

**HISTORICAL DEVELOPMENT AND PRESENT LAW  
OF THE FEDERAL TAX EXEMPTION FOR  
CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS**

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Before the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on April 20, 2005

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# CONTENTS

	<u>Page</u>
INTRODUCTION .....	1
EXECUTIVE SUMMARY .....	2
I. OVERVIEW OF ORGANIZATIONS EXEMPT FROM FEDERAL INCOME TAX... 18	
A. Size and Growth of the Exempt and Charitable Sector .....	18
B. Reasons for Tax Exemption.....	27
C. Common Tax Law Features of Exempt Organizations.....	37
II. HISTORY AND EVOLUTION OF THE EXEMPT STATUS OF SECTION 501(C)(3) ORGANIZATIONS.....	45
A. In General.....	45
B. Summary of Threshold Requirements of Charitable Status .....	48
C. Exempt Purposes of Section 501(c)(3) Organizations.....	61
D. Public Charity or Private Foundation .....	82
E. General History of the Unrelated Business Income Tax .....	100
F. Related Organization Structures Involving Exempt Organizations.....	110
III. SPECIFIC TYPES OF CHARITABLE ORGANIZATIONS AND EVOLVING STANDARDS OF CHARITY .....	122
A. Overview.....	122
B. Charitable Hospitals.....	123
C. Elder Care Facilities.....	132
D. Credit Counseling Organizations.....	135
E. Low-income Housing.....	139
F. Environmental Organizations .....	142
G. College Sports.....	145
IV. DATA ON EXEMPT SECTOR AND CHARITABLE ORGANIZATIONS.....	148
V. ADVANTAGES OF TAX-EXEMPT STATUS FOR SECTION 501(C)(3) ORGANIZATIONS AND SUMMARY OF CRS REPORT .....	155
VI. DESCRIPTION OF EXEMPT ORGANIZATIONS.....	159
VII. APPENDIX.....	194

## INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on April 20, 2005, on “An Overview of the Tax-Exempt Sector.” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the historical development and present law of the Federal tax exemption for charities and other tax-exempt organizations.<sup>2</sup>

This document begins with an executive summary. Following the executive summary, Part I of this document provides an overview of organizations exempt from Federal income tax, including statistical information about the sector, reasons for tax exemption, and common tax law features of exempt organizations. Part II describes the history and evolution of the exempt status of organizations described in section 501(c)(3), including a discussion of the meaning of exempt purposes described in section 501(c)(3), the distinction between private foundations and public charities, a general history of the unrelated business income tax, and an overview of related organization structures used by exempt organizations. Part III contains a description of several types of organizations that are described in section 501(c)(3), including a discussion of the change in legal standards over time. Organizations described here are hospitals, elder care facilities, credit counseling organizations, low-income housing organizations, environmental organizations, and college sports organizations. Part IV provides statistical information showing the size and growth of the charitable and exempt sectors. Part V is an overview of tax and nontax benefits of exemption for section 501(c)(3) organizations and a summary of a Congressional Research Service document (included as an Appendix to this pamphlet) that lists the benefits of charitable exemption under Federal and certain State laws. Part VI is a description, including the legislative history, of the many various organizations that may qualify for tax-exempt status.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations* (JCX-29-05), April 19, 2005.

<sup>2</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

## EXECUTIVE SUMMARY

### A. Overview of Organizations Exempt from Federal Income Tax

#### **Size and growth of the exempt sector generally**

Since the inception of the Federal income tax, the Congress has exempted certain types of entities from income taxation. Many exempt entities, such as charitable organizations, are familiar. Yet charitable organizations are but one type of exempt entity. The benefit of tax exemption is extended to groups as diverse as social welfare organizations, title holding companies, fraternal organizations, small insurance companies, credit unions, cooperative organizations, and cemetery companies. The statistics reported in this document do not include churches, which are not required to file returns with the Internal Revenue Service (“IRS”), and are not recorded in the IRS Master File of Exempt Organizations.

There are now 28 different types of organizations listed in the main exemption section of the Code (section 501), and numerous other exemptions provided elsewhere. The number and financial holdings of these organizations are large and have grown significantly since record-keeping began in 1975. The revenue reported to the IRS by such organizations has increased from approximately \$0.3 trillion (in 2001 dollars) in 1975 to about \$1.2 trillion in 2001. The 2001 revenue represented approximately 12.2 percent of gross domestic product in that year. The assets reported by the organizations have similarly increased, from approximately \$0.5 trillion (in 2001 dollars) in 1975 to almost \$2.9 trillion in 2001.

While a large majority of exempt entities fall into familiar categories, such as charitable organizations, there are also a fair number of organizations that fall into more obscure categories. Eight categories have fewer than 150 qualifying entities each, with four categories having fewer than five entities each.

#### **Size and growth of the charitable sector**

Charitable organizations described in section 501(c)(3) represent by far the largest category of exempt organizations, comprising about two-thirds of all exempt organizations. The 2004 IRS Master File of Exempt Organizations shows 1,010,365 charitable organizations. In terms of asset size and revenues, the share of charitable organizations in the exempt sector is similar. In 2001, the total revenue of charitable organizations (including private foundations but not including churches and other organizations not required to file) was about 9.3 percent of gross domestic product.

Among charitable organizations not including churches, the largest categories of organizations are hospitals and post-secondary educational organizations. In 2001, hospitals held 29 percent of total assets and collected 42 percent of total revenues in the charitable sector. Colleges and universities held 21 percent of the total assets and collected 11 percent of total revenue.

There has been significant recent growth in the number and size of charitable organizations. The number of such organizations has increased from 259,523 in 1976 to 1,010,365 in 2004, an increase of 289 percent. The total asset value and revenues (in 2001

dollars) reported to the IRS by charitable organizations similarly increased from about \$360 billion and \$155 billion, respectively, in 1975, to over \$2 trillion and about \$942 billion, respectively, in 2001.

The growth in the number and size of charitable organizations has been accompanied by growth in the amount of charitable deductions. In 1975, the total amount claimed as charitable deductions was about \$43.7 billion whereas in 2002, the total was about \$145 billion (both numbers in constant 2000 dollars).

## **B. Reasons for Tax Exemption**

There is no unifying theme or singular principle that explains tax exemption for the many diverse organizations in the exempt sector, although there are some factors that may help to explain the exemption for certain of them.

Over the years, Congress has granted tax exemption only to certain types of organizations. As an initial matter, not all “nonprofit” organizations are afforded tax exemption, and not all tax-exempt organizations have the typical characteristics of a “nonprofit” organization. The term “nonprofit” generally refers to an organization’s form under State law, not its Federal tax status. State law generally does not prohibit “nonprofits” from earning a profit, as one might expect. Instead, State law typically prohibits the distribution of earnings by nonprofit corporations (but not necessarily by other forms of entities) to their members.

The Federal exemption is extended in some instances to organizations that are not subject to a State-law constraint on distributions, as some entities are not required for exemption purposes to be organized in corporate form. Therefore, exemption may be obtained by some organizations that do not fit the classic definition of “nonprofit.” However, the Federal tax laws applicable to certain types of exempt organizations (though not all) contain prohibitions, such as the “no private inurement” and “no private benefit” doctrines, that are in some respects similar to the State-law constraint.

For some organizations, exemption from tax may be explained based on the nature of its activities. For example, charitable activities or activities that provide a public benefit may be viewed as governmental in nature and therefore not appropriate subjects of taxation. This may explain the exemption for charitable organizations, social welfare organizations, U.S. instrumentalities, and State and local governments. Promotion of certain activities may also be viewed as desirable policy, and therefore tax exemption is intended to encourage the activity. This may explain the tax exemption for arrangements to provide employee benefits, arrangements for individuals to save for health, retirement, and education, and the exemption for small or rural commercial organizations that engage in certain activities, such as farming, provision of financial services, insurance, electricity, or other public good.

Exempt status may also be attributable to the structure of an organization. Some organizations are funded exclusively by their members and expend all funds exclusively for members. If such an organization collects more in membership dues than its expenses, the excess is reinvested in the organization for the benefit of the members. Under general tax principles, the organization may not be considered as having any income because there has not

been a shifting of benefit from the member to the organization -- the organization merely facilitates a joint activity of its members. Thus, in some cases, the Code adopts a result that might occur even in the absence of statutory law, e.g., social clubs, fraternal organizations, voluntary employees' beneficiary associations, cemetery companies, and homeowners associations.

Another factor that may explain some cases of tax exemption is the nature of the legislative process. Congress did not provide exemption for all organizations that are not organized for profit; rather, the general rule is that an organization is subject to tax absent a specific exemption. Such a rule means that once broad categories of exemption are codified, there will be specific classes of organizations that do not fit within the broad category and that seek and receive exempt status. Social welfare organizations, business leagues, labor, agricultural, and horticultural organizations and other organizations may be examples.

Another factor to consider is simple expediency, in that taxing certain small organizations was viewed at the time the exemption was granted as too costly to administer, especially when often little or no tax would be due. This appears partially to explain the reason for exempting single-parent title holding companies from tax as well as social clubs. As stated in 1916 legislative history: "the securing of returns from them has been a source of annoyance and expense and has resulted in the collection of either no tax or an amount which is practically negligible."

### **C. Common Tax Law Features of Exempt Organizations**

#### **In general**

Despite varying standards regarding qualification for exempt status, different categories of exempt organizations share some common characteristics. For example, many types of exempt organizations are subject to a prohibition against "private inurement," and most exempt organizations are subject to the general rules regarding the taxation of unrelated business income. Contributions to a limited number of exempt organizations are deductible as charitable contributions, while contributions to others may be deductible as a business expense but not as a charitable contribution. Most exempt organizations also are subject to rules regarding lobbying and political campaign activities and are required to file annual information returns.

#### **Private inurement prohibition**

The doctrine of private inurement generally prohibits an exempt organization from using its assets for the benefit of a person or entity with a close relationship to the organization. For example, section 501(c)(3) provides that an organization will qualify for charitable exempt status only if "no part of the net earnings [of the organization] inures to the benefit of any private shareholder or individual." The regulations under section 501(a), which generally apply to organizations subject to the inurement proscription, define "private shareholder or individual" as "persons having a personal and private interest in the activities of the organization." Inurement thus applies to transactions between applicable exempt organizations and persons sometimes deemed "insiders" of the organization, such as directors, officers, and key employees. The issue of private inurement often arises where an organization pays unreasonable compensation (i.e.,

more than the value of the services) to such an insider. However, the inurement prohibition is designed to reach any transaction through which an insider is unduly benefited by an organization, either directly or indirectly.

There is no “de minimis” exception under the inurement prohibition, and an organization that engages in an inurement transaction may face revocation of its exempt status. Until 1996, there was no sanction short of revocation of exempt status in the event of an inurement transaction. In 1996, however, Congress imposed excise taxes, frequently referred to as “intermediate sanctions,” on “excess benefit transactions” between certain exempt organizations and “disqualified persons.” The intermediate sanctions rules, which apply only to transactions involving organizations exempt under sections 501(c)(3) and 501(c)(4), impose excise taxes on a disqualified person who receives an excess benefit and, under certain circumstances, on organization managers who approved the transaction. No such sanctions are presently imposed against the organization itself.

Section 501(c)(3) organizations (but generally not other organizations) also are subject to a prohibition against conferring more than incidental “private benefit.” The private benefit prohibition applies to non-fair market value transactions with individuals or entities, not merely with insiders, and thus is in some respects broader than the private inurement prohibition.

### **Unrelated business income tax**

In general, an exempt organization may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (e.g., program service revenue); investment income; and trade or business income that is not related to exempt activities. In general, the Federal income tax exemption extends to the first three categories, and does not extend to an organization’s unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.

The unrelated business income tax was introduced in 1950 to address the problem of unfair competition between for profit companies and non profit organizations conducting an unrelated for profit activity. The unrelated business income tax generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions. Most exempt organizations are subject to the tax.

Most exempt organizations generally may operate an unrelated trade or business so long as it is not a primary purpose of the organization. Therefore, engaging in a substantial amount of unrelated business activity before jeopardizing exempt status is permitted. By contrast, a charitable organization may not operate an unrelated trade or business as a substantial part of its activities.

Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.

For the tax year 2001, 35,540 organizations filed unrelated business income tax returns, reporting a total of \$7.9 billion of gross unrelated business income. This translated into unrelated business taxable income (after taking into account allowable deductions) of approximately \$792 million and total tax of approximately \$226 million.

### **Contributions**

Another feature of a minority of tax-exempt organizations is that contributions to such organizations may be deductible by the donor as charitable contributions for income, estate, and gift tax purposes. Contributions to charitable organizations, for example, generally are deductible for income, estate, and gift tax purposes, although the amount of deduction may be affected by such factors as the recipient organization's classification as a public charity or private foundation and the type of property contributed. Other types of organizations that are eligible recipients of charitable contributions include: certain Federal, State, and local government entities, if the contribution is exclusively for public purposes; certain fraternal beneficiary societies, if the contributions are used for charitable purposes; cemetery companies, if the contributions are used for certain purposes; and certain organizations of war veterans.

Contributions to other types of exempt organizations generally are not deductible as charitable contributions. Under certain circumstances, however, contributions to a membership organization, such as a social welfare organization or trade association, may be deductible as a business expense under section 162. In addition, contributions to tax-exempt employee benefit arrangements (e.g., qualified retirement plans) or individual savings arrangements (such as individual retirement accounts) may be deductible.

### **Lobbying and political activities**

Tax-exempt organizations are also subject to rules regarding the permissible level of lobbying and political campaign activities. In general, the lobbying and political activity rules applicable to charitable organizations are more severe than the rules applicable to other types of exempt organizations.

### **Information returns**

Exempt organizations are required to file an annual information return, stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe. The requirement that an exempt organization file an annual information return does not apply to certain exempt organizations, including organizations (other than private foundations) the gross receipts of which in each taxable year normally are not more than \$25,000. Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain state institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.



## **D. Summary of Requirements of Exempt Status of Charitable Organizations and Selected Issues Relating to Such Organizations**

### **In general**

In general, the requirements for exempt status of an organization under section 501(c)(3) of the Code are that (1) the organization must be organized and operated exclusively for certain purposes; (2) there must not be private inurement to organization insiders; (3) there must be no more than an incidental private benefit to private persons who are not organization insiders; (4) no substantial part of the organization's activities may be lobbying; and (5) the organization may not participate or intervene in political activities. Permitted purposes are religious, charitable, scientific, testing for public safety, literary, educational, the fostering of national or international amateur sports competition, or the prevention of cruelty to children or animals. Failure to satisfy any of these requirements should result in an organization not qualifying for exempt status under section 501(c)(3), or should result in a loss of such status once a violation is detected by the IRS. Most of the Federal law of charitable organizations is designed around ensuring that each of the requirements is satisfied by an organization initially and on an ongoing basis. Each of the requirements is simple to state, but none are simple, as each carries with it a significant body of statutory, common, and administrative law.

If an organization satisfies each of the requirements, there is a further question of what type of charitable organization it is. A section 501(c)(3) organization is either a public charity or a private foundation. In general, the basis for distinguishing between public charities and private foundations is the level of public support an organization receives over time. Organizations with widespread public support tend to qualify as public charities; organizations funded by just a few donors tend to be classified as private foundations. There is a substantial body of law detailing how to determine whether an organization is publicly supported. Certain organizations also may qualify as public charities as a matter of law (e.g., churches, hospitals). The classification matters because private foundations generally are subject to more restrictions on their activities than are public charities, are subject to tax on their net investment income, and contributions to private foundations generally do not receive as favorable treatment as do contributions to public charities for purposes of the charitable contribution deduction.

Satisfaction of the requirements for exemption, classification of an organization as a public charity or private foundation, plus the resulting benefit that contributions to charitable organizations generally are tax deductible provides the simplest snapshot of the law of charitable organizations.

### **Exempt purposes of section 501(c)(3) organizations**

#### The meaning of charity – present law

In general, there are two approaches to the meaning of the term charitable -- the legal sense and the ordinary and popular sense. The legal definition is derived from the law of charitable trusts and is broader than the ordinary sense of the term, which generally means the relief of the poor and distressed. Since 1959, Treasury regulations have defined the term "charitable" in the legal sense, to include:

Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

This definition is broad, encompassing several ideas that would not generally be considered as charitable in the ordinary sense. In addition to meeting the regulatory definition of charitable, an organization described in section 501(c)(3) is not organized and operated for exempt purposes if a purpose of the organization is against public policy or is illegal.

In addition to the public policy requirement, certain common law principles inform the Federal tax law definition of charity. The charitable class requirement provides that an organization be organized to benefit a sufficiently large or indefinite class of people. The community benefit doctrine permits exemption as a charitable organization if the result of an activity inures to the benefit of the community, even though a private person is the immediate beneficiary of the activity.

#### The meaning of charity and the rationale for tax exemption and charitable deductions

There is no agreed upon explanation of the rationale behind the charitable tax exemption and tax deduction. Some of the basic rationales that have been offered, described in greater detail in Part II.C of this pamphlet, may be summarized as follows: (1) charitable organizations serve the public and therefore should be supported through provision of tax benefits; (2) charitable organizations provide goods and services that otherwise would have to be provided by the Government and therefore should be supported by the Government; (3) it is difficult to measure the net income of charitable organizations, and therefore they should be exempt from tax; (4) charitable organizations promote pluralism; (5) charitable organizations are efficient providers of services but have inherent limits on their ability to raise capital compared to for-profit entities and therefore need government support in the form of tax exemption (and charitable contributions); and (6) exemption is afforded to those organizations that can prove their worth through sustained donations.

#### Educational purposes

Tax exemption for educational organizations was provided in the Tariff Act of 1894, and has been replicated in each subsequent income tax act. Educational organizations have been eligible to receive tax deductible contributions since 1917. Like the term charitable, the term educational has no precise meaning. The Treasury regulations set forth the basic definition as relating to the “instruction or training of the individual for the purpose of improving or developing his capabilities.” This definition is consistent with provision of exemption for organizations that fit within the common conception of an educational organization, such as schools, colleges, and universities. Yet educational organizations are not limited to such traditional forms. The “instruction of the individual standard” may be met by many other types of organization. The Treasury regulations also provide that educational means the “instruction of

the public on subjects useful to the individual and beneficial to the community.” The IRS and the courts have permitted a broad array of organizations to be considered educational under this standard.

A primary issue in determining whether something is educational is not the content of the information but the method the organization uses to convey information, irrespective of content. In general, the analytical exercise is to determine whether an organization’s presentation of information is objective and balanced, or whether the organization instead is an advocate or a mouthpiece for propaganda.

### Religious purposes

The Federal tax exemption for organizations operated for religious purposes was, along with charitable and educational purposes, provided for originally in the Tariff Act of 1894, and religious organizations were designated as eligible for charitable contributions in 1917. There is no definition of “religious” provided by regulation. The manifest reason is the constitutional law framework that limits Federal involvement in religion. The IRS has developed a multi-factor list of characteristics that inform whether an organization may be considered a church (which is a kind of religious organization), and the IRS is careful to point out that this list is not comprehensive and that in each case, the facts and circumstances will be considered. In many cases in which a religious organization’s claim to exempt status is questioned, the issue of whether the organization serves religious purposes often is not addressed because exempt status may be denied on other grounds, for example, private benefit or private inurement, commerciality, or violation of the political activities prohibition.

The Constitutional concerns regarding Federal involvement in religious organizations extend to the application of regulatory requirements. For example, certain religious organizations are exempted from the requirement to apply for tax exempt status, from annual information return requirements, and special audit procedures apply to churches. As a result, although religious organizations, particularly churches, constitute a significant part of the charitable sector, information about such organizations is scarce.

### Scientific purposes

Scientific purposes were the first addition to the original three exempt charitable purposes and were added in 1913. Charitable contributions to scientific organizations were made deductible in 1917. A tax exempt scientific purpose hinges on the performance of basic or fundamental research in the public interest. Scientific research that is “applied” or “practical” may be subject to the unrelated business income tax, but generally is not inconsistent with exempt purposes. There is no precise definition of scientific research, and, in general, courts and the IRS have determined whether an organization is engaged in scientific research on a case-by-case basis. Scientific research must be in the public interest. Scientific research does not include activities of a type ordinarily carried on as incidental to commercial or industrial operations.

## **E. Public Charity or Private Foundation**

### **Present law – definition**

Once an organization qualifies for tax exempt status under section 501(c)(3), the organization must be classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways. For example, it may be a specified type of organization, such as a church, educational institution, hospital and certain other organizations; it may qualify as a publicly supported public charity; it may qualify as a “supporting organization.” An organization that does not qualify as a public charity is a private foundation.

### **Legislative history and background for the 1969 public charity-private foundation distinction**

The Tax Reform Act of 1969 defined a private foundation in the Code for the first time and set forth the basis for today’s law regulating their conduct. Prior to 1969, incremental changes distinguished private foundations from other charitable organizations. The Revenue Act of 1950 established a preference for publicly supported and certain other charitable organizations over private foundations by providing that certain self-dealing transactions between private foundations and foundation insiders could result in loss of exemption if the transactions were not made at arm’s length. A possible loss of exempt status also was imposed for unreasonable income accumulations, use of income to a “substantial” degree for non exempt purposes, or investment of income in a manner that jeopardizes the achievement of exempt purposes.

On the charitable contribution side, the public charity-private foundation distinction began with the adoption of the Revenue Code of 1954. Congress increased the percentage limitation for charitable contributions to 30 percent, but made the increase available only for certain charitable organizations. Congress expanded this preference in the Revenue Act of 1964, by extending it to organizations that were publicly or governmentally supported, thus excluding private foundations.

Concerns about the uses and abuses of private foundations was an ongoing theme in the years leading up to the Tax Reform Act of 1969. In 1952 and 1953, two House Committees investigated the activities of foundations. In the 1960’s, Congressman Wright Patman issued a series of highly critical reports regarding private foundations. In 1965, the Treasury Department issued a report on private foundations, which concluded that most private foundations were not abusive, but identified six “major problems” and recommended legislation. The major problems were self-dealing, the delay in benefit to charity, foundation involvement in business, family use of foundations to control corporate and other property, financial transactions unrelated to charitable functions, and donor involvement in foundation management.

### **The Tax Reform Act of 1969**

The Tax Reform Act of 1969 defined private foundations in the Code and established new rules regulating the conduct of foundations, a two-tier system of excise taxes intended to ensure compliance with the new rules, and a tax on the net investment income of foundations. These excise taxes replaced the principal penalties imposed under prior law for foundation

misuse, i.e., possible loss of exempt status and eligibility to receive deductible contributions, which had proved difficult to administer and to enforce. In general, the rules of the 1969 Act remain in force today.

The Act generally prohibited self-dealing transactions between a private foundation and a disqualified person in order to minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to improve enforcement. Congress also determined that the highest fiduciary standards required complete elimination of all self-dealing, rather than merely imposition of arm's length standards.

Congress replaced the 1950 rule of loss of tax-exempt status if the organization's aggregate accumulated income was "unreasonable in amount or duration" with a provision that required a payout based on a specified percentage of a private foundation's non-charitable use assets. Congress also adopted rules that limit the amount of permitted business holdings of a private foundation. Congress determined that a number of private foundations were being used to maintain control of businesses and was concerned that as a result foundations with significant business holdings tended to be relatively unconcerned about producing income, that the attention and interest of such foundations would be devoted to the operation, maintenance, and improvement of the business and not exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons.

Prior to the Tax Reform Act of 1969, a private foundation would lose its tax-exempt status if its accumulated income was invested in a manner that jeopardized the carrying out of its charitable purposes. No similar limitation applied to investment of principal. Congress determined that investments of principal that jeopardize exempt purposes may reduce benefits to charity just as much as jeopardizing investments of accumulated income. In addition, the loss of exemption of prior law was considered too harsh a sanction, and a more limited sanction was provided. The 1969 Act taxed certain expenditures of a private foundation as a means of enforcing several of the general prohibitions on the conduct of charitable organizations and foundations. Congress also imposed a termination tax on private foundations that terminate existence.

### **1996 Taxpayer Bill of Rights 2 – intermediate sanctions on public charities**

Prior to 1996, there was no sanction, short of revocation of tax exemption, on organization insiders or disqualified persons for engaging in self-dealing transactions with respect to a public charity, even though private foundations had been subject to self-dealing rules since 1969. In 1996, Congress enacted new "intermediate sanctions" in the form of excise taxes on "excess benefit transactions" between a public charity or a social welfare organization and an insider of the organization. Like the 1950 Act self-dealing rules applicable to private foundations, the 1996 intermediate sanctions rules generally permit insider transactions to occur so long as no excess benefit is provided to an organization insider.

## **Selected issues relating to the public charity – private foundation distinction**

In 2005, thirty-six years after Congress first drew a meaningful legal distinction between publicly supported organizations and private foundations, it may not be as clear, given the growth and diversity of publicly supported organizations, why some of the private foundation rules are not relevant for certain public charities, or whether some of the private foundation rules are performing their intended purpose. For example, the retention of substantial holdings in a commercial business, the making of investments or expenditures that jeopardize or are inconsistent with exempt purposes, or the maintenance of large endowment funds raise some of the same concerns whether conducted by a public charity or a private foundation.

In defining a private foundation, the 1969 Act provided that an organization that provides support to a public charity (a “supporting organization”) is considered a public charity and not a private foundation. Thus, supporting organizations receive the benefit of the favorable charitable contribution deduction rules and avoid the excise tax regime applicable to private foundations. Donors to supporting organizations may take a fair market value deduction for contributions of capital gain property such as closely held stock, which would not be permitted for gifts to private foundations. As a public charity, supporting organizations also are not subject to the private foundation self-dealing rules (e.g., barring loans and other transactions with insiders), limitations on business holdings, or subject to the private foundation payout rules. However, unlike other public charities but like private foundations, supporting organizations generally do not have broadly based support, and may resemble private foundations in other respects.

Community foundations and donor advised funds, which generally qualify as public charities, offer limited ways for donors to exercise post-transfer control or direction over the use of funds or other property transferred to a charity for which the donor is entitled to a deduction in the year of transfer. Contributors to community foundations and donor advised funds receive the benefit of the favorable public charity rules and some elements of the control over distributions without being subject to the legal constraints placed on a private foundation. Thus, a donor can fund an account in a community foundation or donor advised fund with cash or capital gain property, take a fair market value deduction, accumulate income in the fund, and from time to time recommend that amounts be paid out of the fund for charitable purposes. Community foundations and donor advised funds, like supporting organizations, resemble private foundations in many ways, but are considered public charities.

### **F. General History of the Unrelated Business Income Tax**

Until the introduction of the unrelated business income tax in 1950, exempt organizations enjoyed a full exemption from Federal income tax. If a charitable or other exempt organization met the organizational and operational requirements of the statute, there was no statutory limitation on the amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. Courts extended this “destination of income test” to the exemption even of charitable organizations that did not conduct any charitable programs, but rather operated commercial businesses for the benefit of a charitable organization, so called “feeder” organizations. In the years before 1950, charitable organizations also were acquiring real estate with borrowed funds. In a typical transaction, a tax-exempt organization would borrow money to acquire real estate, lease the property back to the seller

under a long-term lease, and service the loan with tax-free rental income from the lease. Under such transactions, there was a concern that exempt organizations were in effect leveraging their tax exemption and threatening the tax base by acquiring, through debt, income producing assets that after the acquisition no longer generated revenue for the Federal government.

As a response to such practices and rulings, in 1950 Congress subjected charitable organizations (not including churches), and certain other exempt organizations to tax on their unrelated business income. The tax was intended to prevent unfair competition. Excluded from the tax was passive investment income and certain gains and losses from the disposition of property. Excluded from the definition of an unrelated trade or business was a trade or business in which substantially all the work in carrying on the business is performed without compensation, a trade or business carried on primarily for the convenience of the members, and a trade or business that sells merchandise, substantially all of which is received by the organizations as gifts or contributions.

To address the issue of feeder organizations, the 1950 Act provided that, in general, an organization that is operated primarily for the purpose of carrying on a trade or business for profit may not be recognized as tax-exempt merely because all of the organization's profits are payable to tax-exempt organizations. To address the leveraging of exemption, the 1950 Act also taxed certain rents received in connection with the leveraged sale and leaseback of real estate.

Nineteen years later, in the Tax Reform Act of 1969, Congress made significant changes to the unrelated business income tax rules, extending the tax to all exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities). In addition, the 1969 Act expanded the tax on debt-financed income to cover not only certain rents from debt-financed acquisitions of real estate, but to tax in addition other debt-financed income. In order to prevent evasion of the unrelated business income tax through the use of controlled subsidiaries, the Act also generally provided that payments to a tax-exempt organization of interest, annuities, royalties, and rent from a taxable or tax-exempt subsidiary of such organization may be subject to tax. These provisions were intended to prevent tax-exempt organizations from "renting" assets to a subsidiary for use in an unrelated business, thereby permitting the subsidiary to escape income taxes through a large rent deduction. Since 1969, Congress has made a number of changes to the unrelated business income tax rules, but the structure of the tax has remained largely intact.

### **Selected issues relating to the unrelated business income tax**

In general, exempt organizations have greater discretion than taxable organizations in determining whether to report income as taxable or not, through the questions of whether income is from a regularly conducted trade or business, and whether the conduct of such a trade or business is "substantially related" to exempt purposes. In addition, even if an exempt organization treats income as unrelated and therefore as subject to tax, an exempt organization might allocate expenses for an exempt activity to an unrelated activity in order to minimize or eliminate the tax.

Issues often arise regarding whether certain types of receipts constitute royalties, which generally are excluded in determining an organization's unrelated business taxable income.

Two issues that have been the source of considerable debate in this area are: (1) whether income from an affinity credit card program constitutes a royalty and (2) whether income from a mailing list rental constitutes a royalty. Notwithstanding several court decisions, a taxpayer that provides more than a small amount of clerical services may risk having payments received in exchange for a license classified as payments for services rather than as excludable royalties.

### **G. Related Organization Structures Involving Exempt Organizations**

An exempt organization may be affiliated with other organizations or entities, some exempt and some taxable. Thus, an exempt organization might be a parent of one or more incorporated organizations, a subsidiary of another exempt organization, or an organization that is under the common control of another exempt organization. In general, an exempt organization will be treated as separate from its related corporations as long as the purposes for which the related entity was formed are carried out in its activities. Related organization structures involving exempt organizations often are used by exempt organizations: (1) to isolate potential State law liability (tort, contract, or other) in a separate entity; (2) to isolate actual or potential income tax attributes (e.g., unrelated business income) in a separate entity; (3) to conduct for-profit or dissimilar nonprofit activities in a separate entity for management, administrative, reporting, or other reasons; (4) to participate in an investment; or (5) because State or Federal law, or a third party such as a lender, might require or encourage the use of a separate State law or tax entity for the particular type of arrangement.

### **H. Specific Types of Charitable Organizations and Evolving Standards of Charity**

#### **Charitable hospitals**

##### **In general**

The Code does not provide a per se charitable exemption for hospitals. Rather, a hospital qualifies for exemption if it is organized and operated for a charitable purpose and meets additional requirements of section 501(c)(3). The promotion of health has long been recognized as a charitable purpose that is beneficial to the community as a whole. It includes not only the establishment or maintenance of charitable hospitals, but clinics, homes for the aged, and other providers of health care.

Medical care generally is provided by government-owned, for-profit, and tax-exempt organizations. In the hospital sector, tax-exempt organizations dominate, with approximately 60 percent of the nation's hospitals operating as charitable institutions. Historically, charitable hospitals were characterized as voluntary because they generally were supported by philanthropy, staffed by doctors who worked without compensation, and served, almost exclusively, the sick poor. However, the character of the charitable hospital sector has changed significantly over the past several decades due to the growth of such resources as employer-provided health insurance and governmental programs such as Medicare (for the elderly and disabled) and Medicaid (for the poor). Today, charitable hospitals generally provide medical and other health-related services in a manner similar to their for-profit counterparts. They operate under the same healthcare regulations, compete for the same patients and doctors, and derive funding from many of the same sources as other types of hospitals.



### Evolution of the legal standard

Financial Ability Standard.—Much like the nature of the health-care industry itself, the definition of the term charitable as applied to hospitals has not been static. In 1956, the IRS adopted the “financial ability standard,” requiring that a charitable hospital be “operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay.” This standard effectively meant that a charitable hospital could not refuse to accept patients in need of hospital care who could not pay for such services. However, the IRS acknowledged that hospitals normally charge patients who are able to pay for services in order to meet the hospital’s operating expenses and stated that the “fact that the hospital’s charity record is relatively low is not conclusive that a hospital is not operated for charitable purposes to the full extent of its financial ability.” The ruling’s requirement that charitable hospitals provide some amount of free or reduced-rate care reflected the view that hospitals and other health care institutions were only charitable if they both provided relief to the poor and promoted health.

Community Benefit Standard.—The financial ability standard governed charitable hospitals until 1969. Congress had criticized the financial ability standard as imprecise concerning the extent to which a hospital must accept patients who are unable to pay. In addition, the creation of Medicare and Medicaid in 1965 had a fundamental effect on hospitals; a substantial portion of the free care previously subsidized by charitable hospitals now was reimbursed through these governmental programs. In response to these developments, the IRS adopted the “community benefit standard,” which remains the test applied by the IRS for determining whether a hospital is charitable. Under the community benefit standard, the promotion of health care is “one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members, provided that the class is not so small that its relief is not of benefit to the community.” Applying this community benefit standard, the IRS found that a hospital’s operation of a generally accessible emergency room open to all persons, regardless of ability to pay, provided a benefit to a sufficiently broad class of persons in the community. The requirement of the financial ability standard that charitable hospitals provide care to patients without charge or at rates below cost was removed. The community benefit standard applies not only to traditional hospitals, but also other health care provider organizations, such as clinics or health maintenance organizations (HMOs).

### Elder care facilities

The IRS’s historical position was that the aged were not a charitable class per se. Exemptions for organizations providing care and housing services to the aged generally were conditioned upon traditional notions of charity, such as whether the organization provided relief of the poor and distressed. In 1972, the IRS ruled that the aged, apart from considerations of financial hardship, are as a class highly susceptible to other forms of distress. The IRS identified three primary needs of aged persons: the need for housing, the need for health care, and the need for financial security. The satisfaction of these needs “contributes to the prevention and elimination of the causes of the unique forms of distress to which the aged, as a class, are highly susceptible.” Organizations operated in a manner designed to satisfy all three primary needs

may qualify for charitable status even though direct financial assistance to the elderly may not be involved. The ruling that the elderly are a charitable class has led to recognition of a number of charitable activities for the benefit of the elderly, including senior citizen centers, rural rest homes, meal delivery organizations, broadcasting organizations, transportation providers, and a beauty shop.

### **Credit counseling organizations**

In a 1969 ruling, the IRS concluded that a credit counseling organization was exempt as a charitable or educational organization described in section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients. The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions. In 1978, a court held that the law did not require that an organization must perform its exempt functions solely for the benefit of low-income individuals to be considered charitable. The court found the debt management plans of the agency at issue were an integral part of its counseling function.

During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 from 2000 to 2003. As of late 2003, the IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3). A number of new credit counseling entities have engaged in aggressive marketing and advertising while providing very little legitimate credit counseling or financial training. In addition, many of today's credit counseling organizations conduct as their primary activity, and derive most of their revenues from, debt management planning and other activities. Because of these changes in the industry, Congress and the IRS have expressed concern that tax-exempt credit counseling organizations are not fulfilling their exempt purpose. The IRS has commenced a broad examination and compliance program with respect to the credit counseling industry. The IRS concluded in a recent legal memorandum that many credit counseling organizations may not qualify for exemption under section 501(c)(3) because of operation for a substantial nonexempt purpose, substantial private benefit, and private inurement.

### **Low-income housing**

Nonprofit housing organizations created to aid low-income families may qualify as charitable organizations on the basis of providing relief to the poor. Over the past few decades, new models of affordable housing have been established as an alternative to large public housing projects, including many mixed-income developments. Questions arose whether organizations serving individuals with a mix of incomes, only some of whom are poor, qualify as charitable. In response, the IRS issued low-income housing guidelines in 1996 that set forth criteria for determining whether a housing organization provides relief to the poor. The guidelines contain a safe harbor, under which an organization must reserve a significant percentage of residential

units for occupancy by both low-income and very low-income families, and only a limited number of housing units may be occupied by residents with incomes above low-income limits. In addition, organizations providing housing assistance that is not limited to the poor may qualify for exemption if the organization serves other charitable purposes such as lessening the burdens of government, lessening neighborhood tensions, eliminating prejudice and discrimination, combating community deterioration, or providing specialized housing for the elderly.

### **Environmental organizations**

Organizations established to preserve and promote the natural environment may be exempt under section 501(c)(3) as charitable, educational, or scientific organizations. The exemption for environmental organizations generally is based on the principle that efforts to preserve and protect the natural environment for the benefit of the public serve a charitable purpose. In addition, organizations engaged in activities designed to enhance land conservation and preservation may be viewed as advancing education and science.

For example, the IRS ruled that an organization formed for the purpose of preserving the natural environment by acquiring ecologically significant undeveloped land, and either maintaining the land itself with limited public access or transferring the land to a government conservation agency by outright gift, or being reimbursed by the agency for its cost, qualified as charitable. The IRS has described the benefit to the public from environmental conservation as deriving “not merely from the current educational, scientific, and recreational uses that are made of natural resources, but from their preservation as well.” However, the mere preservation of existing land without a showing that the land has any distinctive ecological significance did not constitute a charitable purpose.

In 1980, Congress provided a charitable deduction for “qualified conservation contributions” to certain qualified organizations for conservation purposes. The legislative history to the Act indicates that specified preservation activities yield significant benefits to the public and are to be encouraged. Subsequent to the 1980 law, the IRS issued an internal legal memorandum stating that organizations that are established to accept and preserve qualified conservation contributions may be entitled to exemption and that the 1980 law raised a strong implication as to Congressional intent that charitable purposes of necessity expand beyond the ecologically significant standard articulated in prior IRS rulings.

### **College sports**

College athletic organizations that promote certain aspects of athletic competition have generally been held to be educational and, thus, exempt under section 501(c)(3). The exemption is based on the principle that an athletic program conducted for the physical development and betterment of the students is an integral part of a university’s overall educational activities. In addition, the revenue that a college or university derives from admission to athletic events is income from a related business to the extent the activities are substantially related to the institution’s educational programs. Today, colleges and universities may generate significant financial benefits from their participation in athletic events.

# I. OVERVIEW OF ORGANIZATIONS EXEMPT FROM FEDERAL INCOME TAX

## A. Size and Growth of the Exempt and Charitable Sector

### In general

Since the inception of the Federal income tax, the Congress has exempted certain types of entities from income taxation. Many exempt entities, such as charitable organizations, are familiar.<sup>3</sup> Yet charitable organizations are but one type of exempt entity. The benefit of tax exemption is extended to groups as diverse as social welfare organizations, title holding companies, fraternal organizations, small insurance companies, credit unions, cooperative organizations, and cemetery companies. The statistics reported in this document do not include churches, which are not required to file returns with the Internal Revenue Service (“IRS”), and generally are not recorded in the IRS Master File of Exempt Organizations.

There are now 28 different types of organizations listed in the main exemption section of the Code, and numerous other exemptions provided elsewhere.<sup>4</sup> In 2001, organizations described in sections 501(c)(1) through 501(c)(25) were reported to hold \$2.9 trillion in assets. Their revenues totaled \$1.2 trillion, or approximately 12 percent of gross domestic product. The number and financial holdings of these organizations has grown significantly since record-keeping began in 1975. The number of section 501(c) organizations filing returns with the IRS has increased from 247,086 in 1975 to 384,534 in 2001. Revenues reported on these returns have increased from approximately \$.3 trillion in inflation adjusted dollars in 1975, while assets have increased from approximately \$.5 trillion. Figure 1 provides a graphic illustration of the size of the sector in 1975, and in 2001, in terms of number of returns, assets, and revenues for organizations described in sections 501(c)(1) through 501(c)(25). Assets and revenues are presented in constant (inflation-adjusted) dollars.<sup>5</sup>

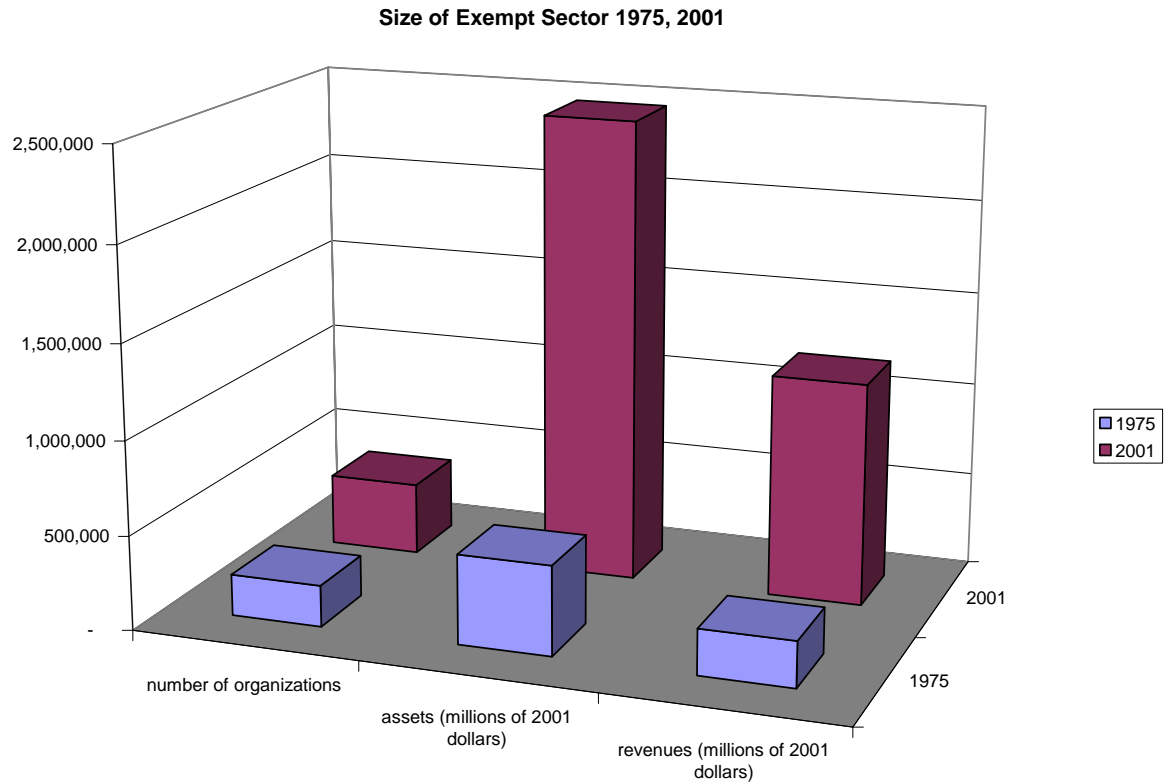
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<sup>3</sup> The word “charitable” generally is used in this pamphlet to include any of the purposes described in section 501(c)(3), e.g., religious, educational, scientific, and other.

<sup>4</sup> See secs. 115, 220, 223, 401(a), 408(e), 457(g), 501(c), 501(d), 501(e), 501(f), 501(k), 501(n), 516, 521, 526-530, and 7871. Although section 501(c) has 28 subsections, the exemption provided for section 501(c)(20) organizations expired for taxable years beginning after June 30, 1992. Sec. 120(e). Apart from general descriptions provided in Part VI, this document does not discuss those entities that are exempt under section 401 of the Code, i.e., retirement savings vehicles, which are subject to a completely different regulatory apparatus than other organizations exempt under section 501.

<sup>5</sup> See Table 5, Part IV.

Figure 1



SOURCE: Joint Committee staff tabulations from Tables 5 and 6, Part IV.

**Size of exempt sector (especially the charitable sector)**

While a large majority of exempt entities fall into familiar categories, such as charitable organizations, there are also a fair number of organizations that fall into more obscure categories. Table 1 shows the number of entities for the three largest categories of section 501(c) organizations for selected years since 1976. (Table 7 provides more detail on the number of organizations for each organization type.) In 2004, the IRS Master File of Exempt Organizations shows 1,540,534 organizations exempt from tax.<sup>6</sup> Of these, 1,010,365, or 66 percent, are organizations described in section 501(c)(3) (i.e., charitable organizations). In terms of number of entities, the next largest are social welfare organizations (nine percent), business leagues (5.6 percent), social clubs (4.6 percent), section 501(c)(8) fraternal beneficiary societies (4.5 percent), labor, agricultural, and horticultural organizations (4.1 percent), and veterans organizations (2.3 percent). In terms of asset size and revenues, the proportions are similar.<sup>7</sup>

<sup>6</sup> This includes organizations in sections 501(c)(1) through (25). Of the organizations described in section 501(c)(3), it does not include churches and other organizations not required to file an application for tax exemption. See Table 7, Part IV.

<sup>7</sup> Joint Committee staff calculations based on data in Table 7, Part IV.

Some organizations are very few in number: U.S. instrumentalities (116 entities), black lung trusts (33 entities), crop financing corporations (21 entities), teachers retirement funds (16 entities), certain ERISA trusts (4 entities), certain employee funded trusts (2 entities), and pre-1880 veterans organizations (2 entities). In one case, only one entity meets the requirements set forth in the Code, e.g., educational cooperatives described in section 501(f).

Table 1.—Number of Organizations on the IRS Master File by 501(c) Section  
Selected Years, 1976-2004

Type of Organization	1976	1985	1995	2004
Total	756,594	844,806	1,162,810	1,540,534
501(c)(3), charitable, religious, and similar organizations	259,523	366,071	626,226	1,010,365
501(c)(4) social welfare organizations	125,415	131,250	139,451	138,193
501(c)(8) fraternal benefit societies	141,725	84,435	91,972	69,798
all other 501(c) organizations	229,931	263,050	305,161	322,178

Source: Joint Committee staff calculations based on Table 7, Part IV.

Charitable organizations also constitute a disproportionately large part of the exempt sector in terms of asset size and revenues. For example, in 2001, the total assets and total revenues of charitable organizations (not including private foundations) comprised 69 percent and 76 percent respectively of the total assets and total revenues of organizations described in sections 501(c)(1) through 501(c)(25).<sup>8</sup> Relative to gross domestic product, in 2001, the total revenue of charitable organizations (including private foundations but not including churches and other organizations not required to file) was 9.3 percent.<sup>9</sup>

#### Size among different charitable organizations

Among charitable organizations not including churches or private foundations, the largest categories of organizations are hospitals and post-secondary educational organizations. In 2001, hospitals held 29 percent of total assets and collected 42 percent of total revenues in the charitable sector. Colleges and universities held 21 percent of the total assets and collected 11 percent of total revenue. Combined, hospitals, colleges, and universities accounted for 50 percent of total assets and 53 percent of total revenue of charitable organizations in 2001.<sup>10</sup> Table 2 shows the allocation of returns, assets, and revenues across the major National Tax Exempt Entity (“NTEE”) categories for 2001 for charitable organizations (excluding churches

<sup>8</sup> See Table 5, Part IV. Of the organizations described in section 501(c)(3), this table does not include churches and other organizations not required to file a return.

<sup>9</sup> Joint Committee staff calculation based on information in Table 6, Part IV, and Gross Domestic Product data from *Economic Report of the President*, February 2005, U.S. GPO, Table B-1.

<sup>10</sup> JCT staff calculations based on data in Table 8, Part IV.

and private foundations). Note that hospitals generally are a subset of the “health” category, and colleges and universities generally are a subset of the “education” category. Because churches are not required to file returns, filers in the religious category make up a relatively small (6.2 percent) portion of charitable returns, and hold an even smaller (one percent) portion of reported charitable assets.

Table 2.—Returns, Assets, and Revenues for Charitable Organizations by NTEE Category for 2001

	Number of Returns		Assets		Revenues	
	Number	percent	dollars in millions	percent	dollars in millions	percent
Total	240,569		1,631,719		896,974	
Arts, Culture, and humanities	26,006	10.8%	65,714	4.0%	22,743	2.5%
Education	41,153	17.1%	518,738	31.8%	157,307	17.5%
<i>colleges and universities</i>	1,374	0.6%	344,657	21.1%	98,837	11.0%
Environment, animals	9,413	3.9%	24,150	1.5%	9,019	1.0%
Health	32,195	13.4%	646,979	39.7%	509,017	56.7%
<i>hospitals</i>	3,961	1.6%	473,925	29.0%	374,414	41.7%
Human services	91,131	37.9%	189,449	11.6%	135,846	15.1%
International, foreign affairs	3,360	1.4%	10,789	0.7%	10,494	1.2%
mutual, membership benefit	583	0.2%	10,262	0.6%	1,667	0.2%
public, societal benefit	21,537	9.0%	149,554	9.2%	43,666	4.9%
religion related	14,989	6.2%	15,932	1.0%	7,163	0.8%
unknown, unclassified	202	0.1%	153	0.0%	52	0.0%

SOURCE: Compiled from Table 8 in Part IV, and *SOI Bulletin, Fall 2004, vol. 24, no.2*, “Charities and Other Tax-Exempt Organizations, 2001”, Figure D, p. 129, with Joint Committee staff calculations.

Of the different types of charitable organizations, in 2001, a small percentage (7.4 percent of organizations filing returns) had assets of \$10 million or more, but this group accounted for 88 percent of total assets and 80 percent of total revenues.<sup>11</sup>

### **Growth of exempt sector (especially the charitable sector)**

In recent years, the exempt sector has grown significantly. As shown in Table 1, above, in 2004, organizations on the IRS Master File of Exempt Organizations recorded 1,540,534 organizations exempt from tax; in 1995, the number was 1,162,810.<sup>12</sup> That is, in the space of

<sup>11</sup> Table 9, Part IV.

<sup>12</sup> This includes organizations in sections 501(c)(1) through (25). Of the organizations described in section 501(c)(3), it does not include churches and other organizations not required to file an

nine years, there were an additional 377,724 exempt organizations, or an increase of 32 percent. In 1976, the number of exempt entities was 756,594, meaning that since 1976 there has been an increase in the number of exempt organizations of 783,940, or more than 100 percent growth in the number of organizations. Organizations described in section 501(c)(3) have experienced a disproportionate share of this growth, increasing in number from 259,523 entities on the IRS Master File in 1976 to 1,010,365 entities in 2004, an increase of 289 percent.

