition to candidates for elective public office nor may they set up separately segregated 527 organizations to engage in such activities without endangering their IRC Section 501(c)(3) status.

Political Activities and IRC Section 4955

Depending on the facts and circumstances, engaging in political activity can result in:

- The loss of exempt status.

- The imposition of the IRC Section 4955 tax.
- Both the loss of exempt status and imposition of the IRC Section 4955 tax.

Congress enacted IRC Section 4955 in 1987, which subjected IRC Section 501(c)(3) organizations that make political expenditures to an excise tax as follows:

IRC Section	Rate of Amount Involved[1]	Imposed On	Act[2]
IRC 4955(a)(1)[1]	10%	Organization	Making political expenditures
IRC 4955(b)(1)[1]	100%	Organization	Not correcting the expenditure within the taxable period
IRC 4955(a)(2)[2]	2.5% (maximum of $5,000)	Organization Manager	Agreeing to make the expenditure, knowing that it is a political expenditure
IRC 4955(b)(2)[2]	50% (maximum of $10,000)	Organization Manager	Refusing to correct a political expenditure

[1] The taxable period begins on the date the expenditure is made, and ends on the earlier of the date: the 90 day letter for the first tier tax is mailed or the first tier tax assessment.

[2]The initial tax can be abated if the organization can establish that its making the expenditure wasn't willful and flagrant.

Under IRC Section 4955(d)(2) certain expenditures of candidate-controlled organizations are considered political expenditures for the purpose of the tax imposed by IRC Section 4955. A candidate-controlled organization is an organization formed primarily to promote an individual's candidacy or prospective candidacy for public office or effectively controlled by a candidate or prospective candidate for political purposes. An organization is effectively controlled by the candidate if the candidate "has a continuing, substantial involvement in the day-to-day operations or management of the operation." The expenditures of this organization, amounts paid or incurred for any of the following purposes are considered political expenditures:

- Amounts paid to or incurred by the candidate for speeches or other services,
- Travel expenses of the candidate,
- Expenses for conducting polls, surveys or other studies, or preparing papers or other materials for use by the candidate,
- Expenses for advertising, publicity and fund-raising for the candidate,
- Any other expense that has the primary effect of promoting public recognition or otherwise primarily accruing to the benefit of the candidate.

In general, apply the IRC Section 4955 sanction instead of proposing revocation, if, based on the facts and circumstances, you determine all of these are met:

- The violation was found to be unintentional.
- The expenditure involved a relatively small amount.

- The organization corrected the violation and adopted procedures to make sure it wouldn’t make similar a expenditure in the future. (If the organization makes a correction, you may abate the first tier tax.)

Provisions of IRC Sections 6852 and IRC 7409 – Flagrant Violations of Political Campaign Prohibition

In certain situations, Congress found that audit and enforcement procedures did not deter an IRC Section 501(c)(3) organization from flagrantly violating the political campaign prohibition. Accordingly, it enacted IRC Section 6852 and IRC Section 7409, authorizing the IRS to take further measures.

Under IRC Section 6852, the IRS is authorized to make an immediate determination and assessment of income tax or tax imposed by IRC Section 4955 for the current taxable year and the immediately preceding taxable year.

Note: For this purpose, the organization's current taxable year is treated as if the organization terminated its exempt status on the date the tax liability is determined. Any taxes assessed under IRC Section 6852 against the organization or its managers are due and payable immediately.

Under IRC Section 7409, the IRS can seek an injunction (a civil action) to bar political expenditures by an IRC Section 501(c)(3) organization but only after it has notified the organization it will seek an injunction if the organization doesn’t immediately cease the expenditures. The Commissioner personally must determine the organization flagrantly participated in a political campaign and an injunction is the appropriate measure to prevent further abuse.

Note: The IRS also may seek such other injunctive relief as may be appropriate to ensure that the organization's funds are preserved for IRC Section 501(c)(3) purposes.

EXHIBITS 1 – 12.