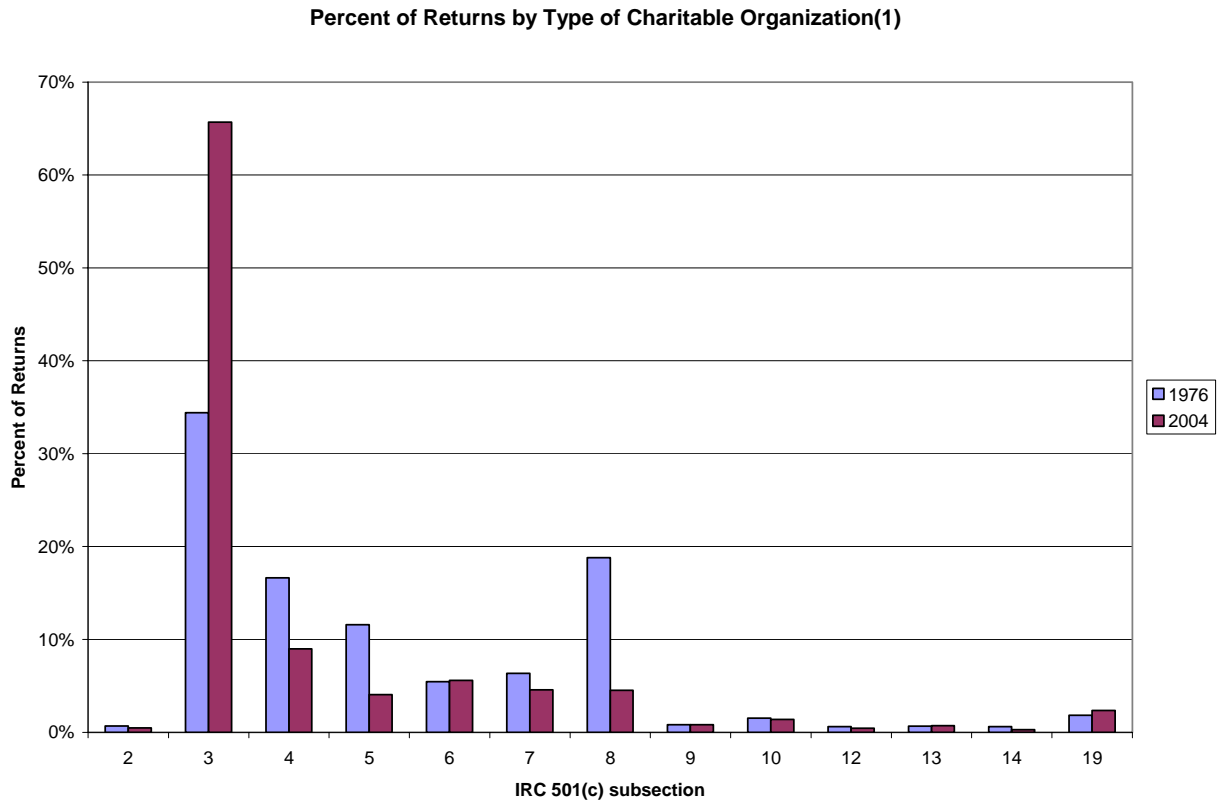
Figure 2 illustrates the growth and increasing concentration of exempt organizations in the charitable sector. It shows the percentage of organizations in several section 501(c) categories on the IRS Master File for 1976 and 2004. Most of the organizations are concentrated in the charitable, fraternal benefit and social welfare categories. The concentration in the charitable sector has increased since 1976.

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application for tax exemption. These numbers differ from the number filing returns because the Master File records those filing for exemption from filing as well as actual filers.



Figure 2



(1) excludes organizations with fewer than one percent of returns

Source: Joint Committee staff calculations based on Table 7 in Part IV.

The growth in the number of entities is reflected in the growth of the total assets and total revenue of the exempt sector. Table 3 shows growth, in returns and inflation-adjusted assets and revenues, for all section 501(c) and 501(c)(3) organizations between 1975 and 2001. In 2001, of all section 501(c) organizations filing returns, total assets were \$2.9 trillion and total revenues were \$1.2 trillion.<sup>13</sup> By contrast, in 1975 in 2001 dollars (adjusted for inflation), total assets of such organizations were \$543 billion and total revenues were \$252 billion. This growth represents roughly a fivefold increase in assets and revenue of 501(c)(3)s from 1975 to 2001.

The growth of section 501(c)(3) organizations in terms of asset size and revenues is similar. In 2001, of all section 501(c)(3) organizations filing returns (e.g., excluding churches but including private foundations), the total asset value was \$2.045 trillion, with total revenues of

<sup>13</sup> See Tables 5 and 6, Part IV for more details. Private foundations in 2001 had total assets of \$455.423 billion and total revenues of about \$45.263 billion.

about \$942 billion. In 1975, using constant, 2001 dollars, the total asset value of such organizations was about \$360 billion with total revenues of about \$155 billion. In percentage terms, the growth in assets since 1975 is 567 percent and the growth in revenues since 1975 is 609 percent.

Table 3.—Growth of Exempt Entities from 1975 to 2001

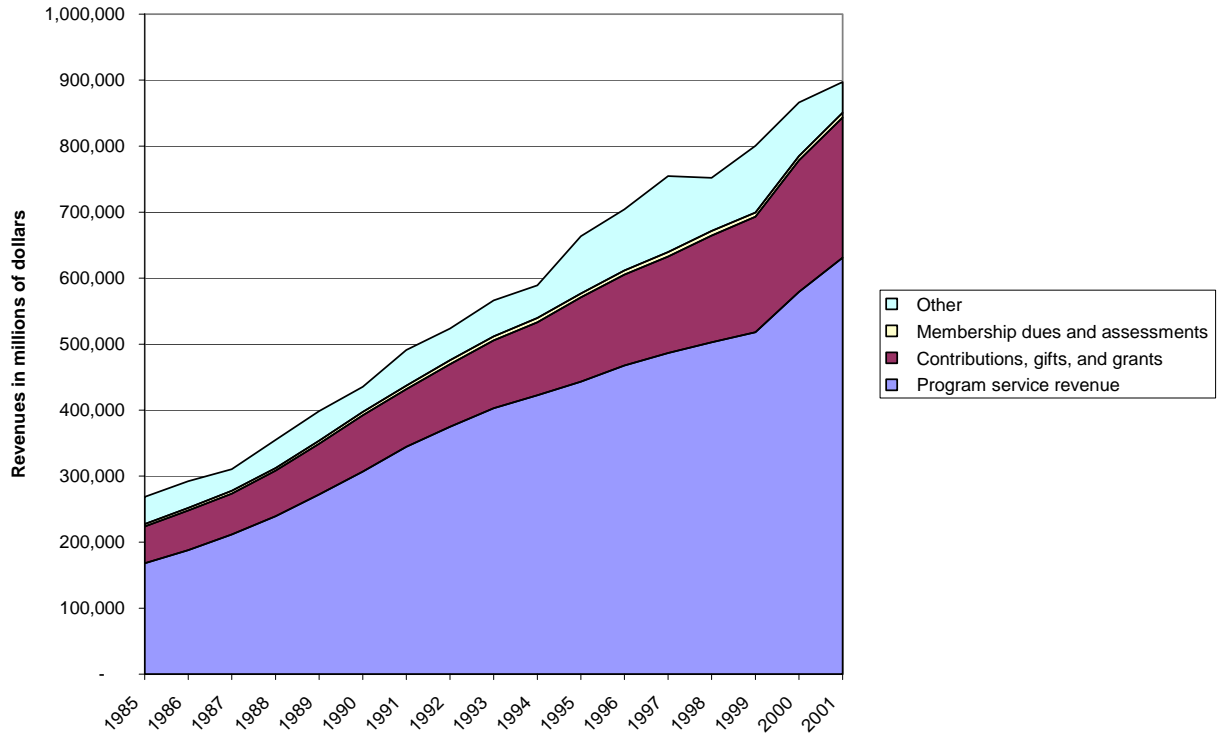
	1975		2001		percent change 1975-2001	
	all 501(c)'s	501(c)(3)'s	all 501(c)'s	501(c)(3)'s	all 501(c)'s	501(c)(3)'s
Number of returns filed	247,086	108,937	455,321	382,143	184%	351%
Total assets (millions)	543,554	360,988	2,879,487	2,045,296	530%	567%
Total revenues (millions)	252,157	154,643	1,231,468	942,238	488%	609%

SOURCE: Joint Committee staff calculations from Tables 5 and 6 in Part IV.

For additional information about the growth of the exempt sector, see Table 5, Part IV, which shows a breakdown of section 501(c)(1)-501(c)(25) organizations in terms of number of organizations, total assets, total liabilities, total revenue, program service revenue, contributions gifts and grants, gross dues and assessments, and total expenses for years 2001 and 1975. Table 6, Part IV shows the growth of section 501(c)(3) organizations (including private foundations) from 1975 to 2001. These tables also show the composition of the revenue sources for charitable organizations, including the size of “program service revenues” relative to other sources of revenues. “Program service revenues” are fees collected for services provided by the tax exempt organization. Such fees include, for example, patient charges levied by tax exempt hospitals, and tuition paid to private, non-profit colleges and universities. Figure 3 shows the composition of revenues to tax exempt entities for 1985 through 2001. Program service revenues are represented by the gray area on the bottom of the graph. As Figure 3 illustrates, most of the growth of revenues in the charitable sector comes from program service revenues. The next, darker gray region, contributions, gifts, and grants, has also grown steadily. In contrast, memberships (the narrow white strip) has barely grown. And “other,” which includes investment income (the light gray area at the top), grew during the stock market bubble of the late 1990s, and contracted with the stock market bust.

Figure 3

Revenue Sources of Charitable Organizations



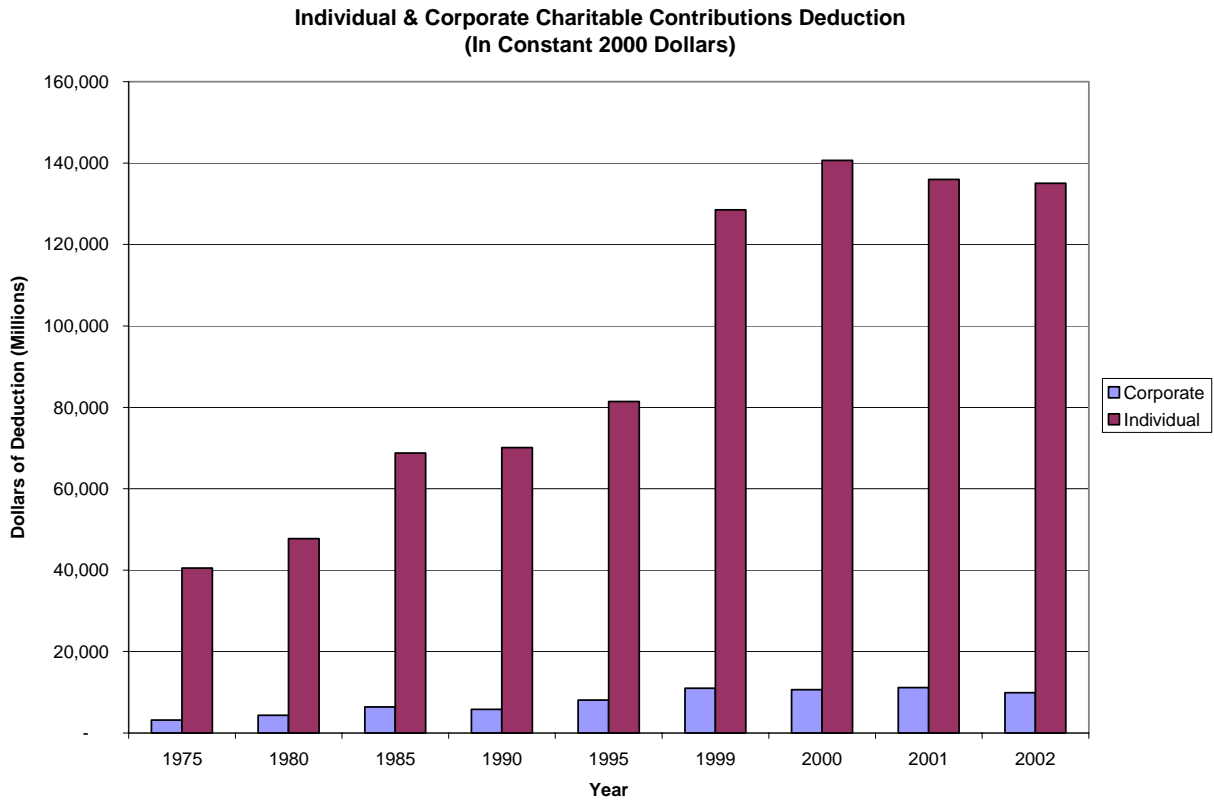
SOURCE: data from [www.irs.gov/taxstats/charitablestats/article0](http://www.irs.gov/taxstats/charitablestats/article0). "Table 16: Nonprofit Charitable Organizations and Domestic Private Foundation Information Returns and Tax-Exempt Organization Business Income Tax Returns: Selected Financial Data, Reporting Years 1985-2001"

### Growth in charitable deductions

The growth in contributions, gifts, and grants to exempt organizations is mirrored by growth in the amount of charitable deductions. As illustrated in Figure 4, in 1975, the total amount claimed (in constant 2000 dollars) as charitable deductions was \$43.664 billion; in 2002, the total amount claimed was \$144.966 billion, or an increase of 232 percent.<sup>14</sup>

<sup>14</sup> See also Table 10, Part IV.

Figure 4



SOURCE: data from Table 10, Part IV.

## B. Reasons for Tax Exemption

In general, the exempt sector has evolved over more than a century's worth of legislation. The first exemptions are found in the Tariff Act of 1894, including exemptions for charitable, religious, and educational organizations and certain fraternal beneficiary societies operating under the lodge system. As recently as 2001, Congress added a new exempt category to the Code.<sup>15</sup> Indeed, of the exempt entities described in Part VI of this pamphlet,<sup>16</sup> 14 exemptions were enacted before 1925,<sup>17</sup> five were enacted between 1926 and 1950,<sup>18</sup> nine were enacted between 1951 and 1975,<sup>19</sup> and 18 were enacted between 1976 and the present.<sup>20</sup> Table 4, beginning on page 31 lists many of the existing exempt entities and shows for each type, the year the exemption was enacted, the number of entities on the IRS Master File in 2004, the nature of its activities, and basic tax treatment. As an initial matter, not all "nonprofit" organizations are afforded tax exemption, and not all tax-exempt organizations have the typical characteristics of a "nonprofit" organization. The term "nonprofit" generally refers to an organization's form under State law,<sup>21</sup> not its Federal tax status. State law generally does not prohibit "nonprofits" from earning a profit, as one might expect. Instead, State law typically prohibits the distribution of

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<sup>15</sup> Sec. 501(c)(28) (the National Railroad Retirement Investment Trust); Pub. L. No. 107-90, 115 Stat. 890 (2001).

<sup>16</sup> This includes a description of the characteristics and legislative history of organizations described in sections 115, 501(c), 501(d), 501(e), 501(f), 501(k), 501(n), 516, 521, 526, 527, 528, and 7871, as well as arrangements to provide employee benefits and arrangements for individuals to save for health, retirement, and education.

<sup>17</sup> This figure includes the following sections of the current Code or precursors to the following sections: 115, 401(a), 501(c)(2), 501(c)(3), 501(c)(4), 501(c)(5), 501(c)(6), 501(c)(8), 501(c)(12), 501(c)(13), 501(c)(15), and 521. Certain of these Code sections (sections 501(c)(12) and 521) contain more than one category of exemption, each of which was added to the Code at a different time within the period.

<sup>18</sup> This figure includes the following sections of the current Code or precursors to the following sections: 501(c)(1), 501(c)(9), 501(c)(11), 501(c)(16), and 501(d).

<sup>19</sup> This figure includes the following sections of the current Code or precursors to the following sections: 408(e), 501(c)(10), 501(c)(14), 501(c)(17), 501(c)(18), 501(c)(19), 501(e), 501(f), and 527. Sections 501(e) and 501(f) each describes a class of entities that qualifies for exemption as charitable organizations under section 501(c)(3).

<sup>20</sup> This figure includes the following sections of the Code: 220, 223, 457(g), 501(c)(20), 501(c)(21), 501(c)(22), 501(c)(23), 501(c)(24), 501(c)(25), 501(c)(26), 501(c)(27), 501(c)(28), 501(k), 501(n), 528, 529, 530, and 7871. Sections 501(k) and 501(n) each describes a class of entities that qualifies for exemption as charitable organizations under section 501(c)(3).

<sup>21</sup> Many States and the District of Columbia have separate corporation law statutes that provide for the establishment of nonprofit, or "non-stock," corporations, i.e., corporations that do not have shareholders, and which may or may not have members.

earnings by nonprofit corporations (but not necessarily by other forms of entities) to their members.

The Federal exemption is extended in some instances to organizations that are not subject to a State-law constraint on distributions, as some entities are not required for exemption purposes to be organized in corporate form. Therefore, exemption may be obtained by some organizations that do not fit the classic definition of “nonprofit.” However, the Federal tax laws applicable to certain types of exempt organizations (though not all) contain prohibitions, such as the “no private inurement” and “no private benefit” doctrines, that are in some respects similar to the State-law constraint. The following brief discussion provides a description of some of the sometimes overlapping factors that may explain exemption for certain types of organizations.<sup>22</sup>

Exemption from tax may be explained based on the nature of an organization’s activities. For example, charitable activities or activities that provide a public benefit may be viewed as governmental in nature and therefore not appropriate subjects of taxation. This may explain the exemption for charitable organizations, social welfare organizations, U.S. instrumentalities, and State and local governments. Promotion of certain activities may also be viewed as desirable policy, and therefore tax exemption is intended to encourage the activity. This may explain the tax exemption for arrangements to provide employee benefits, arrangements for individuals to save for health, retirement, and education, and the exemption for small or rural commercial organizations that engage in certain activities, such as farming, provision of financial services, insurance, electricity, or other public good.

Exempt status may also be attributable to the structure of an organization. Some organizations are funded exclusively by their members and expend all funds exclusively for members. If such an organization collects more in membership dues than it expends, the excess is reinvested in the organization for the benefit of the members. Under general tax principles, the organization may not be considered as having any income because there has not been a shifting of benefit from the member to the organization -- the organization merely facilitates a joint activity of its members. Thus, in some cases, the Code adopts a result that might occur even in the absence of statutory law. This principle is described in 1969 legislative history describing the basis for exemption of social clubs (exempt since 1916).

Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income in pleasure or recreation (or other benefits) without the intervening separate organization.<sup>23</sup>

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<sup>22</sup> For purposes of this discussion, the exempt sector, or exempt entities, when referred to as a group, generally means all of the organizations presently described in section 501(c) plus those other organizations described in Part VI.

<sup>23</sup> S. Rep. No. 91-552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 71 (1969).

Other organizations that may fit this model are fraternal organizations, voluntary employees' beneficiary associations, cemetery companies, and homeowners associations.<sup>24</sup> This principle generally does not extend to exempting nonmember income, such as investment income, from tax. Indeed, the legislative history quoted above was in the context of subjecting the investment income of social clubs to the unrelated business income tax rules. The structure of an organization may also explain in part the exemption for title holding companies, which are required to pay all income to an exempt organization.<sup>25</sup>

Another factor that may explain some cases of tax exemption is the nature of the legislative process. Congress did not provide exemption for all organizations that are not organized for profit; rather, the general rule is that an organization is subject to tax absent a specific exemption.<sup>26</sup> Such a rule means that once broad categories of exemption are codified, there will be specific classes of organizations that do not fit within the broad category that seek and receive exempt status. For example, in 1913, the U.S. Chamber of Commerce sought exemption for "civic or commercial" organizations, which were not covered by previous exemptions,<sup>27</sup> and subsequently social welfare organizations and business leagues became exempt organizations. Labor, agricultural, and horticultural organizations may be another example. Other examples may be cooperative hospital service organizations (sec. 501(e)), cooperative service organizations of operating educational organizations (sec. 501(f)), child care organizations (sec. 501(k)), and charitable risk pools (sec. 501(n)), which are all treated as charitable organizations described within section 501(c)(3) but subject to their own organizational and operational requirements not applicable to other charitable organizations. The effect is that many categories of exempt status are very narrowly tailored to an organization's specific characteristics.<sup>28</sup>

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<sup>24</sup> See secs. 501(c)(8), 501(c)(9), 501(c)(10), 501(c)(13), and 528.

<sup>25</sup> Secs. 501(c)(2) and 501(c)(25). However, other feeder organizations, i.e., organizations that operate a trade or business for profit and pay all profits to an exempt organization, do not qualify as exempt organizations. Sec. 502.

<sup>26</sup> This was not always the case. The first income tax act, the Tariff Act of 1894, 28 Stat. 509, (later held unconstitutional) subjected to tax "corporations, companies, or associations doing business for profit." Nonprofits generally were exempt from the tax (by virtue of not doing business for profit). To the extent the tax applied, exemption was provided for certain organizations, e.g., "corporations, companies or associations organized and conducted solely for charitable, religious, or educational purposes," fraternal beneficiary societies, certain mutual savings banks, and certain mutual insurance companies. The default rule changed in the 1913 Revenue Act, Pub. L. No. 63-16, 38 Stat. 114, under which the corporate income tax generally applied, unless there was a specific exemption.

<sup>27</sup> *Hearings on Tariff Schedules of the Revenue Act of 1913 Before the Subcommittee on the Committee on Finance*, 63d Cong., 1<sup>st</sup> Sess., at 2001 (1913).

<sup>28</sup> See, for example, domestic fraternal beneficiary societies (sec. 501(c)(10)), teachers' retirement funds (sec. 501(c)(11)), corporations to finance crop operations (sec. 501(c)(16)), religious and apostolic organizations (sec. 501(d)), farmers' cooperatives (sec. 521), shipowners' protection and indemnity associations (sec. 526), and homeowners associations (sec. 528), to name a few.

Another factor to consider is simple expediency, in that taxing certain small organizations was viewed at the time the exemption was granted as too costly to administer, especially when often little or no tax would be due. This appears partially to explain the reason for exempting single-parent title holding companies from tax as well as social clubs. As stated in 1916 legislative history: “the securing of returns from them has been a source of annoyance and expense and has resulted in the collection of either no tax or an amount which is practically negligible.”<sup>29</sup>

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<sup>29</sup> H.R. Rep. No. 922, 64<sup>th</sup> Cong., 1<sup>st</sup> Sess. 4 (1916) (referring to “corporations similar to those enumerated in the present law as exempt from taxation”).



**Table 4.—Types and Tax Treatment of Section 501(c) Organizations**

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File in 2004
501(c)(1)	Corporations organized under Act of Congress	1934	U.S. instrumentality	No	Generally No	Only if exclusively for public purposes	No	No	116
501(c)(2)	Title holding corporations	1916	Holding title to property for another exempt organization	Yes	Generally No	No	No	Optional	7144
501(c)(3)	Charitable organizations	1894	Religious, charitable, scientific, educational, etc.	Yes	Generally No (but private foundations are subject to tax on net investment income)	Yes	Yes	Yes (except for certain organizations including churches and small organizations)	1,010,365
501(c)(4)	Social welfare organizations	1913	Promoting the common good and general welfare of people of a community	Yes	Generally No	No	Yes	Optional	138,193
501(c)(5)	Labor, agricultural, and horticultural organizations	1909	Betterment of the conditions of those engaged in labor, education, or horticulture	Yes	Generally No	No	Yes	Optional	62,561

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File in 2004
501(c)(6)	Business leagues, chambers of commerce, trade associations, etc.	1913	Improvement of conditions in one or more lines of business	Yes	Generally No	No	Yes	Optional	86,054
501(c)(7)	Social clubs	1916	Social or recreational	Yes	Yes	No	Yes	Optional	70,422
501(c)(8)	Fraternal beneficiary societies	1894	Fraternal activities and payment of life, sick, accident, or other benefits to members	Yes	Generally No	Only if used for charitable purposes	No	Optional	69,798
501(c)(9)	Voluntary employees' beneficiary associations	1928	Provides for payment of life, sick, accident, or other benefits to members or dependents, etc.	Yes	Yes	No	Yes (except for payments of life, sick, accident or other benefits to members)	Yes	12,866
501(c)(10)	Domestic fraternal societies	1969	Fraternal activities	Yes	Generally No	Only if used for charitable purposes	No	Optional	21,320
501(c)(11)	Teachers' retirement fund associations	1928	Payment of retirement benefits to teachers	Yes	Generally No	No	Yes, generally	Optional	16

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File in 2004
501(c)(12)	Benevolent life insurance associations, rural cooperatives, etc.	1916	Activities of a mutually beneficial nature	Yes	Generally No	No	No	Optional	6,716
501(c)(13)	Cemetery companies	1913	Operation of cemetery company or burial and cremation	Yes	Generally No	Only under certain circumstances (but not for estate and gift tax purposes)	Yes	Optional	10,728
501(c)(14)	State credit unions and mutual reserve funds	1951	Operating credit union for mutual purposes	Yes	Generally No	No	No	Optional	4,289
501(c)(15)	Certain small insurance companies	1916	Providing insurance to members at cost	Yes	Generally No	No	No	Optional	1,988
501(c)(16)	Crop-financing corporations	1928	Financing of crops for section 521 farmers' cooperative marketing associations	Yes	Generally No	No	No	Optional	21

Section of 1986 Code	Description of Organization	Year Exemption was Introduced	General Nature of Activities	Subject to UBIT	Taxed on Investment Income	Contributions Generally Deductible as Charitable Contributions	Subject to Private Inurement Restriction	Required to File Exemption Application	Number of Entities on Master File in 2004
501(c)(17)	Supplemental unemployment benefit trusts	1960	Payment of supplemental unemployment compensation benefits	Yes	Yes	No	No	Yes	462
501(c)(18)	Funded pension trusts	1969	Trust that forms part of a pension plan funded only by employee contributions	Yes	Generally No	No	No	Optional	2
501(c)(19)	Veterans' organizations	1972	Organization of veterans; provision of insurance and other benefits	Yes (but certain insurance premium income excluded from UBTI)	Generally No	Limited to certain organizations of war veterans for income and gift taxes and to organizations incorporated by Act of Congress for estate tax	Yes	Optional	36,141
501(c)(20) (expired for taxable years beginning after June 30, 1992)	Qualified group legal services plans	1976	Provision of legal services benefits	Yes	Yes	No	No	Yes	n.a.
501(c)(21)	Black lung benefits trusts	1977	Provision of black lung benefits	Yes	Generally No	No	No	Optional	33

<b>Section of 1986 Code</b>	<b>Description of Organization</b>	<b>Year Exemption was Introduced</b>	<b>General Nature of Activities</b>	<b>Subject to UBIT</b>	<b>Taxed on Investment Income</b>	<b>Contributions Generally Deductible as Charitable Contributions</b>	<b>Subject to Private Inurement Restriction</b>	<b>Required to File Exemption Application</b>	<b>Number of Entities on Master File in 2004</b>
501(c)(22)	Multiemployer Plan trusts	1980	Payment of withdrawal liability and withdrawal-type payments to plans	Yes	Generally No	No	No	Optional	0
501(c)(23)	Pre-1880 veterans' organizations	1982	Organization of veterans; provision of insurance and other benefits	Yes	Generally No	Limited to certain organizations of war veterans for income gift taxes and to organizations incorporated by Act of Congress for estate tax	No	Optional	2
501(c)(24)	Employee Trusts	1986	Used in efforts to recover from an employer that terminated its pension plan assets sufficient to provide certain plan benefits	Yes	Generally No	No	No	Optional	4
501(c)(25)	Multi parent title holding organizations	1986	Hold title to assets for multiple parent exempt organizations	Yes	Generally No	No	No	Optional	1,285

<b>Section of 1986 Code</b>	<b>Description of Organization</b>	<b>Year Exemption was Introduced</b>	<b>General Nature of Activities</b>	<b>Subject to UBIT</b>	<b>Taxed on Investment Income</b>	<b>Contributions Generally Deductible as Charitable Contributions</b>	<b>Subject to Private Inurement Restriction</b>	<b>Required to File Exemption Application</b>	<b>Number of Entities on Master File in 2004</b>
501(c)(26)	High-risk individuals health care coverage organizations	1996	Coverage of medical care to certain high-risk individuals	Yes	Generally No	No	Yes	Optional	11
501(c)(27)	State-sponsored workmens' compensation insurance organizations	1996	Established by a State to reimburse members for losses arising under the workmens' compensation acts	Yes	Generally No	No	No	Optional	9
501(c)(28)	The National Railroad Investment Trust	2001	Manage and invest certain assets of Railroad Retirement System	Yes	Generally No	No	No	Not determined	n.a.

## C. Common Tax Law Features of Exempt Organizations

### In general

Despite varying standards regarding qualification for exempt status, different categories of exempt organizations share some common characteristics. For example, many types of exempt organizations are subject to a prohibition against “private inurement,” and most exempt organizations are subject to the general rules regarding the taxation of unrelated business income. Contributions to a limited number of exempt organizations are deductible as charitable contributions, while contributions to others may be deductible as a business expense but not as a charitable contribution. Most exempt organizations also are subject to rules regarding lobbying and political campaign activities and are required to file annual information returns. These characteristics, each common to at least two or more categories of exempt organization, are discussed in the following subsections.

### Private inurement prohibition

The doctrine of private inurement generally prohibits an exempt organization from using its assets for the benefit of a person or entity with a close relationship to the organization. The private inurement prohibition applies to the following categories of exempt organizations: charitable organizations (section 501(c)(3));<sup>30</sup> social welfare organizations (section 501(c)(4)); agricultural, horticultural, and labor organizations (section 501(c)(5));<sup>31</sup> business leagues, trade associations, and other organizations exempt from tax under section 501(c)(6); social clubs (section 501(c)(7)); voluntary employees’ beneficiary associations (section 501(c)(9)); teachers’ retirement fund associations (section 501(c)(11)); cemetery companies (section 501(c)(13)); veterans’ organizations (section 501(c)(19)); high-risk individuals health care coverage organizations (501(c)(26)), shipowners’ protection and indemnity associations (sec. 526), and homeowners associations (sec. 528).

Section 501(c)(3) provides that an organization will qualify for charitable exempt status only if “no part of the net earnings [of the organization] inures to the benefit of any private shareholder or individual.” Other sections of the Code describe the inurement prohibition using similar language. The regulations under section 501(a), which generally apply to organizations subject to the inurement proscription, define “private shareholder or individual” as “persons

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<sup>30</sup> Certain organizations are treated as charitable organizations described within section 501(c)(3) but are described elsewhere within section 501, namely cooperative hospital service organizations (sec. 501(e)), cooperative service organizations of operating educational organizations (sec. 501(f)), child care organizations (sec. 501(k)), and charitable risk pools (sec. 501(n)). Such organizations are subject to the private inurement prohibition.

<sup>31</sup> Although section 501(c)(5) of the Code does not state that section 501(c)(5) organizations are subject to the inurement prohibition, the Treasury regulations extend the prohibition to such organizations. Treas. Reg. sec. 1.501(c)(5)-1(a)(1).

having a personal and private interest in the activities of the organization.”<sup>32</sup> Inurement thus applies to transactions between applicable exempt organizations and persons sometimes deemed “insiders” of the organization, such as directors, officers, and key employees. The issue of private inurement often arises where an organization pays unreasonable compensation (i.e., more than the value of the services) to such an insider. However, the inurement prohibition is designed to reach any transaction through which an insider is unduly benefited by an organization, either directly or indirectly.

There is no “de minimis” exception under the inurement prohibition, and an organization that engages in an inurement transaction may face revocation of its exempt status. Until 1996, there was no sanction short of revocation of exempt status in the event of an inurement transaction. In 1996, however, Congress imposed excise taxes, frequently referred to as “intermediate sanctions,” on “excess benefit transactions” between certain exempt organizations and “disqualified persons.”<sup>33</sup> The intermediate sanctions rules, which apply only to transactions involving organizations exempt under sections 501(c)(3) and 501(c)(4), impose excise taxes on a disqualified person who receives an excess benefit and, under certain circumstances, on organization managers who approved the transaction. No such sanctions are presently imposed against the organization itself. The intermediate sanctions rules are discussed in greater detail in Part II.D of this pamphlet.

As is discussed in Part II.B, section 501(c)(3) organizations (but not other organizations) also are subject to a prohibition against conferring more than incidental “private benefit.” The private benefit prohibition applies to non-fair market value transactions with individuals or entities, not merely with insiders, and thus is in some respects broader than the private inurement prohibition.

### **Unrelated business income tax**

In general, an exempt organization may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (e.g., program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization’s unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.<sup>34</sup>

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<sup>32</sup> Treas. Reg. sec. 1.501(a)-1(c).

<sup>33</sup> Disqualified persons essentially are insiders of the organization, including those in a position to exercise substantial influence over the organization, as defined in section 4958.

<sup>34</sup> This is the case for social clubs (sec. 501(c)(7)), voluntary employees’ beneficiary associations (sec. 501(c)(9)), and organizations and trusts described in section 501(c)(17) and 501(c)(20). Sec. 512(a)(3). The investment income of certain non-501(c) and non-401(a) organizations not subject to the general unrelated business income tax rules also is subject to taxation. See, e.g., sec. 527 (political organizations).



As described in Part II.E of this pamphlet, the unrelated business income tax was introduced in 1950 to address the problem of unfair competition between for profit companies and nonprofit organizations conducting an unrelated for profit activity. The unrelated business income tax generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.<sup>35</sup> Most exempt organizations are subject to the tax.<sup>36</sup> An organization that is subject to the unrelated business income tax and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations generally may operate an unrelated trade or business so long as it is not a primary purpose of the organization. Therefore, engaging in a substantial amount of unrelated business activity before jeopardizing exempt status is permitted.<sup>37</sup> By contrast, a charitable organization may not operate an unrelated trade or business as a substantial part of its activities.<sup>38</sup>

Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

For the tax year 2001, 35,540 organizations filed unrelated business income tax returns, reporting a total of \$7.9 billion of gross unrelated business income. This translated into unrelated business taxable income (after taking into account allowable deductions) of

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<sup>35</sup> Secs. 511-514.

<sup>36</sup> Organizations subject to the unrelated business income tax include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2).

<sup>37</sup> Because the exempt purposes of organizations differ, there may be differences in application of the unrelated business income tax rules, in particular, the determination of whether an activity is substantially related to an organization's exempt purposes.

<sup>38</sup> Treas. Reg. sec. 1.501(c)(3)-1(e).

approximately \$792 million and total tax of approximately \$226 million.<sup>39</sup> Section 501(c)(3) organizations accounted for approximately 41.8 percent of the unrelated business income tax returns filed and for approximately 38.2 percent of the total amount of unrelated business income tax paid.<sup>40</sup>

### Debt-financed property

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. For purposes of determining unrelated business income, debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by qualified organizations (certain educational organizations and pension plans) to acquire or improve real property. Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed income-producing property. An exempt organization's share of partnership income that is derived from such debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

### Treatment of income from controlled entities

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary, and generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary). Interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the

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<sup>39</sup> See Table 6, Part IV; IRS Statistics of Income Division, *Unrelated Business Income Tax Returns, Tax Year 2001*, Winter 2005, at 59.

<sup>40</sup> IRS Statistics of Income Division, *Unrelated Business Income Tax Returns, Tax Year 2001*, Winter 2005, at 61, 80.

latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

## **Contributions**

Another feature of a minority of tax-exempt organizations is that contributions to such organizations may be deductible by the donor as charitable contributions for income, estate, and gift tax purposes. Contributions to charitable organizations, for example, generally are deductible for income, estate, and gift tax purposes, although the amount of deduction may be affected by such factors as the recipient organization's classification as a public charity or private foundation (discussed in Part II.D of this pamphlet) and the type of property contributed.<sup>41</sup> Other types of organizations that are eligible recipients of charitable contributions include: certain Federal, State, and local government entities, if the contribution is exclusively for public purposes; certain fraternal beneficiary societies, if the contributions are used for charitable purposes; cemetery companies, if the contributions are used for certain purposes; and certain organizations of war veterans.<sup>42</sup>

Contributions to other types of exempt organizations generally are not deductible as charitable contributions. Under certain circumstances, however, contributions to a membership organization, such as a social welfare organization or trade association, may be deductible as a business expense under section 162. In addition, contributions to tax-exempt employee benefit arrangements (e.g., qualified retirement plans) or individual savings arrangements (such as individual retirement accounts) may be deductible.

## **Lobbying and political activities**

Tax-exempt organizations are also subject to rules regarding the permissible level of lobbying and political campaign activities. In general, the lobbying and political activity rules applicable to charitable organizations are more severe than the rules applicable to other types of exempt organizations.

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<sup>41</sup> For a contribution to a charitable organization to be deductible as a charitable contribution for income tax purposes, the contribution must be made to an organization "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States." Sec. 170(c)(2)(A). No such limitation applies under the estate and gift tax rules. See secs. 2055(a)(2) and 2522(a)(2).

<sup>42</sup> Sec. 170(c). Certain contributions to cemetery companies are deductible for income tax purposes, but not for estate or gift tax purposes. Otherwise, the categories of eligible recipients of deductible charitable contributions are largely coextensive for income, estate, and gift tax purposes. See secs. 170(c), 2055(a), and 2522(a).

Charitable organizations may engage in only a limited amount of lobbying.<sup>43</sup> The two alternate tests for determining whether a charitable organization has engaged in excess lobbying are described in Part II.B of this pamphlet. Other types of exempt organizations, however, generally are not limited in their lobbying activities, so long as the lobbying is related to exempt purposes.

Charitable organizations are subject to an absolute prohibition on political campaign activity, which is defined as “participat[ing] in, or interven[ing] in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”<sup>44</sup> Other exempt organizations generally may engage in political campaign activities so long as such activity is not a primary activity of the organization. Certain expenditures for political activities may, however, cause an organization to be subject to tax on such expenditures.<sup>45</sup>

As is discussed above, contributions to many types of organizations exempt from tax under section 501(c) are not deductible as charitable contributions. However, a section 162 business expense deduction may be available for some payments to section 501(c) organizations, such as payment of membership dues to tax-exempt business leagues. Because a business expense deduction is not allowed for certain lobbying and political expenditures,<sup>46</sup> present law provides a mechanism to prevent the deduction of any portion of membership dues that is allocable to nondeductible lobbying expenses. Accordingly, exempt organizations<sup>47</sup> (but not section 501(c)(3) organizations) generally are required to provide annual information disclosure to members (sometimes referred to as “flow-through information disclosure”) estimating the portion of their dues allocable to non-deductible lobbying activities. A member receiving such disclosure is not permitted a deduction for such portion of dues. If an organization does not provide flow-through information disclosure (by its election or otherwise), the organization is subject to a proxy tax based on the amount of the organization’s non-deductible lobbying expenditures.<sup>48</sup>

Flow-through information disclosure is not required for an organization that (1) incurs only a de minimis amount (i.e., \$2,000 or less) of in-house political campaign and lobbying expenditures during the taxable year or (2) establishes pursuant to Treasury Department rules

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<sup>43</sup> Lobbying activities of charitable private foundations constitute prohibited “taxable expenditures.” See Part II.D.

<sup>44</sup> Sec. 501(c)(3).

<sup>45</sup> Sec. 527(f).

<sup>46</sup> Sec. 162(e).

<sup>47</sup> This includes any organization exempt from tax under section 501 (other than a section 501(c)(3) organization).

<sup>48</sup> Sec. 6033(e).

that substantially all of its dues monies are paid by members not entitled to deduct such dues in computing their taxable income.

### **Information returns**

Exempt organizations are required to file an annual information return, stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe.<sup>49</sup> The requirement that an exempt organization file an annual information return does not apply to certain exempt organizations, including organizations (other than private foundations) the gross receipts of which in each taxable year normally are not more than \$25,000. Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain state institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.<sup>50</sup>

Section 501(c)(3) organizations that are classified as public charities must file Form 990 (Return of Organization Exempt From Income Tax)<sup>51</sup> and an additional form, Schedule A, which requests information specific to section 501(c)(3) organizations. An organization that is required to file an information return, but that has gross receipts of less than \$100,000 during its taxable year, and total assets of less than \$250,000 at the end of its taxable year, may file Form 990-EZ. Private foundations are required to file Form 990-PF rather than Form 990.<sup>52</sup>

On the applicable annual information return, organizations are required to report their gross income, information on their finances, functional expenses, compensation, activities, and other information required by the IRS in order to review the organization's activities and operations during the previous taxable year and to review whether the organization continues to meet the statutory requirements for exemption. Examples of the information required by Form 990 include: (1) a statement of program accomplishments; (2) a description of the relationship of

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<sup>49</sup> Sec. 6033(a). An organization that has not received a determination of its tax-exempt status, but that claims tax-exempt status under section 501(a), is subject to the same annual reporting requirements and exceptions as organizations that have received a tax-exemption determination.

<sup>50</sup> Sec. 6033(a)(2)(A); Treas. Reg. secs. 1.6033-2(a)(2)(i) and (g)(1).

<sup>51</sup> Social welfare organizations, labor organizations, agricultural organizations, horticultural organizations, and business leagues are subject to the generally applicable Form 990, Form 990-EZ, and Form 990-T annual filing requirements.

<sup>52</sup> Form 990-PF requires, among other things, reporting of: the foundation's gross income for the year; expenses attributable to such income; disbursements for exempt purposes; total contributions and gifts received and the names of all substantial contributors; names, addresses, and compensation of officers and directors; an itemized statement of securities and other assets held at the close of the year; an itemized statement of all grants made or approved; and information about whether the organization has complied with the restrictions applicable to private foundations (secs. 4941 through 4945).

the organization's activities to the accomplishment of the organization's exempt purposes; (3) a description of payments to individuals, including compensation to officers and directors, highly paid employees and contractors, grants, and certain insider transactions and loans; and (4) disclosure of certain activities, such as expenses of conferences and conventions, political expenditures, compliance with public inspection requirements, and lobbying activities. The IRS currently is revising Form 990.

## II. HISTORY AND EVOLUTION OF THE EXEMPT STATUS OF SECTION 501(C)(3) ORGANIZATIONS

### A. In General

The charitable sector<sup>53</sup> (i.e., organizations described in section 501(c)(3)) is a significant part of the national economy. As noted above, relative to gross domestic product, in 2001, the total revenue of charitable organizations (including private foundations but not including churches and other organizations not required to file) was 9.3 percent.<sup>54</sup> In 2001, of all section 501(c)(3) organizations filing returns (e.g., excluding churches but including private foundations), the total asset value was \$2.045 trillion, with total revenues of about \$942 billion.<sup>55</sup> In 2004, the number of section 501(c)(3) organizations was 1,010,365.<sup>56</sup> With respect to the charitable contribution deduction, it is estimated to benefit taxpayers through tax savings of \$228 billion over fiscal years 2005-2009.<sup>57</sup> In 2002, the total amount claimed as a charitable deduction was about \$145 billion.<sup>58</sup>

In general, the requirements for exempt status of an organization under section 501(c)(3) of the Code are that (1) the organization must be organized and operated exclusively for certain purposes; (2) there must not be private inurement to organization insiders; (3) there must be no more than an incidental private benefit to private persons who are not organization insiders; (4) no substantial part of the organization's activities may be lobbying; and (5) the organization may not participate or intervene in political activities. Permitted purposes are religious, charitable, scientific, testing for public safety, literary, educational, the fostering of national or international amateur sports competition, or the prevention of cruelty to children or animals. Failure to satisfy any of these requirements should result in an organization not qualifying for exempt status under section 501(c)(3), or should result in a loss of such status once a violation is detected by the IRS. Most of the Federal law of charitable organizations is designed around ensuring that each of the requirements is satisfied by an organization initially and on an ongoing basis. Each of the requirements is simple to state, but none are simple, as each carries with it a significant body of statutory, common, and administrative law.

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<sup>53</sup> The word "charitable" generally is used in this pamphlet to include any of the purposes described in section 501(c)(3), e.g., religious, educational, scientific, and other.

<sup>54</sup> Joint Committee staff calculation based on information in Table 6, and Gross Domestic Product data from *Economic Report of the President*, February 2005, U.S. GPO, Table B-1.

<sup>55</sup> Joint Committee staff calculations from Tables 5 and 6, Part IV.

<sup>56</sup> Table 7, Part IV.

<sup>57</sup> See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCS-1-05), January 12, 2005.

<sup>58</sup> Table 10, Part IV.

If an organization satisfies each of the requirements, there is a further question of what type of charitable organization it is. A section 501(c)(3) organization is either a public charity or a private foundation. In general, the basis for distinguishing between public charities and private foundations is the level of public support an organization receives over time. Organizations with widespread public support tend to qualify as public charities; organizations funded by just a few donors tend to be classified as private foundations. There is a substantial body of law detailing how to determine whether an organization is publicly supported.<sup>59</sup> Certain organizations also may qualify as public charities as a matter of law (e.g., churches, hospitals). The classification matters because private foundations generally are subject to more restrictions on their activities than are public charities, are subject to tax on their net investment income, and contributions to private foundations generally do not receive as favorable treatment as do contributions to public charities for purposes of the charitable contribution deduction.

Satisfaction of the requirements for exemption, classification of an organization as a public charity or private foundation, plus the resulting benefit that contributions to charitable organizations generally are tax deductible provides the simplest snapshot of the law of charitable organizations.

The statutory law regarding the threshold requirements for the income tax exemption of charitable organizations is longstanding and has developed as follows:

- **1894** – The Tariff Act of 1894 provided the first statutory Federal income tax exemption for charitable organizations: “nothing herein contained shall apply to ... corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes.”
- **1909** – The Payne Aldrich Tariff Act of 1909 exempted from a general corporate excise tax “any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.”
- **1913** – The Tariff Act of 1913 exempted from Federal income tax “any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private shareholder or individual.” Compared to the 1909 excise tax exemption, this income tax exemption included corporations organized for scientific purposes.

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<sup>59</sup> As explained in greater detail in Part II.D, an organization may qualify as publicly supported under either of two sections of the Code: section 509(a)(1) or section 509(a)(2). An organization generally will satisfy the requirements of section 509(a)(1) if it receives at least one-third of its support from governmental units and the general public, or, failing this mechanical test, if it satisfies a “facts and circumstances” test. Treas. Reg. sec. 1.170A-9(e)(2) and (3). Section 509(a)(2) generally extends public charity status to organizations that receive extensive public support through the operation of trades of businesses that are related to such organizations’ exempt purposes, as well as from contributions, grants and the like. Certain other organizations qualify for public charity status regardless of whether they meet one of the above-described public support tests. See secs. 509(a)(1) and 170(b)(1)(a)(i) through (v); sec. 509(a)(3); sec. 509(a)(4).



- **1918** – The Revenue Act of 1918 expanded the list of charitable purposes to include the prevention of cruelty to children or animals.
- **1921** – The Revenue Act of 1921 expanded the type of organizations eligible for exemption to include any community chest, fund, or foundation, and added literary purposes to the list of exempt purposes.
- **1934** – The Revenue Act of 1934 added the requirement that no substantial part of an organization’s activities may be lobbying (i.e., the carrying on of “propaganda” or “attempting to influence legislation”).
- **1954** – The Revenue Code of 1954 added the requirement that charitable organizations may not participate or intervene in political activity. The Act also added testing for public safety as an exempt purpose.
- **1969** – The Tax Reform Act of 1969 codified the distinction between public charities and private foundations and imposed a series of excise taxes on private foundations.
- **1976** – The Tax Reform Act of 1976 established an elective standard for determining whether a public charity’s lobbying activities were permitted and imposed excise taxes on excess lobbying activities. The Act also added the fostering of national or international amateur sports competition as an exempt purpose.
- **1987** – The Revenue Act of 1987 imposed excise taxes on the lobbying activities of public charities and clarified that political campaign activities may not be conducted “in opposition to” a candidate.
- **1996** – The Taxpayer Bill of Rights 2 of 1996 imposed excise taxes on “excess benefit transactions” between a charitable organization and an insider of the organization.

To summarize the major provisions: the initial statutory income tax exemption of 1913 included religious, charitable, scientific, and educational purposes, and also contained the prohibition on private inurement. The lobbying restriction originated in 1934, and the ban on political activity was introduced in 1954, each of which was supplemented with an excise tax regime in 1976 and 1987 respectively. The present law classification of public charities and private foundations and the stricter regulation of private foundations occurred in 1969,<sup>60</sup> and taxes on insider transactions involving public charities were enacted in 1996. There are numerous other Code sections that affect charitable organizations that are not detailed above. The most significant are the charitable contribution deduction, which first appeared in 1917 for contributions to organizations and associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals; and the rules imposing taxation on the unrelated business income of exempt organizations (including charitable organizations), which were introduced in 1950.

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<sup>60</sup> As discussed in Part II.D, prior to 1969 foundations were distinguished from other charities, but it was the 1969 Act that codified the distinction.

## **B. Summary of Threshold Requirements of Charitable Status**

### **In general**

The threshold requirements for exempt status can be broken down into three categories. The first category concerns whether the organization and operation of an organization is exclusively for exempt purposes. This requirement addresses whether and to what extent an organization's activities further exempt purposes. Read in conjunction with the meaning of a charitable purpose, a narrow or broad reading of the operational test helps to define the scope of the charitable sector. The organizational test also sets structural limits on an organization, including that the organization's assets be dedicated to charity in perpetuity. The second category concerns the use of a charitable organization's assets to benefit private parties, i.e., the "private inurement" and "private benefit" doctrines. These are designed to ensure that charitable funds are used exclusively to further public (or charitable) purposes and not private ends. The third category concerns the politics-related activities of lobbying and electoral activity. Although the historical rationale for these rules is less clear, their longstanding pedigree has established the policy of strict limits on a charitable organization's activities in the political process. Failure to satisfy any of the requirements may result in loss of tax exemption. In addition to satisfying each of the statutory and regulatory requirements, the courts have held that an organization's purpose must not be contrary to public policy.<sup>61</sup>

### **Organized and operated test -- present law**

#### In general

By statute, an organization qualifies as charitable only if it is organized and operated exclusively for exempt purposes. The regulations require in addition that an organization serve a public rather than a private interest.<sup>62</sup>

#### Organizational test

Satisfaction of the organizational test may be achieved by adopting certain formal requirements in the founding documents of the organization. For example, an organization must limit its purposes to one or more exempt purposes and must not be permitted to engage in activities that do not further exempt purposes (except to an insubstantial extent). Thus, a charitable organization may not have something noncharitable as its purpose.<sup>63</sup> For example, an organization empowered "to engage in a manufacturing business" does not meet the organizational test, regardless of the fact that the articles of incorporation state the organization

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<sup>61</sup> See, e.g., *Bob Jones University v. United States*, 461 U.S. 574, 595 (1983).

<sup>62</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii) and (iii).

<sup>63</sup> This is so even if the organization's operations are consistent with charitable purposes. Treas. Reg. sec. 1.501(c)(3)-1(b)(1)(iv).

is created for charitable purposes.<sup>64</sup> In addition, the organizational documents generally must prohibit violation of the lobbying and legislative prohibitions, and must provide that the organization's assets are dedicated to an exempt purpose in perpetuity.<sup>65</sup> An organization's assets are considered dedicated to an exempt purpose if, for example, upon dissolution, such assets are distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose.<sup>66</sup> An organization fails the organizational test if its articles of organization empower it to engage in activities that characterize it as an "action" organization, e.g., if its primary purpose may be accomplished only by legislation and it advocates for such aim.

### Operational test

The operational test generally requires that an organization operate consistent with the requirements of the Code, i.e., the private inurement, lobbying, and political activities rules must be adhered to in the organization's operations.<sup>67</sup> Violation of such requirements means an organization fails the operational test, is therefore not operated exclusively for charitable purposes, and should lose tax-exempt status.

Exclusively operated for exempt purposes -- the primary purpose test.—The operational test enforces and explicates the Code requirement that an organization be operated exclusively for exempt purposes. Under Treasury regulations, an organization is regarded as operating exclusively for exempt purposes "only if it engages *primarily* in activities which accomplish" exempt purposes.<sup>68</sup> "An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."<sup>69</sup> Thus, under the regulations, "exclusively" is not given its common sense meaning of "solely" but rather is construed as "primarily," with the result that an organization may to a certain extent be operated for nonexempt purposes.<sup>70</sup> In other words, the law expressly permits a charitable organization to conduct activities that do not accomplish exempt purposes, so long as such activities are not substantial. In addition, as held by the Supreme Court, "the presence of a single [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or

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<sup>64</sup> Treas. Reg. sec. 1.501(c)(3)-1(b)(1)(iii).

<sup>65</sup> See Treas. Reg. sec. 1.501(c)(3)-1(b)(3) and (4).

<sup>66</sup> Treas. Reg. sec. 1.501-1(b)(4).

<sup>67</sup> See Treas. Reg. sec. 1.501(c)(3)-1(c).

<sup>68</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(1) (emphasis added).

<sup>69</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

<sup>70</sup> As a practical matter, if "exclusively" were construed by regulations in its ordinary sense, an organization would not be permitted to engage in unrelated business income tax activities, rendering the unrelated business income tax rules moot.

importance of truly [exempt] purposes.”<sup>71</sup> Applying this test, the Court held that an organization with an “important” nonexempt purpose was subject to tax. Thus, under the regulation, insubstantial nonexempt activities are consistent with exempt status, and, under the Court’s holding, nonsubstantial nonexempt purposes are consistent with exempt status.

Application of the primary purpose test.—Neither the Code nor regulations provide a clear standard for determining the existence or nonexistence of a substantial nonexempt purpose. In the absence of bright line rules, the courts have applied a facts and circumstances approach. According to the Tax Court, “[f]actors such as the particular manner in which an organization’s activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence of a forbidden predominant purpose.”<sup>72</sup>

In applying the primary purpose test, however, it is “the purpose towards which an organization’s activities are directed, and not the nature of the activities themselves, [that are] ultimately dispositive.”<sup>73</sup> The test’s goal is to identify the charity’s primary purposes. In other words, an activity may be commercial in nature and still further exempt purposes. Thus, an organization may have a trade or business as its primary activity and be a charitable organization so long as the trade or business accomplishes exempt purposes.<sup>74</sup> The regulations expressly permit an organization to operate a trade or business as a substantial part of its activities so long as the operation of such trade or business is in furtherance of exempt purposes and the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.<sup>75</sup>

The analysis of whether activities further exempt purposes can be problematic. Because an activity can further both an exempt and a nonexempt purpose, focusing solely on the nature of the activity without asking how that activity is related to the charity’s purpose can lead to erroneous results.<sup>76</sup> For example, the provision of legal services generally is not an exempt

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<sup>71</sup> *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945).

<sup>72</sup> *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 358 (1978); see also *Fides Publishing v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967) (holding that an independent, profit-making publisher of specialized literature was operated for a business purpose); see also *Washington Research Foundation v. Commissioner*, T.C. Memo 1985-570 (upholding revocation of educational organization’s exemption because it failed to show it would not compete with commercial firms); compare *Peoples Translation Service/Newsfront Int’l v. Commissioner*, 72 T.C. 42, 49 (1979) (setting rates below cost distinguished organization from organizations denied exempt status).

<sup>73</sup> *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. at 356.

<sup>74</sup> Under the Code an organization may not have as its primary purpose the conduct of a trade or business for profit, even if the entire proceeds from the business are dedicated to charitable purposes. Sec. 502.

<sup>75</sup> Treas. Reg. sec. 1.501(c)(3)-1(e)(1).

<sup>76</sup> *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. at 357.

activity; however, the provision of free legal services for residents of economically depressed communities accomplishes an exempt activity, notwithstanding the fact that the charitable organization subsidizes the services through salaries to the attorneys performing the services. The IRS stated that “[t]he fact that the recipients of the organization’s financial assistance, the legal interns, are not themselves members of a charitable class does not mean the organization is not operating primarily for charitable purposes. The interns are merely the instruments by which the charitable purposes are accomplished.”<sup>77</sup> Thus, although the performance of the activity of the organization (legal services) directly benefited noncharitable beneficiaries (the attorney), the primary purpose of the organization was to provide free legal services to the disadvantaged and the organization’s primary purpose was found to be charitable.

Commerciality doctrine.—If an organization conducts a trade or business that is not related to exempt purposes, the question under the operational test is whether such activity is substantial. If so, then the organization should lose exempt status under what generally is known as the commerciality doctrine.<sup>78</sup> Under the commerciality doctrine, exempt status is denied if unrelated trade or business activities are substantial in relation to charitable activities because a primary purpose of the organization is unrelated commercial pursuits. However, as a practical matter, the fact that there is a tax on the unrelated business income of charities has the effect of condoning the conduct of substantial unrelated commercial activity, making enforcement of the commerciality doctrine a test for substantiality, which is a difficult inquiry. The commerciality doctrine generally will be invoked in cases where the organization pays no unrelated business income tax on clearly substantial commercial activity, and therefore the organization “looked” more like a for profit enterprise than a charitable one.<sup>79</sup> For example, the IRS and courts have

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<sup>77</sup> Rev. Rul. 72-559, 1972-2 C.B. 247. Similarly, student loan organizations may qualify for exemption despite the fact that lending activities traditionally are commercial. See Rev. Rul. 61-87, 1961-1 C.B. 191 (holding that an organization’s purpose of helping students attain an education is a charitable purpose, and the mere fact that interest is charged on loans is not sufficient, of itself, to deny exemption).

<sup>78</sup> This doctrine originated in 1924 in the Supreme Court decision *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).

<sup>79</sup> See, e.g., *Living Faith, Inc. v. Commissioner*, 950 F.2d 365, 373-74 (7<sup>th</sup> Cir. 1991) (holding that activities of organization whose primary activity consists of operating restaurants and food stores, were “presumptively commercial”); *Federation Pharmacy Services, Inc. v. Commissioner*, 625 F.2d 804, 808 (8<sup>th</sup> Cir. 1980) (holding that pharmaceutical service did not qualify as tax-exempt because it relied financially on sale of prescription drugs to public with no accommodation made for those unable to pay and that, consequently, it was engaged in competition with for-profit pharmacies); *Fides Publishers Association v. United States*, 263 F. Supp. 924, 936 (N.D. Ind. 1967) (holding that publisher of specialized literature designed to promulgate the “Catholic Action” movement operated for a business purpose so as to disqualify it from exemption). As one commentator points out, the IRS tends to argue cases as either raising an exemption issue under the commerciality doctrine or an unrelated business income tax issue, but the intersection of the two issues generally is not considered. John D. Colombo, *Commercial Activity and the Charitable Tax Exemption*, 44 William & Mary L. Rev. 487, 508 (2002).

invoked the commerciality doctrine to revoke the exempt status of organizations with substantial commercial publishing activities.<sup>80</sup>

Nonetheless, to avoid the possible application of the commerciality doctrine to substantial unrelated business activities (and for other reasons), some charitable organizations establish subsidiary corporations to conduct an unrelated activity. The IRS generally recognizes the separate identity of the corporate form<sup>81</sup> and thus, in general, the unrelated activities of the (often taxable) subsidiary will not be imputed to the charitable parent organization. By using a taxable subsidiary, a charitable organization generally can avoid application of the primary purpose test to the activities of its subsidiary. Special rules exist on treatment of payments from a subsidiary to a charitable parent.<sup>82</sup>

Dissolution of an exempt organization.—Under the organizational test, a charitable organization must pledge to distribute its assets for exempt purposes upon dissolution. However, unlike other organizational requirements, there is in effect no enforcement mechanism of this requirement, at least with respect to public charities, if it is violated in an organization’s operations.<sup>83</sup> Although the operational test affects distributions resulting in private inurement, and so could impact a dissolution of assets where private inurement results, even so, the remedy would be to revoke exempt status, an implausible penalty to levy against an organization that already has relinquished or intends to relinquish exempt status. Although the revocation could in some cases be retroactive to dissolution, recovery of any past taxes due would be unlikely.

### **Prohibition against private inurement and private benefit**

#### In general

As discussed above, charitable organizations may not permit private benefit or private inurement. Private benefit occurs if the assets or revenues of the exempt organization are used to benefit an individual or entity more than incidentally. Inurement, a narrower concept, arises whenever a person in a position to influence the decisions of an exempt organization (i.e., an “insider” of the organization) receives benefits from the organization disproportionate to her

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<sup>80</sup> *Scripture Press Foundation v. United States*, 285 F.2d 800 (Ct. Cl. 1961) (holding that an organization that prepared and sold religious literature was not operated primarily for charitable purposes and was nothing more than a for-profit publisher. The court found that expenditures on educational activities were “unaccountably small” in comparison to the surplus revenues accumulated annually.); see also *Presbyterian & Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070, 1090 (1982), *rev’d*, 743 F.2d 148 (3d Cir. 1984).

<sup>81</sup> *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943).

<sup>82</sup> Sec. 512(b)(13).

<sup>83</sup> Private foundations, unlike public charities, are subject to a tax on termination of the foundation unless the dedication of assets requirement is met. Sec. 507.

contribution to the organization (e.g., unreasonable compensation).<sup>84</sup> The relationship between inurement and private benefit was clarified by the Tax Court in *American Campaign Academy v. Commissioner*.<sup>85</sup> There, the court explained that “while the prohibitions against private inurement and private benefit[] share common and overlapping elements, the two are distinct requirements which must independently be satisfied.”<sup>86</sup> The court stated that the presence of private inurement violates both prohibitions, but the absence of inurement does not mean the absence of private benefit. Inurement, then, may be viewed as a subset of private benefit. This relationship between private inurement and private benefit is important because in situations in which an individual does not rise to the level of insider within an organization, the IRS still would apply a private benefit analysis to the individual’s relationship with the organization.

Both private inurement and private benefit may occur in many different forms, including, for example, excessive compensation;<sup>87</sup> payment of excessive rent;<sup>88</sup> receipt of less than fair market value in sales or exchanges of property;<sup>89</sup> inadequately secured loans;<sup>90</sup> other questionable loans;<sup>91</sup> joint venture activities;<sup>92</sup> or conversion transactions.<sup>93</sup>

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<sup>84</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(2). For purposes of section 501, Treas. Reg. sec. 1.501(a)-1(c) defines a “private shareholder or individual” as persons having a personal and private interest in the activities of the organization.

<sup>85</sup> 92 T.C. 1053 (1989).

<sup>86</sup> *Id.* at 1068-69 (internal citations omitted).

<sup>87</sup> *Harding Hospital, Inc. v. United States*, 505 F.2d 1068, 1072 (6th Cir. 1974).

<sup>88</sup> *Texas Trade School v. Commissioner*, 30 T.C. 642 (1958), *aff’d*, 272 F.2d 168 (5th Cir. 1959).

<sup>89</sup> *Sonora Community Hospital v. Commissioner*, 46 T.C. 519, 526 (1966).

<sup>90</sup> *Lowery Hospital Association v. Commissioner*, 66 T.C. 850, 858-59 (1976).

<sup>91</sup> *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970).

<sup>92</sup> Although charitable organizations are not prohibited from entering into joint ventures, the presence of a for-profit partner may raise private inurement and private benefit issues. *Redlands Surgical Services v. Commissioner*, 113 T.C. 47, 74-75 (1999), *aff’d*, 242 F.3d 904 (9th Cir. 2001).

<sup>93</sup> Some charitable organizations, especially in recent years hospitals and other health care providers, convert from charitable to for-profit status, resulting in significant amounts of charitable assets being converted to for-profit uses. Private benefit and private inurement can occur during the conversion process if charitable assets are transferred for below fair market value. See Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 *Indiana L. J.* 937, 962-63 (Fall 2004) (“[c]ommunities have been worrying about behind-closed-doors sales of nonprofit hospital assets: the community might be short-changed either in the amount paid for the assets (and hence the funds available for future charity) or in the quality and price of future for-profit hospital services”).

### History of the proscription on private inurement and private benefit

In general, throughout the history of the corporation income tax, Congress has confined exemption to organizations that in legal structure and operation are basically nonprofit in character in the sense that they are neither organized nor operated for pecuniary gain of stockholders or others standing in relationship to the organizations as investors for private gain, nor for the economic benefit of any individual, other than through the proper performance of functions characteristic of the particular class of organizations for which exemption is provided.

The private inurement clause of section 501(c)(3) dates to the Corporation Excise Tax Act of 1909.<sup>94</sup> The legislative history shows that the language was added to provide assurance that the exemption for charities was limited only to those institutions that have no element of personal gain and that are exclusively devoted to exempt purposes.<sup>95</sup> The inurement clause in the charity exemption provisions of the 1909 Act was repeated in each of the subsequent major income, estate and gift tax charity provisions.<sup>96</sup>

Conceptually, the private benefit doctrine is implicit in the charitable exemption as part of the requirement that an organization operate exclusively for exempt purposes. When an organization operates 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, the organization by definition does not operate exclusively for exempt purposes.<sup>97</sup> The proscription against private benefit corresponds to a similar proscription in the law of charitable trusts providing that “[a] trust is not a charitable trust if the property or the income therefrom is to be devoted to a private use.”<sup>98</sup>

### Private inurement

The inurement prohibition, although stated in terms of the net earnings of an organization, applies to any of an organization’s charitable assets and is not limited to the net profits shown on the books of the organization or the surplus of gross receipts over disbursements.<sup>99</sup> Similarly, net earnings may inure to the benefit of an individual in ways other

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<sup>94</sup> Corporation Excise Tax Act of 1909, ch. 6, sec. 38, 36 Stat. 11 (1909).

<sup>95</sup> 44 Cong. Rec. 4150 (1909) (remarks of Sen. Bacon)

<sup>96</sup> For example, the 1913 Act provided an exemption from taxation for any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, “no part of the net income of which inures to the benefit of any private stockholder or individual.” 38 Stat. 172 (1913). The Revenue Act of 1918 altered the “no part of the net income” language in the inurement provision to read “no part of the net earnings.” The private inurement clause also was incorporated in other exemption provisions. See Part I.C.

<sup>97</sup> *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1065-66 (1989).

<sup>98</sup> Restatement (Second) of Trusts sec. 376 (1959).

<sup>99</sup> *Harding Hospital, Inc. v. United States*, 505 F.2d 1068, 1072 (6th Cir. 1974).



than through the distribution of dividends.<sup>100</sup> Inurement may be found even though the amounts involved are small or de minimis.<sup>101</sup> Although insiders are subject to the inurement proscription, economic dealings between such individuals and the related organization are permitted. For example, the payment of reasonable compensation to officers or employees is permitted.<sup>102</sup>

Historically, the only sanction for a private inurement violation was the revocation of the organization's tax exemption. The intermediate sanctions rules enacted in 1996, however, provide a sanction short of revocation of tax exemption for cases of private inurement. In general, these rules allow the IRS to impose an excise tax on insiders who improperly benefit from transactions with charitable organizations (and social welfare organizations) and on organization managers.<sup>103</sup>

### Private benefit

Unlike the absolute prohibition against private inurement, de minimis private benefit is permitted. If private benefit exists, it must be incidental in both a qualitative and quantitative sense to the public benefit. To be qualitatively incidental, a private benefit must occur as a necessary concomitant of the activity that benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting private individuals.<sup>104</sup> Such benefits might also be characterized as indirect or unintentional. To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity.<sup>105</sup>

A fact pattern in which more than incidental private benefit accrued to physicians from the activities of a hospital was discussed in *Sonora Community Hospital v. Commissioner*.<sup>106</sup> In that case, two doctors who previously had owned the hospital facilities and founded the hospital in question shared in the fees from the privately-operated laboratory and X-ray departments within the hospital even though they performed no associated services. The Tax Court found

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<sup>100</sup> *Id.*

<sup>101</sup> *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151, 153 (E.D. Wash. 1963).

<sup>102</sup> *World Family Corp. v. Commissioner*, 81 T.C. 958, 969 (1983) (stating that the law "places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts."). Whether compensation is reasonable is a question of fact. *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1200 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970).

<sup>103</sup> Sec. 4958.

<sup>104</sup> See *American Campaign Academy v. Commissioner*, 92 T.C. at 1076.

<sup>105</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 19.10 (8<sup>th</sup> ed. 2003).

<sup>106</sup> 46 T.C. 519, 526 (1966), *aff'd*, 397 F.2d 814 (9th Cir. 1968).

that 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.

### **Political and lobbying activities of charitable organizations**

#### In general

Charitable organizations are prohibited from engaging in political activity and face limitations on the amount of permissible lobbying activity.

#### Legislative history

The principal statutory rules regarding the lobbying and political activities of charitable organizations were enacted in 1934 and 1954 respectively. The statutory scheme developed as follows:

- **1934** – The Revenue Act of 1934 added the requirement that no substantial part of an organization’s activities may be lobbying (i.e., the carrying on of “propaganda” or “attempting to influence legislation”).
- **1954** – The Revenue Code of 1954 added the requirement that charitable organizations may not participate or intervene in political campaign activity.
- **1976** – The Tax Reform Act of 1976 established an elective standard for determining whether a public charity’s lobbying activities are insubstantial and imposed excise taxes on excess lobbying activities.<sup>107</sup>
- **1987** – The Revenue Act of 1987 imposed excise taxes on the political campaign activities of charitable organizations and clarified that political campaign activities may not be conducted “in opposition to” a candidate.

History of the lobbying rule.—The 1934 rule limiting lobbying was accepted by the Senate as a floor amendment and enacted after word changes in conference that deleted a reference to “partisan politics.”<sup>108</sup> The amendment had been considered but rejected by the Finance Committee, where, according to floor statements by two Senators, the intent was to deny a deduction for contributions that were to be used to influence legislation. Such contributions were viewed as “selfish” and “made to advance the personal interests of the giver of the

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<sup>107</sup> Sec. 501(h).

<sup>108</sup> 78 Cong. Rec. 5861 (1934).

money.”<sup>109</sup> The Senators noted that the language of the amendment was not well phrased, yet it is largely the language that was enacted.<sup>110</sup>

Four years before, the case of *Slee v. Commissioner*<sup>111</sup> had been decided. In an opinion by Learned Hand, the court held that an organization was not an exempt charitable organization because a significant purpose of the organization was “political agitation,” or in modern parlance, lobbying activity. Although the organization conducted charitable programs relating to procreation, the organization also “agitat[ed] for the repeal of laws preventing birth control.” Noting that “[p]olitical agitation as such is outside the statute” and therefore that the organization’s purposes were not “exclusively” charitable, educational, or scientific, the court upheld the lower court’s denial of deductions for contributions to the organization.

The 1934 legislation limiting lobbying activity affirms some aspects of *Slee* and modifies others. If *Slee* had been decided after 1934, the organization’s lobbying activity likely would have been consistent with exempt status, so long as the lobbying was not substantial. Deductions to the organization thus would have been permitted. However, to the extent that lobbying was a substantial activity for the organization, the *Slee* holding survives enactment of the lobbying limitation.

History of the political activities ban.—Similar to the lobbying rule, there is little legislative history regarding the political campaign activities ban. This rule also originated as a Senate floor amendment, offered by Senator Lyndon Johnson in order to “deny[] . . . tax-exempt status to not only those people who influence legislation but also to those who intervene in any political campaign on behalf of any candidate for any public office.”<sup>112</sup> Senator Johnson evidently was concerned that a charitable organization was providing funds to an electoral opponent in a primary election.<sup>113</sup>

#### Lobbying activities -- present law

As noted, under present law, an organization does not qualify for tax-exempt status as a charitable organization unless “no substantial part” of its activities constitutes “carrying on propaganda, or otherwise attempting, to influence legislation” (commonly referred to as

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<sup>109</sup> Statement of Senator David A. Reed, 78 Cong. Rec. 5861 (1934). Senator Byron P. Harrison noted that “there are certain organizations which are receiving contributions in order to influence legislation and carry out propaganda. The Committee thought there ought to be an amendment which would stop that.” 78 Cong. Rec. 5959 (1934).

<sup>110</sup> Senator Reed stated that the intent of the amendment was not to affect “worthy institutions.” 78 Cong. Rec. 5861 (1934).

<sup>111</sup> 42 F.2d 184 (2d Cir. 1930).

<sup>112</sup> 100 Cong. Rec. 9604 (1954).

<sup>113</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 12.1(a) (8<sup>th</sup> ed. 2003).

“lobbying”).<sup>114</sup> Public charities may engage in limited lobbying activities, provided that such activities are not substantial, without losing their tax-exempt status and generally without being subject to tax. In contrast, private foundations are subject to a restriction that lobbying activities, even if insubstantial, may result in the foundation being subject to penalty excise taxes.<sup>115</sup> For purposes of determining whether lobbying activities are a substantial part of a public charity’s overall functions, a public charity may choose between two standards, the “substantial part” test or the “expenditure” test.<sup>116</sup>

The substantial part test derives from the statutory language quoted above and uses a facts and circumstances approach to measure the permissible level of lobbying activities. Because there is no statutory or regulatory guidance clarifying this standard, it is not clear whether the determination is based on the organization’s activities, its expenditures, or both. An arithmetical percentage test (e.g., looking only at the percentage of the budget, or employee’s time spent on lobbying), although relevant, has been held not determinative. If public charities exceed the substantial part standard, they risk losing their tax exemption. In addition, excise taxes may be imposed if a public charity (other than certain religious organizations) ceases to qualify for tax-exempt status under section 501(c)(3) due to its substantial lobbying activities.<sup>117</sup>

The expenditure test sets specific dollar limits, calculated as a percentage of a charity’s total exempt purpose expenditures, on the amount a charity may spend to influence legislation.<sup>118</sup> The test establishes two expenditure limits: one restricts the total amount of lobbying expenditures the public charity can make, the other restricts grass roots lobbying expenditures as a subset of total lobbying expenditures. A public charity’s total lobbying expenditures for a year are the sum of its expenditures for direct lobbying and its expenditures for grass roots lobbying. The allowable amount of lobbying expenditures that can be made for any tax year is determined under a sliding-scale formula. In no event can the allowable amount of lobbying for a charity electing the expenditure test exceed \$1 million for any year.<sup>119</sup> A charity wishing to be subject to the expenditure test must affirmatively elect to do so.<sup>120</sup> Charities that do not file an election (and certain religious organizations) are subject to the substantial part test.<sup>121</sup>

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<sup>114</sup> Sec. 501(c)(3).

<sup>115</sup> Sec. 4945(d)(1).

<sup>116</sup> Secs. 501(c)(3), 501(h), and 4911. Churches and certain church-related entities may not choose the expenditure test. Sec. 501(h)(5).

<sup>117</sup> Sec. 4912.

<sup>118</sup> Secs. 501(h) and 4911.

<sup>119</sup> Sec. 4911(c)(2).

<sup>120</sup> The election is known as the “section 501(h) election.”

<sup>121</sup> Churches and church related entities were precluded from making a section 501(h) election in response to their specific request. At the time section 501(h) was enacted, churches were concerned that

## Political campaign activities -- present law

As noted, under present law, charitable organizations may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.<sup>122</sup> The prohibition on such political campaign activity is absolute and, in general, includes activities such as making contributions to a candidate's political campaign, endorsements of a candidate, lending employees to work in a political campaign, or providing facilities for use by a candidate. Many other activities may constitute political campaign activity, depending on the facts and circumstances. The sanction for a violation of the prohibition is loss of the organization's tax-exempt status.

In general, activities that are educational are permitted. An organization may advocate a particular position or conduct an educational activity that is related to the political process, but the advocacy or activity must be unbiased and nonpartisan. The IRS will look to the method used by the organization in advocating a position to determine whether educational purposes are met.<sup>123</sup> However, even if an organization's activities in general are educational, a particular activity may violate the political campaign activities ban. As to specific activities, public charities generally may provide a forum for debates by candidates, so long as the forum is fair and neutral and all qualified candidates are given equal time for debate.<sup>124</sup> Voter registration and get-out-the-vote projects by public charities generally are permitted so long as the activity is conducted in a nonpartisan and fair manner.<sup>125</sup> Other forms of voter education, such as publication of voter guides, also may be permissible if certain guidelines are followed.<sup>126</sup> The prohibition on political campaign activity is not intended to restrict free expression on political matters by persons speaking for themselves as individuals and not as representatives of a charitable organization.

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accepting eligibility for the election would undermine their position that constitutional law prohibits limitations on their free speech. Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), December 29, 1976, at 415. Churches also were concerned that extending the law to churches could be construed as Congressional approval for a court decision that upheld the revocation of a church's tax-exemption for excess lobbying activity. *Id.* at 415-16; *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10<sup>th</sup> Cir. 1972).

<sup>122</sup> Sec. 501(c)(3).

<sup>123</sup> “[T]he method used by an organization in advocating its position, rather than the position itself, is the standard for determining whether an organization has educational purposes.” Rev. Proc. 86-43, 1986-2 C.B. 729.

<sup>124</sup> See Rev. Rul. 86-95, 1986-2 C.B. 73.

<sup>125</sup> Special rules apply to the conduct of political activities by private foundations, such as voter registration drives. See secs. 4945(d)(2) and 4945(f).

<sup>126</sup> Rev. Rul. 78-248, 1978-1 C.B. 154.

For organizations that engage in prohibited political campaign activity, the Code provides three penalties that may be applied either as alternatives to revocation of tax exemption or in addition to loss of tax-exempt status: an excise tax on political expenditures,<sup>127</sup> termination assessment of all taxes due,<sup>128</sup> and an injunction against further political expenditures.<sup>129</sup>

A charitable organization may engage in political activity that does not amount to political *campaign* activity without violating the political campaign activity ban;<sup>130</sup> however, such political activity may be subject to tax.<sup>131</sup> For example, attempting to influence the nomination of an individual to a public office is political activity, but is not political campaign activity.

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<sup>127</sup> Sec. 4955.

<sup>128</sup> Sec. 6852(a)(1).

<sup>129</sup> Sec. 7409.

<sup>130</sup> Gen. Couns. Mem. 39694 (January 21, 1988) (noting that political activity as defined in section 527, relating to political organizations, is broader than the prohibited political campaign activity of section 501(c)(3), and thus charitable organizations may be subject to tax as a political organization).

<sup>131</sup> Sec. 527(f).

## C. Exempt Purposes of Section 501(c)(3) Organizations

### **In general**

The Code lists the exempt purposes that may qualify an organization for exemption as a charitable organization,<sup>132</sup> including religious, charitable, scientific, literary, or educational purposes. The meaning of such purposes is left to Treasury regulations, other administrative guidance, and court decisions. In general, none of the exempt purposes listed in section 501(c)(3) has a precise meaning. Over time, the IRS and the courts have struggled to provide meaning to the terms in the context of actual organizations, and, in general, the meanings have expanded rather than contracted.

Since the inception of the exemption for charitable organizations, issues have arisen as to the meaning of the term charitable. In general, there are two definitions of charity, the ordinary and popular sense and the legal sense.<sup>133</sup> As described below, these two definitions of charity are significantly different and, depending on which is used, point to a narrowly defined or expansive charitable sector. As the law has developed, charitable has been construed in its legal sense and not in its ordinary sense.

### **The meaning of charity -- present law**

#### Legal versus ordinary sense

As noted above, there are two approaches to the meaning of the term charitable -- the legal sense and the ordinary and popular sense. The legal definition is derived from the law of charitable trusts and is broader than the ordinary sense of the term, which generally means the relief of the poor and distressed.<sup>134</sup> Since 1959, Treasury regulations have defined the term “charitable” in the legal sense, as follows:

The term “charitable” is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of “charity” as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works;

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<sup>132</sup> The word “charitable” generally is used to include any of the purposes described in section 501(c)(3), e.g., religious, educational, scientific, and other.

<sup>133</sup> The meaning of charitable for purposes of tax exemption and for purposes of the charitable deduction are the same.

<sup>134</sup> See generally, Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 5.1 (8<sup>th</sup> ed. 2003) (noting that the ordinary sense of charitable “is usually thought to mean assistance to the poor, the indigent, the destitute”).

lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.<sup>135</sup>

This definition is broad, encompassing several ideas that would not generally be considered as charitable in the ordinary sense. For example, the “erection or maintenance of public buildings” is not grounded in helping the poor or distressed but is directed more to the provision of a public good. The “promotion of social welfare” indicates that an activity is charitable if it aids the public at large, through community benefit programs, or by advocating ideals such as human and civil rights, even if no particular needy person is directly benefited by the activity. Thus, in general, the legal definition of charitable is best understood as including activities that are intended to benefit the general welfare or public interest (including charitable activities in the ordinary sense of the term), which itself can be construed broadly or narrowly, and which will expand and contract over time to reflect changing notions of the public interest.<sup>136</sup>

#### Public policy requirement

In addition to meeting the regulatory definition of charitable, an organization described in section 501(c)(3) is not organized and operated for exempt purposes if a purpose of the organization is against public policy or is illegal. The leading example of violation of the public policy doctrine is *Bob Jones University v. United States*.<sup>137</sup> *Bob Jones University* concerned whether schools with racially discriminatory admissions policies qualified for exemption under section 501(c)(3). The Supreme Court concluded that Congress intended that the definition of charity be based on the common law with the result that the purpose of a charitable organization

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<sup>135</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(2). The regulations also make clear that the exempt purposes listed in section 501(c)(3) are independent bases for exemption. Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(iii) (“Since each of the [listed] purposes . . . is an exempt purpose in itself, an organization may be exempt if it is organized and operated exclusively for any one or more of such purposes.”).

<sup>136</sup> For example, the Assistant Treasury Secretary for Tax Policy, Edwin S. Cohen, stated in 1972 in a hearing before the House Ways and Means Committee: “We have tried to avoid interpreting the word ‘charitable’ in a fixed, immutable fashion. As the courts have done in many nontax settings, we have tried to give it meaning that changes and expands as the needs of society change and expand.” House Committee on Ways and Means, 92<sup>nd</sup> Cong., 2d Sess., *Legislative Activity by Certain Types of Exempt Organizations* 5 (Comm. Print 1972). One commentator has written that “[c]harity in its popular and ordinary sense admits of only one class of beneficiaries, the poor or distressed, and only one type of activity, the relief of their condition, usually through direct assistance. In contrast, in its legal sense charity includes a wide variety of purposes which can be accomplished by an even wider variety of means. Since the catch-all category of charity -- purposes beneficial to the community -- is so broad, it can conceivably encompass almost any program to promote social welfare, making the exemption difficult to define and administer.” Tommy F. Thompson, *The Unadministrability of the Federal Charitable Tax Exemption: Causes, Effects and Remedies*, 5 *Virginia Tax Rev.* 1, 14 (1985).

<sup>137</sup> 461 U.S. 574 (1983).



“may not be illegal or violate established public policy.”<sup>138</sup> The Court stated that: “Clearly an educational institution engaging in practices affirmatively at odds with [the] declared position of the whole government cannot be seen as exercising a ‘beneficial and stabilizing influence[e] in community life,’ and is not ‘charitable,’ within the meaning of section 170 and section 501(c)(3).” The Court also described charitable as measured by “the common community conscience” and as providing a “public benefit.” The IRS has applied the public policy doctrine to activities such as demonstrations, boycotts, and strikes.<sup>139</sup>

#### Common law principles – charitable class and community benefit

Consistent with the Court’s conclusion in *Bob Jones University* that “charity” is based on the common law, common law principles in addition to the public policy requirement inform the Federal tax law definition of charity. The charitable class requirement provides that an organization be organized to benefit a sufficiently large or indefinite class of people.<sup>140</sup> The IRS has applied this rule in many cases, for example denying exemption because the class of beneficiaries served by an organization was so small as not to provide a public benefit.<sup>141</sup>

The community benefit doctrine permits exemption as a charitable organization if the result of an activity inures to the benefit of the community, even though a private person is the immediate beneficiary of the activity. Through the community benefit doctrine, the IRS has recognized the exemption of an organization that gave financial assistance to legal interns, ruling that although the interns received an incidental private benefit, the purpose of the payments were to assist residents of a depressed community through the provision of free legal services.<sup>142</sup>

Charity is an evolving concept, as its definition depends in part upon contemporary standards.<sup>143</sup> In many cases, the IRS has changed the standard for charitable as conditions in society have changed. For example, until 1969 charitable hospitals were required to provide

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<sup>138</sup> *Id.*; Restatement (Second) of Trusts sec. 377 (1959).

<sup>139</sup> Gen. Couns. Mem. 37858 (February 16, 1979); Rev. Rul. 75-384, 1975-2 C.B. 204 (ruling that an organization formed to promote world peace was not charitable because its primary activity was to promote anti-war protest demonstrations where it urged participants to violate the law).

<sup>140</sup> This was a requirement for charitable trusts because under the normal trust rules, a trust may be organized to benefit just one or a few beneficiaries, often persons related to the grantor. For a trust to be charitable, the class of beneficiaries had to be sufficiently broad so as to ensure some public benefit. See *Green v. Connally*, 330 F. Supp. 1150, 1157-58 (D.D.C. 1971).

<sup>141</sup> See, e.g., *Crellin v. Commissioner*, 46 B.T.A. 1152, 1155-56 (1942); *James Sprunt Benevolent Trust v. Commissioner*, 20 B.T.A. 19, 24-5 (1930).

<sup>142</sup> Rev. Rul. 72-559, 1972-2 C.B. 247.

<sup>143</sup> Restatement (Second) of Trusts sec. 374 cmt. A (1959).

some patient care for low or no cost. This standard was changed to a community benefit standard in 1969.<sup>144</sup>

### Examples

Some examples of organizations that have been recognized as charitable under the legal definition include organizations: providing legal services to the poor;<sup>145</sup> providing individual psychological and educational evaluations for children and adolescents with learning disabilities;<sup>146</sup> managing community correctional centers for the rehabilitation of prisoners;<sup>147</sup> posting bail for individuals who were otherwise incapable of paying;<sup>148</sup> exhibiting and selling artwork;<sup>149</sup> providing rescue and emergency services to disaster victims;<sup>150</sup> providing money management advice;<sup>151</sup> providing medical and dental referral services;<sup>152</sup> assisting in the operation of a mass transportation system;<sup>153</sup> and carrying on all or a substantial part of its otherwise charitable activities in a foreign country.<sup>154</sup> Some other examples of charitable organizations are described in Part VI of this pamphlet, including hospitals, elder care facilities, credit counseling organizations, low-income housing organizations, environmental organizations, and college sports organizations.

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<sup>144</sup> The requirements for hospitals to qualify as charitable are described in Part III.B. Also discussed in that Part are the exemption standards for elder care facilities, credit counseling organizations, low-income housing organizations, environmental organizations, and college sports organizations.

<sup>145</sup> Rev. Rul. 78-428, 1978-2 C.B. 177.

<sup>146</sup> Rev. Rul. 77-68, 1977-1 C.B. 142 (held to be promoting public health).

<sup>147</sup> Rev. Rul. 70-583, 1970-2 C.B. 114.

<sup>148</sup> Rev. Rul. 76-21, 1976-1 C.B. 147.

<sup>149</sup> *Goldsboro Art League, Inc. v. Commissioner*, 75 T.C. 337, 343-44 (1980) (noting that the promotion of the arts has consistently been recognized as both charitable and educational).

<sup>150</sup> Rev. Rul. 69-174, 1969-1 C.B. 149.

<sup>151</sup> Rev. Rul. 69-441, 1969-2 C.B. 115.

<sup>152</sup> *Fraternal Medical Specialist Services v. Commissioner*, 49 T.C.M. (CCH) 289 (1984).

<sup>153</sup> Rev. Rul. 71-29, 1971-1 C.B. 150.

<sup>154</sup> Rev. Rul. 71-460, 1971-2 C.B. 231.

## Meaning of charitable before 1959

### Treasury interpretation

Prior to adoption by Treasury of the legal definition of charitable in the 1959 regulations, charitable was construed in regulations in its ordinary and popular sense. The Treasury Regulations interpreting the Revenue Acts of 1918, 1921, 1924, 1926, 1928, 1932, 1934, 1936, and 1938 all construed charity in the ordinary and popular sense, providing that “[c]orporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor.”<sup>155</sup> Three sets of regulations construed the meaning of charitable under the Revenue Code of 1939, and each one prescribed the ordinary and popular sense of the term.<sup>156</sup>

### Congressional intent

Notwithstanding the established administrative construction of the term “charitable,” both before and after 1959, there is not clear evidence whether Congress intended that the popular and ordinary sense of the term or the legal sense be used. One common argument based on statutory construction is that Congress intended that the ordinary sense be used.<sup>157</sup> For example, the fact that the exempt purposes are listed in the disjunctive, e.g., “charitable, religious, *or* educational,” indicates the ordinary usage because the “or” signals that religious and educational should have a separate meaning apart from charitable, which would not be the case if the legal sense of the term was intended. However, the Supreme Court took note of this argument in *Bob Jones* and favored another rule of statutory construction, “that a court should go beyond the literal language of a statute if reliance on that language would defeat the plain purpose of the statute.”<sup>158</sup> The

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<sup>155</sup> See Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 Florida L. Rev. 419, 429 n.30 (1998).

<sup>156</sup> See Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 5.2 (8<sup>th</sup> ed. 2003) (citing Reg. 103, sec. 19.101(6)-1; Treas. Reg. 111, sec. 29.101(6)-1; Reg. 118, sec. 39.101(6)-1(b)); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A165 (1954). There were two published prior drafts of the 1959 regulations. In the first, charitable organizations included “generally organizations for the relief of poverty, distress, or other conditions of similar public concern.” Prop. Treas. Reg. sec. 1.501(c)(3)-1, 21 Fed. Reg. 460, 464 (January 21, 1956). In the second, charitable was defined “in its generally accepted legal sense” and included the “advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare.” Prop. Treas. Reg. sec. 1.501(c)(3)-1, 24 Fed. Reg. 1421, 1423 (February 26, 1959). There is no evident explanation for the Treasury Department’s change in position in the 1959 regulations, which are in large part the regulations that are in effect today. These regulations construed the 1954 Revenue Code, which in replacing the 1939 Revenue Code reordered the tax exemption for charitable organizations into a new Code section. However, a Ways and Means Committee report regarding the new section stated that “[n]o change in substance has been made . . .” H.R. Rep. No. 1337, 83d Cong., 2d Sess. A165 (1954).

<sup>157</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 5.2 (8<sup>th</sup> ed. 2003).

<sup>158</sup> *Bob Jones University v. United States*, 461 U.S. 574, 585 (1983).

Court concluded that an examination of Congressional purposes “reveals unmistakable evidence that, underlying all relevant parts of the Code, is the intent that entitlement to tax exemption depends on meeting certain common law standards of charity -- namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy.”<sup>159</sup>

### Legislative history

The sponsor of the 1909 statute that exempted charitable corporations from excise tax stated that the exemption was intended for organizations “devoted exclusively to the relief of suffering, to the alleviation of our people, and to all things which commend themselves to every charitable and just impulse.”<sup>160</sup> This indicates a more expansive notion of charitable than the ordinary sense of the term. However, legislative history pointing toward a narrow construction of charity may be found in the 1924 effort by a Senator specifically to provide for an expansive statutory definition of charitable. On the Senate floor, Ohio Senator Willis complained that the IRS (then the Bureau of Internal Revenue) was construing charitable narrowly to mean organizations that served the poor. The Senator wanted charitable to include “preventive and constructive service for relief, rehabilitation, health, character building and citizenship.”<sup>161</sup> Other Senators objected that the vague terms “health” and “character building” were potentially too expansive, and Senator Willis withdrew his amendment.<sup>162</sup>

The most commonly cited example of legislative history points to a broad meaning of the term charitable. A 1939 House Committee Report provides that the exemption is provided for “charitable and other purposes” and that the exemption provides “benefits resulting from the promotion of the general welfare.”<sup>163</sup> This language points to a broad sense of the term charitable, but is not contemporaneous with enactment of the first exemption for charitable organizations. More recently, in 1969, the House Report on the Tax Reform Act of 1969 described the term “charitable” as “a term that has been used in the law of trusts for hundreds of years,”<sup>164</sup> the implication being that charitable should be construed in its legal sense. In general, commentators conclude that there is no clear indication of Congressional intent regarding the meaning of charitable.<sup>165</sup>

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<sup>159</sup> *Id.* at 586.

<sup>160</sup> 44 Cong. Rec. 4150 (1909).

<sup>161</sup> 65 Cong. Rec. 8171 (1924).

<sup>162</sup> 65 Cong. Rec. 8171 (1924).

<sup>163</sup> H.R. Rep. No. 1860, 75<sup>th</sup> Cong., 3d Sess. 19 (1938).

<sup>164</sup> H.R. Rep. No. 91-413, pt. 1, at 43 (1969).

<sup>165</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 5.2 (8<sup>th</sup> ed. 2003) (“There is little concrete evidence to support a proposition that Congress intended the application of either definition.”); Lars F. Gustafsson, *The Definition of “Charitable” for Federal Income Tax Purposes:*

### Other sources of meaning for charity

In general, there is historical support for the proposition that in exempting charitable organizations from tax, Congress merely codified principles of English law, and by doing so, imported the legal definition of charitable, which has its roots in charitable trust law.<sup>166</sup> This is the conclusion of the Supreme Court in *Bob Jones*: “The form and history of the charitable exemption and deduction sections of the various income tax Acts reveal that Congress was guided by the common law of charitable trusts.” As support, the Supreme Court noted that the drafters of the 1894 income tax law, the first statutory exemption for charitable organizations, “relied heavily on English concepts of taxation; and the list of exempt organization appears to have been patterned upon English income tax statutes”<sup>167</sup> and cited early opinions of the Court that charity is imbued with the charitable trust concepts of public benefit.<sup>168</sup>

Similar to the approach taken in the early U.S. tax statutes and in today’s Code, the often cited 1601 preamble to the English Statute of Charitable Uses provides not a definition of charity but a list of charitable purposes, as follows:

some for relief of aged, impotent and poor people, some for maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, sea-banks and highways, some for education and preferment of orphans, some for or towards relief, stock or maintenance for houses of correction, some for marriages of poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen . . . and others for relief or redemption of prisoners or captives, and for aid or ease of any poor

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*Defrocking the Old and Suggesting Some New Fundamental Assumptions*, 33 Houston L. Rev. 587, 619 (1996) (“Congress gave no indication when it passed an income tax in 1894, 1909, or 1913 of the appropriate definition of charitable for purposes of the exemption provisions nor when it provided for the deductibility of charitable contributions in 1917.”).

<sup>166</sup> The standard definition of charity in the context of charitable trusts was articulated in the 19<sup>th</sup> century English case of *Commissioners for Special Purposes of Income Tax v. Pemsel*, which provided that “‘Charity’ in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not failing under any of the preceding heads.” *Commissioners for Special Purposes of Income Tax v. Pemsel*, 1891 A.C. 531, 583.

<sup>167</sup> *Bob Jones*, 461 U.S. at 589 (citing 26 Cong. Rec. 584-88, 6612-15 (1894)).

<sup>168</sup> *Perin v. Carey*, 24 How. 465, 501 (1861) (it “has now become an established principle of American law, that courts of chancery will sustain and protect . . . a gift . . . to public charitable uses, provided the same is consistent with local laws and public policy”); *Ould v. Washington Hospital for Foundlings*, 95 U.S. 303, 311 (1877) (“A charitable use, where neither law nor public policy forbids, may be applied to almost any thing that tends to promote the well-doing and well-being of social man.”).

inhabitants concerning payments of fifteens, setting out of soldiers and other taxes.”<sup>169</sup>

The Restatement (Second) of Trusts,<sup>170</sup> is another source for a meaning of charity, often relied on by courts. It provides that: “Charitable purposes include (a) the relief of poverty; (b) the advancement of education; (c) the advancement of religion; (d) the promotion of health; (e) governmental or municipal purposes; (f) other purposes the accomplishment of which is beneficial to the community.” The comments to the Second Restatement explain that: “A purpose is charitable if its accomplishment is of such social interest to the community as to justify permitting the property to be devoted to the purpose in perpetuity. There is no fixed standard to determine what purposes are of such social interest to the community; the interests of the community vary with time and place. . . . As to what other purposes are of such interest to the community as to be charitable, no definite rule can be laid down.”

### **The meaning of charity and the rationale for tax exemption and charitable deductions**

#### In general

A variety of rationales for the charitable tax exemption and tax deduction have been offered in legislative history, court cases, and commentary. Some of the basic rationales that have been offered may be summarized as follows: (1) charitable organizations serve the public and therefore should be supported through provision of tax benefits; (2) charitable organizations provide goods and services that otherwise would have to be provided by the Government and therefore should be supported by the Government; (3) it is difficult to measure the net income of charitable organizations, and therefore they should be exempt from tax; (4) charitable organizations promote pluralism; (5) charitable organizations are efficient providers of services but have inherent limits on their ability to raise capital compared to for-profit entities and therefore need government support in the form of tax exemption (and charitable contributions); and (6) exemption is afforded to those organizations that can prove their worth through sustained donations.

#### Public service/morality

Probably the most frequently made statement regarding the reason for tax exemption and deduction for charitable organizations is that providing tax benefits for charity, however it is defined, is the right thing to do. Along these lines, one commentator argues that morality was

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<sup>169</sup> Lars G. Gustafsson, “*Lessening the Burdens of Government*”: *Formulating a Test for Uniformity and Rational Federal Income Tax Subsidies*, 45 U. Kansas L. Rev. 787, 795 & n.25 (1997) (quoting from 43 Eliz. Chap. 4 (Eng. 1601)).

<sup>170</sup> Restatement (Second) of Trusts sec. 368 (1959).

one of three basic considerations when Congress first provided for tax exemption in the Tariff Act of 1894.<sup>171</sup>

In framing the income tax law, certain value judgments were made by Congress that it was simply wrong to tax certain types of organizations. . . . In addition, it seemed anomalous, in the formative years of this country, to discourage the growth of educational, civic, charitable, or other similar organizations which not only relieved the burdens of government, but also helped to form the moral fiber of the young nation.<sup>172</sup>

In a dissenting opinion, Justice Blackmun also suggested that the rationale for the charitable exemption was based in morality:

Obviously, section 501(c)(3) is not designed to raise money. Its purpose, rather, is to assure the existence of truly philanthropic organizations and the continuation of the important public benefits they bestow.<sup>173</sup>

#### Performance of public or governmental functions

Perhaps the most conventional rationale offered for the charitable tax exemption and deduction is that Congress intended to provide support for organizations that perform functions and services that are public in nature and that otherwise would have to be provided by the government. An early Supreme Court decision provides limited support for this view, as the Court declared that: “Evidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain.”<sup>174</sup> A 1939 House Committee Report, quoted from above, speaks more directly to this rationale for exemption:

[t]he exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare.<sup>175</sup>

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<sup>171</sup> James J. McGovern, *The Exemption Provisions of Subchapter F*, 29 *Tax Lawyer* 523, 526 (1976). McGovern argues that the other two rationales were (1) heritage (i.e., Congress was following established traditions) and (2) the influence of special interests. *Id.* at 525-27. McGovern’s analysis extends to all the exemption provision enacted as part of the Tariff Act of 1894; his analysis is not limited to charitable organizations.

<sup>172</sup> *Id.* at 526.

<sup>173</sup> *Alexander v. “Americans United” Inc.*, 416 U.S. 752, 772 (1974) (dissenting).

<sup>174</sup> *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).

<sup>175</sup> H.R. Rep. No. 1860, 75<sup>th</sup> Cong., 3d Sess. 19 (1938).

Justice Harlan, in a concurring opinion in *Walz*, noted that a New York constitutional provision for tax exemption applies to organizations that perform “certain social services in the community that might otherwise have to be assumed by government.”<sup>176</sup> In a separate concurring opinion, Justice Brennan stated that “private, nonprofit organizations contribute to the well-being of the community . . . and thereby bear burdens that would otherwise either have to be met by general taxation, or be left undone, to the detriment of the community.”<sup>177</sup> The Court in *Bob Jones* stated that by providing for exemption, Congress intended to help organizations “that serve a useful public purpose or supplement or take the place of public institutions of the same kind.”<sup>178</sup>

This theory generally is evident in the regulatory definition of charity, which provides that an organization is charitable if it “lessens the burdens of government.”<sup>179</sup> The other types of charity listed in the regulation also are consistent with the idea that a charitable organization conducts activities which are in some sense governmental in nature, whether it is relief of the poor, the erection of public buildings, or the promotion of social welfare.<sup>180</sup>

#### Difficulty of measuring net income

A theory of charitable exemption advanced by scholars Boris I. Bittker and George K. Rahdert in the 1970s posits that organizations engaged in public service are exempt from taxation because there is no reasonable way of measuring net income under established principles developed for the taxation of for-profit entities.<sup>181</sup> First, because traditional notions of gross income rest on an entity’s desire to maximize profits, such principles cannot readily be applied to determine the gross income of organizations that do not have a profit motive.<sup>182</sup> It may be difficult, for example, to determine whether contributions to a charity should be included

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<sup>176</sup> 397 U.S. at 696.

<sup>177</sup> *Id.* at 687.

<sup>178</sup> 461 U.S. at 587; see also *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972) (“the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government”).

<sup>179</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

<sup>180</sup> *Id.*

<sup>181</sup> Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale L.J. 299, 305 (1976). Another scholar, Henry Hansmann, takes issue with the assertion of Bittker and Rahdert that the net income of a charitable organization could not be determined under ordinary principles of taxation. Hansmann notes, for example, that a large percentage of charities are what he terms “commercial” nonprofits, i.e., those that derive nearly all of their income from sales of goods or services that they produce, and that the income of such organizations could easily be measured under established principles. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 Yale L.J. 54, 59 (1981).

<sup>182</sup> Bittker & Rahdert, 85 Yale L.J. at 307.



in its ordinary income or excluded from ordinary income as gifts received. Classification issues may also arise in determining which expenses should be deductible in computing net income, as business expenses generally are deductible only when incurred with a profit motive.<sup>183</sup> Bittker and Rahdert assert that even if the net income of such organizations could be measured in a meaningful way, there is no satisfactory way to establish suitable tax rates.<sup>184</sup> They argue, for instance, that the burden of a tax would fall on the organization's ultimate beneficiaries, but "the burden of the tax would not reflect the ability to pay of the individual beneficiaries."<sup>185</sup>

### Promotion of pluralism

Commentators and courts often cite pluralism as a rationale for Federal tax exemption of charities. Author and practitioner Bruce Hopkins, for example, identifies pluralism as one of the philosophical underpinnings of tax exemption.<sup>186</sup> In a 1971 opinion, the United States District Court for the District of Columbia cited pluralism as a significant purpose of the charitable deduction:

The public policy limitation on tax benefits [for activities that are illegal or against public policy] applies *a fortiori* to the case before us involving the charitable deduction whose very purpose is rooted in helping institutions because they serve the public good. The Internal Revenue Code does not contemplate the granting of special Federal tax benefits to trusts or organizations, whether or not entitled to the special state rules relating to charitable trusts, whose organization or operation contravene Federal public policy. This principle cannot be applied without taking into account that as to private philanthropy, the promotion of a healthy pluralism is often viewed as a prime social benefit of general significance.<sup>187</sup>

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<sup>183</sup> *Id.* at 309-10.

<sup>184</sup> *Id.* at 314.

<sup>185</sup> *Id.* at 315, 358.

<sup>186</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 1.4 (8<sup>th</sup> ed. 2003); *see also* Norman S. Fink, *Taxation & Philanthropy -- A 1976 Perspective*, 3 *Journal of College & University L.* 1, 6-7 (citing volunteerism as being responsible for the creation and maintenance of such institutions as churches, colleges, and hospitals); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 *Florida L. Rev.* 419, 430 and n. 31 (citing the promotion of pluralism as an often-stated rationale of tax exemption for charitable organizations).

<sup>187</sup> *Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D. C.), *aff'd sub nom.*, *Colt v. Green*, 404 U.S. 997 (1971).

One commentator argues that, beyond the specific and direct benefits that charities provide, charities also deliver certain “metabenefits,” including the promotion of pluralism and altruism, which are inherently good and thus deserve subsidization through tax exemption.<sup>188</sup>

### Inability to raise capital

In a series of articles published in the early 1980s, Law Professor and Economist Henry Hansmann articulated an economic theory in an attempt to explain why income tax exemption is granted to certain categories of nonprofit organizations.<sup>189</sup> Hansmann first notes that nonprofit corporations are subject to “distribution constraints” imposed by state corporation law, i.e., prohibitions against the distribution of net earnings to individuals.<sup>190</sup> He then describes certain “contract failures” that occur when consumers are unable to determine the relative quality of offered products or services or whether a promised service will in fact be delivered. Under such circumstances, consumers may find nonprofit firms more trustworthy than for-profit firms because of the nondistribution constraint applicable to nonprofits. In other words, a consumer may believe that a nonprofit firm is more likely to provide promised services, particularly where such services are to be delivered to a third party and the consumer is unable to monitor such delivery. A for-profit firm, on the other hand, might be less likely to deliver high-quality services to the third party, instead bending to pressures to provide a return to its owners. As such, where contract failure occurs, a nonprofit firm may be able to serve consumers more efficiently than a for-profit firm that provides comparable products or services. Hansmann asserts that tax exemption is an appropriate means of encouraging the development of nonprofit organizations in industries where, as a result of contract failure, they have an efficiency advantage.

Hansmann further argues that, because of the nondistribution constraint, nonprofits have particular difficulty in raising capital; because they cannot issue ownership shares to individuals, they lack needed access to equity capital and are thus unable to accumulate earnings required to reach an optimal level of efficiency. Hansmann concludes that the exemption from income tax is a subsidy to compensate nonprofit organizations with an efficiency advantage for this lack of access to equity capital.<sup>191</sup>

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<sup>188</sup> Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. Rev. 501, 605 (1990).

<sup>189</sup> Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835 (1980); Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 Yale L.J. 54 (1981).

<sup>190</sup> Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 Yale L.J. 54, 56 (1981).

<sup>191</sup> *Id.* at 70. Hansmann concedes that his theory may not justify the exemption from tax afforded certain types of exempt organizations, such as certain nonprofit hospitals and nursing homes, which operate in a manner similar to for-profit entities. Hansmann argues, however, that this incongruity between his theory and the categories of exemption then allowed under the tax laws “may simply be a problem of an uncritical overextension of the exemption.”

### Ability to attract donations

Scholars Mark Hall and John Colombo describe a “donative theory” that they contend explains why certain organizations, including charitable organizations, are afforded tax exemption.<sup>192</sup> Under this theory, only those organizations capable of attracting substantial support from the public should be entitled to exemption, i.e., the willingness of individuals to donate to an organization demonstrates the organization’s worthiness of support. However, because of “free rider” problems, such organizations can rarely optimally meet public needs on donations alone.<sup>193</sup> The tax exemption, they contend, is thus intended to provide a subsidy to charitable organizations in an effort to make up for such shortfalls.<sup>194</sup>

Hall and Colombo assert that neither the particular market defect that leads to the donation nor the motivation for the donation is relevant to whether the recipient of the donation qualifies for a subsidy (i.e., for exemption). In this respect, the donative theory departs from Hansmann’s contract failure theory and other theories that focus on factors such as altruism as a reason for donations.

### Educational purposes

Tax exemption for educational organizations was provided in the Tariff Act of 1894, and has been replicated in each subsequent income tax act. Educational organizations have been eligible to receive tax deductible contributions since 1917. Like the term charitable, the term educational has no precise meaning. The Treasury regulations set forth the basic definition as relating to the “instruction or training of the individual for the purpose of improving or developing his capabilities.”<sup>195</sup> This definition is consistent with provision of exemption for organizations that fit within the common conception of an educational organization, such as schools, colleges, and universities. In general, such organizations are educational because they provide instruction to the individual, in an institutional setting, have a formal curriculum, and rely on faculty to teach.<sup>196</sup> Yet educational organizations are not limited to such traditional forms. The law does not require a faculty, a formal setting such as a classroom, a curriculum, or a student body. Such factors may demonstrate an educational purpose, but are not required.

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<sup>192</sup> Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 Ohio St. L.J. 1379 (1991).

<sup>193</sup> *Id.* at 1398.

<sup>194</sup> *Id.* at 1383-84.

<sup>195</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(3).

<sup>196</sup> Such classically defined educational organizations have given rise to exemption for related organizations, such as university bookstores (Rev. Rul. 69-538, 1969-2 C.B. 116), student publications operating under faculty supervision (Rev. Rul. 63-235, 1963-2 C.B. 210), student housing corporations (Rev. Rul. 76-336, 1976-2 C.B. 143), scholarship organizations (Rev. Rul. 63-220, 1963-2 C.B. 208), and others. Frances R. Hill & Douglas M. Mancino, *Taxation of Exempt Organizations*, sec. 3.03[2] (2004).

Thus, the “instruction or training of the individual” standard may be met by an organization that provides vocational training to improve employment prospects,<sup>197</sup> an organization that operates community correctional centers for the rehabilitation of prisoners,<sup>198</sup> an organization that provides dancing classes<sup>199</sup> or marriage counseling.<sup>200</sup> The list of organizations that are educational under this standard is long and varied.<sup>201</sup>

The Treasury regulations also provide that educational means the “instruction of the public on subjects useful to the individual and beneficial to the community.”<sup>202</sup> Such a standard involves difficult issues of judgment about what is “useful” to an individual or “beneficial to the community.” In general, organizations recognized as educational under this category have been described as fitting a number of broad categories: (1) provision of certain personal services deemed beneficial to the general public; (2) providing instruction in the form of counseling; (3) instruction of the public in the field of civic betterment; (4) instructing the public through conduct of study and research; and (5) the publication of printed material.<sup>203</sup> One commentator has concluded that an organization may qualify as educational merely through the dissemination of information.<sup>204</sup> The IRS and the courts have permitted a broad array of organizations to be considered educational under this standard. One example is a private law library, which through the collection of written materials and provision of access to such materials for members serves an educational purpose.<sup>205</sup> Another is an organization educating the public regarding the quality of radio and television programs.<sup>206</sup> Perhaps less conventional is an organization that promotes student and cultural exchanges,<sup>207</sup> an organization developing and disseminating safety standards

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<sup>197</sup> Rev. Rul. 73-128, 1973-1 C.B. 222.

<sup>198</sup> Rev. Rul. 70-583, 1970-2 C.B. 114.

<sup>199</sup> Rev. Rul. 65-270, 1965-2 C.B. 160.

<sup>200</sup> Rev. Rul. 70-640, 1970-2 C.B. 117.

<sup>201</sup> See, e.g., Rev. Rul. 70-584, 1970 C.B. 114 (recruiting organization); Rev. Rul. 70-534, 1970-2 C.B. 113 (study tour operator); Rev. Rul. 76-336, 1976-2 C.B. 143 (nonprofit student housing corporation); *Kentucky Bar Foundation, Inc. v. Commissioner*, 78 T.C. 921 (1982) (continuing legal education programs of bar association).

<sup>202</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(3).

<sup>203</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 7.5 (8<sup>th</sup> ed. 2003).

<sup>204</sup> Tommy F. Thompson, *The Unadministrability of the Federal Charitable Tax Exemption: Causes, Effects and Remedies*, 5 Virginia Tax Rev. 1, 9 (1985).

<sup>205</sup> *United States v. Proprietors of Social Law Library*, 102 F.2d 481 (1<sup>st</sup> Cir. 1939); Rev. Rul. 75-196, 1975-1 C.B. 155.

<sup>206</sup> Rev. Rul. 64-192, 1964-2 C.B. 136.

<sup>207</sup> Rev. Rul. 80-286, 1980-2 C.B. 179.

for small boats,<sup>208</sup> a county fair,<sup>209</sup> an organization encouraging understanding and tolerance of homosexuals,<sup>210</sup> and an organization that studies and makes available to the public methods for divining the future.<sup>211</sup>

Treasury regulations give examples of organizations that meet either the “instruction of the individual” or “instruction of the public” standard, which although not set forth as a legal standard, provide a basis for analogous organizations to qualify as educational. Regulatory examples include: (1) an organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs, including programs on radio or television; (2) an organization which presents a course of instruction by means of correspondence or through the utilization of television or radio; and (3) museums, zoos, planetariums, symphony orchestras, and other similar organizations.<sup>212</sup> A “similar organization” has included repertory theater.<sup>213</sup> Some have questioned the presumption in the regulations that a symphony orchestra or similar organizations are educational.<sup>214</sup>

As the variety of organizations recognized as educational shows, the primary issue in determining whether something is educational is not the content of the information but the method the organization uses to convey information, irrespective of content. In general, the analytical exercise is to determine whether an organization’s presentation of information is objective and balanced, or whether the organization instead is an advocate or a mouthpiece for propaganda. This is a fine and difficult line to draw, and one with constitutional implications. Because “educational” is in no way limited in the statute, and is “inherently general,”<sup>215</sup> in administering the term, the IRS has to be careful not to deny tax exemption as an educational organization because of the content of the organization’s speech. Indeed, part of the Treasury

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<sup>208</sup> Rev. Rul. 68-164, 1968-1 C.B. 252.

<sup>209</sup> Rev. Rul. 67-216, 1967-2 C.B. 180.

<sup>210</sup> Rev. Rul. 78-305, 1978-2 C.B. 172.

<sup>211</sup> Rev. Rul. 77-258, 1977-2 C.B. 195.

<sup>212</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(3). Another regulatory example, alluded to above, is an organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

<sup>213</sup> Rev. Rul. 64-175, 1964-1 C.B. 185.

<sup>214</sup> Henry Hansmann, *The Rational for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 Yale L.J. 54, 58 n.16 (1981-82) (“rather than deny exemption to such a large and growing class of nonprofits, the Service chose to engage in another act of imaginative reinterpretation, ruling that the performing arts come within the category of ‘educational’ institutions covered by sec. 501(c)(3)”).

<sup>215</sup> *National Alliance v. United States*, 710 F.2d 868, 873 (D.C. Cir. 1983).

regulations defining educational were held unconstitutionally vague on the ground that the regulation left too much discretion over the content of speech to IRS determinations.<sup>216</sup> As an alternative, the IRS developed a four part test, the “methodology test,” which it now uses to determine whether the activities of an organization that advocates a particular viewpoint or position are educational.<sup>217</sup>

Under the methodology test, the IRS views the presence of any of the following four factors as evidence that an organization’s method is not educational:

- The presentation of viewpoints or positions unsupported by facts is a significant portion of the organization's communications.
- The facts that purport to support the viewpoints or positions are distorted.
- The organization’s presentations make substantial use of inflammatory and disparaging terms and express conclusions more on the basis of strong emotional feelings than of objective evaluations.
- The approach used in the organization's presentations is not aimed at developing an understanding on the part of the intended audience or readership because it does not consider their background or training in the subject matter.

In applying the methodology test, the IRS states that failure to meet the test shows that an organization’s *method* is not educational, thus indicating that, as a practical matter, whether an organization is “educational” generally is based on procedure and not on substance.

There are limitations on the meaning of educational, as the IRS has denied exemption to a number of organizations, for example: an organization that had a purpose to advocate the abolition of taxes on industry and replacement with a single tax upon land;<sup>218</sup> an organization with the stated purpose of arousing in white Americans of European ancestry “an understanding of and a pride in their racial and cultural heritage and an awareness of the present dangers to that

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<sup>216</sup> The suspect regulations provide that “[a]n organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.” Treas. Reg. sec. 1.501(c)(3)-1(d)(3)(i). The “full and fair exposition” test was held unconstitutional in *Big Mama Rag, Inc. v. United States*, 631 F.2d 1030 (D.C. Cir. 1980).

<sup>217</sup> Regarding the methodology test, the IRS states that it is the long-standing position of the IRS “that the method used by an organization in advocating its position, rather than the position itself, is the standard for determining whether an organization has educational purposes.” Rev. Proc. 86-43, 1986-2 C.B. 729.

<sup>218</sup> *Leubuscher v. Commissioner*, 54 F.2d 998 (2d Cir. 1932).

heritage;”<sup>219</sup> and an organization that advocated voluntary emigration or repatriation of foreigners and minorities.<sup>220</sup>

An issue in the educational context is the conduct of commercial activities by educational organizations. The operation of a restaurant, bookshop, publication, or retail shop are all commercial activities regularly conducted by for profit entities, and also frequently undertaken by tax exempt educational organizations.<sup>221</sup> The IRS has ruled that each such activity may be consistent with exempt status.<sup>222</sup> The issue is whether the commercial activity is a substantial nonexempt purpose of the organization, which generally is unlikely in the context of a university or museum. However, organizations that engage in publishing as a primary activity will not qualify for exemption as an educational organization if the publishing activity takes on too much of a “commercial hue.” This determination is especially difficult because publishing clearly is a commercial activity yet also involves the dissemination of the information to the public.<sup>223</sup> The IRS has successfully denied exemption to a number of publishing organizations (many of them religious organizations with a primary activity of publishing) on commerciality grounds. If an activity like publishing or operation of a bookshop does not jeopardize exemption (because it is not a substantial nonexempt purpose of the organization), it in many cases will not result in unrelated business income tax, either because the activity is considered related to exempt educational purposes or because it is for the convenience of the organization’s members or students.<sup>224</sup>

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<sup>219</sup> *National Alliance v. United States*, 710 F.2d 868 (D.C. Cir. 1983).

<sup>220</sup> *Nationalist Movement v. Commissioner*, 102 T.C. 558 (1994), *aff’d per curiam*, 37 F.3d 216 (5th Cir. 1994), *cert. denied* 513 U.S. 1192 (1995).

<sup>221</sup> This may also be an issue with respect to scientific research and technology transfers by educational organizations. Treasury regulations provide that an organization that carries on research which is not in furtherance of an exempt purpose described in section 501(c)(3) will not preclude such organization from meeting the requirements of section 501(c)(3) so long as the organization meets the organizational test and is not operated for the primary purpose of carrying on such research. See Treas. Reg. sec. 1.513-2(a)(5), with respect to research that constitutes an unrelated trade or business, and section 512(b)(7), (8), and (9), with respect to income derived from research which is excludable from the tax on unrelated business income.

<sup>222</sup> See, e.g., Rev. Rul. 67-217, 1967-2 C.B. 181 (restaurant); Rev. Rul. 68-538, 1968-2 C.B. 116 (university store); Rev. Rul. 62-234, 1963-2 C.B. 210 (journal).

<sup>223</sup> The IRS has ruled that a publication distributed below cost may be educational in nature if (1) the content of the publication is educational, (2) the preparation of material follows methods generally accepted as “educational” in character, (3) the distribution of the materials is necessary or valuable in achieving the organization’s educational and scientific purposes, and (4) the manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices. Rev. Rul. 67-4, 1967-1 C.B. 121.

<sup>224</sup> Sec. 513(a)(2).

## **Religious purposes**

The Federal tax exemption for organizations operated for religious purposes was, along with charitable and educational purposes, provided for originally in the Tariff Act of 1894, and religious organizations were designated as eligible for charitable contributions in 1917. However, unlike charitable and educational organizations, there is no definition of “religious” provided by regulation. The manifest reason is the constitutional law framework that limits Federal involvement in religion: “Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof.”<sup>225</sup> General Constitutional concerns may explain one basis for tax exemption of religious organizations, as taxing religious organizations would more directly involve the Federal Government in their affairs than does the provision of exemption.<sup>226</sup>

The near impossibility of defining “religious” or “religion” for Federal tax law purposes means that in general, it is very difficult to determine whether an organization is organized and operated for religious purposes. The IRS has developed a multi-factor list of characteristics that inform whether an organization may be considered a church (which is a kind of religious organization),<sup>227</sup> and the IRS is careful to point out that this list is not comprehensive and that in each case, the facts and circumstances will be considered. Courts have in various contexts provided general descriptions of the term religious belief or religion to mean, for example, “belief in a relation to God involving duties superior to those arising from any human relation”<sup>228</sup> or a “belief that is sincere and meaningful [and] occupies a place in the life of its possessor parallel to that filled by the orthodox belief in God.”<sup>229</sup> In the context of tax exemption, it is

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<sup>225</sup> U.S. Constitution, 1<sup>st</sup> Amendment.

<sup>226</sup> See *Walz v. Tax Commission of the City of New York*, 397 U.S. 664, 674-76 (1970) (considering the constitutionality of a New York State law exempting religious organizations from property tax, the Supreme Court noted that “[e]limination of exemption would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures, and the direct confrontations and conflicts that follow in the train of those legal processes. Granting tax exemptions to churches necessarily operates to afford an indirect economic benefit and also gives rise to some, but yet a lesser, involvement than taxing them. . . . The exemption creates only a minimal and remote involvement between church and state and far less than taxation of churches.”).

<sup>227</sup> There are 15 factors on the list, only some of which generally need be met. Some of the factors include a recognized creed and form of worship, a definite and distinct ecclesiastical government, a formal code of doctrine and discipline, a literature of its own, established places of worship, regular congregations, regular religious services. Treasury Regulations describe the term “church” for purposes of determining the exemption from the unrelated business income tax for the taxable years of churches and conventions and associations of churches beginning before January 1, 1970. Treas. Reg. sec. 1.511-2(a)(3)(ii).

<sup>228</sup> *United States v. Macintosh*, 283 U.S. 605, 633 (1931).

<sup>229</sup> *Welsh v. United States*, 398 U.S. 333, 344 (1970) (Harlan, J. concurring) (quoting *U.S. v. Seeger*, 380 U.S. 163, 165-66 (1965)).



instructive that in many cases in which a religious organization's claim to exempt status is questioned, the issue of whether the organization serves religious purposes often is not addressed because exempt status may be denied on other grounds, for example, private benefit or private inurement,<sup>230</sup> commerciality,<sup>231</sup> or violation of the political activities prohibition.<sup>232</sup>

The Constitutional concerns regarding Federal involvement in religious organizations extend to the application of regulatory requirements. For example, certain religious organizations are exempted from the requirement to apply for tax exempt status,<sup>233</sup> from annual information return requirements,<sup>234</sup> and special audit procedures apply to churches.<sup>235</sup> As a result, although religious organizations, particularly churches, constitute a significant part of the charitable sector, information about the number, net worth, and assets of religious organizations is scarce. In addition, the special treatment of religious organizations has been a source of tax evasion, as individuals form organizations claiming church status and shelter personal income from tax.<sup>236</sup>

### **Scientific purposes**

Scientific purposes were the first addition to the original three exempt charitable purposes and were added in 1913. Charitable contributions to scientific organizations were made deductible in 1917. A tax exempt scientific purpose hinges on the performance of basic or

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<sup>230</sup> *Saint Germain Foundation v. Commissioner*, 26 T.C. 648 (1956); *Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969).

<sup>231</sup> The denial of exemption on commerciality grounds has occurred in several cases of religious organizations engaging in publishing activities. See, e.g., *Scripture Press Foundation v. United States*, 285 F.2d 800 (Ct. Cl. 1961); *Fides Publishers Association v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967); *Incorporated Trustees of Gospel Worker Society v. United States*, 510 F. Supp. 374 (D.D.C.), *aff'd*, 672 F.2d 894 (D.C. Cir.), *cert. denied*, 456 U.S. 944 (1981).

<sup>232</sup> *Branch Ministries, Inc. v. Rossotti*, 40 F. Supp. 2d 15 (D.D.C. 1999); *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10<sup>th</sup> Cir. 1972).

<sup>233</sup> Sec. 508(c)(1)(A) (churches, their integrated auxiliaries, and conventions or associations of churches do not have to file an exemption application). Such organizations may nonetheless choose to file for a determination of tax-exempt status in order to provide donors certainty that contributions to such organizations are deductible as charitable contributions.

<sup>234</sup> Sec. 6033(a)(2)(A) (churches, their integrated auxiliaries, and conventions or associations of churches do not have to file an annual information return).

<sup>235</sup> Sec. 7611.

<sup>236</sup> See, e.g., *Miedaner v. Commissioner*, 81 T.C. 272, 282 (1983) ("our tolerance for taxpayers who establish churches solely for tax avoidance purposes is reaching a breaking point. Not only do these taxpayers use the pretext of a church to avoid paying their fair share of taxes, even when their brazen schemes are uncovered many of them resort to the courts in a shameless attempt to vindicate themselves.").

fundamental research in the public interest.<sup>237</sup> Scientific research that is “applied” or “practical” may be subject to the unrelated business income tax, but generally is not inconsistent with exempt purposes.<sup>238</sup> There is no precise definition of scientific research, and, in general, courts and the IRS have determined whether an organization is engaged in scientific research on a case-by-case basis. One court described scientific research as follows: “[w]hile projects may vary in terms of degree of sophistication, if professional skill is involved in the design and supervision of a project intended to solve a problem through a search for a demonstrable truth, the project would appear to be scientific research.”<sup>239</sup>

Scientific research does not include activities of a type ordinarily carried on as incidental to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment or buildings.<sup>240</sup> One court has described such activity as “generally repetitive work done by scientifically unsophisticated employees for the purpose of determining whether the time tested met certain specifications, as distinguished from testing done to validate a scientific hypothesis.”<sup>241</sup> The IRS has ruled that organizations that tested pharmaceuticals for commercial companies,<sup>242</sup> and that inspected, tested, and certified shipping containers pursuant to contracts with container manufacturers<sup>243</sup> were impermissibly involved in commercial activities.

Scientific research also must be in the public interest. Under Treasury regulations, scientific research will be regarded as carried on in the public interest: (1) if the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis; (2) if such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or (3) if such research is directed toward benefiting the public.<sup>244</sup> The regulations provide examples of scientific research that is considered as directed toward benefiting the public, including scientific research carried on for the purpose of: (1) aiding in the scientific education of college or university students; (2) obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; (3) discovering a cure for a disease; or (4) aiding a community or geographical

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<sup>237</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(5)(i).

<sup>238</sup> *Id.*; sec. 512(b)(9).

<sup>239</sup> *Midwest Research Institute v. United States*, 554 F. Supp. 1379, 1386 (W.D. Mo. 1983).

<sup>240</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(5)(ii).

<sup>241</sup> *Midwest Research Institute*, 554 F. Supp. at 1386.

<sup>242</sup> Rev. Rul. 68-373, 1968-2 C.B. 206.

<sup>243</sup> Rev. Rul. 78-426, 1978-2 C.B. 175.

<sup>244</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(5)(iii).

area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area. Scientific research is regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.<sup>245</sup>

An organization is not regarded as organized and operated for the purpose of carrying on scientific research in the public interest if: (1) such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or (2) such organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public.<sup>246</sup>

### **Other exempt purposes**

The prevention of cruelty to children or animals became an exempt purpose in 1918; literary purposes were added in 1921, public safety organizations<sup>247</sup> were added in 1954, and amateur sports organizations in 1976. Charitable contributions to all organizations described in section 501(c)(3) except for public safety organizations may be deductible.

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<sup>245</sup> *Id.*

<sup>246</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(5)(iv).

<sup>247</sup> The term “testing for public safety” includes the testing of consumer products, such as electrical products, to determine whether they are safe for use by the general public. Treas. Reg. sec. 1.501(c)(3)-1(d)(4).

## D. Public Charity or Private Foundation

### Present law – in general

#### Definition

Once an organization qualifies for tax exempt status under section 501(c)(3), the organization must be classified as either a public charity or a private foundation.<sup>248</sup> An organization may qualify as a public charity in several ways.<sup>249</sup> For example:

- It may be a specified type of organization, such as a church, educational institution, hospital and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit.<sup>250</sup>
- It may qualify as a publicly supported public charity if at least one-third of its total support is from governmental units or the general public,<sup>251</sup> or, failing this mechanical test, if it passes a “facts and circumstances” test.<sup>252</sup> In general, this includes publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or to the general public, and organizations such as the American Red Cross.<sup>253</sup>
- It may qualify as a publicly supported public charity based on support received through the operation of trades or businesses that are related to such organizations’ exempt purposes, i.e., if it normally receives more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and

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<sup>248</sup> Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations. Operating foundations are not subject to the payout requirements of private foundations and are not considered a private foundation for purposes of the charitable contribution deduction rules.

<sup>249</sup> The Code does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

<sup>250</sup> Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

<sup>251</sup> Treas. Reg. sec. 1.170A-9(e)(2).

<sup>252</sup> Treas. Reg. sec. 1.170A-9(e)(3).

<sup>253</sup> Treas. Reg. sec. 1.170A-9(e)(1)(ii).

furnishing of facilities in connection with activities that are related to the organization's exempt purposes.<sup>254</sup>

- It may qualify as a “supporting organization” by providing support to another section 501(c)(3) entity that is not a private foundation.<sup>255</sup>
- It may qualify by being organized and operated exclusively for testing for public safety.<sup>256</sup>

An organization that does not fit within any of the above categories is a private foundation. In general, private foundations generally are funded from a limited number of sources (e.g., an individual, a family, or a corporation).

### Substantive rules

Unlike public charities, private foundations are subject to tax on their net investment income at a rate of 2 percent (1 percent in some cases).<sup>257</sup> Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are required to make a minimum amount of charitable distributions each year,<sup>258</sup> are limited in the extent to which they may control a business,<sup>259</sup> may not make speculative investments,<sup>260</sup> and may not make certain expenditures (including expenditures for noncharitable purposes, lobbying, political activities, grants to individuals without prior IRS approval, grants to organizations other than public charities and certain foundations unless special procedures are followed).<sup>261</sup> Violations result in excise taxes on the foundation and, in the case of speculative investments and taxable expenditures, on the management of the foundation.

Although there are rules that regulate transactions between a public charity or a private foundation and a respective insider of the organization, the private foundation “self-dealing”

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<sup>254</sup> Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

<sup>255</sup> Sec. 509(a)(3). Supporting organizations are described in greater detail below.

<sup>256</sup> Sec. 509(a)(4).

<sup>257</sup> Sec. 4940.

<sup>258</sup> Sec. 4942.

<sup>259</sup> Sec. 4943.

<sup>260</sup> Sec. 4944.

<sup>261</sup> Sec. 4945.

regime<sup>262</sup> is much more restrictive than the public charity “intermediate sanctions” regime.<sup>263</sup> The self-dealing regime generally prohibits transactions between a foundation and an insider of the foundation, whereas the intermediate sanctions regime permits public charities to enter into insider transactions so long as no excess benefit is provided to the insider.<sup>264</sup> If the self-dealing or intermediate sanctions rules are violated, the resulting excise taxes on the insider generally are significantly more punitive with respect to transactions with private foundations than with public charities.<sup>265</sup>

Contributions to private foundations generally do not receive as favorable treatment as do contributions to public charities for purposes of the charitable contribution deduction. Contributions to a public charity generally are deductible up to 50 percent of the donor’s adjusted gross income (30 percent for capital gain property), whereas contributions to most private foundations generally are deductible up to 30 percent of the donor’s adjusted gross income (20 percent for capital gain property).<sup>266</sup> In addition, gifts of capital gain property to a public charity generally are deductible at the property’s fair market value,<sup>267</sup> whereas gifts of capital gain property (other than publicly traded stock) to most private foundations are deductible at the taxpayer’s basis (cost) in the property.<sup>268</sup>

Public charities and private foundations both are subject to the annual requirement to file an information return with the IRS.<sup>269</sup> Public charities generally file the Form 990;<sup>270</sup> private foundations file the Form 990-PF. Small charitable organizations (e.g., organizations with gross

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<sup>262</sup> Sec. 4941.

<sup>263</sup> Sec. 4958.

<sup>264</sup> The two regimes take a similar approach with respect to the payment of compensation to an organization insider, i.e., the payment of compensation is permitted so long as the amount paid is reasonable and not excessive.

<sup>265</sup> The self-dealing tax is imposed on the entire amount involved in the transaction (except for the payment of compensation, with respect to which the tax is imposed on the excess compensation), whereas the intermediate sanctions tax is imposed on the excess benefit provided.

<sup>266</sup> Sec. 170(b)(1).

<sup>267</sup> Sec. 170(e)(1). However, contributions of tangible personal property not for an exempt purpose of the donee organization are deductible at the taxpayer’s basis in the property. Sec. 170(e)(1)(B)(i). A special rule determines the aggregate deduction for contributions of certain intellectual property. Secs. 170(e)(1)(B)(iii) and 170(m).

<sup>268</sup> Sec. 170(e)(1)(B)(ii) and 170(e)(5).

<sup>269</sup> Sec. 6033.

<sup>270</sup> A short form, the Form 990-EZ, may be filed by certain small organizations.

receipts normally under \$25,000 per year), churches, and certain other groups are exempt from the filing requirements.

### **Legislative history and background for the 1969 public charity-private foundation distinction**

#### In general

The Tax Reform Act of 1969 defined a private foundation in the Code for the first time and set forth the basis for today's law regulating their conduct. Prior to 1969, incremental changes distinguished private foundations from other charitable organizations.

#### Legislation before 1969

The original 1894 tax-exemption for charitable organizations did not distinguish between public charities and private foundations. All charitable organizations generally were treated the same until the Revenue Act of 1943 when Congress, without explanation in legislative history, provided that certain exempt organizations were required to file annual information returns.<sup>271</sup> Exempt from the filing requirement were religious organizations, schools, certain fraternal organizations, certain government entities, and publicly supported charitable organizations.

The Revenue Act of 1950 cemented the preference for publicly supported and certain other charitable organizations over organizations that generally were referred to as private foundations.<sup>272</sup> As described in Part II.E of this pamphlet, in 1950 Congress examined the conduct of charitable organizations, resulting in the introduction of the unrelated business income tax. As part of its review, Congress also became aware of abusive transactions between private foundations and insiders of the foundation. Substantial contributors, or other insiders, were known to engage in property rental or purchase transactions, loans, and other transactions that were not necessary to the foundation's charitable purposes and which inappropriately benefited the insider.

In response, the House of Representatives proposed a prohibition on self-dealing transactions between foundations and foundation insiders, as well as a tax on the accumulated investment income of a foundation that was not paid out within two and a half months of the end of a the foundation's taxable year. However, the Senate took a different approach and adopted an arm's length dealing standard for such self-dealing transactions, and a reporting requirement for income accumulations.

The 1950 Act followed the Senate approach, and added loss of exemption as a possible penalty for engaging in self-dealing transactions that were not at arm's length, as well as for unreasonable income accumulations, use of income to a "substantial" degree for non exempt purposes, or investment of income in a manner that jeopardizes the achievement of exempt

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<sup>271</sup> Pub. L. No. 78-235, sec. 117(a) (1943).

<sup>272</sup> Pub. L. No. 81-814, sec. 331 (1950).

purposes.<sup>273</sup> Under the 1950 Act, several charitable organizations were exempt from the new provisions, including religious organizations, schools, medical organizations (including hospitals), government-supported organizations, and publicly supported organizations.<sup>274</sup>

On the charitable contribution side, the public charity-private foundation distinction began with the adoption of the Revenue Code of 1954. Then, as now, charitable contributions generally were deductible up to a stated percentage of the donor's adjusted gross income. Before 1954, the percentage was the same (20 percent at the time) for all charitable organizations. In drafting the 1954 Code, however, Congress increased the percentage limitation to 30 percent, but the increase was available only for contributions to religious, educational, or certain hospital organizations.<sup>275</sup> Legislative history indicates that the increase was "designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds."<sup>276</sup> Although other charitable organizations presumably would have benefited from the increased percentage limitation, only these were chosen by Congress.

This limited expansion of the percentage limitation marked Congress's continuing preference for certain types of charitable organizations. Congress expanded the preference in the Revenue Act of 1964, by extending the 30 percent of adjusted gross income limitation to organizations that were publicly or governmentally supported. The legislative history to the 1964 Act specifies that contributions to private foundations were not entitled to the 30 percent limit because private foundations generally were not active charitable organizations and often used funds for investment purposes. The purpose of the increased percentage limitation was to encourage gifts to organizations that would spend the money immediately.<sup>277</sup>

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<sup>273</sup> The provision provided for a loss of tax-exempt status for at least one year (and, in some cases, loss of eligibility to receive tax-deductible contributions) if the foundation engaged in certain "prohibited transactions" with related persons other than on an arm's-length basis. The prior-law sanctions applied if a foundation engaged in the following with certain insiders: (1) lending of any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest; (2) payment of any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered; (3) making any part of its services available on a preferential basis; (4) making any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth; (5) sales of any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth; or (6) engaging in any other transaction which results in a substantial diversion of its income or corpus to the creator of the organization (if a trust). Pub. L. No. 81-814, sec. 331.

<sup>274</sup> *Id.*

<sup>275</sup> These three types of charitable organization generally are considered under present law to qualify as a public charity.

<sup>276</sup> H. R. Rep. No. 1337, 83<sup>rd</sup> Cong., 2d Sess. 25 (1954).

<sup>277</sup> See H. R. Rep. No. 749, 88<sup>th</sup> Cong. 1<sup>st</sup> Sess. 53 (1964) (noting that private foundations "frequently do not make contributions to the operating philanthropic organizations for extended periods



## Congressional investigations before 1969

Concerns about the uses and abuses of private foundations was an ongoing theme in the years leading up to the Tax Reform Act of 1969. In 1952, the House created a Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations to investigate whether foundations were being used for “un-American and subversive” activities. The “Cox Committee”<sup>278</sup> reported that although there were confirmed cases of communist infiltration into foundations and that foundations were vulnerable to infiltration or misuse, “on balance, the record of the foundations was good.” The Committee largely praised the important role of foundations in society in the fields of medicine, public health, international relations, public administration, the humanities, race relations, the arts, adult education, recreation, and economics. However, the Committee recommended the disclosure by foundations to the Bureau of Internal Revenue of additional information, including disclosure of most contributors, administrative expenses, compensation of certain persons, accumulation of income, and the public disclosure of foundation grants. The Committee noted that it did not have enough time for a full investigation.

Following the Cox Committee, in 1953, the House established the Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations to investigate further whether foundations were using funds for nonexempt purposes, subversive activities, political purposes, propaganda, or to influence legislation. The “Reece Committee” reported in 1954,<sup>279</sup> and found that foundations were rapidly increasing in number, and that the increase was due to the tax-favored status of foundations and not to charitable intent. Foreshadowing the 1969 Act, the Reece committee recommended a Code based definition of private foundation, expressed concern about excess business holdings of foundations, recommended a mandatory distribution of income, and suggested that any revocation of a foundation’s exempt status be retroactive. The Reece committee did not support certain other ideas, such as the elimination of tax-exempt status for foundations.

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of time and in the meanwhile use the funds for investments. The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations.”).

<sup>278</sup> The Cox Committee was named for its chairman, Representative E.E. Cox of Georgia. It held hearings in November and December of 1952 and reported, after the death of its chairman, on January 1, 1953. See *Tax-Exempt Foundations: Hearings before the House Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations*, 82<sup>nd</sup> Cong., 2d Sess. (1952); H. R. Rep. No. 2514, 82<sup>nd</sup> Cong., 2d Sess. (1953).

<sup>279</sup> The Reece Committee was named for its chairman, Representative B. Carroll Reece of Tennessee. It conducted hearings in 1954 and issued a report on December 16, 1954. See *Tax Exempt Foundations: Hearings before the House Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations*, 83<sup>nd</sup> Cong., 2d Sess., on H. Res. 217 (1954); H. R. Rep. No. 2681, 83<sup>nd</sup> Cong., 2d Sess. (1954).

In the 1960's, Congressman Wright Patman issued a series of reports regarding private foundations, largely in his capacity as chair of the Select Committee on Small Business.<sup>280</sup> His reports emphasized the impact of foundations on small businesses. In general, the reports were highly critical of foundations and of IRS and Treasury oversight of foundations. Mr. Patman studied foundations broadly (one report examined how 575 foundations spend their money) and also focused intensively on a handful of foundations (one report contained more than 1,000 pages regarding a single foundation). The first report made 17 recommendations, including limiting foundation life to 25 years, prohibiting foundations from engaging in business, barring commercial lending and borrowing, enforcing the 1950 self-dealing rules, limiting the business holdings of foundations, and applying the corporate accumulated earnings tax to certain foundations.

### 1965 Treasury Report

In response to requests by the House Committee on Ways and Means and the Senate Finance Committee, in 1965 the Treasury Department issued a report (the "Treasury Report") on private foundations. The Treasury Report concluded that "the preponderant number of private foundations perform their functions without tax abuse," but identified "serious faults" among a minority of foundations.<sup>281</sup> In general, the Treasury Report evaluated three broad criticisms leveled at private foundations: (1) that the interposition of a foundation between the donor and the conduct of charitable activity results in undue delay in effectuating gifts; (2) that foundations were becoming a disproportionately large part of the national economy; and (3) that foundations represent dangerous concentrations of economic and social power.<sup>282</sup> The Treasury Report concluded that the first criticism could be specifically addressed through legislation, the second was unwarranted, and the third was being addressed by the foundations through establishment of independent boards and professional staffs, securing the independence of grantees, and by encouraging public scrutiny.

Still, the Treasury Report identified six "major problems" and recommended legislation. The major problems were self-dealing, the delay in benefit to charity, foundation involvement in business, family use of foundations to control corporate and other property, financial transactions unrelated to charitable functions, and donor involvement in foundation management.

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<sup>280</sup> *Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy*, Report to the Select Committee on Small Business, House of Representatives, First Installment, 87<sup>th</sup> Cong. 2d Sess. (1962); Second Installment, 88<sup>th</sup> Cong. 1<sup>st</sup> Sess. (1963); Third Installment, 88<sup>th</sup> Cong. 2d Sess. (1964); Fourth Installment, 89<sup>th</sup> Cong., 2d Sess. (1966); Fifth Installment, 90<sup>th</sup> Cong., 1<sup>st</sup> Sess., (1967); Sixth Installment, 90<sup>th</sup> Cong., 2d Sess. (1968); Seventh Installment, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. (1969); Eighth Installment, 92d Cong., 2d Sess. (1972).

<sup>281</sup> *Treasury Department Report on Private Foundations*, Committee on Finance United States Senate, 89<sup>th</sup> Cong., 1<sup>st</sup> Sess. (February 2, 1965) (hereinafter "1965 Treasury Report") at 2.

<sup>282</sup> *Id.* at 5, 13-14.

With respect to self dealing, the Treasury Report concluded that the approach of the 1950 Act, which permitted self-dealing at arm's length, was "difficult and expensive to administer, hard to enforce in litigation, and otherwise insufficient to prevent abuses. Whatever minor advantages charity may occasionally derive from the opportunity for free dealings between foundations and donors are too slight to overcome the weight of these considerations."<sup>283</sup> Consequently, the Treasury Report recommended a general prohibition of self-dealing transactions, patterned on the 1950 House bill.

To counter the problem of a delay in benefit to charity, the Treasury Report recommended a mandatory payout of all of a foundation's net income on a reasonably current basis. Regarding involvement in business, the Treasury Report recommended an absolute limit (20 percent) on participation by foundations in business activities. To address family abuse of controlled foundations, the Treasury Report generally recommended denial of a deduction with respect to gifts of business interests in which the donor maintains control of the business, unless certain conditions were met.

With respect to financial transactions unrelated to charitable functions, the Treasury Report cited three problem areas: heavy foundation borrowing to acquire productive assets resulting in private benefit, loans for the benefit of private parties who were not subject to the self-dealing rules, and the active trading of securities or speculative practices. In response, the Treasury Report proposed banning all foundation borrowing for investment purposes, confining foundation loans to necessary and safe loans that are appropriate for charitable fiduciaries, and prohibiting foundations from trading activities and speculative practices.

In order to limit the influence of donor management of foundations, the Treasury Report recommended that after a foundation had been in existence for 25 years, no more than 25 percent of the foundation's governing body could consist of donors or related parties.

### **The Tax Reform Act of 1969**

The private foundation provisions of the 1969 Tax Reform Act were enacted in light of the Treasury Report, Congressional hearings, and the Wright Patman series of reports. In general, a consensus had emerged that prior law was insufficient and in some respects inadministrable with respect to private foundations. Accordingly, the 1969 Act, closely following the Treasury Report, defined a private foundation and developed special rules and excise taxes to address the reported abuses.

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<sup>283</sup> *Id.* at 6.

### Definition of private foundation and two-tier excise taxes

The 1969 Act generally defined private foundations as all charitable, educational, or religious organizations (including trusts with charitable, etc. beneficiaries)<sup>284</sup> other than those described above, which are generally referred to as public charities.<sup>285</sup>

The Tax Reform Act of 1969 established a two-tier system of excise taxes intended to ensure compliance with the new private foundation rules. These excise taxes replaced the principal penalties imposed under prior law for foundation misuse, i.e., possible loss of the foundation's exempt status and its eligibility to receive deductible contributions. In general, a first tier tax is imposed on a disqualified person (and in some cases, foundation managers) for a violation of a specific rule. If the violation is not corrected, a large second tier tax is imposed on the disqualified person, and in some cases foundation managers.

### Tax on investment income

In the 1969 Act, Congress "concluded that private foundations should share some of the burden of paying the cost of government, especially for more extensive and vigorous enforcement of the tax laws relating to exempt organizations."<sup>286</sup> Accordingly, a tax on the net investment income of private foundations was imposed.<sup>287</sup>

### Self-dealing

The 1969 Act generally prohibited self-dealing transactions between a private foundation and a disqualified person.<sup>288</sup> The prohibition was chosen in order to minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for

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<sup>284</sup> The Act further defined and provided favorable treatment for a special type of private foundation, the operating foundation. See footnote 248.

<sup>285</sup> See text at footnotes 250 to 256.

<sup>286</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 29.

<sup>287</sup> "Exempt operating foundations," which are a subcategory of private operating foundations, were introduced in 1984 and are exempt from the tax on net investment income. Sec. 4940(d)(1) and (2).

<sup>288</sup> In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (5) certain payments of money or property to a government official. Sec. 4941(d)(1). Certain exceptions apply. See sec. 4941(d)(2). Disqualified person is defined in section 4946(a).

noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical properly to enforce the law. Congress also determined that the highest fiduciary standards required complete elimination of all self-dealing, rather than merely imposition of arm's length standards.<sup>289</sup>

On a practical level, Congress concluded that the arm's length standards had proved difficult to enforce, resulting in sporadic and uncertain effectiveness. The prior-law penalty of loss of exempt status also seemed unduly harsh in comparison to the offense involved, causing reluctance in enforcement, especially considering the subjectivity involved in applying arms'-length standards. Even if the IRS sought to apply sanctions, these same factors encouraged extensive litigation and a noticeable reluctance by the courts to uphold severe sanctions.<sup>290</sup>

Also, the Congress concluded that compliance with arm's-length standards often did not in itself prevent the use of a private foundation to benefit improperly those who control it. This was true, for example, where a foundation (1) purchases property from a substantial donor at a fair price, but does so in order to provide funds to the donor who needs cash and cannot find a ready buyer; (2) lends money to the donor with adequate security and at a reasonable rate of interest, but at a time when the money market is too tight for the donor to readily find alternate sources of funds; or (3) makes commitments to lease property from the donor at a fair rental when the donor needs such advance leases in order to secure financing for construction or acquisition of the property.<sup>291</sup>

#### Mandatory payout rules

Under the Revenue Act of 1950, certain charitable organizations (generally corresponding to private foundations) would lose their tax-exempt status if the organization's aggregate accumulated income was "unreasonable in amount or duration" in order for the organization to carry out its charitable functions. In 1969, Congress replaced this rule with a provision that required a payout based on a specified percentage of a private foundation's non-charitable use assets.<sup>292</sup>

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<sup>289</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 30-31.

<sup>290</sup> *Id.*

<sup>291</sup> *Id.*

<sup>292</sup> As enacted in 1969, the payout was the greater of a foundation's income or six percent of the foundation's investment assets. The Secretary of the Treasury had the authority to adjust the percentage periodically. The present law payout is five percent of a foundation's investment assets.

Congress determined that the prior-law restriction was defective in two respects.<sup>293</sup> First, the prohibition on unreasonable income accumulations failed to preclude private foundations from holding or investing in assets which produced no current income, such as undeveloped land. As a result, although a donor to a foundation would receive an immediate charitable deduction on making a gift of nonproductive assets (or of property converted into such assets by the foundation), there could be an indefinite delay between the loss of tax revenues due to the deduction and the benefit intended to accrue to the public from the gift. Second, the prohibition on unreasonable income accumulations was difficult to enforce both because of its vagueness and the subjective nature of the test, and because the penalty of loss of exempt status, as was the case with self-dealing, was either unduly harsh for minor violations or largely ineffective for more substantial violations. As noted in the Treasury Report, court cases had sanctioned accumulations of income for up to 10 years for the sole purpose of increasing the size of the foundation's corpus.<sup>294</sup>

### Limitations on business holdings

In 1969, Congress adopted rules that limit the amount of permitted business holdings of a private foundation.<sup>295</sup> Previously, no specific provisions addressed ownership of businesses by charitable organizations, including private foundations (although under the commerciality doctrine, any charitable organization could lose exempt status if the business activities of the organization predominated over charitable activities).

Congress determined that a number of private foundations were being used to maintain control of businesses and was concerned that as a result foundations with significant business holdings tended to be relatively unconcerned about producing income, that the attention and interest of such foundations would be devoted to the operation, maintenance, and improvement of the business and not exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over

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<sup>293</sup> See H.R. Rep. No. 91-413 (Pt. 1), 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 25-27 (1969); S. Rep. No. 91-552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 34-38 (1969); Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 36-40 (1970); *Treasury Department Report on Private Foundations*, House Committee on Ways and Means, 89<sup>th</sup> Cong., 1<sup>st</sup> Sess. 23-30, 58-60, 92-96 (Comm. Print 1965).

<sup>294</sup> See 1965 Treasury Report, at 26.

<sup>295</sup> In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons. If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. Similar rules apply with respect to holdings in a partnership and to other unincorporated enterprises. Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax. Sec. 4943(c)(6). This five-year period may be extended an additional five years in limited circumstances. Sec. 4943(c)(7).

businesses owned by taxable persons. Thus, the Congress concluded that a private foundation should be limited in the amount of a business that it may control.

#### Prohibition on jeopardizing investments

Prior to the Tax Reform Act of 1969, a private foundation would lose its tax-exempt status if its accumulated income was invested in a manner that jeopardized the carrying out of its charitable purposes. No similar limitation applied to investment of principal. Congress determined that investments of principal that jeopardize exempt purposes may reduce benefits to charity just as much as jeopardizing investments of accumulated income. In addition, the loss of exemption of prior law was considered too harsh a sanction, and a more limited sanction was needed.

#### Restrictions on foundation expenditures

The taxation of certain expenditures of a private foundation was intended as an enforcement mechanism to several of the general prohibitions on the conduct of charitable organizations and foundations, for example, the lobbying limitation, the prohibition of political activities, and the use of accumulated income for non exempt purposes. Congress determined that, with respect to foundations, these prior-law rules were defective not only because of the harshness of the sanction, but also because, in the case of the lobbying rules, large foundations could still engage in significant amounts of lobbying, and, in the case of political activities, the law was unclear as to whether certain activities, such as voter registration campaigns and publication of the views, personalities, and activities of candidates, were prohibited. Congress also was concerned that some grants by foundations were not being used for charitable purposes, but instead were being used for purposes such as vacations or to subsidize the preparation of material furthering political viewpoints. The Congress also concluded that private foundations should take substantial responsibility for the proper use of grants they make. Accordingly, Congress adopted rules that treated as taxable expenditures expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility<sup>296</sup> with respect to the grant; or (5) for any non-charitable purpose.

#### Tax on termination of private foundations

As highlighted by the Reece Committee, there was a concern that the sanction of revocation of tax exempt status was ineffective for private foundations unless the revocation could be made retroactive. In general, a fully funded private foundation may have received many of the benefits of tax exemption and be indifferent to revocation. Thus, the Reece

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<sup>296</sup> In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

Committee suggested that revocations be retroactive. Also, prompted by a concern that the definition of a private foundation by the 1969 Act and the imposition of tough new rules might lead a number of private foundations to terminate or reorganize, Congress imposed a termination tax on private foundations that terminate existence.<sup>297</sup> “Congress concluded that foundations should not receive substantial and continuing tax benefits in exchange for the promise of the use of the assets involved for educational, charitable, religious, etc., purposes but avoid the carrying out of these responsibilities.”<sup>298</sup> A change in private foundation status generally would not be permitted unless the foundation “repays to the government the aggregate tax benefits (with interest) which have resulted from its exempt status.”<sup>299</sup>

## **1996 Taxpayer Bill of Rights 2 -- intermediate sanctions on public charities**

Prior to 1996, there was no sanction, short of revocation of tax exemption, on organization insiders or disqualified persons for engaging in self-dealing transactions with respect to a public charity, even though private foundations had been subject to self-dealing rules since 1969. In 1996, Congress enacted new “intermediate sanctions” in the form of excise taxes on “excess benefit transactions” between a public charity or a social welfare organization and an insider of the organization.<sup>300</sup> An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity or social welfare organization directly or indirectly to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. An excise tax is imposed on any such excess.

Like the 1950 Act self-dealing rules applicable to private foundations, the 1996 “intermediate sanctions” rules generally permit insider transactions to occur so long as no excess benefit is provided to an organization insider.<sup>301</sup> Congress determined in 1996 that under prior law the chances of the IRS finding an abusive self-dealing transaction and actually revoking the organization’s exemption were slim and that an intermediate sanction was appropriate. The

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<sup>297</sup> The tax is imposed on the voluntary or involuntary termination of the status of an organization as a private foundation unless such organization transfers its net assets to, or begins to operate as, a public charity. The tax generally is equal to the aggregate tax benefit resulting from the organization’s status as a charitable organization (including the entire period the organization was exempt as a charitable organization), not to exceed the value of the net assets of the foundation. The tax also applies in certain cases involving willful repeated acts or failures to act, or a willful and flagrant act or failure to act, that gives rise to liability for excise taxes under the private foundation rules. Sec. 507.

<sup>298</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 56.

<sup>299</sup> *Id.*

<sup>300</sup> Sec. 4958.

<sup>301</sup> As noted above, Congress significantly tightened the private foundation rules in 1969 in part because arm’s length standards proved difficult to enforce.



Secretary issued proposed regulations with respect to excess benefit transactions in January 2001 and final regulations in January 2002.

### **Selected issues relating to the public charity - private foundation distinction**

#### In general

The 1969 Act solidified the distinction between public charities and private foundations, and there are now very different rules that apply to each type of charitable organization. In the years leading up to the 1969 Act, private foundations were widely seen as abusive because substantial contributors of foundations generally retained control of the foundation, calling into question the foundation's commitment to charitable purposes. The 1969 Act, the Treasury Report, and the Reece and Cox committees (though not the Patman reports) recognized the important role of private foundations in the charitable sector, but recognizing abuses, sought to constrain the foundation, while continuing its favored tax status. In 2005, thirty-six years after Congress first drew a meaningful legal distinction between publicly supported organizations and private foundations, it may not be as clear, given the growth and diversity of publicly supported organizations, why some of the private foundation rules are not relevant for certain public charities, or whether some of the private foundation rules are performing their intended purpose. For example, some have argued that publicly supported organizations are in general no less susceptible to abuse than private foundations by certain insiders of the organization, yet very different rules apply. The retention of substantial holdings in a commercial business, the making of investments or expenditures that jeopardize or are inconsistent with exempt purposes, or the maintenance of large endowment funds raise some of the same concerns whether conducted by a public charity or a private foundation. Some also have questioned the relevance of a tax on the net investment income of private foundations, either as an anachronism or as burden that should be shared equally among exempt or charitable organizations.

#### Supporting organizations

As noted above, in defining a private foundation, the 1969 Act provided that an organization that provides support to a public charity (a "supporting organization") is considered a public charity and not a private foundation. Thus, supporting organizations receive the benefit of the favorable charitable contribution deduction rules and avoid the excise tax regime applicable to private foundations.<sup>302</sup> For example, because a supporting organization is treated as a public charity, donors to supporting organizations may take a fair market value deduction for contributions of capital gain property such as closely held stock, which would not be permitted for gifts to private foundations. As a public charity, supporting organizations also are not subject to the private foundation self-dealing rules (e.g., barring loans and other transactions with insiders), limitations on business holdings, or subject to the private foundation payout rules. However, unlike other public charities but like private foundations, supporting organizations generally do not have broadly based support, and may resemble private foundations in other respects, for example by having grant-making as a primary or sole activity or by holding

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<sup>302</sup> Sec. 509(a)(3).

substantial funds for investment. Nevertheless, in general, supporting organizations are considered as public charities because of their supporting function and their relationship to one or more public charities.<sup>303</sup>

The determination of whether an organization qualifies as a supporting organization and, thus, exception from the private foundation rules often involves the consideration of complex rules and regulations.<sup>304</sup> Use of supporting organizations has been increasing in recent years and the IRS has listed abusive use of the supporting organization form as one of the “dirty dozen” notorious tax scams.

Under present law, to qualify as a supporting organization, an organization must meet three tests: (1) it must be organized and at all times operated for the benefit of, and to perform the function of, supported organizations (the “organizational and operational test”);<sup>305</sup> (2) it must be operated, supervised, or controlled by, or in connection with, one or more supported organizations (the “relationship test”);<sup>306</sup> and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more supported organizations (the “lack of outside control test”).<sup>307</sup>

Because the public charity status of a supporting organization is derivative of the status of another public charity, the solidity of the relationship between the supporting and the supported organization is important. Under present law, relationships must be one of three types. The first two types of supporting organizations are based on relationships with their supported organizations similar to that between a parent and subsidiary corporation (“type I supporting organizations”)<sup>308</sup> and a brother-sister corporation (“type II supporting organizations”).<sup>309</sup> The

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<sup>303</sup> This is based on the theory that supporting organizations are “subject to the scrutiny of a public charity.” *Quarrie v. Commissioner*, 603 F.2d 1274, 1278 (7th Cir.1979).

<sup>304</sup> In considering the regulations for supporting organizations, one court commented that “the IRS has drafted fantastically intricate and detailed regulations to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while evading the imposition of taxes.” *Windsor Foundation v. United States*, 77-2 U.S.T.C. 9709 (E.D. Va. 1977).

<sup>305</sup> Sec. 509(a)(3)(A).

<sup>306</sup> Sec. 509(a)(3)(B).

<sup>307</sup> Sec. 509(a)(3)(C).

<sup>308</sup> The distinguishing feature is the presence of a substantial degree of direction over the policies, programs, and activities of the supporting organization. Treas. Reg. sec. 1.509(a)-4(g)(1)(i). The relationship may be established by the fact that a majority of the members of the controlling body of the supporting organization (e.g., its officers, directors, or trustees) are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity or the membership of one or more publicly supported organizations.

<sup>309</sup> This relationship requires common supervision and control by the persons supervising or controlling both the supporting organization and the supported organization. Treas. Reg. sec. 1.509(a)-

relationship between the third type of supporting organization (“type III supporting organizations”) and the supported organization lacks the supervision or control present with both type I and type II supporting organizations. Rather than control, type III supporting organizations must be “operated in connection with” one or more publicly supported organizations.<sup>310</sup>

#### Examples of supporting organizations

The following are examples of supporting organizations:

- A university press organized as a nonstock educational corporation and operated to perform a university’s printing and publishing. The organization is controlled by a board of governors appointed by the university’s board of trustees (type I).<sup>311</sup>
- A charitable trust, whose trustees are appointed by a university. The trust was organized and is operated to pay over all its income to certain hospitals that allow the university’s faculty members to use the hospitals’ research facilities (type I).<sup>312</sup>
- A scientific study council organized under the joint sponsorship of several independent, publicly supported organizations. Each of the sponsoring organizations elects members to the council’s board. The remaining board members are the council’s president and at-large members elected by the council’s board (type I).<sup>313</sup>
- A community trust created by a publicly supported community chest to hold permanently endowed charitable funds and to distribute income to local publicly-supported charities. A majority of the community trust’s trustees are appointed by the community chest’s governing body (type I).<sup>314</sup>

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4(h)(1). In order to this meet this requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the supported organizations.

<sup>310</sup> Treas. Reg. sec. 1.509(a)-4(f)(2)(iii). The “operated in connection with” relationship rests upon findings that the supporting organization is “responsive” to and significantly involved in (or an “integral part” of) the operations the supported organization. Treas. Reg. sec. 1.509(a)-4(i)(1). The responsiveness test requires a showing that the supporting organization is responsive to the needs and demands of the supported organization. The integral part test requires a showing that the supporting organization maintains a significant involvement in the operations of one or more supported organizations. In neither case does the law require that a supported organization consent to or necessarily be aware of a supporting organization organized and operated for its benefit.

<sup>311</sup> Treas. Reg. sec. 1.509(a)-4(g)(2), Example (1).

<sup>312</sup> Treas. Reg. sec. 1.509(a)-4(g)(2), Example (3).

<sup>313</sup> Treas. Reg. sec. 1.509(a)-4(g)(2), Example (2).

<sup>314</sup> Rev. Rul. 81-43, 1981-2 C.B. 350.

- A certain charitable trust established for the benefit of a church (Type II).<sup>315</sup>
- A charitable trust established to provide college scholarships for students at a community high school. The municipality, of which the community high school is an integral part, is the beneficiary organization (Type III).<sup>316</sup>

#### Community foundations and donor advised funds

Once a donor makes a gift to charity, the gift becomes the property of the charitable organization and the donor generally retains little or no authority over use or investment of the donated property. The Code and Treasury regulations, however, offer limited ways for donors to exercise post-transfer control or direction over the use of funds or other property transferred to a charity for which the donor is entitled to a deduction in the year of transfer. One such mechanism is the community trust (or community foundation) which permits donors to designate, subject to certain restrictions, the purposes for which the assets are to be used.<sup>317</sup> Another such mechanism is the donor advised fund.

Generally, a community foundation is an organization established to receive gifts or bequests from the public and to administer them for charitable purposes primarily in the community or area in which it is located. A community foundation generally is classified as a public charity, rather than a private foundation, because the component funds it receives from the public allow it to qualify as a publicly supported organization. The first community foundation was established in 1914 by the Cleveland Trust Company, a bank. By 1991, the IRS estimated that there were over 400 community foundations holding over \$8 billion in assets and distributing \$525 million to charities.<sup>318</sup>

In recent years, many commercial entities have established and promoted donor advised funds to attract contributions from individual taxpayers who wish to have input or specify how they would like their contributions to be distributed. Although not defined by the Code or regulations,<sup>319</sup> donor advised funds, sometimes referred to as the “poor man’s private

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<sup>315</sup> Treas. Reg. sec. 1.509(a)-4(h)(3), Example (3).

<sup>316</sup> *Nellie Callahan Scholarship Fund v. Commissioner*, 73 T.C. 626 (1980). The IRS does not acquiesce in this decision. 1980-2 C.B. 2.

<sup>317</sup> See Treas. Reg. secs. 1.170A-9(e)(10) through (13). Generally, a community foundation is an organization established to receive gifts or bequests from the public and to administer them for charitable purposes primarily in the community or area in which it is located.

<sup>318</sup> Wendell R. Bird, *How to Establish Donor-Advised Funds and Community Foundations*, 13 J. Tax’n Exempt Org. 68 (September-October 2001), (citing George Johnson and David Jones, *Community Foundations*, IRS, Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 1994, page 135 (1993)).

<sup>319</sup> Recently revised instructions to the Form 1023, the application for exempt status under section 501(c)(3), define a “donor-advised fund” as a fund established with “separate accounts for a donor whereby the donor may exercise a right to make a recommendation on either uses of the account,

foundation,” may be described as publicly supported organizations or funds operated by public charities, in which contributors to the fund are permitted to advise the fund as to either investments, distributions, or both. In general, because the IRS has determined that certain donor advised funds qualify as publicly supported charities,<sup>320</sup> contributors to donor advised funds can have the benefit of the favorable public charity rules and some elements of the control over distributions provided by a private foundation without being subject to the legal constraints placed on a private foundation. Thus, a donor can fund an account in a donor advised fund with cash or capital gain property, take a fair market value deduction, accumulate income in the fund, and from time to time recommend that amounts be paid out of the fund for charitable purposes. Donor advised funds, like supporting organizations, illustrate an entity that resembles a private foundation in many ways, but is considered a public charity.

The first donor advised fund formed by a mutual fund was established by Fidelity Investments in 1991. By 1999, this fund had grown to assets of \$1.7 billion and annual income of \$867 million.<sup>321</sup> As of 2001, Fidelity was the largest donor advised fund and also the fifth largest charity in the United States. According to one estimate, the total assets in donor advised funds have more than tripled from 1995 to 1999, to approximately \$7.5 billion.<sup>322</sup>

Both community foundations and donor advised funds allow donors to make contributions and later give nonbinding advice about distributions to public charities.<sup>323</sup> Charities typically establish a community foundation, whereas a mutual fund, bank, or community foundation may establish a donor advised fund. Community foundations (at least if formed as trusts) are defined by and subject to Treasury regulations, while the IRS has not applied those regulations to donor advised funds.

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such as providing advice about how to invest, or distributions from the account, such as providing advice about how to make expenditures.”

<sup>320</sup> See Priv. Ltr. Rul. 9807030 (November 19, 1997); Priv. Ltr. Rul. 9412039 (March 25, 1994).

<sup>321</sup> Wendell R. Bird, *How to Establish Donor-Advised Funds and Community Foundations*, 13 J. Tax'n Exempt Org. 68 (September-October 2001).

<sup>322</sup> *Id.*

<sup>323</sup> If the advice or direction of the donor is binding on the donor advised fund or community foundation, the donor is unlikely to be viewed as having relinquished sufficient control over the donated funds or assets to have made a completed gift. Under such circumstances, the donor would not be entitled to an immediate deduction at the time of the contribution. In practice, however, most donor advised funds and community foundations follow the nonbinding advice of donors.

## E. General History of the Unrelated Business Income Tax

### In general

The Code imposes a tax, at ordinary corporate rates, on the income that a tax-exempt organization obtains from an “unrelated trade or business ... regularly carried on by it.”<sup>324</sup> Generally, “unrelated trade or business” is “any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose.”<sup>325</sup> The Code thus sets up a three-part test for determining whether income from an activity is subject to the unrelated business income tax: (1) the activity constitutes a trade or business; (2) the activity is regularly carried on; and (3) the activity is not substantially related to the organization’s tax-exempt purposes. The fact that a charity requires revenues to accomplish its charitable mission does not make a revenue raising activity (e.g., fund raising) related to its exempt purposes.<sup>326</sup>

### Business income prior to 1950

Until the introduction of the unrelated business income tax in 1950, exempt organizations enjoyed a full exemption from Federal income tax. If a charitable or other exempt organization met the organizational and operational requirements of the statute, there was no statutory limitation on the amount of business activity an exempt organization could conduct so long as the earnings from the business were used for exempt purposes. In other words, prior to 1950, exempt organizations did not pay tax on commercial business income and could invest business earnings in the conduct and expansion of exempt programs.

An early Supreme Court decision, *Trinidad v. Sagrada Orden de Predicadores*, established this “destination of income” test.<sup>327</sup> In *Trinidad*, the taxing authority sought to apply the corporate income tax to a religious organization on the ground that the organization was not operated exclusively for exempt purposes. The organization held investment property, from which it received rents, interest, and dividends, and engaged for profit in the limited trade of goods such as wine and chocolate to related organizations. In upholding the organization’s tax exemption, the Court found it important that the income from the properties “is devoted exclusively to religious, charitable and educational purposes” conducted by the organization and the trading in goods was “purely incidental to the pursuit of those purposes, and is in no sense a distinct or external venture.”<sup>328</sup> Because the statutory language creating exemption said nothing

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<sup>324</sup> Secs. 512(a)(1), 511(a)(1).

<sup>325</sup> Sec. 513(a).

<sup>326</sup> Treas. Reg. sec. 1.513-1(a).

<sup>327</sup> 263 U.S. 578 (1924). As discussed elsewhere, *Trinidad* also laid the foundation for the commerciality doctrine, i.e., an organization could lose exemption if it became too commercial in character.

<sup>328</sup> *Id.* at 581.

about the source of an organization's income, the statute "makes the destination the ultimate test of exemption."<sup>329</sup> However, as if foreshadowing the unrelated business income tax, the Court noted that "[i]t is not claimed that there is any selling to the public or in competition with others."<sup>330</sup>

In later years, courts extended the destination of income test to the exemption even of charitable organizations that did not conduct any charitable programs, but rather operated commercial businesses for the benefit of a charitable organization. Tax exemption for such so called "feeder" organizations was recognized in *Roche's Beach, Inc. v. Commissioner*,<sup>331</sup> in which the court held that a bathing beach business that turned its profits over to a charitable organization was exempt. The business was purely a commercial operation, the renting of bath houses, swim suits, towels, and other activities.

The destination of income and feeder corporation concepts reached their peak in *C.F. Mueller Co. v. Commissioner*,<sup>332</sup> in which the C.F. Mueller Company, one of the nation's leading makers of pasta, was acquired by a new tax exempt corporation, which distributed all the dividends received from operating the noodle company to the New York University School of Law, a tax exempt educational organization. The Commissioner challenged the tax-exemption of the pasta company, but the court upheld the exemption on the ground that the pasta company's profits were destined for the School of Law's exempt programs. Accordingly, the operation of a commercial business was held to be consistent with operation for a charitable purpose.<sup>333</sup>

In addition to the use of feeder corporations as a source of revenue, another common practice of charitable organizations in the years before 1950 was the acquisition of real estate with borrowed funds. In a typical transaction, a tax-exempt organization, often a college or university, would borrow money to acquire real estate, lease the property back to the seller under a long-term lease, and service the loan with tax-free rental income from the lease. Under such transactions, there was a concern that exempt organizations were in effect leveraging their tax exemption and threatening the tax base by acquiring, through debt, income producing assets that after the acquisition no longer generated revenue for the Federal government.

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<sup>329</sup> *Id.*

<sup>330</sup> *Id.* at 582.

<sup>331</sup> 96 F.2d 776 (2d Cir. 1938).

<sup>332</sup> 190 F.2d 120 (3d Cir. 1951).

<sup>333</sup> In *Mueller*, the new corporation purchased the pasta company for \$3.5 million. Other acquisitions had been made on behalf of New York University in the same time period, e.g., Howes Leather Company at \$35 million, American Limoges China, Inc., at \$3.3 million, and a piston ring manufacturer, the Ramsey Corporation, at \$3 million. Hearings Before the House Committee on Ways and Means, 81st Cong., 2d Sess., pt. 1 at 780, 799 (1950).

## **Revenue Act of 1950**

As a response to the practices and rulings discussed above, in the Revenue Act of 1950 Congress subjected charitable organizations (not including churches), labor, agricultural, and horticultural organizations, business leagues, certain trusts, and certain title holding companies to tax on their unrelated business income.<sup>334</sup> The legislative history of the 1950 Act provides that “the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition.”<sup>335</sup> Congress decided not to deny or revoke tax-exempt status solely because the organization carried on unrelated active business enterprises, but instead “merely [imposed] the same tax on income derived therefrom as is borne by their competitors.”<sup>336</sup> The unrelated business income tax did not apply to all commercial activity of an exempt organization, but only to businesses that were unrelated to the organization’s exempt purposes. In addition, excluded from the tax was passive investment income, such as dividends, interest, annuities, royalties, certain rents, and gains and losses from the disposition of property other than inventory or property held primarily for sale to customers in the ordinary course of the trade or business. Excluded from the definition of an unrelated trade or business was a trade or business in which substantially all the work in carrying on the business is performed for the organization without compensation, a trade or business carried on primarily for the convenience of the members, students, patients, officers, or employees of the organization, and a trade or business (such as a thrift shop) that sells merchandise, substantially all of which is received by the organizations as gifts or contributions.<sup>337</sup>

Specifically to address the issue of feeder organizations, the 1950 Act provided that, in general, an organization that is operated primarily for the purpose of carrying on a trade or business for profit may not be recognized as tax-exempt merely because all of the organization’s profits are payable to tax-exempt organizations. The legislative history explained that a feeder organization “obviously is in direct competition with other taxable businesses” and thus should be fully taxable. Unrelated trade or business income thus is subject to tax whether the trade or business activity is conducted directly by the organization or through a feeder subsidiary.

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<sup>334</sup> Revenue Act of 1950, Pub. L. No. 81-814, sec. 301. In 1951, Congress extended the unrelated business income tax to the income of State colleges and universities. Sec. 511(a)(2)(B).

<sup>335</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). The Supreme Court has stated that the “undisputed purpose” of the unrelated business income tax is “to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed.” *United States v. American Bar Endowment*, 477 U.S. 105, 114 (1986); *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986) (“Congress perceived a need to restrain the unfair competition fostered by the tax laws.”).

<sup>336</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 39 (1950).

<sup>337</sup> Sec. 513(a).



The 1950 Act also taxed certain rents received in connection with the leveraged sale and leaseback of real estate.<sup>338</sup> Here, Congress was concerned that the debt-financed sale-leaseback transaction could result in exempt organizations owning “the great bulk of the commercial and industrial real estate in the country. This, of course, would lower drastically the rental income included in the corporate and individual income tax bases.”<sup>339</sup>

### **Tax Reform Act of 1969**

Nineteen years later, in the Tax Reform Act of 1969, Congress made significant changes to the unrelated business income tax rules. The 1969 Act extended the tax to all exempt organizations described in section 501(c) and 401(a) (except United States instrumentalities). Thus, churches, social welfare organizations, social clubs, fraternal beneficiary societies, employees’ beneficiary organizations, teachers retirement fund associations, benevolent life insurance associations, cemetery companies, credit unions, mutual insurance companies, and farmers cooperatives formed to finance crop operations were subjected to the tax.<sup>340</sup> The legislative history explains: “Some churches are engaged in operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, restaurants, etc. Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not tax a country club or lodge engaged in similar activity.”<sup>341</sup>

In addition, the 1969 Act expanded the tax on debt-financed income, in response to a Supreme Court decision,<sup>342</sup> to cover not only certain rents from debt-financed acquisitions of real estate, but to tax in addition other debt-financed income such as interest, dividends, other rents, royalties, and certain gains and losses from any type of property. The change was made because under the 1950 legislation, exempt organizations continued to be able to leverage exempt status

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<sup>338</sup> There was an exception for rental income from a lease of five years or less.

<sup>339</sup> H.R. Rep. No. 2319, 81st Cong., 2d Sess. 39 (1950).

<sup>340</sup> The tax also applies to certain State colleges and universities and their wholly owned subsidiaries. Sec. 511(a)(2)(B).

<sup>341</sup> Joint Committee on Taxation, *General Explanation of the Revenue Act of 1969* (JCS-16-70), December 3, 1970, at 67.

<sup>342</sup> *Commissioner v. Clay B. Brown*, 380 U.S. 563 (1965). The “Clay Brown” transaction was one in which a corporate business was sold to a charitable organization, which made a small or no down payment and agreed to pay the balance of the purchase price out of profits from the property. The charity liquidated the corporation, leased the business assets back to the seller, who formed a new corporation to operate the business. The newly formed corporation paid a large portion of its business profits as “rent” to the foundation, which then paid most of these receipts back to the original owner as installment payments on the initial purchase price. In this fashion, a taxable business was able to realize increased after-tax income, and the exempt organization acquired the ownership of a business without the investment of its own funds. See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

to buy businesses and investments on credit, often at more than market price, without contributing much if anything to the transaction other than tax exemption.<sup>343</sup>

In order to prevent evasion of the unrelated business income tax through the use of controlled subsidiaries, the 1969 Act also generally provided that payments to a tax-exempt organization of interest, annuities, royalties, and rent from a taxable subsidiary of such organization are subject to the unrelated business income tax.<sup>344</sup> Also subjected to unrelated business income tax were payments from a tax-exempt subsidiary to its tax-exempt parent to the extent that the subsidiary's income is unrelated income of the subsidiary. These provisions were intended to prevent tax-exempt organizations from "renting" assets to a subsidiary for use in an unrelated business, thereby permitting the subsidiary to escape income taxes through a large rent deduction.<sup>345</sup>

The 1969 Act also introduced the "fragmentation" rule, pursuant to which a trade or business activity still is considered a trade or business even if it is merely a part of a larger aggregate of activities that may or may not be related activities of an organization. Thus, an exempt organization that publishes a periodical for educational purposes generally will be subject to unrelated business income tax with respect to income from advertising in the periodical.<sup>346</sup>

### **Post-1969 modifications -- in general**

Since 1969, Congress has made a number of changes to the unrelated business income tax rules, but the structure of the tax has remained largely intact. Mostly, changes have been to provide addition exclusions from tax for income on certain specified activities, such as: (1) qualified public entertainment activities; (2) qualified convention and trade show activities; (3) providing certain hospital services; (4) conducting bingo games; (5) engaging in telephone pole rentals; (6) distribution of low-cost articles in soliciting charitable contributions; (7) certain exchanges or rentals of member or donor mailing lists; and (8) certain corporate sponsorship payments (discussed below). In 1997 the rules relating to payments from taxable and tax exempt subsidiaries to an exempt parent were tightened "to prevent subsidiaries of tax-exempt organizations from reducing their otherwise taxable income by borrowing, leasing, or licensing assets from a tax-exempt parent organization at inflated levels."<sup>347</sup> The American Jobs Creation

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<sup>343</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 62.

<sup>344</sup> See sec. 512(b)(13).

<sup>345</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 71.

<sup>346</sup> Sec. 513(c).

<sup>347</sup> Pub. L. No. 105-34. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, at 239.

Act of 2004 modified the debt-finance income rules to provide an exclusion from the definition of acquisition indebtedness certain indebtedness of a small business investment company licensed under the Small Business Investment Act of 1958,<sup>348</sup> and provided an exclusion from the unrelated business income tax rules the gain or loss from certain dispositions of certain brownfield property.<sup>349</sup>

### **Selected issues relating to the unrelated business income tax**

#### Fundraising

Although the unrelated business income tax and the feeder corporation rule generally overturned the destination of income test, the general principle of the test -- that the source of a charitable organization's income is not important so long as the income is used to further charitable purposes -- is still viable with respect to noncommercial or passive investment activity. For example, exempt organization law does not tax proceeds from fundraising unless the fundraising activity is considered an unrelated trade or business. Thus, an organization may conduct significant activities that are not in themselves charitable in order to raise funds for charitable purposes. For example, the sale of educational items in a museum shop, royalties received from the licensing of an organization's logo or intellectual property, corporate sponsorship payments, and proceeds from car donation programs all are exempt from tax, even if the revenue raising activity is a substantial part of an organization's programs, because the funds raised are used to further charitable purposes (including the funding of the fundraising activity itself).

#### Reporting of unrelated business income

As noted, the rationale of the unrelated business income tax was to level the playing field between the unrelated commercial activities of exempt organizations and the activities of for profit taxable organizations. Thus, the unrelated business income tax is similar to the corporate income tax, in that an exempt organization may net unrelated income and expenses attributable to such income in calculating the tax. However, the reporting of unrelated business income by exempt organizations differs from reporting of income by taxable organizations. In general, exempt organizations have greater discretion than taxable organizations in determining whether to report income as taxable or not, for example by finessing the question of whether income is from a regularly conducted trade or business, and if so, whether the conduct of that trade or business is "substantially related" to its exempt purposes. In addition, even if an exempt organization treats income as unrelated and therefore as subject to tax, an exempt organization might allocate expenses for an exempt activity to an unrelated activity in order to minimize or eliminate the tax.

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<sup>348</sup> Sec. 514(c)(6)(A)(ii).

<sup>349</sup> Sec. 512(b)(18) [sic. 512(b)(19)].

## Corporate sponsorship payments

The unfair competition rationale underlying the unrelated business income tax is implicated when exempt organizations receive income from activities that are not subject to the tax but that may provide an exempt organization with a competitive advantage in conducting an activity over a for-profit organization. Congress recently addressed such a case in 1997 by enacting rules about the tax treatment of corporate sponsorship payments, which some have argued is a form of advertising. Corporate sponsorship payments generally are exempt from unrelated business income tax under a special rule, so long as certain requirements are met.<sup>350</sup> Prior to enactment of the special rule, the IRS had often questioned whether such arrangements allow charitable entities the ability to offer advertising to corporations at a lower rate.

In general, a corporate sponsorship payment is a payment from a corporation to a tax-exempt organization in exchange for becoming an “official sponsor” of a particular event of the tax-exempt organization. For example, a corporate sponsorship payment may occur when a corporation pays a university to become an official sponsor of the university’s football program, and the university in turn displays the corporation’s name and logo on the university’s football stadium where it can be seen by attendees and television viewers.<sup>351</sup> Another example is payment to an educational organization that regularly broadcasts a program in exchange for being featured on the program as a sponsor.

For a number of years, the IRS was of the view that many corporate sponsorship payments were subject to the unrelated business income tax. One notable example concerned the 1991 Mobil Cotton Bowl, whereby the Cotton Bowl Athletic Association (a tax-exempt organization) received a \$1.5 million corporate sponsorship payment from Mobil Oil. The IRS challenged Mobil Oil’s sponsorship payment and determined that the payment was for advertising.<sup>352</sup>

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<sup>350</sup> Sec. 513(i).

<sup>351</sup> In 1991 total corporate sponsorship payments to tax-exempt organizations was \$1.1 billion, of which about \$64 million was paid to the college football bowl organizations. Of this \$64 million, an estimated \$19.6 million was received for corporate title sponsorships rather than as corporate royalty payments. See Dennis Zimmerman, *Corporate Title Sponsorship Payments to Nonprofit College Football Bowl Games: Should They Be Taxed?*, Congressional Research Service 92-157E, Doc. 92-1744 (Feb. 11, 1992).

<sup>352</sup> See Frank James Vari, *The Unrelated Business Income Tax and its Effects Upon Collegiate Athletics*, 9 Akron Tax J. 111 (1992). Several key court decisions were used in support of the IRS’s position. Included among these cases is *United States v. American Bar Endowment*, 477 U.S. 105 (1986), in which the Supreme Court stated that the standard test for the existence of a “trade or business” is whether the provision of goods or services is entered into with the dominant hope and intent of realizing a profit. Using that rationale, the IRS concluded that by providing valuable services, including advertising services, in return for large payments, the organization was engaged in an activity for the production of income from the provision of services. Hence, the organization was engaged in a trade or business activity.

In 1993, the IRS published proposed regulations to clarify the tax treatment of sponsorship payments and provide a safe harbor whereby sponsorship payments that met certain criteria would not be treated as unrelated business income. However, the proposed regulations generated controversy and left unanswered questions. Thus, in 1997, Congress added section 513(i) to the Code in order to reduce the uncertainty with regard to the tax treatment of corporate sponsorship payments to exempt organizations. Congress determined that it was appropriate to distinguish sponsorship payments for which the donor receives no substantial return benefit other than the use or acknowledgment of the donor's name or logo as part of a sponsored event from payments made in exchange for advertising provided by the recipient organization. The latter, but not the former, are subject to the unrelated business income tax.<sup>353</sup>

#### Affinity credit card arrangements and mailing list rentals

Issues often arise regarding whether certain types of receipts constitute royalties, which generally are excluded in determining an organization's unrelated business taxable income.<sup>354</sup> Whether a particular income item is a royalty received in exchange for the passive license of an organization's intellectual property will be determined based on the facts and circumstances of the case.<sup>355</sup> Two issues that have been the source of considerable debate in this area are: (1) whether income from an affinity credit card program constitutes a royalty and (2) whether income from a mailing list rental constitutes a royalty.

Affinity credit card arrangements generally involve an agreement between an organization and a credit card issuer under which the organization's name and logo will appear on the issuer's credit cards. The cards are then marketed to an "affinity group," i.e., a group of individuals associated with the organization. The organization, in turn, receives a payment that is usually based on a percentage of charges on the affinity cards. The issue that generally arises is whether the payment to the exempt organization is in exchange for the passive license of valuable intellectual property or is instead a payment for services, and thus not a royalty. For

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<sup>353</sup> Sec. 513(i). An exempt "qualified sponsorship payment" is defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities. However, if the business receives advertising (or other benefits) in exchange for making a payment, then the payment may be considered payment for the advertising or other benefits. In that case, only the amount of the payment (if any) that exceeds the fair market value of the advertising or other benefits is a qualified sponsorship payment. On April 24, 2002, the IRS issued final regulations providing a safe harbor from taxation for qualified sponsorship payments. The final regulations clarified that payments other than qualified sponsorship payments are not automatically subject to unrelated business income tax. Instead, the tax treatment of nonqualified payments is determined under otherwise applicable unrelated business income tax rules. Treas. Reg. sec. 1.513-4.

<sup>354</sup> Sec. 512(b)(1).

<sup>355</sup> Treas. Reg. sec. 1.512(b)-1.

example, in *Sierra Club v. Commissioner*,<sup>356</sup> the Tax Court considered whether the retention by Sierra Club of the right to review promotional and marketing materials constituted the provision of marketing services by Sierra Club such as would convert the payment from a payment for a passive license to a payment for Sierra Club's active participation in the marketing program. The court also considered whether an agreement by Sierra Club "to cooperate" in the solicitation and encouragement of Sierra Club's members to participate in the program. The court sided with the taxpayer on both issues, finding that neither the retained right to approve marketing materials nor the obligation to cooperate constituted the provision of services such as would defeat the characterization of the payment as a royalty. The right to approve marketing materials simply helped Sierra Club protect its valuable intellectual property. The obligation to cooperate did not constitute an impermissible endorsement of the card issuer beyond that which necessarily results from licensing a name, logo, etc. Therefore, the court held that the income Sierra Club received in connection with the affinity arrangement was excludable from Sierra Club's unrelated business taxable income.

Courts have taken a similar approach to income from the rental of an exempt organization's mailing list. For example, in *Oregon State University Alumni Association, Inc. v. Commissioner*,<sup>357</sup> the United States Court of Appeals for the Ninth Circuit held that income from mailing list rentals constituted a royalty even where the exempt organization that owned and licensed the list provided some clerical services and engaged in some promotional activity with regard to the arrangement.

Notwithstanding the holdings in the above-described affinity credit card and mailing list rental cases, a taxpayer that provides more than a small amount of clerical services may risk having payments received in exchange for a license classified as payments for services rather than as excludable royalties.

#### Travel tours

A number of exempt organizations, including colleges and universities, offer travel tours that are promoted as educational. The IRS takes the position that travel tours of a more social or recreational nature are not substantially related to an organization's exempt educational purpose, and the income from such tours is unrelated business taxable income. Where a travel tour is truly educational, however, it may be related to an organization's exempt purposes.<sup>358</sup> The determination whether a particular travel tour is sufficiently educational to be considered substantially related to an organization exempt purposes is not always easy and thus has been the source of considerable controversy. In February 2000, the IRS issued final regulations that

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<sup>356</sup> 65 T.C.M. (CCH) 2582 (1993).

<sup>357</sup> 193 F.3d 1098 (9<sup>th</sup> Cir. 1999).

<sup>358</sup> Rev. Rul. 70-534, 1970-2 C.B. 113.

provide several examples in an effort to demonstrate when travel tours are educational, and thus related, and when they are not.<sup>359</sup>

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<sup>359</sup> Treas. Reg. sec. 1.513-7.

## F. Related Organization Structures Involving Exempt Organizations

### In general

An exempt organization may be affiliated with other organizations or entities, some exempt and some taxable. Thus, as is the case with taxable for-profit corporations, an exempt organization might be a parent of one or more incorporated organizations (e.g., an exempt parent of a health care system or educational system containing multiple entities), a subsidiary of another exempt organization (e.g., an exempt social welfare organization whose sole member is an exempt charity), or an organization that is under the common control of another exempt organization (e.g., a supporting organization of a public charity or two organizations with a brother-sister relationship).<sup>360</sup> In general, an exempt organization will be treated as separate from its related corporations as long as the purposes for which the related entity was formed are carried out in its activities.<sup>361</sup> An exempt organization also may participate in or be related to, through ownership or control, unincorporated entities, such as partnerships or limited liability companies. A leading commentator has stated that “[o]ne of the most important developments involving tax-exempt organizations in the modern era is the use of related organizations.”<sup>362</sup>

Related organization structures involving exempt organizations may serve a variety of purposes. Separate entities often are used by exempt organizations: (1) to isolate potential State law liability (tort, contract, or other) in a separate entity; (2) to isolate actual or potential income tax attributes (e.g., unrelated business income) in a separate entity;<sup>363</sup> (3) to conduct for-profit or dissimilar nonprofit activities in a separate entity for management, administrative, reporting, or other reasons; (4) to participate in an investment; or (5) because State or Federal law, or a third party such as a lender, might require or encourage the use of a separate State law or tax entity for the particular type of arrangement.

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<sup>360</sup> For a discussion of exempt organizations in various inter-organizational structures and operational forms, see Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, Part 6 - Inter-Organizational Structures and Operational Forms (8<sup>th</sup> ed. 2003).

<sup>361</sup> *Moline Properties v. Commissioner*, 319 U.S. 436 (1943) (involving a corporate subsidiary). If a parent organization controls the business and affairs of a subsidiary to such an extent that the subsidiary is merely an extension of the parent, however, the subsidiary will not be respected as a separate entity. *E.g.*, Gen. Couns. Mem. 33912 (August 15, 1968); Gen. Couns. Mem. 35719 (March 11, 1974); Gen. Couns. Mem. 39326 (August 31, 1984). Considerations include the amount of control the parent has over the subsidiary’s day-to-day operations, the business purpose for the arrangement, and the degree of overlap of officers and directors of the two organizations. If the separateness of the entities is not respected for Federal income tax purposes, the subsidiary’s activities will be treated as those of the parent organization for such tax purposes.

<sup>362</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, Part 6 - Inter-Organizational Structures and Operational Forms 933 (8<sup>th</sup> ed. 2003).

<sup>363</sup> *E.g.*, Priv. Ltr. Rul. 199938041 (June 28, 1999) (exempt organization formed subsidiary to conduct various unrelated trade or business activities).



A related organization structure may include two or more organizations and involve an exempt organization that owns the entire interest of a subsidiary, an exempt organization that co-owns a subsidiary or affiliate with other exempt organizations, individuals, or for-profit entities, or a combination of such arrangements. Charities and certain other types of exempt organizations may not be owned by private interests, but generally may be a subsidiary of another organization if the parent organization also is a charitable organization or is a similar type of tax-exempt organization (e.g., a social welfare organization may be a subsidiary of another social welfare organization).<sup>364</sup>

Affiliations between an exempt organization and other persons or entities have both State law and tax law implications. In general, State law determines the rights and obligations of the parties to the relationship, both among themselves (e.g., the governance and financial rights of the participants) and with respect to others who are not parties to the relationship (e.g., a creditor, customer, or supplier). Federal tax law determines how the affiliation and the participating parties will be treated for Federal income tax purposes. Not every State law entity is a separate entity for Federal income tax purposes. Also, an entity may be formed for Federal income tax purposes even if a separate legal entity is not created under State law (e.g., a contractual arrangement or joint operating agreement that provides for the sharing of profits or losses rather than merely a cost sharing arrangement among the parties to the arrangement).<sup>365</sup>

State law entities include corporations, limited liability companies (LLCs), and partnerships (including general and limited partnerships).<sup>366</sup> Under most State laws, a corporation or limited liability company may be formed with one shareholder or member, or with

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<sup>364</sup> Organizations described in sections 501(c)(3), (c)(4), (c)(6), (c)(7), (c)(9), (c)(11), (c)(13), (c)(19), and (c)(26), are subject to a private inurement prohibition that generally prohibits private persons from owning an equity interest in the net earnings of the exempt organization.

<sup>365</sup> *E.g.*, Priv. Ltr. Rul. 9609012 (March 1, 1996) (joint operating agreement among three charitable organizations relating to the operation but not ownership of hospital facilities of each created a partnership under section 7701(a)(1) at the time the agreement was executed; agreement provided for financial integration of the separate organization's facilities through annual payments based on adjusted cash flows). Such contractual arrangements, however, also may be regarded as general partnerships under certain State laws.

<sup>366</sup> In some States, additional types of partnerships are possible. For example, some States provide for limited liability partnerships, which generally are partnerships formed under a general partnership statute for which the partners make an election and register with the State to have the limited liability shield apply to the general partners. Limited liability partnerships permit partners to retain the management and governance provisions applicable to general partnerships while obtaining limited liability protection, and frequently are used in professional partnership settings (e.g., a law or public accounting partnership). In addition, some States provide for limited liability limited partnerships, which generally are limited partnerships for which an election is made to have the limited liability shield also apply to the partnership's general partners. Limited liability limited partnerships generally possess the management and governance characteristics of limited partnerships (i.e., management by general partners rather than by limited partners), and might be used when passive investors intend that management be vested in one or a select few of the partners.

multiple owners. A partnership formed under State law requires two or more partners. Most State laws also provide for the formation of nonprofit corporations that permit the conduct of an activity other than for profit.<sup>367</sup>

Under Federal income tax laws, business entities generally are treated as partnerships, corporations, associations taxable as corporations, or disregarded entities.<sup>368</sup> In many cases, the status of an entity for State law purposes is not determinative of the entity's status for Federal income tax purposes. For example, a State law partnership or multiple-member limited liability company may be taxed either as a partnership or a corporation, generally at the election of the partners or members.<sup>369</sup>

### **Wholly-owned subsidiaries of exempt organizations**

#### In general

Organizations that are wholly owned or controlled by an exempt organization generally take the form of a nonprofit tax-exempt organization, a for-profit corporation, or a single member limited liability company. General Federal income tax considerations that pertain to such structures include: (1) whether the subsidiary will be treated as a separate taxable entity (two potential levels of tax) or as a part of the exempt parent organization (one potential level of tax); (2) if the subsidiary is treated as separate from the parent for Federal income tax purposes, whether the subsidiary may qualify for exempt status or treatment as a pass-through entity; (3) whether certain of the payments from the subsidiary to the parent are subject to the controlled-entity rules of section 512(b)(13); and (4) the allocation of shared expenses (e.g., shared facilities or personnel) between the organizations and across exempt, investment, and unrelated trade or business activities.

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<sup>367</sup> Some States also permit the formation of business trusts, which have characteristics similar to business corporations.

<sup>368</sup> Treas. Reg. secs. 301.7701-1 through 301.7701-4. Under certain circumstances, an arrangement may constitute a trust for Federal income tax purposes. Treas. Reg. sec. 301.7701-4 (e.g., fixed investment trusts treated as grantor trusts). A disregarded entity generally is a single member limited liability company for which the sole member has elected not to treat the company as a corporation for Federal income tax purposes. Treas. Reg. secs. 301.7701-1(a)(4), -2(c), and -3(a). Another type of disregarded entity is a qualified subchapter S subsidiary (QSUB), which is a corporation wholly owned by an S corporation and for which an election is made to treat the subsidiary as a part of the parent for Federal income tax purposes. Sec. 1361(b)(3). A disregarded entity is not permitted or required to file a separate Federal income tax return.

<sup>369</sup> In most cases, however, an entity that is a corporation under State law is treated as a corporation for Federal income tax purposes (i.e., may not be taxed as a partnership or treated as a disregarded entity), or under other special provisions (e.g., as a bank or insurance company). Treas. Reg. sec. 301.7701-2(b).

### Exempt corporate subsidiaries

An exempt organization may form a nonprofit corporation of which it is the sole member or stockholder, and seek exempt status for the subsidiary. A tax-exempt subsidiary might be used because the subsidiary might not be entitled to the same exempt status as the parent (e.g., a charity might form a social welfare organization described in section 501(c)(4) to conduct lobbying activities that could not be performed by the charity under the lobbying rules applicable to the charity), or for business reasons, such as to isolate the liability of an activity in the subsidiary.

In general, a separate organization such as a nonprofit subsidiary of an exempt organization must derive its exemption on the basis of its own activities. It is possible, however, for an organization to derive its tax exemption by reason of its relationship with a tax-exempt affiliate or affiliates, under the integral part doctrine.<sup>370</sup> This doctrine may apply if an organization functions as an integral part of the exempt activities of one or more exempt affiliates. Traditionally, the integral part doctrine has applied if the activities of the organization seeking exemption are carried on under the supervision or control of an exempt organization and could be carried on by such supervising or controlling organization without materially constituting an unrelated trade or business.<sup>371</sup> Organizations that derive their exempt status in this manner are treated as separate tax entities from the supervising or controlling affiliates.<sup>372</sup>

In limited cases, a single member LLC might seek status as an organization exempt from Federal income tax. The IRS has provided guidance that permits a single member limited liability company to seek exemption from Federal income tax, such as an organization described in section 501(c)(3), in limited circumstances.<sup>373</sup>

### Taxable corporate subsidiaries

Taxable corporate subsidiaries often are used by an exempt organization to conduct unrelated trade or business activities that cause State law liability or unrelated business income tax concerns to the exempt organization.<sup>374</sup> Although an exempt organization generally may

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<sup>370</sup> In limited circumstances, an exempt organization may derive its exempt status by virtue of its relationship with another exempt organization. For example, a group exemption may permit the subordinate members of a group of organizations to be treated as exempt without each subordinate having to seek a separate determination from the IRS.

<sup>371</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 23.8 (8<sup>th</sup> ed. 2003).

<sup>372</sup> *Id.*

<sup>373</sup> See Richard A. McCray and Ward L. Thomas, *Limited Liability Companies as Exempt Organizations – Update*, 2001 Exempt Organizations CPE Text, 27-33.

<sup>374</sup> The formation and capitalization of a corporation by an exempt organization generally is governed by the general rules regarding contributions of property by a controlling shareholder. Secs. 351-362 (generally providing tax-free treatment for the transferor and the transferee in the case of a

conduct unrelated trade or business activities without jeopardizing its exempt status, an organization's exempt status may be revoked if its unrelated trade or business activities become substantial relative to its exempt activities. Conducting an unrelated trade or business in a corporate subsidiary, rather than in the exempt parent, might provide protection against the potential loss of the parent's exempt status that could result from the parent directly conducting excessive unrelated trade or business activities.<sup>375</sup>

Provided that a corporate subsidiary is respected as a separate C corporation for Federal income tax purposes, the tax-exempt parent organization generally is not taxed on the subsidiary's income, even if ultimately distributed to the exempt parent as a dividend.<sup>376</sup> Capital gains on the disposition of the C corporation's stock generally are excluded from an exempt organization's unrelated business taxable income.<sup>377</sup> However, dividends and capital gains might be treated as unrelated business taxable income under the debt-financed property rules.<sup>378</sup> Further, other types of payments received by an exempt organization from a subsidiary corporation that otherwise might be excluded from unrelated business taxable income (i.e., interest, annuities, royalties, and rents) may be taxed as unrelated business taxable income to an exempt parent under the controlled-entity rules of section 512(b)(13).<sup>379</sup>

An S corporation generally does not pay an entity level tax, and its shareholders are taxed on their respective shares of the corporation's income, whether or not distributed. Distributions of income already taxed to the shareholder are not taxed a second time when distributed. Special unrelated business income rules apply to exempt organizations that are shareholders of an S corporation.<sup>380</sup> Prior to 1998, exempt organizations were not permitted to be shareholders of an S corporation. After 1997, charitable organizations and qualified plans or trusts (but not other types of exempt organizations) may own stock in an S corporation,<sup>381</sup> but the organization's share of all items of income, loss, or deduction of the S corporation, and any gain or loss

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transfer of property as capital by a shareholder who controls the corporation immediately after the transfer).

<sup>375</sup> This protection is not available if the exempt organization conducts the trade or business in a partnership of which it is a partner, because the partnership's trade or business activities are treated as conducted by the tax-exempt parent for purposes of determining the exempt organization's unrelated trade or business income tax liability. Sec. 512(c).

<sup>376</sup> Sec. 512(b)(1). The controlled-entity rules of section 512(b)(13) do not apply to dividends.

<sup>377</sup> Sec. 512(b)(5).

<sup>378</sup> Sec. 514.

<sup>379</sup> For this purpose, a controlled entity generally is one that is more than 50-percent owned, directly or indirectly, by the exempt organization.

<sup>380</sup> Sec. 512(e).

<sup>381</sup> Secs. 1361(c)(6) and 1361(b)(1)(B).

attributable to the disposition of the stock of the S corporation, are taken into account in computing the unrelated business taxable income of the exempt organization (regardless of the character or nature of the income in the hands of the S corporation).<sup>382</sup>

### Wholly-owned limited liability companies

A single member limited liability company of which an exempt organization is the sole member may be treated as a taxable corporation or as a disregarded entity, at the election of the exempt organization. If the exempt organization elects to treat the limited liability company as a corporation, the limited liability company will be taxed as a corporation, subject to treatment as a C or S corporation.<sup>383</sup> In such a case, the rules described above for corporate subsidiaries apply to the exempt organization and the limited liability company. If the exempt organization does not elect to treat the single member limited liability company as a corporation, the limited liability company is disregarded and treated as a branch or division of the exempt organization, and the assets, liabilities, income, gains, losses, deductions, and credits of the limited liability company are treated as belonging to the tax-exempt parent for Federal income tax purposes. A disregarded single-member limited liability company need not request a determination from the IRS that it is to be treated as a part of the exempt organization in such cases.<sup>384</sup>

### Exempt organizations and joint ventures

#### In general

Joint ventures are growing in use among charitable and other organizations that are exempt from Federal income tax. As a leading commentator has said: “Joint ventures continue to play an increasingly important role for exempt organizations faced with the challenge of operating in a difficult economic environment. They offer a way for nonprofits to successfully shape their own destiny, rather than accept the priorities of public and private funders. . . . These arrangements, assuming they are structured properly, provide an alternative, viable way for exempt organizations to accomplish their missions, eliminating the need for total reliance on the more traditional sources of funding.”<sup>385</sup> Joint ventures might be used by an exempt organization to hold a passive investment, to conduct an activity that furthers an exempt purpose, or to

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<sup>382</sup> Secs. 1361(c)(6) and 512(e).

<sup>383</sup> As described above, in limited circumstances a single member limited liability company might be entitled to exempt status independent of the exempt status of the sole member.

<sup>384</sup> A single member limited liability company formed by an exempt organization generally is disregarded unless a Form 8332, Entity Classification Election, is filed with the IRS to elect to treat the limited liability company as a corporation.

<sup>385</sup> Michael I. Sanders, *Joint Ventures Involving Tax-Exempt Organizations*, Supplement at ix (2d ed. 2000 and Supp. 2004).

conduct an unrelated trade or business. In some cases, a joint venture might be formed to conduct a dual purpose activity that achieves both commercial and exempt purpose objectives.<sup>386</sup>

Joint ventures between charitable or educational organizations and for-profit investors are used in low-income housing projects, health care delivery arrangements (such as hospitals, diagnostic testing centers, rehabilitation facilities, and ambulatory surgery centers), redevelopment of urban areas (including through the new markets tax credit), and to develop research and educational technologies and systems.<sup>387</sup> Although much of the growth and development in this area has involved health care organizations, joint ventures increasingly are used by others, such as by universities to provide distance learning over the Internet or to affiliate with faculty members in research joint ventures. A public charity may form and use a supporting organization (as described in section 509(a)(3)) to participate in a joint venture, or a social welfare organization described in section 501(c)(4) might be used in such arrangements if tax exemption is desired for one of the participating entities but such entity is unable or unwilling to satisfy the more stringent requirements of section 501(c)(3).<sup>388</sup> Other types of exempt organizations also use joint ventures. For example, business leagues described in section 501(c)(6) use joint ventures to operate real estate ventures, professional football leagues, and computer databases, and to facilitate the sale of broadcasting rights.<sup>389</sup>

Exempt organizations may come together to form corporate or partnership joint ventures. For example, certain types of exempt organizations may form a multiple-owner title holding corporation or trust for which exempt status is available.<sup>390</sup> Exempt organizations might enter into joint operating agreements or other types of contractual arrangements with other exempt organizations, pursuant to which each exempt organization agrees to make certain of its assets (e.g., intellectual property or physical facilities) available for use by the parties to the agreement under the specified terms of the arrangement.<sup>391</sup> Exempt organizations also might use corporate or partnership entities to conduct the venture.

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<sup>386</sup> E.g., Priv. Ltr. Rul. 200041038 (October 13, 2000) (involving conservation organization's participation in a limited liability company formed to manage the timber rights of for-profit owners, to preserve working forests and to generate income from cutting activity in such forests).

<sup>387</sup> Sanders at 4-8. For a discussion of joint ventures in the new markets tax credit area, *see id.*, 2004 Cumulative Supplement, at 158-71.

<sup>388</sup> For example, health maintenance organizations (HMOs) often obtain exempt status under section 501(c)(4) rather than under section 501(c)(3) because of private benefit concerns and the difficulty in satisfying the charitable purpose requirement of section 501(c)(3).

<sup>389</sup> Sanders at 479.

<sup>390</sup> Sec. 501(c)(25). Multiple-owner title holding corporations or trusts generally are subject to more stringent requirements than single owner title holding corporations described in section 501(c)(2). The IRS reported 1,259 such title holding corporations or trusts on the IRS master file for 2003.

<sup>391</sup> E.g., Priv. Ltr. Rul. 9609012 (March 1, 1996) (hospital facilities); Priv. Ltr. Rul. 9716021 (April 18, 1997) (health care facilities); Priv. Ltr. Rul. 200245057 (November 8, 2002) (health care and

The term “joint venture” has different meanings in different contexts, but the term generally encompasses a variety of arrangements between or among two or more exempt organizations, or between or among an exempt organization and persons or entities who are not exempt from tax (e.g., for-profit corporations, limited liability companies, or partnerships).<sup>392</sup>

#### Tax consequences of a joint venture

Under present law, a joint venture must be examined to determine whether (1) the charity’s income derived from the venture is taxed as unrelated business taxable income; (2) the charity receives fair market value in connection with all aspects of the venture; (3) the joint venture furthers a charitable purpose; and (4) the arrangement does not provide an impermissible private benefit to any private persons, including exempt organization insiders and others who participate in the joint venture.<sup>393</sup> The IRS and the courts recently have emphasized the extent to which the charity may and does control the activities of the joint venture, particularly with respect to the charitable aspects and day-to-day operations of the venture, when examining whether the joint venture jeopardizes the exempt status of the participating charity, or causes the charity’s share of the income from the venture to be taxed as unrelated business taxable income. Other important facts and circumstances include the type of State law entity (if any) used for the joint venture, the activities to be conducted, the size of the joint venture’s activities compared to

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clinical facilities); Priv. Ltr. Rul. 200305031 (January 31, 2003) (health care facilities); Priv. Ltr. Rul. 200324047 (June 13, 2003) (hospital facilities financed by tax-exempt bonds).

<sup>392</sup> One commentator defines a joint venture as “an association of persons or entities jointly undertaking a particular transaction for mutual profit,” and divides joint ventures into four categories: those involving only exempt organizations (exempt-only joint ventures), those entered as passive investments (investment-type joint ventures), those that represent a small proportion of the assets of the exempt organization (ancillary joint ventures), and those to which the exempt organization devotes all or substantially all of its assets (disposition-type joint ventures). Sanders at 2 and Cumulative Supplement 44-46; Michael I. Sanders, *How to Structure Joint Ventures Involving Charities in Today’s Climate*, 14 *Taxation of Exempts* 3 (July/August 2002).

<sup>393</sup> Under the section 4958 excess benefit transaction rules, a public charity or social welfare organization must receive fair market value upon the transfer of property to a joint venture, during the term of the joint venture, and upon liquidation of the joint venture, if the joint venture or another participant in the joint venture is a disqualified person with respect to the charitable, educational, or social welfare organization. For example, if a charitable organization enters into a partnership arrangement with one or more members of its board of directors, then the charitable organization must receive a partnership interest that has a fair market value that equals or exceeds the value of the property the organization transferred to the partnership in exchange for the partnership interest. If the fair market value of the interest received is less than the value of the property transferred by the charitable organization, the transaction constitutes an excess benefit transaction subject to the excise taxes imposed by section 4958. The excess benefit transaction tax rules apply to compensation paid to a disqualified person of a public charity whether the compensation is paid directly by the charity or indirectly by a subsidiary controlled by the charity.

the exempt organization's other activities, and whether the exempt organization receives fair market value in exchange for its financial and other contributions to the venture.<sup>394</sup>

In general, joint ventures among exempt organizations of a similar type do not raise the same concerns that exist if for-profit entities or individuals also are parties to the arrangement.<sup>395</sup> For example, a partnership joint venture consisting of two charitable organizations that come together to conduct an exempt activity generally are free to do so without regard to the private benefit and private inurement doctrines that apply when an individual or entity other than a charity is a party to the arrangement. This might provide the charitable organizations some increased flexibility in structuring their respective financial and governance rights, because only charities are involved in the joint venture and thus will necessarily control the venture. However, a charity generally is required to treat non-charitable exempt organizations (e.g., a social welfare organization described in section 501(c)(4)) in the same manner as a for-profit organization for these purposes, in order to ensure that charitable purposes are served and that charitable assets remain dedicated to charitable purposes.

An exempt organization that owns some but not all of the stock of a for-profit corporation generally is not taxed on the activities of the corporate joint venture, and generally excludes the dividends and capital gains relating to the investment from unrelated business taxable income under the generally applicable unrelated business income tax rules. The provisions of section 512(b)(13) apply if the exempt organization owns (directly or indirectly) more than 50-percent of the corporate joint venture.

If a joint venture is a partnership in which an exempt organization is a partner, the exempt organization's distributive share of the partnership's income or loss is treated as if the partnership directly conducted the activity that generated the income or loss. If a trade or business regularly carried on by the partnership is an unrelated trade or business with respect to the exempt organization, then the exempt organization must treat its share (whether or not distributed) of the income from the unrelated trade or business as unrelated business taxable income.<sup>396</sup> In addition, the controlled-entity rules of section 512(b)(13) apply to a partnership that is more than 50-percent owned (directly or indirectly) by an exempt organization.<sup>397</sup>

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<sup>394</sup> In addition, special considerations apply if the exempt organization is a private foundation. Such an organization is subject to the self-dealing, net investment income, excess business holdings, jeopardized investments, and taxable expenditure provisions of sections 4941 through 4945.

<sup>395</sup> See, e.g., Priv. Ltr. Rul. 199913035 (April 12, 1999); Priv. Ltr. Rul. 199913051 (April 12, 1999); Priv. Ltr. Rul. 200102052 (January 12, 2001); Priv. Ltr. Rul. 200102053 (January 12, 2001); Priv. Ltr. Rul. 200117043 (April 27, 2001); Priv. Ltr. Rul. 200325003 (June 20, 2003); and Priv. Ltr. Rul. 200325004 (June 20, 2003) (involving joint ventures among exempt organizations).

<sup>396</sup> Sec. 512(c)(1).

<sup>397</sup> Sec. 512(b)(13)(D)(ii).



### Evolution of legal standards

The Federal income tax law regarding joint ventures involving exempt organizations has changed slowly but significantly over the past 30 years. During this period the IRS position regarding participation by charitable organizations in such ventures has changed from one that prohibited certain types of participation by the organization to one that acknowledges that charities may participate in joint ventures if they satisfy certain requirements.

Before 1982, the IRS took the position that a charitable organization could not participate as a general partner in a limited partnership that involved for-profit limited partners because the exempt organization would have a fiduciary duty to further the private economic interests of the for-profit limited partners. The IRS was concerned that this duty would conflict with the exempt organization's mission to operate exclusively for charitable purposes.<sup>398</sup> The standard changed after *Plumstead Theatre Society v. Commissioner*.<sup>399</sup> In *Plumstead*, the court held that a charitable organization could serve as a general partner in a limited partnership that included for-profit limited partners without losing its exempt status. Crucial to the court was whether: (1) the partnership's activities furthered the charitable purposes of the exempt organization, and (2) the structure of the partnership protected the exempt organization against potential conflicts between its fiduciary duties to its for-profit partners and its charitable mission. Subsequently, a court held that an exempt organization's activities as a co-general partner in a limited partnership substantially furthered non-exempt purposes when the exempt organization's authority as a co-general partner was limited and the other co-general partner (a taxable organization) was in a position of control.<sup>400</sup>

In 1998, the IRS issued guidance regarding its position on the effect a particular type of transaction, a "whole-hospital" joint venture, had on the exempt status of the participating charitable organization. Revenue Ruling 98-15<sup>401</sup> used two examples, both involving a public charity that contributed all of its assets to a limited liability company in exchange for a

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<sup>398</sup> See Gen. Couns. Mem. 36293 (May 30, 1975) (joint profit motive of partnership made it incompatible with charitable purpose of the exempt entity); Priv. Ltr. Rul. 7820058 (February 17, 1978) (participation by a charitable organization as a general partner in a partnership with private investors as limited partners conveyed impermissible private benefit, even though venture was formed to provide low-income housing).

<sup>399</sup> *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9<sup>th</sup> Cir. 1982).

<sup>400</sup> *Housing Pioneers, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2191, *aff'd* 49 F.3d 1395 (9<sup>th</sup> Cir. 1995) (denying exempt status on the basis that the exempt organization substantially furthered non-exempt purposes and private interests). Compare Priv. Ltr. Rul. 9736039 (September 5, 1997) (ruling that a charitable organization's participation as a co-general partner in a limited partnership did not adversely affect its exempt status because the organization was the managing general partner with responsibility for day-to-day operations and with authority to cause the project to be managed in a manner that furthered its exempt purposes).

<sup>401</sup> Rev. Rul. 98-15, 1998-1 C.B. 718.

membership interest in the limited liability company, and a for-profit corporation that contributed assets to the limited liability company in exchange for a membership interest that was proportionate to its financial contribution. Facts in the two examples differed with respect to the terms of the management agreement and the respective rights of the charity and the for-profit relating to board governance, approval of major decisions, and the provision of charity care by the joint venture. In one example, the charity had 60 percent of the board membership, controlled approval of major decisions, and could terminate the management agreement between the joint venture and an unrelated management company. The joint venture agreement also required that the hospital operate in a manner that furthered charitable purposes. The IRS ruled that the exempt organization in this example did not jeopardize its exempt status by participating in the joint venture. In the other example, the charity possessed only 50 percent of the board control, held only a veto right with respect to approval of major decisions, and could not terminate the management agreement between the joint venture and a service provider that was related to the for-profit participant. In addition, in this example, there was no express requirement that the hospital operate to further charitable purposes, and the officers responsible for oversight of day-to-day operations of the joint venture were individuals who previously were employed by the for-profit member. The IRS ruled that the activities of the joint venture in the latter example did not further the exempt purposes of the charity, and that the organization would not remain tax-exempt.

The control standard established in *Plumstead Theatre* and developed further in Revenue Ruling 98-15 and private letter rulings<sup>402</sup> was the focal point of two recently litigated cases involving exempt organizations and for-profit investors in health care joint ventures.<sup>403</sup> *Redlands* and *St. David's* both focused on the extent of the exempt organization's control over the venture's activities in determining whether exempt status of the tax-exempt partner was retained or denied.

In 2004, the IRS issued a Revenue Ruling<sup>404</sup> to provide guidance regarding ancillary joint ventures (i.e., joint ventures in which the participating exempt organization did not contribute all

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<sup>402</sup> See, e.g., Priv. Ltr. Rul. 200118054 (May 4, 2001) (exempt organization retained 70 percent ownership and control); Priv. Ltr. Rul. 200206058 (February 8, 2002) (ruling that a public charity that transferred three percent of its assets to a limited liability company in exchange for a 60 percent membership interest therein did not jeopardize its exempt status even though the other membership interests were held by individual physicians); Priv. Ltr. Rul. 200304041 (January 24, 2003) (exempt organization maintained majority control); Priv. Ltr. Rul. 200304042 (January 24, 2003) (exempt organization maintained majority control).

<sup>403</sup> *Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff'd* 242 F.3d 904 (9<sup>th</sup> Cir. 2001) (nonprofit subsidiary of a tax-exempt hospital system failed to retain control of a joint venture ambulatory surgery center); *St. David's Health Care System v. United States*, No. A-01-CA-046 JN (W.D. Texas) (June 7, 2002), *vacated by* 349 F.3d 232 (5<sup>th</sup> Cir. 2003) (exempt organization did retain sufficient effective control of the venture). On remand, a jury in the *St. David's* case found that *St. David's* was entitled to exempt status.

<sup>404</sup> Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

or substantially all of its assets). In the ruling, a university described in section 501(c)(3) formed a limited liability company and transferred a small portion of its assets to the limited liability company in exchange for a 50-percent membership interest. A for-profit corporation contributed interactive video assets to the limited liability company in exchange for a 50-percent membership interest. The limited liability company's exclusive purpose was to provide teacher training programs to various locations using interactive video technology provided by the for-profit member. Both the exempt university and the for-profit member held equal ownership interests and representation on the limited liability company's board of directors, and all financial rights were shared equally. The training programs to be conducted by the joint venture contained the same substantive material that was provided at the university's on-campus seminars. The university possessed the right to determine and approve the curriculum, training materials, instructors, and educational standards of the programs. The for-profit possessed the right to select the technical employees and the locations at which the programs would be conducted. Other decisions were to be made by both members. The limited liability company's activities were limited to those connected with the training programs, and the company could not engage in an activity that jeopardized the exempt status of the university. On these facts, the IRS determined that the educational organization's participation in the ancillary joint venture did not jeopardize the exempt status of the university. Further, the IRS determined that the university's share of income derived by the joint venture from the training programs did not constitute unrelated business taxable income to the university.<sup>405</sup>

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<sup>405</sup> For an analysis of the revenue ruling, see Michael I. Sanders, *The Impact of Rev. Rul. 2004-51 on Ancillary Joint Ventures*, Taxation of Exempts (November/December 2004), 99. See also, Paul Streckfus, *Ancillary Joint Ventures May Involve Exemption Risk*, Tax Notes Today (February 1, 2005); *Practitioners Pleased With Revenue Ruling on Ancillary Joint Ventures*, Tax Notes Today (May 7, 2004).

### **III. SPECIFIC TYPES OF CHARITABLE ORGANIZATIONS AND EVOLVING STANDARDS OF CHARITY**

#### **A. Overview**

As discussed above, the meaning of charitable has evolved during the course of the 20<sup>th</sup> century. Charitable is an expansive concept,<sup>406</sup> bestowing exempt status on a wide range of organizations and activities. Certain charitable organizations are more notable than others, if only because they fit within relatively discreet categories, form a large part of the sector, are identified with a specific purpose, or are of longstanding origin. Within categories of charitable organizations, the meaning of charity proves to be fluid, and malleable enough to account for changes in society, yet also unrestrained due to the many sources of meaningful authority that inform its content -- whether it be Congress, the IRS, the courts, or society. The following descriptions are of different categories of charitable organizations, including hospitals, elder care facilities, credit counseling organizations, low-income housing organizations, environmental organizations, and college sports organizations. All are recognized as charitable organizations under section 501(c)(3) of the Code, and all are subject to the same organizational and operational restrictions despite their very different natures and activities.

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<sup>406</sup> The word “charitable” generally is used in this pamphlet to include any of the purposes described in section 501(c)(3), e.g., religious, educational, scientific, and other.

## B. Charitable Hospitals

### In general

The Code does not provide a per se charitable exemption for hospitals. Rather, a hospital qualifies for exemption if it is organized and operated for a charitable purpose and meets additional requirements of section 501(c)(3).<sup>407</sup> The promotion of health has long been recognized as a charitable purpose that is beneficial to the community as a whole.<sup>408</sup> It includes not only the establishment or maintenance of charitable hospitals, but clinics, homes for the aged, and other providers of health care. However, not every activity that promotes health qualifies for tax exemption under section 501(c)(3).<sup>409</sup> For example, selling prescription pharmaceuticals promotes health, but pharmacies cannot qualify as charitable on that basis alone.<sup>410</sup> Furthermore, an organization providing health care, such as a hospital, is not a charitable organization if it is privately owned and is run for the profit of the owners.<sup>411</sup> The standard the IRS and the courts apply to determine whether a hospital promotes health in a charitable manner has evolved in response to significant changes in the health-care industry.

Medical care generally is provided by government-owned, for-profit, and tax-exempt organizations. In the hospital sector, tax-exempt organizations dominate, with approximately 60 percent of the nation's hospitals operating as charitable institutions.<sup>412</sup> Historically, charitable hospitals were characterized as voluntary because they generally were supported by

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<sup>407</sup> Although nonprofit hospitals generally are recognized as tax-exempt by virtue of being “charitable” organizations, some may qualify for exemption as educational organizations because they are organized and operated primarily for medical education and research purposes.

<sup>408</sup> Rev. Rul. 69-545, 1969-2 C.B. 117; see also Restatement (Second) of Trusts sec. 368, 372 (1959); see Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 33.3(b) (8<sup>th</sup> ed. 2003) (discussing various forms of health-care providers that may qualify for exemption under section 501(c)(3)).

<sup>409</sup> See *Sonora Community Hospital v. Commissioner*, 46 T.C. 519, 525-526 (1966), *aff'd* 397 F.2d 814 (9th Cir. 1968) (while the diagnosis and cure of disease are indeed purposes that may furnish the foundation for characterizing the activity as “charitable,” something more is required.).

<sup>410</sup> *Federation Pharmacy Services, Inc. v. Commissioner*, 72 T.C. 687 (1979) (finding that organization relied financially on the sale of prescription drugs to the public with no accommodation made for those unable to pay and, thus, did not have a charitable purpose) *aff'd*, 625 F.2d 804 (8th Cir. 1980).

<sup>411</sup> Rev. Rul. 98-15, 1998-1 C.B. 718.

<sup>412</sup> Gary J. Young, *Federal Tax-Exemption Requirements for Joint Ventures Between Nonprofit Hospital and For-Profit Entities: Form over Substance*, 13 *Annals of Health L.* 327 (Summer 2004); see also GAO Report to the Chairman, Select Committee on Aging, House of Representatives, *Nonprofit Hospitals: Better Standards Needed for Tax Exemption Tax Compliance of Nonwage Earners*, GAO/HRD-90-84, May 1990.

philanthropy, staffed by doctors who worked without compensation, and served, almost exclusively, the sick poor.<sup>413</sup> However, the character of the charitable hospital sector has changed significantly over the past several decades due to the growth of such resources as employer-provided health insurance and governmental programs such as Medicare (for the elderly and disabled) and Medicaid (for the poor).<sup>414</sup> The availability of third-party payment programs also spurred the emergence of for-profit hospital systems, which increased competition for patients. Demands for managed care and other efforts by employers, insurers, and Federal and State governments to contain the rapid growth of health care costs have led to an increasingly cost-conscious hospital sector.<sup>415</sup> These factors combined to transform the nature of the charitable sector so that today's charitable hospitals generate most of their revenues by serving paying patients rather than from charitable contributions.<sup>416</sup> In addition, charitable hospitals have increasingly entered into business arrangements similar to those employed by the for-profit sector in an effort to contain costs, improve efficiency, and generate surplus revenues. For example, mergers and consolidations, the formation of joint ventures with for-profit entities, and the creation of integrated delivery systems<sup>417</sup> all have been common in the charitable hospital sector.

Today, charitable hospitals generally provide medical and other health-related services in a manner similar to their for-profit counterparts. They operate under the same healthcare regulations, compete for the same patients and doctors, and derive funding from many of the

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<sup>413</sup> See *Eastern Kentucky Welfare Rights Association v. Simon*, 506 F.2d 1278, 1288-89 (D.C. Cir. 1974), *vacated on other grounds* 426 U.S. 26 (1975) (noting that hospitals in the early part of this nation's history were almshouses supported by philanthropy and serving almost exclusively the sick poor); see also *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265 (Utah 1985) (holding that voluntary hospitals were charities for the obvious reason that they housed and tended to those who were both sick and poor, i.e., those without resources and in need of charity. Because hospitals performed no medical treatment function and because they were largely institutions for the poor, the non-poor in need of medical treatment and their treating private physicians overwhelmingly avoided them.).

<sup>414</sup> Mark A. Hall and John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 Wash. L. Rev. 307 (April 1991).

<sup>415</sup> GAO Report to the Chairman, Select Committee on Aging, House of Representatives, *Nonprofit Hospitals: Better Standards Needed for Tax Exemption Tax Compliance of Nonwage Earners*, GAO/HRD-90-84, May 1990, at 13-14. The GAO reported that cost-containment initiatives may make it more difficult for nonprofit hospitals to provide uncompensated care.

<sup>416</sup> Helena G. Rubinstein, *Nonprofit Hospitals and the Federal Tax Exemption: A Fresh Prescription*, 7 Health Matrix 381 (Summer 1997); see also *Sound Health Assoc. v. Commissioner*, 71 T.C. 158, 180-81 (1978), *acq.* 1981-2 C.B. 2.

<sup>417</sup> Integrated delivery systems are combinations of nonprofit hospitals and private physician groups. These systems were originally created to enable nonprofits to enter the managed care business, a sector dominated by taxable insurance companies and by tax-exempt and taxable health-maintenance organizations.

same sources as other types of hospitals.<sup>418</sup> Federal tax exemption does not prevent charitable hospitals from generating surplus revenues, but unlike for-profit hospitals, the assets of a charitable hospital must remain in charitable trust for the benefit of the community, whereas the assets of a for-profit hospital are owned by private investors.

## **Evolution of the legal standard**

### Promotion of Health as a Charitable Purpose

**Financial Ability Standard.**—Much like the nature of the health-care industry itself, the definition of the term charitable as applied to hospitals has not been static. In 1956, the IRS issued Revenue Ruling 56-185, which addressed the tax-exempt status of charitable hospitals.<sup>419</sup> The ruling adopted the “financial ability standard,” requiring that a charitable hospital be “operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay.”<sup>420</sup> This standard effectively meant that a charitable hospital could not refuse to accept patients in need of hospital care who could not pay for such services. However, the IRS acknowledged that hospitals normally charge patients who are able to pay for services in order to meet the hospital’s operating expenses and stated that the “fact that the hospital’s charity record is relatively low is not conclusive that a hospital is not operated for charitable purposes to the full extent of its financial ability.”<sup>421</sup> Although the ruling allowed hospitals to satisfy the charity requirement by furnishing services at reduced rates which are below cost, if a hospital operated with the expectation of full payment from all patients, the hospital would not be deemed to “dispense charity merely because some of its patients fail to pay for the services rendered.”<sup>422</sup> The ruling’s requirement that charitable hospitals provide some amount of free or reduced-rate care reflected the view that hospitals and

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<sup>418</sup> Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCLA L. Rev. 1345 (August 2003). Charitable hospitals also are generally exempt from State and local taxes, as well as Federal taxes. In addition, charitable hospitals benefit from access to tax-exempt financing. Charitable hospitals generally have been the largest borrowers of tax-exempt bonds issued for section 501(c)(3) organizations. See Table 11, Part IV.

<sup>419</sup> Rev. Rul. 56-185, 1956-1 C.B. 202, modified by Rev. Rul. 69-545, 1969-2 C.B. 117.

<sup>420</sup> *Id.* The ruling also required an open staff provision, mandating that charitable hospitals not restrict use of their facilities to particular groups of physicians or surgeons, to the exclusion of other qualified physicians. Finally, the ruling provided that a charitable hospital’s net earnings must not inure directly or indirectly to the benefit of any private shareholder or individual; a requirement that repeated the statutory prohibition on private inurement and private benefit.

<sup>421</sup> *Id.*; see also *Commissioner v. Battle Creek, Inc.*, 126 F.2d 405 (5th Cir. 1942) (noting that it is usual for charitable hospitals and sanitariums to charge those able to pay for services rendered, in order to pay the expenses of the institution, while not denying treatment to others unable to pay anything).

<sup>422</sup> Rev. Rul. 56-185, 1956-1 C.B. 202.

other health care institutions were only charitable if they both provided relief to the poor and promoted health.<sup>423</sup>

Community Benefit Standard.—The financial ability standard governed charitable hospitals until 1969. Congress had criticized the financial ability standard as imprecise concerning the extent to which a hospital must accept patients who are unable to pay.<sup>424</sup> In addition, the creation of Medicare and Medicaid in 1965 had a fundamental effect on hospitals; a substantial portion of the free care previously subsidized by charitable hospitals now was reimbursed through these governmental programs.<sup>425</sup> In response to these developments, the IRS issued Revenue Ruling 69-545, modifying its position in Revenue Ruling 56-186 and adopting the “community benefit standard,”<sup>426</sup> which remains the test applied by the IRS for determining whether a hospital is charitable.

In Revenue Ruling 69-545, the IRS stated that the promotion of health care is “one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members, provided that the class is not so small that its relief is not of benefit to the community.”<sup>427</sup> Applying this community benefit standard, the IRS found that a hospital’s operation of a generally accessible emergency room open to all persons, regardless of ability to pay, provided a benefit to a sufficiently broad class of persons in the community. The ruling did not, however, require that the hospital accept indigent patients on an inpatient basis for any purpose other than its emergency room. Revenue Ruling 69-545 also expressly removed the requirement that charitable hospitals provide care to patients without charge or at rates below cost.<sup>428</sup>

In addition to the open emergency room requirement, Revenue Ruling 69-545 set forth additional factors for determining whether a hospital qualifies as charitable, specifically whether the hospital: (1) is run by an independent board of trustees composed of representatives of the community (as opposed to financially interested individuals); (2) operates with an open medical staff policy, with privileges available to all qualified physicians; (3) provides care for all those persons in the community able to pay the cost thereof either directly or through third party

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<sup>423</sup> *Geisinger Health Plan v. Commissioner*, 985 F.2d 1210, 1216 (3d Cir. 1993).

<sup>424</sup> See H.R. Rep. No. 91-413, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess., pt.1, at 43 (1969) (“Such obligations to serve those who cannot pay are indefinite under existing law and existing interpretations of the law.”).

<sup>425</sup> See Helena G. Rubinstein, *Nonprofit Hospitals and the Federal Tax Exemption: A Fresh Prescription*, 7 Health Matrix 381 (Summer 1997).

<sup>426</sup> Rev. Rul. 69-545, 1969-2 C.B. 117.

<sup>427</sup> *Id.*

<sup>428</sup> *Id.*



reimbursement; and (4) utilizes surplus funds to improve the quality of patient care, expand its facilities, and advance medical training, education, and research.<sup>429</sup>

The validity of the community benefit standard enunciated in Revenue Ruling 69-545 was challenged in a class action law suit by various health and welfare organizations and private citizens who argued that the IRS should continue to require charitable hospitals to provide free care to those unable to pay. In *Eastern Kentucky Welfare Rights Organization v. Simon*,<sup>430</sup> the district court sustained the challenge and concluded that Congress intended to restrict the term charitable to its narrow sense, that is, relief of the poor. The appeals court reversed, however, and upheld the broader interpretation of charitable applied in Revenue Ruling 69-545.<sup>431</sup> The court explained that the term charitable is capable of a definition far broader than merely the relief of the poor.<sup>432</sup> The court also concluded that Revenue Ruling 69-545 did not overrule the financial ability requirement of Revenue Ruling 56-185, but that it simply provided an alternative method whereby a hospital can qualify as a tax-exempt charitable organization.<sup>433</sup>

In a 1983 ruling, the IRS applied the community benefit standard in the context of a hospital that did not operate an emergency room but that otherwise was identical to the hospital described in Revenue Ruling 69-545.<sup>434</sup> The IRS stated that a charitable hospital need not maintain an emergency room when State health planning authorities determine that doing so would produce unnecessary duplication of services otherwise provided in the community.<sup>435</sup> The IRS ruled that the operation of an emergency room and community access to it is merely one factor evidencing a hospital's benefit to the community. Other significant factors may enter into the community benefit determination, such as "a board of directors drawn from the community, an open medical staff policy, treatment of persons paying their bills with the aid of public programs like Medicare and Medicaid, and application of any surplus to improving facilities, equipment, patient care, and medical training, education, and research."<sup>436</sup> Finally, the IRS noted that certain specialized hospitals, such as eye hospitals and cancer hospitals, offer medical care limited to special conditions unlikely to necessitate emergency care and do not, as a practical matter, maintain emergency rooms. The IRS found that these organizations may also

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<sup>429</sup> *Id.*

<sup>430</sup> 370 F. Supp. 325, 338 (D.D.C. 1973), *rev'd* 506 F.2d 1278 (D.C. Cir. 1974), *vacated on other grounds*, 426 U.S. 26 (1976).

<sup>431</sup> 506 F.2d 1278 (D.C. Cir. 1974), *vacated on other grounds*, 426 U.S. 26 (1976).

<sup>432</sup> *Id.* at 1287-88.

<sup>433</sup> *Id.* at 1289.

<sup>434</sup> Rev. Rul. 83-157, 1983-2 C.B. 94.

<sup>435</sup> *Id.*

<sup>436</sup> *Id.*

qualify as charitable if there are present similar, significant factors that demonstrate that the hospitals operate exclusively to benefit the community.<sup>437</sup>

In 1992, the IRS issued examination guidelines for use by IRS agents in the examination of charitable hospitals. Although the guidelines are not binding, they discuss factors the IRS considers in determining whether a hospital meets the community benefit standard. Some of the factors to be considered are: whether the hospital has a governing board that includes prominent civic leaders rather than primarily hospital administrators and doctors; whether the hospital provides non emergency care to everyone in the community who is able to pay either privately or through third parties including Medicare and Medicaid; whether admission to the hospital's medical staff is open to all qualified physicians in the area, consistent with the size and nature of the facilities; and whether the hospital has a full-time emergency room open to everyone, regardless of their ability to pay.<sup>438</sup>

Community Benefit Standard applied to other Health Care Organizations.—The community benefit standard applies not only to traditional hospitals, but also other health care provider organizations, such as clinics or health maintenance organizations (HMOs). An HMO provides medical care to its subscribers through selected physicians, hospitals and other providers who are connected by contract or other arrangement with the HMO. Although HMOs provide health care, one of their major purposes is to serve their subscribers. In addition, HMO operations are similar to traditional health insurance.<sup>439</sup> Thus, it was not clear whether such entities were organized and operated exclusively for charitable purposes.<sup>440</sup>

In *Sound Health Association v. Commissioner*,<sup>441</sup> the Tax Court answered affirmatively in holding that a staff model HMO<sup>442</sup> qualified as a charitable organization. The court, applying the community benefit analysis derived for hospitals, concluded that the HMO satisfied the community benefit standard as its membership was open to almost all members of the community. Although membership was limited to persons who had the money to pay the fixed premiums, the court held that this was not disqualifying as the HMO had a subsidized premium

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<sup>437</sup> *Id.*

<sup>438</sup> Announcement 92-83, 1992-22 I.R.B. 59 (IRS Audit Guidelines for Hospitals).

<sup>439</sup> Section 501(m) prohibits exemption for an organization that provides commercial-type insurance as a substantial part of its activities. An exception in section 501(m)(3)(B) states that this exclusion does not apply to an HMO providing health insurance that is merely incidental to the HMO's principal activity of providing medical services.

<sup>440</sup> HMOs and other organizations that fail to qualify as charitable under section 501(c)(3) may nevertheless qualify for the more limited exemption under section 501(c)(4), which provides exemption for social welfare organizations.

<sup>441</sup> 71 T.C. 158 (1978), *acq.* 1981-2 C.B. 2.

<sup>442</sup> A staff model HMO employs its own physicians and staff and serves its subscribers at its own facilities.

program for persons of lesser means to be funded through donations and Medicare and Medicaid payments. The HMO also operated an emergency room open to all persons regardless of income. The court rejected the government's contention that the HMO conferred primarily a private benefit to its subscribers, stating that when the potential membership is such a broad segment of the community, benefit to the membership is benefit to the community.

In *Geisinger Health Plan v. Commissioner*,<sup>443</sup> the court applied the community benefit standard to an individual practice association (IPA) model HMO.<sup>444</sup> Reversing a Tax Court decision, the court held that the HMO did not qualify as charitable because the community benefit standard requires that an HMO be an actual provider of health care rather than merely an arranger or deliverer of health care, which is how the court viewed the IPA model in that case.

More recently, in *IHC Health Plans, Inc. v. Commissioner*,<sup>445</sup> the court ruled that three affiliated HMOs did not operate primarily for the benefit of the community they served. The organizations in the case did not provide health care directly, but provided group insurance that could be used at both affiliated and non-affiliated providers. The court found that the organizations primarily performed a risk-bearing function and provided virtually no free or below-cost health care services. In denying charitable status, the court held that a health-care provider must make its services available to all in the community *plus* provide additional community or public benefits.<sup>446</sup> The benefit must either further the function of government-funded institutions or provide a service that would not likely be provided within the community but for the subsidy. Further, the additional public benefit conferred must be sufficient to give rise to a strong inference that the public benefit is the primary purpose for which the organization operates.<sup>447</sup>

Summary.—Since 1956, there have been two very different standards of charity for hospitals. Between 1956 and 1969, a charitable hospital was required to provide some care for the poor. In response to pressure from Congress and changes in the health care industry, the IRS adopted the community benefit standard, under which health-care providers must meet a flexible test based upon a variety of indicia. Providing free care to indigents is not required.<sup>448</sup> Under the community benefit standard, it is not required that “the care of indigent patients be the

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<sup>443</sup> 985 F.2d 1210 (3<sup>rd</sup> Cir. 1993), *rev'g* T.C. Memo. 1991-649.

<sup>444</sup> In the IPA model, health care is provided by physicians practicing independently in their own offices, with the IPA usually contracting on behalf of the physicians with the HMO.

<sup>445</sup> 325 F.3d 1188 (10<sup>th</sup> Cir. 2003).

<sup>446</sup> *Id.* at 1198.

<sup>447</sup> *Id.*

<sup>448</sup> See *Redlands Surgical Services, Inc. v. Commissioner*, 113 T.C. 47, 73 (1999), *aff'd*, 242 F.3d 904 (9<sup>th</sup> Cir. 2001).

primary concern of the charitable hospital, as distinguished from the care of paying patients.”<sup>449</sup> Instead, the community benefit standard reflects “a policy of insuring that adequate health care services are actually delivered to those in the community who need them.”<sup>450</sup> The community benefit standard has proved flexible enough to account for changes in health care providers, and under court decisions, applies not just to hospitals. Thus, a medical care organization like an HMO generally meets the community benefit standard if it demonstrates that its activities are targeted to a charitable class. However, the “precise nature of that charitable class has been and continues to be a source of controversy.”<sup>451</sup>

Congressional Responses to Community Benefit Standard.—The change from the financial ability standard to the community benefit standard clearly is a significant change in law, but without a corresponding change to the Code. Congress, however, was not mute. Immediately after the community benefit standard was articulated, the Senate Finance Committee recommended revocation of the ruling and continuation of the IRS’s prior position “until such time as Congress can devise an alternative approach establishing reasonable yardsticks of charitable service related to the financial capacity of a hospital.”<sup>452</sup> Although the Tax Reform Act of 1969 did result in significant changes to the tax-exempt sector (e.g., establishing a regime distinguishing private foundations from public charities), the Act did not address the concerns expressed by the Senate Finance Committee regarding the community benefit standard.

In later years, the changing hospital marketplace and continued controversy over the IRS’s construction of charitable led to renewed concerns that hospitals recognized as tax exempt were not delivering sufficient medical care to the indigent.<sup>453</sup> A 1990 GAO report found that “the link between tax-exempt status and the provision of charitable activities for the poor or underserved is weak for many nonprofit hospitals,” and recommended that “to the extent that one of the goals of the tax exemption is to continue or expand current levels of charity care and other services to the poor in an increasingly competitive hospital environment, changes in tax policy may be needed.” In response to this report, two separate bills were introduced linking a specified level of charitable care to the availability of tax-exemption.<sup>454</sup> Neither proposal was enacted,

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<sup>449</sup> *Sound Health Association v. Commissioner*, 71 T.C. 158, 180 (1978).

<sup>450</sup> *Id.* at 180-81.

<sup>451</sup> Joint Committee on Taxation, *Description and Analysis of Title VII of HR 3600, S.1757 and S. 1775 (“Health Security Act”)* (JCS-20-93), December 20, 1993.

<sup>452</sup> Report of the Staff to the Committee on Finance, 91<sup>st</sup> Cong. 1<sup>st</sup> Sess., *Medicare and Medicaid: Problems, Issues, and Alternatives* (Feb. 9, 1970), at 58.

<sup>453</sup> GAO Report to the Chairman, Select Committee on Aging, House of Representatives, *Nonprofit Hospitals: Better Standards Needed for Tax Exemption Tax Compliance of Nonwage Earners*, GAO/HRD-90-84, May 1990, at 15.

<sup>454</sup> Hospital Charity Care Act, H.R. 5686, 101<sup>st</sup> Cong., 2<sup>d</sup> Sess. (1990), reintroduced the following year as H.R. 790, 102<sup>d</sup> Cong., 1<sup>st</sup> Sess. (1991). The Charity Care Act proposed a substantive

however. In 1994, Representative Richard Gephardt introduced an amendment to The Health Security Act<sup>455</sup> that would have required section 501(c)(3) or 501(c)(4) organizations that were primarily devoted to providing healthcare services to assess community healthcare needs, prepare written plans to meet those needs, perform qualified outreach services, and provide medically necessary services without regard to ability to pay. The proposed legislation was not enacted.

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test for hospitals to meet in order to obtain and keep their exemption. In addition to satisfying the basic requirements of section 501(c)(3), hospitals would have to serve a reasonable number of Medicare and Medicaid patients in a nondiscriminatory manner, and would have to provide, in an equally nondiscriminatory manner, ample qualified charity care and qualified community benefits. To satisfy the qualified charity care requirement, a hospital would have to expend fifty percent or more of the value of the hospital's tax exemption for the tax year on unreimbursed charity care; see also H.R. 1374, 102nd Cong., 1<sup>st</sup> Sess. (1991) (requiring hospitals to provide emergency medical care, service to Medicaid patients, and certain community benefits to qualify tax exemption).

<sup>455</sup> H.R. 3600, 103d Cong., 2d Sess. (1994).

## C. Elder Care Facilities

### In general

Providing for the special needs of the aged has long been recognized as a charitable purpose for Federal tax purposes where the requisite elements of relief of distress and community benefit have been found to be present. For many years, the IRS took the position that old age homes were not charitable unless they were operated for the relief of poverty. In 1972, the IRS modified its position and ruled that an organization providing housing and other care for the aged may qualify as a tax-exempt charitable organization if it operates in a manner designed to satisfy the three primary needs of the elderly, namely housing, health care, and financial security. Thus, an organization meeting these needs is not required to provide direct financial assistance to the elderly in order to be charitable because poverty is only one form of distress to which the elderly as a class are particularly susceptible.<sup>456</sup>

### Charitable activities

#### Historical position: relief of the poor

The IRS's historical position was that the aged were not a charitable class per se. Exemptions for organizations providing care and housing services to the aged generally were conditioned upon traditional notions of charity, such as whether the organization provided relief of the poor and distressed.<sup>457</sup> For example, in Revenue Ruling 57-467, the IRS held that a home for the elderly that does not accept nonpaying guests and that requires the discharge of guests who fail to make required monthly payments is not charitable.<sup>458</sup>

Similarly, in Revenue Ruling 61-72, the IRS stated that providing "below cost" services to the elderly may qualify as a charitable activity.<sup>459</sup> The IRS ruled that a home for the aged may be charitable if: (1) the organization is dedicated to providing, and in fact provides, care and housing to aged individuals who would otherwise be unable to provide for themselves without hardship, (2) such services are rendered to all or a reasonable proportion of its residents at substantially below cost, to the extent of the organization's financial ability, and (3) the services are of the type that minister to the needs and the relief of hardship or distress of aged individuals.<sup>460</sup> The IRS subsequently clarified that entrance fees paid as a prerequisite to obtaining residence and direct personal services in a home for the aged must be included along

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<sup>456</sup> Rev. Rul. 79-18, 1979-1 C.B. 194.

<sup>457</sup> See Gen. Couns. Mem. 34073 (March 12, 1969).

<sup>458</sup> Rev. Rul. 57-467, C.B. 1957-2, *superseded* by Rev. Rul. 72-124, 1972-1 C.B. 145.

<sup>459</sup> Rev. Rul. 61-72, 1961-1 C.B. 188.

<sup>460</sup> *Id.*

with other care payments in determining whether the home renders services to all or a reasonable proportion of its residents at below cost.<sup>461</sup>

### The elderly as a charitable class

In 1972, the IRS ruled that the aged, apart from considerations of financial hardship, are as a class highly susceptible to other forms of distress.<sup>462</sup> The IRS identified three primary needs of aged persons: the need for housing, the need for health care, and the need for financial security. The satisfaction of these needs “contributes to the prevention and elimination of the causes of the unique forms of distress to which the aged, as a class, are highly susceptible.”<sup>463</sup> Organizations operated in a manner designed to satisfy all three primary needs may qualify for charitable status even though direct financial assistance to the elderly may not be involved.<sup>464</sup> Thus, after 1972, for certain purposes, the elderly can be considered a charitable class.

### Satisfying the needs for housing, health care, and financial security

An organization satisfies the need for housing if it provides residential facilities that are specifically designed to meet “some combination of the physical, emotional, recreational, social, religious, and similar needs of aged persons.”<sup>465</sup>

An organization satisfied the need for health care if it either directly provides some form of health care, or maintains some continuing arrangement with other organizations, facilities, or

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<sup>461</sup> Rev. Rul. 64-231, 1964-2 CB 139.

<sup>462</sup> Rev. Rul. 72-124, 1972-1 C.B. 145. The organization that was the subject of the ruling provided housing, limited nursing care, and other services and facilities to its elderly residents. Admission to the home was generally limited to persons who are at least 65 years of age.

<sup>463</sup> *Id.*

<sup>464</sup> Organizations providing housing for the elderly may qualify as charitable organizations on alternative grounds, for example, if they provide low-income housing (Rev. Proc. 96-32, 1996-1 C.B. 717), assistance to the physically handicapped (Rev. Rul. 79-19, 1979-1 C.B. 195), or hospice-type facilities (Rev. Rul. 79-17, 1979-1 C.B. 193).

<sup>465</sup> *Id.* See Revenue Ruling 79-18, 1979-1 C.B. 194, for an example of housing that is specially designed to meet the needs of the elderly (ruling that apartment units that were constructed with fire-resistant materials and equipped with safety features such as grab bars by bathtubs and toilets, wide entrance-exit doorways, ramps and elevators for wheelchair use, floors designed to help prevent slips and falls, conveniently located electrical outlets and cabinets to avoid strenuous bending or stretching, windows at eye level for residents confined to wheelchairs, and an emergency 24-hour alarm system qualified).

health personnel, designed to maintain the physical, and, if necessary, the mental well being of its residents.<sup>466</sup>

An organization satisfies the need of the elderly for financial security (i.e., the aged person's need for protection against the financial risks associated with the later years of life), if it meets two conditions. First, the organization must be committed to an established policy of maintaining in residence any person who becomes unable to pay their regular charges. Second, the organization must operate so as to provide its services to the aged at the lowest feasible cost. Whether services are provided at the lowest feasible cost is determined by taking into consideration such expenses as the payment of indebtedness, maintenance of adequate reserves sufficient to ensure the life care of each resident, and reserves for physical expansion commensurate with the needs of the community and the existing resources of the organization.<sup>467</sup>

#### Other services provided to the elderly

The ruling that the elderly are a charitable class has led to recognition of a number of charitable activities for the benefit of the elderly, including senior citizen centers,<sup>468</sup> rural rest homes,<sup>469</sup> meal delivery organizations,<sup>470</sup> broadcasting organizations,<sup>471</sup> transportation providers,<sup>472</sup> and a beauty shop.<sup>473</sup>

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<sup>466</sup> Rev. Rul. 72-124, 1972-1 C.B. 145; see also Rev. Rul. 79-18, 1979-1 C.B. 194 (keeping an employee on duty 24 hours a day who gave temporary aid in emergencies, contacted professional help (doctor, ambulance service, etc.) and ensured that steps necessary to render aid were carried out, and providing transportation for medical examination and follow-up treatment).

<sup>467</sup> See Rev. Rul. 79-18, 1979-1 C.B. 194 (ruling that rental charges for apartment units must be set at a level that is within the financial reach of a significant segment of the community's elderly); compare Gen. Couns. Mem. 39487 (March 21, 1986) (ruling that an organization did not qualify for exemption because it sold housing units to the elderly on a fee simple basis with the result that title to the housing unit was held by an independent lender, who could foreclose on the residence).

<sup>468</sup> Rev. Rul. 75-198, 1975-1 C.B. 157 (ruling that senior citizen centers are charitable if the center offers information, referral, and counseling services relating to health, housing, finances, education, and employment, as well as a facility for specialized recreation for a particular community's senior citizens, who need not be members to obtain services or participate in the activities).

<sup>469</sup> Rev. Rul. 75-385, 1975-2 C.B. 205 (ruling that a rural rest home to provide, at a nominal charge, two-week vacations for elderly poor people from nearby metropolitan areas is charitable because the vacations are relieving the distress of being poor as well as aged).

<sup>470</sup> Rev. Rul. 76-244, 1976-1 C.B. 155 (ruling that an organization that provides home delivery of meals to elderly and handicapped people by volunteers, for a fee insufficient to cover the cost of operations but approximating the cost of the meals provided, or for a reduced fee or no fee depending on the recipient's ability to pay, is operated for charitable purposes).

<sup>471</sup> Rev. Rul. 77-42, 1977-1 C.B. 142 (ruling that an organization that set up closed circuit radio systems in nursing homes, rest homes and convalescent homes for senior citizens and broadcast programs and items regarding senior citizens was charitable because the organization relieved the distress of aged



## D. Credit Counseling Organizations

### In general

In the last 40 years, there has been “enormous growth in the availability of credit and the amount of outstanding debt.”<sup>474</sup> In an effort to manage their debt or repair damaged credit, many consumers have sought help from credit counseling organizations. In response, an entire industry of credit counseling, credit repair, and debt management and debt consolidation has emerged over the past 30 years, with much of this activity conducted by nonprofit organizations that received favorable tax-exempt status determinations from the IRS.<sup>475</sup>

Credit counseling organizations may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS reports, however, that the vast majority of credit counseling organizations apply for charitable status under section 501(c)(3). During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 from 2000 to 2003.<sup>476</sup> As of late 2003, the IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3).<sup>477</sup> In

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persons by providing them with an opportunity to listen to free, non-commercial, and educational radio broadcasts concerning their special needs such as employment, financial security, health and legal care, as well as cultural and recreational needs).

<sup>472</sup> Rev. Rul. 77-246, 1977-2 C.B. 190 (ruling that an organization that provides low cost bus transportation to senior citizens and handicapped persons in the community where public transportation is unavailable or inadequate is charitable).

<sup>473</sup> Rev. Rul. 81-61, 1981-1 C.B. 355 (ruling that the operation of a beauty shop by a charitable senior citizens center was not an unrelated trade or business because it served elderly persons with physical impairments who would experience difficulty in obtaining the services elsewhere).

<sup>474</sup> See Chief Coun. Adv. 200431023 (July 13, 2004).

<sup>475</sup> As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States. See United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations’ Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

<sup>476</sup> United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations’ Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

<sup>477</sup> Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

contrast, few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare organizations.<sup>478</sup> The preference for operating as an organization exempt under section 501(c)(3) may be explained, in part, by the regulatory exemptions from certain Federal and State consumer protection laws afforded such organizations that generally are not available for social welfare organizations described in section 501(c)(4).<sup>479</sup>

### **Standards for exemption**

The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations described in section 501(c)(3), or as social welfare organizations described in section 501(c)(4).<sup>480</sup> Judicial decisions relaxed the standard for exemption for a charitable credit counseling organization from that first enunciated by the IRS in published rulings.

In Revenue Ruling 65-299, an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on voluntary contributions from local businesses, lending agencies, and labor unions.

In Revenue Ruling 69-441, the IRS ruled that an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt

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<sup>478</sup> *Id.*

<sup>479</sup> *E.g.*, The Credit Repair Organizations Act, 15 U.S.C. section 1679 *et seq.*, effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

<sup>480</sup> Rev. Rul. 65-299, 1965-2 C.B. 165; Rev. Rul. 69-441, 1969-2 C.B. 115.

management plans for clients who required such services, at no charge to the clients.<sup>481</sup> The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

The IRS's standard for exemption, i.e., requiring that assistance be to low-income individuals (or providing services without charge), was challenged in court.<sup>482</sup> In 1976, the IRS denied charitable status to an organization whose activities were distinguishable from those in Revenue Ruling 69-441 in that (1) it did not restrict its services to the poor and (2) it charged a nominal fee for its debt management plans. The organization appealed the IRS's decision and the court determined that the organization qualified as charitable and educational because it educated the public on subjects useful to the individual and beneficial to the community. The court held that the law did not require that an organization must perform its exempt functions solely for the benefit of low-income individuals to be considered charitable. The court found the debt management plans to be an integral part of the agency's counseling function, and viewed its debt management activities as incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.<sup>483</sup>

### **Recent developments**

Over the past decade, there has been a proliferation of large-volume, commercial-type credit counseling agencies. In recent years, there also have been a number of new credit counseling entities that engage in aggressive marketing and advertising while providing very little legitimate credit counseling or financial training.<sup>484</sup> In addition, many of today's credit counseling organizations conduct as their primary activity, and derive most of their revenues from, debt management planning and other activities. Because of these changes in the industry,

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<sup>481</sup> Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

<sup>482</sup> *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 78-2 U.S.T.C. 9660 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

<sup>483</sup> See also, *Credit Counseling Centers of Oklahoma, Inc., v. U.S.*, 79-2 U.S.T.C. 9468 (D.D.C. 1979) (holding the same on virtually identical facts).

<sup>484</sup> Michelle Singletary, *Mandatory Counseling: A Good Idea in Theory*, Washington Post, March 20, 2005. Under bankruptcy legislation recently passed by Congress, individuals will have to undergo some form of credit counseling at least 180 days before they are allowed to file for bankruptcy protection.

Congress and the IRS have expressed concern that tax-exempt credit counseling organizations are not fulfilling their exempt purpose. The Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,<sup>485</sup> such as the Federal Trade Commission Act.<sup>486</sup> Moreover, the IRS has commenced a broad examination and compliance program with respect to the credit counseling industry, pursuant to which the IRS has initiated audits of 50 credit counseling organizations, including nine of the 15 largest in terms of gross receipts.<sup>487</sup> In a recent legal memorandum, the IRS found that the operations of the new generation of credit counseling organizations are different from those considered in prior revenue rulings and case law in that many organizations are not providing any meaningful education or relief of the poor.<sup>488</sup> The IRS concluded that many credit counseling organizations may not qualify for exemption under section 501(c)(3) because of operation for a substantial nonexempt purpose, substantial private benefit, and private inurement.<sup>489</sup>

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<sup>485</sup> United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004.

<sup>486</sup> 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

<sup>487</sup> United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 31.

<sup>488</sup> See Chief Couns. Adv. 200431023 (July 13, 2004).

<sup>489</sup> *Id.*; see also Priv. Ltr. Rul. 200506038 (November 15, 2004) (denying a credit counseling organization's application for exempt status as an organization described in section 501(c)(3) because (1) its articles of incorporation did not establish an exempt purpose and its services were not limited to the poor, distressed or other charitable class; (2) it operated primarily to provide debt-management plans to customers; an activity that is considered to be commercial in nature; (3) it did not provide public education, and (4) the composition of the board presented a serious risk of inurement).

## E. Low-income Housing

### In general

Nonprofit housing organizations created to aid low-income families may qualify as charitable organizations on the basis of providing relief to the poor. In addition, organizations providing housing assistance that is not limited to the poor may qualify for exemption if the organization serves other charitable purposes such as lessening the burdens of government, eliminating discrimination, combating community deterioration, or providing specialized housing for the elderly.<sup>490</sup>

### Standards for exemption

#### Relief of the poor

In Revenue Ruling 70-585,<sup>491</sup> the IRS considered situations under which a nonprofit organization created to provide housing for low- or moderate-income families may qualify as a charitable organization. In one fact pattern, the organization's activities included developing new and renovating existing homes for sale to low-income families on long-term, low-payment plans. By providing housing for low- and, in certain circumstances, moderate-income families who could not otherwise afford them, the IRS held the organization was relieving the poor and distressed and, thus, was engaged in a charitable activity.<sup>492</sup> The ruling also holds that the determination of what constitutes low income is a factual question based on the surrounding circumstances.

In Revenue Ruling 76-408,<sup>493</sup> the IRS ruled that an organization that provided interest-free loans to homeowners in a deteriorated urban residential area was engaged in charitable activities. In the facts of the ruling, homeowners used loans provided by the organization to make repairs to their homes necessary to meet local housing code regulations. To obtain a loan, homeowners had to qualify under low-income standards determined by a government agency and show that they were unable to obtain a loan elsewhere. The organization periodically reviewed the work on the repairs to assure that the funds were used for the stated purpose. The IRS reasoned that the organization relieved the poor and distressed and was charitable.

Over the past few decades, new models of affordable housing have been established as an alternative to large public housing projects, including many mixed-income developments.

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<sup>490</sup> Rev. Proc. 96-32, 1996-1 C.B. 717.

<sup>491</sup> 1970-2 C.B. 115.

<sup>492</sup> *Id.*; see also Rev Rul 67-138, 1967-1 CB 129 (holding that an organization's activities in coordinating and supervising construction of housing, purchasing building sites for resale at cost, and assisting low-income families in obtaining home construction loans are charitable).

<sup>493</sup> 1976-2 C.B. 145.

Questions arose whether organizations serving individuals with a mix of incomes, only some of whom are poor, qualify as charitable. In response, the IRS issued low-income housing guidelines in 1996 that set forth criteria for determining whether a housing organization provides relief to the poor.<sup>494</sup> Revenue Procedure 96-32 establishes a safe-harbor to identify those low-income housing organizations that will be considered to relieve the poor and distressed. The revenue procedure also describes a facts and circumstances test that applies to determine whether organizations falling outside the safe harbor are charitable organizations.

To satisfy the safe harbor of Revenue Procedure 96-32, an organization must reserve a significant percentage of residential units for occupancy by both low-income and very low-income families.<sup>495</sup> Specifically, the organization must establish that at least 75 percent of the residential units are occupied by low-income residents and either 20 percent of the units are occupied by very low-income residents or 40 percent of the units are occupied by residents whose income does not exceed 120 percent of the low-income limit. To assist in the social and economic integration of poorer residents, Revenue Procedure 96-32 does permit a limited number of housing units to be occupied by residents with incomes above low-income limits. However, the large percentage of units that must actually be occupied by low-income residents is “to avoid giving undue assistance to those who can otherwise afford safe, decent, and sanitary housing.”<sup>496</sup>

Organizations that provide low-income housing, but do not satisfy the safe-harbor procedures of Revenue Procedure 96-32 must demonstrate that they relieve the poor and distressed. In this context, the IRS has held that an organization must establish that it is serving persons who could not afford safe and sanitary housing without assistance. Factors the IRS considers in making this determination include, but are not limited to, the affordability of the residential units provided, participation in a government-housing program designed to provide affordable housing, the level of community-based board membership, and the provision of social services to the poor residents.<sup>497</sup>

#### Exempt purposes other than relieving the poor

Housing organizations may qualify for exemption without having to satisfy the standards for relief of the poor and distressed by providing housing in a manner that accomplishes any other charitable purposes. Lessening the burdens of government,<sup>498</sup> lessening neighborhood

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<sup>494</sup> Rev. Proc. 96-32, 1996-1 C.B. 717.

<sup>495</sup> For purposes of the revenue procedure, low-income and very low-income families are identified in accordance with income limits computed and published by the Department of Housing and Urban Development.

<sup>496</sup> Rev. Proc. 96-32, 1996-1 C.B. 717.

<sup>497</sup> *Id.*

<sup>498</sup> Rev. Ruls. 85-1 and 85-2, 1985-1 C.B. 177-178 (ruling that an organization lessens the burdens of government if (a) there is an objective manifestation by the governmental unit that it considers

tensions,<sup>499</sup> combatting community deterioration,<sup>500</sup> and eliminating prejudice and discrimination<sup>501</sup> are all activities the IRS has recognized as charitable for purposes of determining whether nonprofit housing organizations qualify for exemption under section 501(c)(3).

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the activities of the organization to be the government's burdens, and (b) the organization actually lessens the government's burdens).

<sup>499</sup> Fighting poverty and community deterioration associated with overcrowding in lower income areas in which ethnic or racial tensions are high lessen neighborhood tensions. Rev. Rul. 68-655, 1968-2 C.B. 213; Rev. Rul. 70-585, 1970-2 C.B. 115 (Situation 2); Rev. Proc. 96-32, 1996-1 C.B. 717.

<sup>500</sup> An organization that combats community deterioration must (1) operate in an area with actual or potential deterioration, and (2) directly prevent or relieve that deterioration. Constructing or rehabilitating housing has the potential to combat community deterioration. See Rev. Rul. 68-17, 1968-1 C.B. 247; Rev. Rul. 68-655, 1968-2 C.B. 213; Rev. Rul. 70-585, 1970-2 C.B. 115 (Situation 3) (organization's purposes and activities combat community deterioration by assisting in the rehabilitation of an old and run-down residential area).

<sup>501</sup> Situation 2 of Revenue Ruling 70-585, 1970-2 C.B. 115 describes an organization formed to eliminate prejudice and discrimination. The organization was formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open occupancy basis. Housing was made available to members of minority groups with low and moderate income who are unable to obtain adequate housing because of local discrimination. The IRS held that the organization's activities were designed to eliminate prejudice and discrimination and to lessen neighborhood tensions, thus, it was engaged in charitable activities. See also Rev. Rul. 68-655, 1968-2 C.B. 213.

## F. Environmental Organizations

### In general

Organizations established to preserve and promote the natural environment may be exempt under section 501(c)(3) as charitable, educational, or scientific organizations. The exemption for environmental organizations generally is based on the principle that efforts to preserve and protect the natural environment for the benefit of the public serve a charitable purpose. In addition, organizations engaged in activities designed to enhance land conservation and preservation may be viewed as advancing education and science.

### Administrative and judicial rulings

Several IRS rulings have recognized the charitable and educational nature of organizations designed to preserve and promote the natural environment. For example, in Revenue Ruling 70-186,<sup>502</sup> the IRS ruled that an organization formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake in order to enhance its recreational features qualifies as charitable. By treating the water, removing algae, and otherwise improving the condition of the water, the IRS found the organization insured the continued use of the lake for public recreational purposes and, thus, performed a charitable activity.

In Revenue Ruling 76-204,<sup>503</sup> the IRS ruled that an organization formed for the purpose of preserving the natural environment by acquiring ecologically significant undeveloped land, and either maintaining the land itself with limited public access or transferring the land to a government conservation agency by outright gift, or being reimbursed by the agency for its cost, qualified as charitable. In the ruling, the IRS noted that the promotion of conservation and protection of natural resources has been recognized by Congress as serving a broad public benefit. The IRS described the benefit to the public from environmental conservation as deriving “not merely from the current educational, scientific, and recreational uses that are made of natural resources, but from their preservation as well.”<sup>504</sup> Thus, by preserving ecologically significant land, the IRS ruled the organization was advancing education and science and benefiting the public in a charitable manner. The IRS noted, however, that the organization’s restriction on access to the land was essential to its preservation and, therefore, essential to the fulfillment of the organization’s charitable purpose.

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<sup>502</sup> 1970-1 C.B. 129; see also Rev. Rul. 67-292, 1967-2 C.B. 184 (holding that an organization formed for the purpose of purchasing and maintaining a sanctuary for wild birds and animals for the benefit of the public may qualify as charitable).

<sup>503</sup> 1976-1 C.B. 152, *distinguished* by Rev. Rul. 78-384, 1978-2 C.B. 174.

<sup>504</sup> *Id.*



In Revenue Ruling 78-384,<sup>505</sup> the IRS considered the exemption of an organization that owned farmland and restricted its use to farming or other uses the organization deemed ecologically suitable. However, there was no claim that the land itself was ecologically significant. As a result, the IRS distinguished the organization's activities from those of the organization in Revenue Ruling 76-204 and denied the organization's charitable status. Thus, the IRS took the position that the mere preservation of existing land without a showing that the land has any distinctive ecological significance does not constitute a charitable purpose.

In *Dumaine Farms v. Commissioner*,<sup>506</sup> the Tax Court held that an organization operating a model farm as a demonstration conservation project served scientific and educational purposes, and thus was charitable. The organization was engaged in experimental farming methods with the purpose of showing that farming could be profitable while maintaining sound ecological principles. Similar to Revenue Ruling 78-384, the farm land held by the organization did not have any significant environmental attributes. The court, however, did not find this fact to be a bar to the organization's exempt status. Rather, the court noted that the organization's goal was not to preserve land in an untouched natural state, but to restore "overcultivated and exhausted land to a working ecological balance."<sup>507</sup> Therefore, it was essential to the organization's purpose that the land be generally representative of the surrounding farmland. Rather than focus on the nature of the land, as was the case in Revenue Ruling 78-384, the court looked to the use of the land, i.e., whether the organization used the land for an exempt purpose.

In 1980, Congress passed the Tax Treatment Extension Act,<sup>508</sup> which provided a charitable deduction for "qualified conservation contributions"<sup>509</sup> to certain qualified organizations for conservation purposes.<sup>510</sup> Qualified organizations include section 501(c)(3) organizations that are public charities.<sup>511</sup> Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure. The

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<sup>505</sup> 1978-2 C.B. 174.

<sup>506</sup> 73 T.C. 650 (1980).

<sup>507</sup> *Id.* at 653.

<sup>508</sup> Pub. L. No. 96-541.

<sup>509</sup> Sec. 170(f)(3)(B)(iii).

<sup>510</sup> In general, a charitable deduction is not permitted for a contribution of a partial interest in property. The deduction for qualified conservation contributions is an exception to this general rule.

<sup>511</sup> Sec. 170(h)(3)(B).

legislative history to the Act indicates that the specified preservation activities yield significant benefits to the public and are to be encouraged.<sup>512</sup>

Subsequent to the 1980 amendments to section 170, the IRS issued an internal legal memorandum stating that organizations that are established to accept and preserve qualified conservation contributions that do not otherwise conflict with the requirements of section 501, may be entitled to exemption.<sup>513</sup> The IRS stated that the deduction for qualified conservation contributions does not directly conflict with the exemption standards previously stated in Revenue Rulings 76-204 and 78-384 because Congress indicated that preservation efforts must be directed to “unique or otherwise significant land areas” and not to “the preservation of an ordinary tract of land.”<sup>514</sup> However, the IRS also has stated that the 1980 amendments raise a strong implication as to Congressional intent that organizations that are established to accept and preserve the specified types of properties may be entitled to exemption,<sup>515</sup> meaning that charitable purposes of necessity may expand beyond the “ecologically significant” standard articulated in prior IRS rulings.<sup>516</sup>

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<sup>512</sup> S. Rep. No. 1007, 96<sup>th</sup> Cong., 2d Sess. (1980).

<sup>513</sup> Gen. Couns. Mem. 39055 (May 11, 1983).

<sup>514</sup> *Id.* (citing S. Rep. No. 1007, 96<sup>th</sup> Cong., 2d Sess. (1980)).

<sup>515</sup> Priv. Ltr. Rul. 9526033 (June 30, 1995) (ruling that to the extent an organization’s land preservation guidelines track the language of the 1980 amendments its activities will further charitable purposes).

<sup>516</sup> Gen. Couns. Mem. 39055 (May 11, 1983); see also Priv. Ltr. Rul. 9526033 (June 30, 1995).

## G. College Sports

### In general

College athletic organizations that promote certain aspects of athletic competition have generally been held to be educational and, thus, exempt under section 501(c)(3). The exemption is based on the principle that an athletic program conducted for the physical development and betterment of the students is an integral part of a university's overall educational activities. In addition, the revenue that a college or university derives from admission to athletic events is income from a related business to the extent the activities are substantially related to the institution's educational programs.<sup>517</sup> Today, colleges and universities may generate significant financial benefits from their participation in athletic events.<sup>518</sup>

### Administrative and judicial rulings

Traditionally, the mere promotion of sports was not viewed as a charitable activity.<sup>519</sup> However, several administrative and judicial decisions hold that an athletic organization associated with an educational institution qualifies for exemption if the organization's purposes and activities further the educational program of the institution. For example, in Revenue Ruling 67-291,<sup>520</sup> the IRS considered whether an organization whose principal activity consisted of subsidizing a dining room for coaches and members of the university athletic teams qualified for exemption. In granting exemption, the IRS found that the athletic program of the university was an integral part of its overall educational activities. The organization's purposes and activities furthered the educational program of the university by providing necessary services to the student athletes and coaches.

In *Mobile Arts and Sports Ass'n. v. United States*,<sup>521</sup> the court held that an organization that conducted an annual football game between two all-star teams composed of outstanding seniors from colleges across the country was entitled to exemption as a charitable organization. Each member of the winning team was paid \$500, and each member of the losing team received \$400. The managers and coaches of the respective teams were also paid for their services. In

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<sup>517</sup> In the legislative history of the Revenue Act of 1950, Congress stated that "[a]thletic activities of schools are substantially related to their educational functions." Therefore, "a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students of other schools." H. R. Rep. No. 2319, 81<sup>st</sup> Cong., 2d Sess., at 37 (1950); S. Rep. No. 2375, 81<sup>st</sup> Cong., 2d Sess. (1950).

<sup>518</sup> See David A. Haimen, *Corporate Sponsorships of Charity Events and the Unrelated Business Income Tax: Will Congress or the Courts Block the IRS Rush to Sack the College Football Games?* 67 Notre Dame L. Rev. 1079 (1992).

<sup>519</sup> Restatement (Second) of Trusts, sec. 374 (1959).

<sup>520</sup> 1967-2 C.B. 184.

<sup>521</sup> 148 F. Supp. 311 (S.D. Ala. 1957).

upholding the organization's exemption, the court noted that a player in the game must be a senior in college and must be finished with all competition in collegiate athletics. On the day the game is played, it is the only football game in the nation and is not in competition with any other game. The court held that the game was an integral part of the organization's civic and educational program and bore a close and intimate relationship to the civic and educational objects for which the organization was organized. The court also held that income from the game was not unrelated business income.<sup>522</sup>

Although the IRS disagreed with the result in *Mobile Arts*,<sup>523</sup> a legal memorandum issued by the IRS in 1977 concluded that an organization formed for a similar purpose, i.e., the presentation of an annual college football bowl game, qualified for exemption.<sup>524</sup> The IRS distinguished the case from *Mobile Arts* by the fact the organization was controlled by and its activities were an integral part of the activities of its member universities. The IRS also stated that the game furthered an educational purpose. The IRS initially concluded that the broadcasting revenues received by the organization constituted unrelated trade or business income because broadcasting the game was not substantially related to its exempt purpose and the sale of the broadcasting rights constituted a trade or business activity regularly carried on by the organization.<sup>525</sup> However, the IRS subsequently reversed its position and determined that the broadcast income was substantially related to exempt purposes and not taxable as unrelated business income.<sup>526</sup>

In Revenue Ruling 80-296,<sup>527</sup> the IRS held that the educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Thus, the IRS held the sale of the broadcasting rights and the resultant broadcasting of the game contributes importantly to the accomplishment of an organization's exempt purposes.<sup>528</sup>

The rulings discussed above in which athletic organizations were granted exemption are premised on the educational nature of the organization's activities. The basis for these rulings is

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<sup>522</sup> *Id.* at 316.

<sup>523</sup> A.O.D. (May 14, 1957).

<sup>524</sup> Gen. Couns. Mem. 37048 (March 18, 1977).

<sup>525</sup> *Id.*

<sup>526</sup> Gen. Couns. Mem. 37618 (July 28, 1978).

<sup>527</sup> 1980-2 C.B. 195.

<sup>528</sup> *Id.* Similar issues arise with respect to other types of income educational institutions generate in connection with sporting events. For example, in a case involving the National Collegiate Athletic Association, a court held that income from advertising in a sports program distributed during a three week basketball tournament was not regularly carried on for purposes of the tax on unrelated business income. *National Collegiate Athletic Association v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990).

not to be confused with the statutory inclusion in section 501(c)(3) of organizations that foster national or international sports competition. In 1976, Congress found section 501(c)(3) as written to be “a source of confusion and inequity for amateur sports organizations whereby some gained favored tax-exempt status while others, apparently equally deserving, did not.”<sup>529</sup> Therefore, Congress amended section 501(c)(3) to include in the enumerated charitable classifications organizations whose purpose is to “foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment).” Since the 1976 amendment, Courts have held that the promotion, advancement, and sponsorship of amateur sports are exempt purposes under section 501(c)(3),<sup>530</sup> even if not provided in connection with an educational program.

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<sup>529</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, (JCS-33-76), December 29, 1976, at 423.

<sup>530</sup> *Hutchinson Baseball Enterprises, Inc. v. Commissioner*, 73 T.C. 144 (1979), *aff'd*, 696 F.2d 757 (10<sup>th</sup> Cir. 1982); but compare *Wayne Baseball, Inc. v. Commissioner*, T.C. Memo 1999-304 (denying exemption where amateur baseball team merely served the members social and recreational interests).

## IV. DATA ON EXEMPT SECTOR AND CHARITABLE ORGANIZATIONS

**Table 5.—All Section 501(c) Exempt Organizations, Excluding Private Foundations:  
Number of Organizations and Selected Financial Information, by Type of Organization,  
1975 and 2001, SOI and Master File Data**

[All figures are estimates based on samples, -- money amounts are in millions of constant dollars, 2001=100]

IRC section	Type of Organization	Number of organizations <sup>1</sup>	Total assets	Total liabilities	Total revenue <sup>2</sup>	Program service revenue	Contributions gifts, and grants	Gross dues and assessments	Total expenses
<b>2001</b>									
	<b>Total</b> .....	<b>384,534</b>	<b>2,465,910</b>	<b>959,873</b>	<b>1,186,204</b>	<b>837,644</b>	<b>227,843</b>	<b>43,251</b>	<b>1,141,584</b>
501(c)(1)	Corporations organized under Act of Congress.....	12	18	15	29	29	1	3	29
501(c)(2)	Title holding companies.....	2,898	14,836	3,037	1,813	633	62	38	1,126
501(c)(3)	Charitable, religious, educational, and scientific organizations.....	250,893	1,702,105	608,692	902,510	628,420	218,581	7,881	863,040
501(c)(4)	Civic leagues, social welfare, and local associations of employees.....	24,551	80,789	46,058	50,251	40,960	4,216	2,149	48,720
501(c)(5)	Labor, agricultural, and horticultural organizations.....	21,297	24,290	4,474	18,330	3,732	653	11,895	17,505
501(c)(6)	Business leagues, chambers of commerce and real estate boards.....	31,051	45,640	25,350	28,086	11,866	1,958	11,034	27,629
501(c)(7)	Social and recreational clubs.....	16,910	19,398	6,223	9,979	1,910	104	5,862	9,747
501(c)(8)	Fraternal beneficiary societies.....	7,399	71,319	61,385	11,397	8,214	194	297	11,244
501(c)(9)	Voluntary employee beneficiary associations.....	7,895	112,974	26,798	104,961	97,054	957	3,079	110,527
501(c)(10)	Domestic fraternal societies.....	2,909	2,637	168	590	81	60	132	581
501(c)(11)	Teachers retirement fund associations.....	6	344	63	2	3	1	8	23
501(c)(12)	Local benevolent life insurance associations.....	3,636	67,964	41,467	29,345	26,450	419	293	27,603
501(c)(13)	Cemetery companies.....	2,157	7,540	858	880	364	31	5	817
501(c)(14)	State chartered credit unions.....	1,451	269,669	116,411	19,416	13,285	65	257	16,794
501(c)(15)	Certain mutual insurance companies or associations.....	1,128	5,790	9,851	698	121	3	43	352
501(c)(16)	Farmers co-ops organized to finance crop operations.....	11	404	334	28	22	3	3	26
501(c)(17)	Supplemental unemployment benefit trusts.....	129	313	29	331	297	3	15	321
501(c)(18)	Employee funded pension trusts.....	1	1,605	61	60	33	-	-	122
501(c)(19)	War veterans organizations.....	6,817	2,505	549	1,243	209	212	148	1,192
501(c)(20-25)	Other organizations.....	1,085	31,982	6,785	3,046	1,555	24	17	1,174
	Organizations not specified.....	2,298	3,789	1,262	3,211	2,406	305	101	3,010
<b>1975</b>									
	<b>Total</b> .....	<b>220,197</b>	<b>474,844</b>	<b>203,972</b>	<b>243,370</b>	<b>n.a.</b>	<b>55,393</b>	<b>52,322</b>	<b>233,454</b>
501(c)(1)	Corporations organized under Act of Congress.....	665	16,208	15,640	1,387	n.a.	29	72	1,296
501(c)(2)	Title holding companies.....	3,263	4,445	2,297	1,092	n.a.	61	61	1,080
501(c)(3)	Charitable, religious, educational, and scientific organizations.....	82,048	292,279	97,873	145,855	n.a.	46,086	4,115	138,047
501(c)(4)	Civic leagues, social welfare, and local associations of employees.....	28,064	34,282	24,635	39,598	n.a.	1,833	23,047	39,976
501(c)(5)	Labor, agricultural, and horticultural organizations.....	28,258	10,915	1,395	12,777	n.a.	322	8,710	12,465
501(c)(6)	Business leagues, chambers of commerce and real estate boards.....	17,530	9,343	4,130	8,668	n.a.	620	5,807	8,676
501(c)(7)	Social and recreational clubs.....	18,228	9,103	3,129	5,117	n.a.	86	2,914	5,088
501(c)(8)	Fraternal beneficiary societies.....	12,066	16,961	11,515	3,854	n.a.	123	1,938	3,609
501(c)(9)	Voluntary employee beneficiary associations.....	4,285	11,587	4,060	13,355	n.a.	5,187	4,439	13,041
501(c)(10)	Domestic fraternal societies.....	4,674	3,240	1,078	809	n.a.	57	255	737
501(c)(11)	Teachers retirement fund associations.....	49	638	84	103	n.a.	16	11	60
501(c)(12)	Local benevolent life insurance associations.....	4,975	28,884	21,869	5,294	n.a.	45	416	4,863
501(c)(13)	Cemetery companies.....	1,518	2,813	598	487	n.a.	14	5	416
501(c)(14)	State chartered credit unions.....	1,610	30,051	14,287	2,604	n.a.	3	22	1,555
501(c)(15)	Certain mutual insurance companies or associations.....	864	310	17	153	n.a.	*3	68	133
501(c)(16)	Farmers co-ops organized to finance crop operations.....	36	577	428	139	n.a.	50	33	123
501(c)(17)	Supplemental unemployment benefit trusts.....	496	787	207	1,147	n.a.	658	176	1,644
501(c)(18)	Employee funded pension trusts.....	42	302	2	34	n.a.	18	*3	3
501(c)(19)	War veterans organizations.....	1,921	451	82	239	n.a.	18	62	219
	Other organizations, including (20)-(25).....	9,605	1,669	645	658	n.a.	167	170	583

<sup>1</sup> The number of organizations reported for 2001 represents those organizations that filed a 2001 return with the Internal Revenue Service through the end of the 2003 calendar year.

<sup>2</sup> Estimates from 1975 are imputed from 1975 study; for this reason, detail does not add precisely to total.

<sup>3</sup> Less than \$500,000.

\* Estimate should be used with caution because of the small number of sample returns on which it is based.

SOURCE: Special tabulation by Statistics of Income Division, IRS. Data for 1975 are from the 1975 SOI study. Data for 1995, subsection 501(c)(3) through (9) data are from the 1995 SOI study; all other data are from the IRS's administrative master file. Adjustments for inflation are based on the 2000 chain-type price index for the Gross Domestic Product, as published by the U.S. Department of Commerce, Bureau of Economic Analysis. Tax Year 2001 is the base year.

**Table 6.—Section 501(c)(3) Organizations Including Domestic Private Foundation Information Returns, and Exempt Organization Business Income Tax Returns: Selected Financial Data, Selected Years 1975-2001**

[Money amounts are in millions of dollars]

Item	1975	1985	1990	1995	1998	1999	2000	2001
	(1)	(1)	(6)	(11)	(14)	(15)	(16)	(17)
<b>CHARITABLE ORGANIZATION INFORMATION RETURNS [1]</b>								
Number of organizations on IRS masterfile***	242,000*	334,900	449,777	578,309	677,132	711,240	752,270	794,309
Number of returns filed.....	82,048	106,449	141,757	180,931	207,272	211,615	230,159	240,569
Total assets, book value [2].....	257,802	423,544	697,315	1,143,079	1,351,541	1,453,675	1,562,536	1,631,719
Total liabilities [2].....	86,328	186,390	321,984	512,383	459,188	481,444	539,367	611,390
Total fund balance or net worth [2].....	171,474	237,155	375,331	630,696	892,353	972,232	1,023,169	1,020,329
Total revenue.....	128,650	268,390	435,567	663,371	752,044	800,676	866,208	896,974
Program service revenue [3].....	n.a.	167,893	306,899	443,052	502,832	518,111	579,081	630,817
Contributions, gifts, and grants.....	40,650	55,771	85,332	127,743	161,751	174,992	199,076	212,427
Membership dues and assessments.....	3,629	3,751	5,016	6,148	6,952	6,331	6,660	7,239
Other.....	n.a.	40,975	38,320	86,428	80,508	101,242	81,392	46,491
Total expenses.....	121,763	244,214	409,447	604,645	684,566	714,487	796,434	862,721
Excess of revenue over expenses (net).....	6,887	24,175	26,120	58,725	67,478	86,189	69,775	34,253
<b>DOMESTIC PRIVATE FOUNDATION INFORMATION RETURNS</b>								
Number of returns filed.....	26,889	31,171	40,105	47,917	56,658	62,694	66,738	70,787
Nonoperating foundations.....	n.a.	28,599	36,880	43,966	52,460	58,840	61,501	63,650
Operating foundations.....	n.a.	2,571	3,226	3,951	4,198	3,854	5,238	7,137
Total assets, book value [2].....	25,514	71,394	122,412	195,570	325,672	384,565	409,524	413,577
Total assets, fair market value [2].....	n.a.	94,996	150,997	242,917	397,084	466,863	471,646	455,423
Investments in securities [2].....	19,893**	73,294	114,969	190,739	317,900	363,442	361,418	329,353
Total revenue.....	3,263	16,193	19,006	30,814	59,735	83,286	72,780	45,264
Total expenses.....	3,188	7,141	11,285	17,189	25,902	33,876	37,434	36,661
Contributions, gifts, and grants paid [4].....	1,953	5,171	8,560	12,256	19,394	22,763	27,564	27,383
Excess of revenue over expenses (net).....	75	9,053	7,721	13,626	33,833	49,410	35,346	8,602
Net investment income [5].....	1,514	9,995	11,931	20,355	39,313	57,142	48,830	25,719
<b>EXEMPT ORGANIZATION UNRELATED BUSINESS INCOME TAX RETURNS [6]</b>								
Number of returns, total.....	n.a.	n.a.	31,091	36,394	46,208	42,151	38,567	35,540
With unrelated business taxable income.....	n.a.	n.a.	14,557	18,157	24,332	20,718	19,336	15,277
Without unrelated business taxable income.....	n.a.	n.a.	16,534	18,237	21,876	21,433	19,231	20,264
Gross unrelated business income.....	n.a.	n.a.	3,511	6,280	7,585	7,722	8,413	7,900
Total deductions [7][8].....	n.a.	n.a.	3,513	5,787	6,484	6,835	7,703	7,883
Unrelated business taxable income (less deficit) [8].....	n.a.	n.a.	-2	493	1,100	887	710	18
Unrelated business taxable income.....	n.a.	n.a.	389	893	1,670	1,485	1,427	792
Deficit [7].....	n.a.	n.a.	391	400	569	598	717	774
Unrelated business income tax.....	n.a.	n.a.	99	277	506	423	406	226
Total tax [9].....	n.a.	n.a.	99	277	464	422	403	222

\* Estimate

\*\*Book value

\*\*\*Total number of active 501(c)(3) organizations on IRS masterfile minus a number of 501(c)(3) private foundations

n.a. - Not available

[1] Includes data reported by organizations described in Internal Revenue Code section 501(c)(3), excluding private foundations and most religious organizations. Organizations with receipts under \$25,000 were not required to file.

[2] Balance sheet data are end-of-year amounts.

[3] Represents fees collected by organizations in support of their tax-exempt purposes, and income such as tuition and fees at educational institutions, hospital patient charges, and admission and activity fees collected by museums and other nonprofit organizations or institutions.

[4] The amounts of contributions, gifts, and grants shown reflects the amount actually disbursed, on a cash basis, for charitable purposes.

[5] Represents income not considered related to a foundation's charitable purpose, e.g., interest, dividends, and capital gains. Foundations could be subject to an excise tax on such income.

[6] Includes returns filed by or for entities described in Internal Revenue Code sections 401(a) (qualified pension, profit-sharing, or stock bonus plans), 408(e) (Individual Retirement Arrangements, or IRAs), 408A (Roth IRAs), and 501(c)(2) through 501(c)(27) (charitable and most other types of tax-exempt organizations).

[7] Aggregate amounts of total deductions, unrelated business taxable income (less deficit), and deficit previously published in various issues of the Statistics of Income Bulletin have been adjusted in Table 16 for years prior to 1999. The revisions were required to take into account certain adjustments made to reported amounts of the "net operating loss deduction." During processing of the SOI sample of Tax Year 1999 returns, it was discovered that many Form 990 T filers were deducting the entire amount of any previous years' net operating loss carryover from net income (even when net income was zero or negative), rather than deducting only the part of the carryover amount needed to offset any positive net income amount. Entering the entire amount of the net operating loss carryover, as opposed to entering only the appropriate deduction amount, did not affect a filer's unrelated business income tax liability, but it did inflate the amount of deficit reported.

Prior to 1992, organizations with gross unrelated business income of \$10,000 or less were not required to report NOLD separately; therefore the adjusted amounts for 1990 and 1991 take into account only the larger organizations. If it had been possible to make adjustments for the smaller organizations, the amounts of total deductions and deficit would be somewhat smaller, and the amount of unrelated business taxable income (less deficit) would be somewhat larger.

[8] Excludes cost of sales and services, which was subtracted from gross receipts from sales and services in computing gross profit from sales and services. Gross profit from sales and services is a "gross unrelated business income" component of (upon which the filing requirement is based).

[9] Total tax was unrelated business income tax less the foreign tax credit, general business credit, credit for prior-year minimum tax, and other allowable credits, plus the "proxy tax" on certain lobbying expenditures (applicable only to tax years after 1993), the tax from recomputing certain prior-year credits ("recapture taxes"), the "alternative minimum tax," and the environmental tax (applicable only to tax years prior to 1996). Beginning with Income Year 2001, total tax also can include interest due, computed under the look-back method for certain depreciation property and completed long-term contracts, and "other" taxes, as described by the return filer.

**Table 7.—Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Selected Fiscal Years 1976-2004**

Type of Organization, Internal Revenue Code Section	1976	1980	1985	1990	1995	1998	2001	2004
(1) Corporations organized under act of Congress .....	n.a.	42	24	9	19	14	48	116
(2) Title-holding corporations.....	5,114	5,358	5,758	6,278	7,025	7,125	6,984	7,144
(3) Religious, charitable, and similar organizations [1,2].....	259,523	319,842	366,071	489,891	626,226	733,790	865,096	1,010,365
(4) Social welfare organizations.....	125,415	129,553	131,250	142,473	139,451	139,533	136,882	138,193
(5) Labor and agriculture organizations.....	87,412	85,774	75,632	71,653	66,662	64,804	62,944	62,561
(6) Business leagues.....	41,120	48,717	54,217	65,896	75,695	79,864	82,706	86,054
(7) Social and recreation clubs.....	47,820	51,922	57,343	62,723	65,501	66,691	67,289	70,422
(8) Fraternal beneficiary societies.....	141,725	137,449	84,435	100,321	92,115	84,507	81,112	69,798
(9) Voluntary employees' beneficiary associations.....	6,271	7,738	10,668	14,210	14,681	14,240	13,292	12,866
(10) Domestic fraternal beneficiary societies.....	11,612	16,178	15,924	18,350	21,046	21,962	23,531	21,328
(11) Teachers' retirement funds.....	14	12	11	10	11	13	15	16
(12) Benevolent life insurance associations.....	4,685	4,945	5,244	5,873	6,291	6,423	6,500	6,716
(13) Cemetery companies.....	4,959	5,947	7,239	8,565	9,433	9,792	10,269	10,728
(14) State-chartered credit unions.....	4,686	5,639	6,032	6,352	5,225	4,378	4,409	4,289
(15) Mutual insurance companies.....	1,454	1,140	967	1,137	1,185	1,251	1,423	1,988
(16) Corporations to finance crop operations.....	30	22	18	19	23	25	23	21
(17) Supplemental unemployment benefit trusts.....	790	806	726	667	583	533	490	462
(18) Employee-funded pension trusts.....	4	4	3	8	3	1	1	2
(19) War veterans' organizations.....	13,960	22,247	23,062	27,460	30,828	35,682	35,263	36,141
(20) Legal Services organizations [3].....	n.a.	46	167	197	141	56	N/A	N/A
(21) Black Lung trusts.....	n.a.	-	15	22	25	28	28	33
(22) Multiemployer pension plans.....	n.a.	n.a.	n.a.	0	-	-	-	-
(23) Veteran's associations founded prior to 1880.....	n.a.	n.a.	n.a.	2	2	2	2	2
(24) Trusts described in Section 4049 of Employee Retirement Income Security Act of 1974 (ERISA).....	n.a.	n.a.	n.a.	0	1	1	1	4
(25) Holding companies for pensions and other entities.....	n.a.	n.a.	n.a.	107	638	1,017	1,236	1,285

[1] Not all Internal Revenue Code Section 501(c)(3) organizations are included because certain organizations, such as churches, integrated auxiliaries, subordinate units, and conventions or associations of churches, need not apply for recognition of tax-exemption, unless they specifically request a ruling.

[2] Includes private foundations.

[3] Exemption for these organizations does not apply for taxable years beginning after June 30, 1992

SOURCE: IRS Data Book, FY 2004, Publication 55b. Also, Tax Exempt and Government Entities, Exempt Organizations SE:T:EO.



**Table 8.—Selected SOI Financial Data for All Charitable Organizations, Hospitals, and Colleges and Universities, 1995-2001**

[All figures are estimates based on samples – Money amounts are in millions of dollars]

Item	1995	1996	1997	1998	1999	2000	2001
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
<b>Sec. 501(c)(3) Organizations<sup>1</sup></b>							
Number of returns filed.....	180,931	192,059	198,957	207,272	211,615	230,159	240,569
Total assets, book value.....	1,143,079	1,293,439	1,438,977	1,351,541	1,453,675	1,562,536	1,631,719
Total liabilities.....	512,383	564,566	624,978	459,188	481,444	539,367	611,390
Total fund balance or net worth.....	630,696	728,873	813,998	892,353	972,232	1,023,169	1,020,329
Total revenue.....	663,371	704,346	754,616	752,044	800,676	866,208	896,974
Program service revenue.....	443,052	467,559	486,407	502,832	518,111	579,081	630,817
Contributions, gifts, and grants.....	127,743	137,666	146,171	161,751	174,992	199,076	212,427
Membership dues and assessments.....	6,148	6,347	6,823	6,952	6,331	6,660	7,239
Other .....	86,428	92,774	115,215	80,508	101,242	81,392	46,491
Total expenses.....	604,645	637,917	677,143	684,566	714,487	796,434	862,721
Excess of revenue over expenses (net).....	58,725	66,429	77,473	67,478	86,189	69,775	34,253
<b>Sec. 501(c)(3) Hospitals<sup>2</sup></b>							
Number of returns filed.....	n.a.	3,581	3,425	3,574	3,418	3,905	3,961
Total assets, book value.....	346,220	341,288	367,571	410,898	403,361	452,798	473,925
Total liabilities.....	161,251	162,173	174,307	201,469	196,552	222,211	239,978
Total fund balance or net worth.....	184,969	179,115	193,264	209,429	206,809	230,587	233,947
Total revenue.....	284,251	282,659	290,330	314,448	314,361	350,855	374,414
Program service revenue.....	260,454	260,451	265,750	289,180	287,986	324,169	349,775
Contributions, gifts, and grants.....	7,932	6,283	6,371	6,976	7,487	9,505	10,707
Membership dues and assessments.....	111	102	259	175	137	145	215
Other .....	15,754	15,823	17,950	18,117	18,751	17,036	13,717
Total expenses.....	267,279	266,940	274,733	304,315	306,951	339,086	364,549
Excess of revenue over expenses (net).....	16,972	15,719	15,597	10,133	7,410	11,769	9,865
<b>Sec. 501(c)(3) Colleges Universities<sup>2</sup></b>							
Number of returns filed.....	n.a.	1,404	1,249	1,386	1,567	1,620	1,374
Total assets, book value.....	233,399	219,323	256,054	270,249	293,752	301,571	344,657
Total liabilities.....	50,950	47,155	55,382	57,831	60,950	67,909	98,396
Total fund balance or net worth.....	182,449	172,168	200,672	212,418	232,802	233,662	246,261
Total revenue.....	93,359	82,461	93,665	92,037	105,855	102,650	98,837
Program service revenue.....	49,585	47,139	50,451	51,475	53,432	58,146	63,257
Contributions, gifts, and grants.....	25,067	19,362	22,629	23,560	25,412	26,175	27,133
Membership dues and assessments.....	220	106	106	114	110	87	12
Other .....	18,487	15,854	20,479	16,888	26,901	18,242	8,435
Total expenses.....	75,549	67,572	73,664	76,432	79,837	86,708	94,840
Excess of revenue over expenses (net).....	17,810	14,889	20,001	15,605	26,018	15,942	3,997

n.a. - Not available.

<sup>1</sup> Includes data reported on Forms 990 and 990-EZ by organizations described in Internal Revenue Code section 501(c)(3), excluding private foundations and most religious organizations. Organizations with receipts under \$25,000 were not required to file.

<sup>2</sup> Section 501(c)(3) Hospitals and colleges and universities are those organizations designated as "E2" and "B4," respectively, under the National Taxonomy of Exempt Organizations developed by the National Center for Charitable Statistics.

SOURCE: Special tabulation by Statistics of Income Division, IRS.

**Table 9.—Section 501(c)(3) Charitable Organizations, Not Including Private Foundation or Churches or Other Nonfilers by Size of Total Assets and Total Revenue, 1988, 1995, 2001**

[Dollars in Thousands of Current Dollars]

Item	Returns	Assets	Fund Balance	Revenues
<b>1988</b>				
Size of Total Assets TOTAL	124,233	583,573,213	583,573,207	354,646,576
Under \$100,000.....	50,471	1,673,388	1,673,382	6,000,674
\$100,000 thousand - \$500,000 thousand.....	34,415	8,232,707	8,232,706	12,521,421
\$500,000 thousand - \$1 million.....	11,475	8,205,085	8,205,086	9,006,480
\$1 million - \$10 million.....	21,457	66,130,508	66,130,508	50,202,763
\$10 million - \$50 million.....	4,461	99,037,586	99,037,586	64,867,216
\$50 million or more.....	1,954	400,293,939	400,293,940	212,048,022
<b>1995</b>				
Size of Total Assets TOTAL	142,790	1,141,409,405	629,320,342	661,584,177
Under \$100,000.....	41,279	1,592,783	942,883	7,509,849
\$100,000 thousand - \$500,000 thousand.....	40,125	10,333,700	6,571,903	17,492,516
\$500,000 thousand - \$1 million.....	17,920	12,582,143	8,719,143	12,506,722
\$1 million - \$10 million.....	33,794	105,334,649	65,212,280	97,695,478
\$10 million - \$50 million.....	6,574	143,047,564	88,717,831	94,588,521
\$50 million or more.....	3,098	868,518,566	459,156,301	432,241,090
<b>2001</b>				
Size of Total Assets TOTAL	193,953	1,629,617,136	1,018,428,309	894,813,218
Under \$100,000.....	51,402	2,078,437	1,181,327	9,739
\$100,000 thousand - \$500,000 thousand.....	55,919	14,212,424	10,766,553	20,592,658
\$500,000 thousand - \$1 million.....	23,638	17,072,937	12,426,082	21,369,415
\$1 million - \$10 million.....	48,643	154,987,931	98,783,084	129,764,537
\$10 million - \$50 million.....	9,847	210,987,892	129,052,960	135,024,146
\$50 million or more.....	4,504	1,230,277,515	766,218,302	578,323,027

SOURCE: Compiled from IRS website: [www.irs.gov/taxstats/charitablestats/soi](http://www.irs.gov/taxstats/charitablestats/soi): tables 88\_is&bs\_x\_assets.xls, 01\_is&bs\_x\_assets.xls; also, from IRS, *SOI Bulletin*, Winter 1998/1999, Publication 36.Rev 2199, Table 1.

**Table 10.—Charitable Deductions in 2000 Dollars**

Year	1975	1980	1985	1990	1995	1999	2000	2001	2002
<b>Individual Income Tax Returns</b>									
[All figures are estimates based on samples money amounts are in thousands of dollars]									
<b>Itemized Deductions:</b>									
<b>Charitable Deductions:</b>									
Number of Returns.....	24,642,672	26,601,428	36,162,178	29,230,265	30,540,637	35,523,471	37,524,825	39,386,782	40,399,695
Amount.....	40,501,305	47,740,757	68,789,582	70,138,404	81,410,757	128,538,999	140,681,631	135,975,348	135,038,824
<b>Corporate Income Tax Returns:</b>									
[All figures are estimates based on samples money amounts are in thousands of dollars]									
<b>Total Deductions:</b>									
Number of Returns.....			575,240	400,877	493,490	472,326	443,071	426,620	391,206
Contributions of Gifts.....	3,162,917	4,362,684	6,413,482	5,823,028	8,061,191	10,965,947	10,657,214	11,146,760	9,927,919
Total Corporate and Individual Giving.....									
Contributions.....	43,664,222	52,103,440	75,203,064	75,961,432	89,471,948	139,504,946	151,338,845	147,122,108	144,966,744

[1] Dollar amounts are in 2000 dollars using price index for gross domestic product. Calculations provided by the JCT staff.

**Table 11.—Long-Term Private Activity Bonds, by Purpose of Bond and Type and Year of Issue, 1988-1995**

[Money amounts are in millions of dollars]

Year	1988	1989	1990	1991	1992	1993	1994	1995	1988-1995
<b>New Money Issues</b>									
[1] Section 501(c)(3) Hospital.....	3,382	4,626	5,314	8,508	6,873	6,070	4,632	5,465	44,870
[2] Other Section 501(c)(3).....	4,323	5,748	5,781	5,377	5,672	4,687	4,854	4,394	40,836
<b>Total Item [1] and [2]</b>	<b>7,705</b>	<b>10,374</b>	<b>11,095</b>	<b>13,885</b>	<b>12,545</b>	<b>10,757</b>	<b>9,486</b>	<b>9,859</b>	<b>85,706</b>

SOURCE: IRS, *SOI Bulletin*, Summer 1999, vol.13, no.1, Publication 1136, "Tax Exempt Private Activity bonds, 1988-1995," Table 2.

## V. ADVANTAGES OF TAX-EXEMPT STATUS FOR SECTION 501(C)(3) ORGANIZATIONS AND SUMMARY OF CRS REPORT

### **Tax benefits – in general**

The most obvious benefit enjoyed by organizations described in section 501(c)(3) is the exemption from Federal income tax.<sup>531</sup> Federal tax exemption also may provide exemption from certain Federal excise and employment taxes and relief from State and local taxes, such as corporate income tax and property tax exemptions. In some cases, the exemption from local taxes may equal or exceed the financial benefit derived from the Federal exemption.

In general, a deduction for a charitable contribution made to organizations described in section 501(c)(3) is permitted.<sup>532</sup> In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3). Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes.

State and local governments may act as conduits to provide tax-exempt financing for limited activities conducted and paid for by nongovernmental entities or individuals, including for the exempt activities of section 501(c)(3) organizations.<sup>533</sup> Accordingly, section 501(c)(3) organizations have access to tax-exempt financing through State and local governments.<sup>534</sup> This generally does not include financing for unrelated business activities of such organizations.<sup>535</sup> Tax-exempt organizations other than section 501(c)(3) organizations generally must satisfy requirements generally applicable to nongovernmental entities or individuals in order to obtain tax-exempt financing.

### **Non-tax benefits and CRS Report**

Section 501(c)(3) organizations also may receive a variety of nontax benefits as a result of their Federal exemption or, more generally, their operation as nonprofit organizations. For example, various provisions of Federal securities laws do not apply to organizations described in

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<sup>531</sup> Sec. 501(a).

<sup>532</sup> Deductions for charitable contributions to certain organizations other than section 501(c)(3) organizations are permitted. For example, deductible contributions may be made to governmental entities for exclusively public purposes; a post or organization of war veterans; a domestic fraternal society (sec. 501(c)(8)) exclusively for religious, charitable scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals; and cemetery companies (sec. 501(c)(13)). Sec. 170(c).

<sup>533</sup> Sec. 145.

<sup>534</sup> See Table 11, Part IV, for volume of tax-exempt debt issued on behalf of section 501(c)(3) organizations for the period 1988-1995.

<sup>535</sup> Sec. 145(a).

section 501(c)(3).<sup>536</sup> Another example is the exemption from Federal and State consumer protection laws afforded certain section 501(c)(3) organizations.<sup>537</sup> Another advantage is the exemption that an organization may have from price discrimination laws under the Robinson-Patman Act.<sup>538</sup>

The bankruptcy code distinguishes nonprofit and forprofit organizations and provides that a nonprofit corporation may not be forced into involuntary liquidation or reorganization.<sup>539</sup> Another significant financial benefit enjoyed by some nonprofit organizations is the preferential postal rates for nonprofits.<sup>540</sup>

On November 15, 2004, the staff of the Joint Committee on Taxation (“Joint Committee staff”) requested the Congressional Research Service (“CRS”) to examine the various nontax Federal and State legal benefits associated with an organization being described in section 501(c)(3) of the Code. With respect to a report on State benefits, Joint Committee staff requested that CRS limit its review to five States, California, Florida, Massachusetts, New York, and Pennsylvania.

On February 22, 2005, CRS submitted a report<sup>541</sup> to the Joint Committee staff describing its findings. CRS included in its report nontax benefits provided to nonprofit charitable organizations, a group that is potentially broader than organizations specifically described in section 501(c)(3). CRS grouped its findings with respect to nontax benefits for nonprofit charitable organizations into four general categories as follows: (1) exemption from a provision of law; (2) special rules applicable to nonprofit charitable organizations under various provisions; (3) eligibility to receive property or non-grant money by virtue of nonprofit status; and (4) eligibility to participate in a program (i.e., generally, the organization is eligible to receive grants). For each of these four categories, CRS listed and briefly described the applicable Federal and State statutes pertaining to the nontax benefits. Each of these categories is described more fully below.

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<sup>536</sup> See 15 U.S.C. secs. 77b, 77c, 78c, 80a-3.

<sup>537</sup> Section 501(c)(3) organizations are exempt from restrictions imposed on credit repair organizations under 15 U.S.C. sec. 1679.

<sup>538</sup> 15 U.S.C. sec. 13.

<sup>539</sup> 11 U.S.C. sec. 303(a).

<sup>540</sup> United States Postal Serv., Domestic Mail Manual sec. 424.121.

<sup>541</sup> See Appendix, Congressional Research Service, *Non-Tax Benefits Provided to Organizations Described in Section 501(c)(3)* (February 2005).

## Summary of CRS findings

### Exemption from a provision of law

With respect to nontax benefits where an organization is exempt from a provision of law, there were a total of 150 benefits, broken down as follows: Federal government (14); California (26); Florida (23); Massachusetts (33); New York (25); and Pennsylvania (29). The exemptions from a provision of law were significant in nature in that certain exemptions were provided from consumer protection and securities laws. Notable examples of exemptions include (1) a Federal statute<sup>542</sup> exempting from the definition of investment company, any company organized and operated exclusively for religious educational, benevolent, fraternal, charitable, or reformatory purposes if no part of its earnings inures to the benefit of a private shareholder or individual; (2) a Federal statute<sup>543</sup> exempting from the Telemarketing and Consumer Fraud and Abuse Prevention Act telemarketers calling to solicit charitable contributions; (3) a Florida statute<sup>544</sup> exempting securities from a registration requirement if the securities are issued by a corporation organized and operated exclusively for religious, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, if no part of its net earnings inures to the benefit of a private stockholder or individual; and (4) a New York statute<sup>545</sup> exempting nonprofit corporations and charitable organizations from the registration and bonding requirements in the Telemarketing and Consumer Fraud and Abuse Prevention Act.

### Special rules

With respect to nontax benefits where an organization benefits from a special rule other than exemption from the provision, there were a total of 149 benefits, broken down as follows: Federal government (17); California (30); Florida (29); Massachusetts (27); New York (20); and Pennsylvania (26). The special rules provided under Federal and State laws were varied in nature ranging from special licenses granted to charitable organizations to sell certain products, to life insurance contracts whereby a charitable organization could acquire a life insurance contract for an individual and designate itself as the beneficiary. Notable examples of such special rules include (1) a California statute<sup>546</sup> providing that a nonprofit charitable organization or food bank that receives and distributes food without charge that is fit for human consumption at the time it was distributed is not liable for any injury or death due to the food, unless the injury or death is a direct result of the negligent, reckless or intentional misconduct of the organization; (2) a Florida statute<sup>547</sup> permitting charitable organizations to claim dead bodies; and (3) a

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<sup>542</sup> See 15 U.S.C. sec. 80a-3.

<sup>543</sup> See 16 C.F.R. sec. 310.6.

<sup>544</sup> See Fla. Stat. sec. 517.051.

<sup>545</sup> See NY General Business Law sec. 399-pp.

<sup>546</sup> See Cal. Civil Code sec. 1714.25.

<sup>547</sup> See Fla. Stat. Chapter 406.

Pennsylvania statute<sup>548</sup> permitting a township to occupy streets, roads or highways and destroy private property for the regulation, protection and extension of a water distribution system; however, property belonging to or used as a cemetery or a place of public worship, public or parochial school, or educational or charitable institution or seminary may not be taken, injured or destroyed.

#### Eligibility to receive property or non-grant money

With respect to nontax benefits where an organization is eligible to receive property or non-grant money, there were a total of 64 benefits, broken down as follows: Federal government (14); California (16); Florida (11); Massachusetts (9); New York (5); and Pennsylvania (9). As compared with the other categories of nontax benefits examined, this category of nontax benefits was smaller in number and the nontax benefits were not as significant in nature. Notable examples of organizations receiving property or non-grant money include (1) a Federal statute<sup>549</sup> permitting section 501(c)(3) organizations to receive gifts and decorations that were previously given to Members of the Senate or employees of the Senate and are now being disposed of; (2) a California statute<sup>550</sup> permitting the distribution to nonprofit charitable organizations of property that was forfeited when used in committing telecommunications or computer fraud; and (3) a Massachusetts statute<sup>551</sup> permitting the Massachusetts Parking Authority to donate lost or abandoned property worth less than \$3 to charitable organizations.

#### Eligibility to participate in a program

With respect to nontax benefits where an organization is eligible to participate in a program, there were a total of 136 benefits, broken down as follows: Federal government (33); California (44); Florida (20); Massachusetts (5); New York (22); and Pennsylvania (12). The nontax benefits provided for the Federal and State programs were similar in nature ranging from grants given to section 501(c)(3) organizations to acquire interests in land suitable for purposes of conservation to grants for job training programs.

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<sup>548</sup> See 53 P.S. sec. 57703.

<sup>549</sup> See 5 U.S.C. sec. 7342.

<sup>550</sup> See Cal. Penal Code sec. 502.01.

<sup>551</sup> See ALM Spec L ch. S71, sec. 14A.



## VI. DESCRIPTION OF EXEMPT ORGANIZATIONS

### In general

What follows is a survey of the types of exempt entities, in which the primary purpose, the legislative history, the tax treatment, and basic information about an organization is provided. As the survey shows, there is no overriding principle explaining tax exempt status. Instead, organizations may be grouped into broad categories, such as government entities, member-type organizations, or cooperative organizations, and described accordingly. The survey includes all types of exempt entities, including savings accounts and pension plans. All such entities are included in order to provide a glimpse at the breadth of the meaning of “exempt status.” Organizations described are those in sections 115, 220, 223, 401(a), 408(e), 457(g), 501(c), 501(d), 501(e), 501(f), 501(k), 501(n), 516, 526-530, and 7871. Unless otherwise indicated, each of the entities described below generally is exempt from Federal income tax, but is subject to tax on unrelated business taxable income.<sup>552</sup> To the extent a type of exempt organization is subject to special unrelated business income tax rules, this is noted in the description. Otherwise, the unrelated business income tax rules are not discussed. For an overview of some of the rules generally applicable to exempt organizations, see Part I.C. of this pamphlet.

### Charitable organizations

#### Section 501(c)(3) organizations

The tax exemption for charitable organizations dates to 1894.<sup>553</sup> Unlike most other exempt organizations, charitable organizations are eligible to receive tax deductible contributions.<sup>554</sup> A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.<sup>555</sup> The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, the requirements for charitable status are that: (1) the organization must be organized and operated exclusively for certain purposes, including by assuring that the assets are dedicated to exempt purposes in perpetuity; (2) there must not be private inurement to organization insiders; (3) there must be no more than an incidental private

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<sup>552</sup> Secs. 511-514.

<sup>553</sup> Tariff Act of 1894, sec. 32, 28 Stat. 509 (ruled unconstitutional); 1909 Revenue Act, sec. 38, 36 Stat. 11; sec. 501(c)(3).

<sup>554</sup> Certain organizations described elsewhere within section 501, namely cooperative hospital service organizations (sec. 501(e)), cooperative service organizations of operating educational organizations (sec. 501(f)), child care organizations (sec. 501(k)), and charitable risk pools (sec. 501(n)), are treated as charitable organizations described within section 501(c)(3) and as described below generally are subject to their own organizational and operational requirements.

<sup>555</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

benefit to private persons who are not organization insiders; (4) no substantial part of the organization's activities may be lobbying; and (5) the organization may not participate or intervene in political activities. In addition to satisfying each of these requirements, an organization's purpose must not be contrary to public policy.<sup>556</sup> The requirements of section 501(c)(3) charitable organizations are described in greater detail in Part II.B of this pamphlet.

#### Cooperative hospital service organizations

Since 1968, qualifying cooperative hospital service organizations are treated as charitable organizations, including for charitable contribution purposes.<sup>557</sup> A cooperative hospital service organization must be organized and operated solely for two or more exempt member hospitals and must be organized and operated on a cooperative basis. Certain services on a centralized basis must be performed for members. These services include: (1) data processing; (2) purchasing (including the purchasing of insurance on a group basis); (3) warehousing; (4) billing and collection (including the purchase of patron accounts receivable on a recourse basis); (5) food; (6) clinical; (7) industrial engineering;<sup>558</sup> (8) laboratory; (9) printing; (10) communications; (11) records center; and (12) personnel services (including selection, testing, training and education of personnel). To qualify, these services must constitute exempt activities if performed on its own behalf by a participating hospital.<sup>559</sup>

#### Cooperative service organizations of educational institutions

Since 1974, cooperative service organizations operating educational organizations are treated as charitable organizations, including for charitable contribution purposes.<sup>560</sup> These organizations must be organized and controlled by and composed solely of members that are private or public educational institutions.<sup>561</sup> In addition, they must be organized and operated solely to hold, commingle, and collectively invest and reinvest (including arranging for and

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<sup>556</sup> See *Bob Jones University v. United States*, 461 U.S. 574 (1983).

<sup>557</sup> The Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364 (1968), sec. 109(a), 82 Stat. 251; sec. 501(e). Prior to 1968, the IRS considered such organizations to be feeder organizations disqualified for exempt status under section 502. Exemption was granted because such organizations were viewed as increasing the efficiency and services of hospitals and enabling hospitals to conduct charitable services at lower cost. See James J. McGovern, *The Exemption Provisions of Subchapter F*, 29 Tax Lawyer 523, 543 (1976) (hereinafter "McGovern") (citing Bromberg, *The Effect of Tax Policy on the Delivery and Cost of Health Care*, 53 Taxes 452, 455-59 (1975)).

<sup>558</sup> Rev. Rul. 74-443, 1974-2 C.B. 159.

<sup>559</sup> Rev. Rul. 69-633, 1969-2 C.B. 121.

<sup>560</sup> Sec. 501(f).

<sup>561</sup> Organizations for this purpose are ones defined in sections 170(b)(1)(A)(ii) or (b)(1)(A)(iv) (i.e., schools, colleges and organizations administering property for the benefit of certain government-supported colleges and universities).

supervising the performance by independent contractors of investment services), in stocks and securities, the monies contributed to it by each of the members of the organization, and to collect income from the investments and turn over the entire amount, less expenses, to its members. Although this type of organization is not permitted to invest in assets other than stock and other securities, a taxable subsidiary may be used to make these investments.<sup>562</sup>

The exemption was enacted to forestall the contemplated revocation by the IRS of the tax-exempt status of The Common Fund, a cooperative arrangement formed by a large group of colleges and universities for the collective investment of their funds. The IRS determined that The Common Fund could not provide investment services to members at substantially below cost and regarded this factor as a ground for the disqualification of tax exempt status.<sup>563</sup> Congress responded and clarified that cooperative arrangements for investments of the type typified by the Common Fund are eligible for exemption as charitable entities.

#### Child care organizations

Since 1984, certain organizations that provide for the care of children away from their homes are treated as charitable organizations, including for charitable contribution purposes.<sup>564</sup> Specifically, an organization that provides such child care services is treated as educational under section 501(c)(3) if: (1) substantially all of the care provided by the organization is for purposes of enabling individuals to be gainfully employed, and (2) the services provided by the organization are available to the general public.<sup>565</sup>

Because the services of a section 501(k) child care organization must be made available to the general public, the organization cannot be racially discriminatory.<sup>566</sup> In addition, a child care organization that provides a preference for children of a particular employer will not be treated as making its services available to the general public and thus is not described in section 501(k).<sup>567</sup> An organization that gives a preference to children of a particular employer may nevertheless qualify for exemption under section 501(c)(3) if it qualifies as charitable other than by being educational, for example, by lessening the burdens of government.<sup>568</sup>

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<sup>562</sup> Gen. Couns. Mem. 39776 (February 6, 1989).

<sup>563</sup> See S. Rep. No. 888, 93d Cong. 2d Sess. 2-3 (1974).

<sup>564</sup> Pub. L. No. 98-369, sec. 1032(a) (1934).

<sup>565</sup> Sec. 501(k).

<sup>566</sup> Gen. Couns. Mem. 39757 (October 11, 1988).

<sup>567</sup> Gen. Couns. Mem. 39613 (January 28, 1987).

<sup>568</sup> See *id.*; Treas. Reg. sec. 1-501(c)(3)-1(d)(2).

### Charitable risk pools

Since 1996, there has been an exemption for qualified charitable risk pools, which are treated as charitable organizations, including for charitable contribution purposes.<sup>569</sup> A qualified charitable risk pool is an entity that is organized and operated solely to pool insurable risks of its members (other than medical malpractice risks) and to provide information to its members with respect to loss control and risk management. Only charitable tax-exempt organizations described in section 501(c)(3) may be members of a qualified charitable risk pool.

To qualify for tax-exempt status, a charitable risk pool must (1) be organized as a nonprofit organization under State law provisions authorizing risk pooling for charitable organizations; (2) be exempt from State income tax; (3) be able to obtain at least one million in start-up capital from non-member charitable organizations;<sup>570</sup> (4) be controlled by a board of directors elected by its members; and (5) provide in its organizational documents that members must be tax-exempt charitable organizations at all times. The organizational documents of a qualified charitable risk pool must also require any member that loses its status as a section 501(c)(3) organization to notify the pool immediately. In addition, the organizational documents must require that each insurance policy issued by the organization provide that it will not cover an insured with respect to events occurring after the date of any final determination that the member no longer qualifies as a tax-exempt charitable organization.

An otherwise qualified charitable risk pool will not forfeit its tax-exempt status simply because one of its members ceases to qualify as a section 501(c)(3) organization. The pool must take measures to remove the non-qualifying member within a reasonable period of time.

### **Social welfare organizations, labor organizations, and business leagues**

#### Social welfare organizations

Since 1913, there has been a tax exemption for civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.<sup>571</sup> The basis for the exemption may be from 1913 hearings before the Senate Finance Committee,

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<sup>569</sup> Sec. 501(n); Pub. L. No. 104-191 (1996).

<sup>570</sup> A nonmember charitable organization is a tax-exempt organization described in section 501(c)(3), which is not a member of the risk pool and does not benefit, directly or indirectly, from the insurance coverage provided by the pool to its members. Sec. 501(n)(4)(B).

<sup>571</sup> Tariff Act of 1913, ch. 16, sec. 11(G)(a), 38 Stat. 172; sec. 501(c)(4). The private inurement prohibition was enacted in 1996. Exemption under section 501(c)(4) also includes exemption for certain local associations of employees meeting certain membership requirements. This exemption was introduced in 1924. Revenue Act of 1924, ch. 234, sec. 231(8), 43 Stat. 282.

during which the U.S. Chamber of Commerce sought exemption for “civic or commercial” organizations.<sup>572</sup>

An organization is operated exclusively for the promotion of social welfare if it is engaged primarily in promoting in some way the common good and general welfare of the people of a community.<sup>573</sup> For example:

- A nonprofit firefighters’ association that provides firefighters with retirement benefits, which are funded by government sources and which are the exclusive retirement benefits provided to these firefighters, qualifies for exemption as a social welfare organization.<sup>574</sup>
- An organization that provides and maintains free off-street parking to anyone visiting a city’s downtown business district qualifies for exemption as a social welfare organization.<sup>575</sup>
- A nonprofit organization formed to represent the public interest at legislative and administrative hearings on tax matters qualifies for exemption as a social welfare organization.<sup>576</sup>

The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office; however, social welfare organizations are permitted to engage in political activity so long as it is not the organization’s primary activity. The lobbying activities of a social welfare organization generally are not limited. An organization is not operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations that are operated for profit.

The concept of “social welfare” for purposes of section 501(c)(4) overlaps considerably with the definition of “charitable” under section 501(c)(3). As a result, many organizations could qualify for exemption under either section.<sup>577</sup> However, an organization’s choice between

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<sup>572</sup> *Hearings on Tariff Schedules of the Revenue Act of 1913 Before the Subcommittee on the Committee on Finance*, 63d Cong., 1<sup>st</sup> Sess., at 2001 (1913). See McGovern, at 530.

<sup>573</sup> Treas. Reg. sec. 1.501(c)(4)-1(a)(2).

<sup>574</sup> Rev. Rul. 87-126, 1987-2 C.B. 150.

<sup>575</sup> Rev. Rul. 81-116, 1981-1 C.B. 333.

<sup>576</sup> Rev. Rul. 71-530, 1971-2 C.B. 237.

<sup>577</sup> The regulations under both sections recognize an overlap in exempt purposes. See Treas. Reg. sec. 1.501(c)(3)-1(d)(2) (definition of “charitable” for purposes of section 501(c)(3) includes the promotion of social welfare); Treas. Reg. sec. 1.501(c)(4) (providing that a social welfare organization

social welfare status and charitable status will result in different benefits and burdens. For example, a donor to a charitable organization may take a charitable deduction, whereas a donor to a social welfare organization may not take a charitable deduction. As a result, charitable organizations are generally viewed as having an advantage in attracting contributions.

On the other hand, social welfare organizations have greater operational flexibility than charitable organizations. For example, whereas social welfare organizations may engage in an unlimited amount of lobbying without jeopardizing their exempt status, charitable organizations may engage in only a limited amount of lobbying.<sup>578</sup> In addition, while social welfare organizations may engage in political campaign activity so long as it is not a primary activity of the organization, charitable organizations are prohibited from engaging in any political campaign activity.<sup>579</sup> Social welfare organizations need not, but may, seek formal IRS recognition of exempt status, whereas charitable organizations are required to file an application for recognition of exemption.<sup>580</sup>

#### Labor, agricultural, or horticultural organizations

Since 1909, there has been a tax exemption for certain labor, agricultural,<sup>581</sup> or horticultural organizations,<sup>582</sup> no part of the net earnings of which inure to the benefit of any member. Such organizations must have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.<sup>583</sup> Labor unions are the typical example of a labor organization. Other examples include:

- A local association of farmers, formed to promote more effective agricultural pest control, that employs pest management scouts who periodically inspect members'

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will qualify for exemption as a charitable organization if it falls within the definition of “charitable” under section 501(c)(3) and meets certain other requirements).

<sup>578</sup> Compare sec. 501(c)(3) and Treas. Reg. sec. 1.501(c)(3)-1(c)(3) with sec. 501(c)(4).

<sup>579</sup> Compare sec. 501(c)(3) with sec. 501(c)(4) and Treas. Reg. sec. 1.501(c)(4)-1(a)(2)(ii).

<sup>580</sup> Sec. 508(a).

<sup>581</sup> In 1976, the term “agricultural” was defined as including “the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock.” Sec. 501(g).

<sup>582</sup> 1909 Revenue Act, sec. 38, 36 Stat. 11; sec. 501(c)(5).

<sup>583</sup> Treas. Reg. sec. 1.501(c)(5)-1(a). Labor unions lobbied for a specific exemption from a 1909 excise tax on insurance companies, won full exemption from the 1909 excise tax, and exemption from the income tax introduced in 1913. McGovern notes that the record is silent regarding the rationale for exemption for agricultural and horticultural organizations stating that their exemption likely was introduced in conference prior to the 1913 Act “and may represent a legislative attempt not to discriminate against various sectors of the economy.” See McGovern, at 530-31.

fields, identify and count agricultural pests, and compile data on agricultural pest infestation qualifies for exemption under section 501(c)(5).<sup>584</sup>

- An organization whose members are exempt labor unions representing public employees and which is primarily engaged in supporting litigation activities, proper for any one of its member unions, directed to the betterment of conditions for public employees qualifies for exemption under section 501(c)(5).<sup>585</sup>
- A local association of dairy farmers that participated in the U.S. Department of Agriculture's National Cooperative Dairy Herd Improvement Program qualifies as a tax-exempt agricultural organization.<sup>586</sup>
- A garden club that published a monthly journal, reported new developments in horticultural products to its members, and encouraged the development of new products though provision of awards was a horticultural organization.<sup>587</sup>

An organization generally is not exempt under this provision if its principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs.<sup>588</sup> Contributions to labor, agricultural, and horticultural organizations are not deductible as charitable contributions. However, such payments may be deductible as business expenses if they are ordinary and necessary in the conduct of the taxpayer's trade or business.

Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues

Since 1913, there has been a tax exemption for business leagues and certain other organizations not organized for profit, no part of the net earnings of which inures to the benefit of any private shareholder or individual.<sup>589</sup> As with social welfare organizations, the basis for the exemption may be from 1913 hearings before the Senate Finance Committee, during which the U.S. Chamber of Commerce sought exemption for "civic or commercial" organizations.<sup>590</sup>

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<sup>584</sup> Rev. Rul. 81-59, 1981-1 C.B. 334.

<sup>585</sup> Rev. Rul. 74-596, 1974-2 C.B. 167.

<sup>586</sup> Rev. Rul. 74-518, 1974-2 C.B. 166, clarifying Rev. Rul. 70-372, 1970-2 C.B. 118.

<sup>587</sup> Rev. Rul. 66-179, 1966-1 C.B. 139.

<sup>588</sup> Treas. Reg. sec. 1.501(c)(5)-1(b).

<sup>589</sup> Tariff Act of 1913, ch. 16, sec. 11(G)(a), 38 Stat. 172; sec. 501(c)(6).

<sup>590</sup> *Hearings on Tariff Schedules of the Revenue Act of 1913 Before the Subcommittee on the Committee on Finance*, 63d Cong., 1<sup>st</sup> Sess., at 2001 (1913). See McGovern, at 530.

A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.<sup>591</sup> Such an organization may not have as its primary activity performing “particular services” for members.<sup>592</sup> Contributions to these types of organizations are not deductible as charitable contributions, however, they may be deductible as trade or business expenses if ordinary and necessary in the conduct of the taxpayer’s business. Many organizations known as “trade associations” may qualify for exempt status under this provision. For example, an organization that promotes the commercial fishing industry in a particular State by publishing information about advances in the industry and other information of common interest to fishermen in the State qualifies as a trade association under section 501(c)(6).<sup>593</sup> Other examples are:

- A trust, which was created pursuant to collective bargaining agreements between a labor union and several business leagues for the purposes of monitoring and coordinating business league activities of its member business leagues and collecting, administering, and disbursing funds to the member business leagues for business league purposes, is exempt as a business league under section 501(c)(6).<sup>594</sup>
- A nonprofit organization, formed by a city’s civic leaders, public officials, businessmen, and representatives of the community-at-large to encourage conventions of national organizations in the city by making arrangements for facilities, services, and administrative support necessary to run a convention, qualifies for exemption under section 501(c)(6).<sup>595</sup>

#### Unrelated business income tax treatment

A few special unrelated business income tax rules apply. Certain required annual dues of agricultural and horticultural organizations are not treated as unrelated trade or business income regardless of whether those dues relate to benefits or privileges to which members of such organizations are entitled.<sup>596</sup> In addition, like charitable organizations, social welfare organizations, labor organizations, agricultural organizations, and horticultural organizations (but not business leagues), are subject to special rules regarding income from certain activities of fairs

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<sup>591</sup> Treas. Reg. sec. 1.501(c)(6)-1.

<sup>592</sup> Treas. Reg. sec. 1.501(c)(6)-1.

<sup>593</sup> Rev. Rul. 75-287, 1975-2 C.B. 211.

<sup>594</sup> Rev. Rul. 82-138, 1982-2 C.B. 106.

<sup>595</sup> Rev. Rul. 76-207, 1976-1 C.B. 158.

<sup>596</sup> Sec. 512(d).



and exhibitions.<sup>597</sup> Those same organizations and business leagues are subject to special rules regarding income from qualified convention and trade show activities.<sup>598</sup>

### Affiliations with charitable organizations

Oftentimes, an exempt organization will establish an affiliation or relationship with an organization that is also exempt from tax, but under a different section of the Code. For example, it is not uncommon for a social welfare organization exempt from tax under section 501(c)(4) to have a relationship, whether through overlapping boards of directors, ownership of membership interests, or otherwise, with a charitable organization exempt from tax under section 501(c)(3). Under such circumstances, the charitable organization may choose to conduct exempt educational activities, while its affiliated social welfare organization engages in lobbying activities to an extent greater than would be allowed if performed directly by the charitable organization.

Also common are affiliations between charitable organizations and section 501(c)(6) business leagues. For example, business leagues sometimes choose to establish related charitable organizations to engage in educational or charitable activities and that are eligible to receive deductible charitable contributions.

Such affiliations are generally structured to ensure legal separation of the related entities<sup>599</sup> and thereby to avoid attribution of the activities of one affiliated organization to its related organization for purposes of determining whether the related organization continues to qualify for exempt status. If, for example, affiliated charitable and social welfare organizations are so closely aligned that each is considered the alter ego of the other, the IRS could attribute the lobbying activities of the social welfare organization to the charitable organization for purposes of determining whether the charitable organization has engaged in excess lobbying activities such as could jeopardize its exempt status. Similar attribution issues could arise in the case of an affiliation between a business league and a charitable organization.

## **Governmental entities**

### Income of States, municipalities, other governments

In 1913, Congress specifically provided for exemption for entities that perform an essential governmental function.<sup>600</sup> The exemption applies to (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or

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<sup>597</sup> Sec. 513(d).

<sup>598</sup> *Id.*

<sup>599</sup> See *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943).

<sup>600</sup> Sec. 115. Separately, the constitutional doctrine of intergovernmental tax immunity generally provides that the Federal government will not tax the States.

any political subdivision thereof, or the District of Columbia; or (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whether activities involve the exercise of an “essential governmental function” is generally decided on a case-by-case basis. Relevant factors include whether the activity is one traditionally considered “governmental,” whether it involves the exercise of a governmental activity, and the extent of governmental financial interest in the activity. The income must be derived from a qualifying activity; it is not sufficient that the income be paid over to or benefit a qualifying activity. The second requirement, that the income “accrue to” a State or political subdivision, occurs when the State or subdivision has an unrestricted right to a proportionate share of the income.

Most such entities generally are not subject to taxation on unrelated business taxable income.<sup>601</sup> State colleges and universities, however, generally are subject to unrelated business income taxation.<sup>602</sup> Contributions to or for the use of State and local governments exclusively for public purposes generally are deductible for income, estate and gift tax purposes.<sup>603</sup>

#### United States instrumentalities

Since 1934, there has been exemption for corporations organized under an Act of Congress, if such corporations are instrumentalities of the United States.<sup>604</sup> U.S. instrumentalities include the Federal Deposit Insurance Corporation, the Reconstruction Finance Corporation, Federal Land Banks, Federal National Mortgage Association, Federal Reserve Banks, the Federal Savings and Loan Insurance Corporation, and the Pennsylvania Avenue Development Corporation. Federal credit unions organized and operated under the Federal Credit Union Act are instrumentalities of the United States.<sup>605</sup> U.S. instrumentalities are not subject to taxation on unrelated business taxable income.<sup>606</sup> Prior to 1934, exemption for many U.S. instrumentalities was provided in the act establishing the instrumentality. The general exemption provision was adopted “to bring the section into accord with the acts authorizing such exemptions and to avoid the necessity of referring to all such acts.”<sup>607</sup>

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<sup>601</sup> Sec. 511(a)(2)(A).

<sup>602</sup> Sec. 511(a)(2)(B).

<sup>603</sup> Secs. 170(c)(1), 2055(a)(1), 2522(a)(1).

<sup>604</sup> Revenue Act of 1934, sec. 101(15), 48 Stat. 680; sec. 501(c)(1). See sec. 501(l) (listing certain exempt U.S. instrumentalities).

<sup>605</sup> See Rev. Rul. 89-94, 1989-2 C.B. 283. State credit unions are governed by other provisions.

<sup>606</sup> Sec. 511(a)(2)(A). Contributions to or for the use of a U.S. instrumentality generally are deductible for income, estate and gift tax purposes.

<sup>607</sup> H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934).

### Indian tribal governments

Since the Indian Tribal Government Tax Status Act of 1982, there has been an exemption for Indian tribal governments.<sup>608</sup> The exemption expressly provides that Indian tribal governments are treated as States for certain tax purposes. First, tribal governments may be recipients of deductible charitable contributions for income, estate, and gift tax purposes. Second, tribal governments are extended the treatment provided to States under the following excise taxes: tax on special fuels, manufacturers excise taxes, communications excise tax, and tax on use of certain highway vehicles. Special treatment relating to excise taxes is available to tribal governments only with regard to transactions involving the exercise of an essential governmental function<sup>609</sup> by the Indian tribal government. Third, taxes paid to Indian tribal governments are deductible for income tax purposes to the same extent as state taxes.<sup>610</sup> Fourth, Indian tribal governments may issue tax-exempt bonds and private activity bonds under certain conditions.

In addition, Indian tribal governments are treated as States for purposes of: (1) unrelated business income tax rules that apply to state colleges and universities, (2) treatment of amounts received under a disability and sickness fund maintained by a State, (3) the rules relating to tax-sheltered annuities, (4) original discount rules, (5) the tax on excess expenditures to influence legislation, and (6) private foundation rules.

### **Member-type organizations**

#### Clubs organized for pleasure, recreation, and other nonprofitable purposes

Since 1916, there has been an exemption for clubs organized for pleasure, recreation and other non-profitable purposes (a “social club”), if substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.<sup>611</sup> To qualify as a tax-exempt club, an organization not only must be a nonprofit entity but also must meet both an organizational test and an operational test.<sup>612</sup> In general, this tax exemption extends to social and recreational clubs that are supported primarily by

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<sup>608</sup> Pub. L. No. 97-473 (1983); sec. 7871.

<sup>609</sup> See Secs. 4227, 4484, 6420(i)(4), 6421(j)(3), and 6427(p)(3), which refer to section 7871 for exemption provisions. Section 7871(e) limits the term essential governmental function to exclude any function that is not customarily performed by State and local governments with general taxing powers.

<sup>610</sup> Secs. 7871(a)(3) and 164(g)(2).

<sup>611</sup> Revenue Act of 1916, ch. 463, sec. 11(a)(9), 39 Stat. 766; sec. 501(c)(7). In 1976, Congress relaxed the exemption requirements for social clubs by requiring a substantially all standard in substitution for an exclusively standard. See Pub. L. No. 94-568 (1976).

<sup>612</sup> Rev. Rul. 70-32, 1970-1 C.B. 132.

membership fees, dues, and assessments.<sup>613</sup> Typical exempt social clubs include golf and country clubs, amateur sport clubs, hobby clubs, and luncheon and dinner clubs. For example:

- A nonprofit organization that conducts regular bowling tournaments for its members qualifies where its overall program is designed to effect a commingling of members for their pleasure and recreation. The awarding of cash prizes to tournament winners from tournament entry fees is not an inurement of net income to members.<sup>614</sup>
- A college fraternity that maintains a chapter house for active members who are students of the school qualifies.<sup>615</sup>

Congress exempted social clubs from tax because the operation of a social club does not involve the requisite shifting of income from a member to an entity. The legislative history explains the rationale for exemption:

It was deemed advisable to specifically extend the exemption to other corporations similar to those enumerated in the present law as exempt from tax in view of the fact that the experience of the Treasury Department has been that the securing of returns has been a source of expense and annoyance and resulted in the collection of either: no tax or an amount which is practically negligible.<sup>616</sup>

Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income in pleasure or recreation (or other benefits) without the intervening separate organization.<sup>617</sup>

The unrelated business income tax rules applicable to exempt social clubs are less favorable than those applicable to most other types of exempt organizations. Most other types of exempt organizations, for example, are not required to pay tax on gifts or grants, income from

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<sup>613</sup> Treas. Reg. sec. 1.501(c)(7)-1(a). An organization that otherwise qualifies as an exempt club will not be denied exemption solely because it adopts a method of raising revenue from members by means other than fees, dues, and assessments.

<sup>614</sup> Rev. Rul. 74-148, 1974-1 C.B. 138.

<sup>615</sup> Rev. Rul. 69-573, 1969-2 C.B. 125.

<sup>616</sup> H.R. Rep. No. 922, 64<sup>th</sup> Cong., 1<sup>st</sup> Sess. 4 (1916).

<sup>617</sup> S. Rep. No. 91-552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 71 (1969) (explaining the rationale for exemption in the context of imposing unrelated business income tax on nonmember income).

the performance of exempt functions, investment income, or other forms of passive income. The unrelated business income tax rules applicable to social clubs, however, isolate and exclude from taxation only such organizations' exempt function income.<sup>618</sup> Most other income, including passive investment income, is subject to taxation. Certain amounts set aside for charitable and some other purposes may be included in the organization's exempt function income and thereby excluded from taxation.<sup>619</sup>

#### Fraternal beneficiary societies, orders, or associations

Since 1894, there has been exemption for fraternal beneficiary societies, orders or associations.<sup>620</sup> Contributions to such organizations are deductible as charitable contributions to the extent the contribution is exclusively for charitable purposes.<sup>621</sup> A fraternal beneficiary society, order, or association is entitled to tax-exempt status if it operates under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and provides for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.<sup>622</sup> Operating under the lodge system generally means carrying on activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like.<sup>623</sup> Separately organized insurance branches of fraternal societies need not operate under the lodge system, but must provide permissible benefits exclusively to members of a lodge system.<sup>624</sup>

In general, the term "fraternal" applies to an organization whose members have adopted the same, or a very similar calling, avocation, or profession, and who for that reason have banded together to aid and assist one another and to promote a common cause.<sup>625</sup> A fraternal beneficiary

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<sup>618</sup> Sec. 512(a)(3).

<sup>619</sup> Sec. 512(a)(3)(B).

<sup>620</sup> Tariff Act of 1894, sec. 32, 28 Stat. 509 (ruled unconstitutional); see also sec. 38 of the Tarriff Act of 1909, 36 Stat. 11; sec. 501(c)(8).

<sup>621</sup> Sec. 170(c)(4) (providing that to be deductible, the contribution must be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals).

<sup>622</sup> According to trade association literature, "most fraternal benefit societies were founded more than a century ago to provide a sense of community to new Americans. These societies supported religious, educational and patriotic activities, with fraternal life insurance often providing the only means of support for a family following the death of the primary wage earner." National Fraternal Congress of America, *1998 Activity Report of the Fraternal Benefit System*.

<sup>623</sup> Treas. Reg. sec. 1.501(c)(8)-1.

<sup>624</sup> Rev. Rul. 73-192, 1973-1 C.B. 224.

<sup>625</sup> *National Union v. Marlow*, 74 F. 775, 778-79 (8<sup>th</sup> Cir. 1896).

society does not serve a fraternal purpose unless its members engage in fraternal activities. Rituals, ceremonies, social activities, and the performance of civic, benevolent, or charitable functions may serve to establish a fraternal purpose. As between fraternal purposes and the provision of benefits, fraternal purposes need not predominate. It is sufficient if both the fraternal and benefit features are present, although an organization whose fraternal features are so insubstantial as to make it indistinguishable from an ordinary insurance company does not qualify under section 501(c)(8).<sup>626</sup>

Fraternal beneficiary societies described in section 501(c)(8) generally provide three types of services or benefits: insurance, fraternal, and charitable. Fraternal activities, by definition, benefit only members. Charitable activities of fraternal organizations may provide significant benefits to members and to non-members.<sup>627</sup> A fraternal beneficiary society may engage in non-fraternal activities or provide non-fraternal benefits, but such activities and benefits may be taxable as unrelated business income activities, or result in the organization's loss of exempt status unless the organization remains primarily engaged in fraternal activities and its benefits are primarily fraternal benefits.<sup>628</sup>

The Revenue Act of 1913 provided an exemption to organizations operating for the exclusive benefit of the members of a fraternity itself operating under the lodge system.<sup>629</sup> The early societies provided members on an informal basis relief during sickness and unemployment and at death, with fraternal life insurance (i.e., the providing of death benefits on a more formal basis) appearing in the mid-nineteenth century.<sup>630</sup> The provision of sickness and accident insurance developed later. The IRS takes the position that life, sick, accident, and other benefits encompass those benefits that provide insurance against the risk of loss of earning power.<sup>631</sup>

#### Domestic fraternal societies, orders, or associations

Since 1969, there has been an exemption for domestic fraternal societies, orders, or associations, operating under the lodge system, the net earnings of which are devoted exclusively

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<sup>626</sup> Rev. Rul. 73-165, 1973-1 C.B. 224.

<sup>627</sup> *Report to the Congress on Fraternal Benefit Societies*, Department of the Treasury, Jan. 1993, 12.

<sup>628</sup> Gen. Couns. Mem. 38312 (March 20, 1980).

<sup>629</sup> Pub. L. No. 63-6, section II(G)(a), 38 Stat. 172 (1913).

<sup>630</sup> Priv. Ltr. Rul. 9523027 (June 9, 1995) (citing D. Gregg, *Life and Health Insurance Handbook*, 276 (3<sup>rd</sup> ed. 1973)).

<sup>631</sup> Gen. Couns. Mem. 38312 (March 20, 1980). "Other benefits" include a legal defense fund for charges of misconduct arising from employment (Rev. Rul. 84-48, 1984-1 C.B. 133), an orphanage for surviving children of deceased members (Rev. Rul. 84-49, 1984-1 C.B. 134), and annuities (Gen. Couns. Mem. 39575 (Nov. 18, 1986)).

to religious, charitable, scientific, literary, educational, and fraternal purposes.<sup>632</sup> Unlike fraternal beneficiary societies described in section 501(c)(8), domestic fraternal societies may not provide for the payment of life, sick, accident, or other benefits to their members.

Prior to 1969, there was no exemption provided for fraternal societies operating under the lodge system that did not, in addition to their fraternal activities, provide for the payment of life sick, and accident benefits to their members. The Senate Committee on Finance explained the purpose of the exemption as follows:

[A] new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system where the fraternal activities are exclusively religious, charitable, or educational in nature and no insurance is provided for the members. The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members. This more properly describes the different types of fraternal associations.<sup>633</sup>

#### Cemetery companies

Since 1913, there has been exemption for certain cemetery companies.<sup>634</sup> Today's exemption is for (1) cemetery companies that are owned and operated exclusively for the benefit of their members; (2) nonprofit cemetery companies; and (3) any corporation chartered solely for burial or cremation purposes, that is not permitted by its charter to engage in any business not necessarily incident to those purposes, and no part of the net earnings of which inures to the benefit of the private shareholder or individual. Contributions to tax-exempt cemetery companies are deductible for Federal income tax purposes.<sup>635</sup> The contributions must be voluntary and made for the use of a nonprofit cemetery, the funds of which are irrevocably dedicated to the care of the cemetery as a whole. Contributions made to a cemetery company for the perpetual care of a particular lot or crypt, however, are not deductible.<sup>636</sup>

A mutual cemetery company must be owned and operated exclusively for the benefit of its "lot owners." A lot owner, in turn, must hold the lot for burial purposes and not for resale. A mutual cemetery company, however, that engages in charitable activities (e.g., burial of paupers) will also qualify for exemption. A cemetery company or corporation may qualify for exemption even though it operates certain related businesses. The IRS has ruled that cemetery companies or

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<sup>632</sup> Pub. L. No. 91-172, sec. 121(c)(5), 83 Stat. 541; sec. 501(c)(10).

<sup>633</sup> S. Rep. No. 552, 91st Cong., 1st Sess. 72 (1969).

<sup>634</sup> Tariff Act of 1913, ch. 16, sec. 11(G)(a), 38 Stat. 172; sec. 501(c)(13).

<sup>635</sup> Sec. 170(c)(5).

<sup>636</sup> Rev. Rul. 58-190, 1958-1 C.B. 15.

corporations may sell monuments, makers, vaults, caskets, and flowers for use in the cemetery if the sale proceeds are used for cemetery maintenance.

Exempt cemetery companies include:

- A nonprofit organization, not associated with a cemetery company, formed by citizens of a community to maintain an established cemetery whose lots were purchased by individuals from a landowner.<sup>637</sup>
- An organization receiving and administering funds for the perpetual care of a nonprofit cemetery itself.<sup>638</sup>

### Homeowners associations

Prior to the Tax Reform Act of 1976,<sup>639</sup> homeowners associations and condominium management associations frequently were unable to obtain exemption, despite the fact that they served their members in maintaining common areas of housing developments and condominium buildings.<sup>640</sup> In 1976, Congress specifically provided an exemption for homeowners associations. Under section 528, condominium and residential real estate management associations may elect to be treated as exempt organizations with respect to their “exempt function income,” such as membership dues, fees and assessments. Other income will be taxed at a flat 30 percent rate.

To qualify as a tax-exempt homeowners association, an organization must be a condominium, management association, or residential real estate management association. The electing association must meet all of the following conditions: (1) it must be organized and operated primarily to provide for the acquisition, construction, management, maintenance, and care of association property;<sup>641</sup> (2) it must pass an income test, under which at least 60 percent of

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<sup>637</sup> Rev. Rul. 78-143, 1978-1 C.B. 161.

<sup>638</sup> Rev. Rul. 58-190.

<sup>639</sup> Pub. L. No. 94-455 (1976).

<sup>640</sup> For example, prior to the Tax Reform Act of 1976, homeowners associations were granted exemption as a social welfare organization under section 501(c)(4) only if (1) their activities served an identified community and were not directed to the maintenance of the exterior of private homes, and (2) their common areas were available for the use of the public. Rev. Rul. 72-102, 1972-1 C.B. 149, modified by Rev. Rul. 74-99, 1974-1 C.B. 131.

<sup>641</sup> Treas. Reg. sec. 1.528-2. Association property means not only property held by it but also property commonly held by its members, property within the association privately held by the members, and property owned by a governmental unit and used for the benefit of residents of the unit. Treas. Reg. sec. 1.528-3.



the association's gross income for a tax year consists of exempt function income;<sup>642</sup> (3) it must pass an expenditure test, under which at least 90 percent of the annual expenditures of the association must be to acquire, construct, manage, maintain, and care for or improve its property;<sup>643</sup> (4) no part of the association's net earnings may inure to the benefit of any private shareholder or individual;<sup>644</sup> and (5) substantially all of the dwelling units in the condominium project or lots and buildings in a subdivision, development, or similar area must be used by individuals for residences.<sup>645</sup> Section 528, as amended in 1997, also applies to certain timeshare associations.

## **Cooperative organizations**

### **Benevolent life insurance associations/local cooperatives**

Since 1916,<sup>646</sup> there has been an exemption for mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations.<sup>647</sup> In 1924, the exemption was extended to benevolent life insurance associations of a purely local character.<sup>648</sup> In general, 85 percent or more of the income of these entities must consist of amounts collected from members for the sole purpose of meeting losses and expenses of the organization.<sup>649</sup> The 85 percent

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<sup>642</sup> Treas. Reg. sec. 1.528-5. Exempt function income means any amount received as membership dues, fees, or assessments from persons who are members of the association, namely owners of condominium housing units (in the case of a condominium management association) or owners of real property (in the case of a residential real estate management association). Treas. Reg. sec. 1.528-9.

<sup>643</sup> Treas. Reg. sec. 1.528-6.

<sup>644</sup> Treas. Reg. sec. 1.528-7.

<sup>645</sup> Treas. Reg. sec. 1.528-4.

<sup>646</sup> 1916 Revenue Act, sec. 11(a)(10), 39 Stat. 766; sec. 501(c)(12).

<sup>647</sup> Mutual ditch or irrigation companies, mutual or cooperative telephone companies, and like organizations are commonly regarded as mutual or cooperative electric companies and water companies. Rev. Rul. 67-265, 1967-2 C.B. 205.

<sup>648</sup> Revenue Act of 1924, ch. 234, sec. 231(10), 43 Stat. 283. A court had held that such organizations were not covered by the 1916 Act; thus Congress made its intent clear that such organizations should be exempt. See *Bankers' and Planters' Mutual Insurance Association v. Walker*, 279 F. 53, 55-56 (8<sup>th</sup> Cir. 1922) ("Life insurance is too well known and important for us to suppose that Congress would . . . intend life insurance to be included in the general expression of 'like organizations.'"). Of a purely local character means "confined to a particular community, place, or district, irrespective, however, of political subdivisions," that is, a single identifiable locality. Treas. Reg. sec. 1.501(c)(12)-1(b). Members of a qualifying benevolent life insurance association must continue to reside in the local geographic area at the time of application. Rev. Rul. 83-43, 1983-1 C.B. 108.

<sup>649</sup> Sec. 501(c)(12)(A); Treas. Reg. sec. 1.501(c)(12)-1(a). Some exceptions to the 85-percent-of-income requirement apply with respect to mutual and cooperative telephone and electric companies. Sec. 501(c)(12)(B), (C), (D). In addition, section 319 of the American Jobs Creation Act of 2004, Pub. L. No.

member-income test was intended to insure cooperatives continued serving members rather than placing their member-source income in investments, such as bonds or stocks, and becoming investment companies.<sup>650</sup>

### Farmers' cooperatives

Since 1916, there has been exemption for farmers' cooperative organizations,<sup>651</sup> which are farmers, fruit growers, or like associations (including livestock growers and operators of diaries) organized and operated on a cooperative basis for the purpose of: (1) marketing the products of members and other producers and returning to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them; or (2) purchasing supplies and equipment for the use of members or other persons and turning over the supplies and equipment to them at actual cost plus necessary expenses.<sup>652</sup> An organization engaged in both marketing and purchasing is exempt if, as to each of such functions, it meets the requirements of section 521.

A farmers' cooperative must be organized and operated on a cooperative basis,<sup>653</sup> include bona fide members,<sup>654</sup> and (where appropriate) include producers.<sup>655</sup> A farmers' cooperative may pay dividends on its capital stock,<sup>656</sup> permit proxy voting by its shareholders,<sup>657</sup> and

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108-357, expanded the exceptions in section 501(c)(12) to allow rural electric cooperatives to exclude income from certain nonmember transactions for purposes of the 85-percent test.

<sup>650</sup> See Michael Seto and Cheryl Chasin, *General Survey of I.R.C. 501(c)(12) Cooperatives and Examination of Current Issues*, IRS, Exempt Organizations Continuing Professional Education (CPE) Technical Instruction Program FY 2002.

<sup>651</sup> 1916 Revenue Act, sec. 11(a)(11), 39 Stat. 766; sec. 521. Such organizations are subject to the nonexempt cooperative rules of sections 1381-1388.

<sup>652</sup> Treas. Reg. sec. 1.521-1.

<sup>653</sup> Treas. Reg. sec. 1.521-1(a)(1).

<sup>654</sup> Treas. Reg. sec. 1.521-1(a)(3).

<sup>655</sup> See *Farmers Coop. Creamery Ass'n of Cresco, Iowa v. United States*, 81-1 U.S.T.C. para. 9457 (N.D. Iowa 1981).

<sup>656</sup> Sec. 521(b)(2); Treas. Reg. sec. 1.521-1(a)(2). To be tax-exempt as a farmers' cooperative, substantially all of the capital stock must be owned by producers who market their products or purchase their supplies and equipment through the cooperative. The IRS's position is that at least 85 percent of capital stock must be held by producers to satisfy the "substantially all" test. See Rev. Rul. 73-248, 1973-1 C.B. 295.

<sup>657</sup> Rev. Rul. 75-97, 1975-1 C.B. 167.

maintain a reasonable reserve.<sup>658</sup> The earnings of cooperatives are generally taxed to the cooperative or their patrons.<sup>659</sup> These rules enable tax-exempt farmers' cooperatives to attain certain advantages in computing tax that are not available to other cooperatives.

Examples include:

- A cooperative association, that in connection with its marketing function, processed its members' agricultural products into alcohol, qualifies.<sup>660</sup>
- A nonprofit agricultural cooperative formed to produce and market range grasses, on land owned or leased by its members, by grazing its own herd of breeder cattle and by grazing the cattle of others during the peak growing season qualifies for exemption as a farmers', fruit growers', or like association within the meaning of section 521.<sup>661</sup>

#### Crop-financing corporations

Since 1928, there has been an exemption (now under section 501(c)(16)) for corporations organized by section 521 farmers' cooperative marketing associations or purchasing associations or the members thereof, which are operated in conjunction with the section 521 organization and are formed to finance the ordinary crop operations of the members or other producers.<sup>662</sup> The crop operations finance corporation may retain its exemption even though it issues capital stock, where certain statutory conditions are met, or it accumulates and maintains a reasonable reserve. A tax-exempt crop financing corporation may own all the stock of a business corporation without jeopardizing its tax exempt status.<sup>663</sup>

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<sup>658</sup> To be tax-exempt as a farmers' cooperative, an organization must establish that it does not have any taxable income for its own account other than that reflected in the authorized reserve or surplus. Treas. Reg. sec. 1.521-1(c).

<sup>659</sup> Secs. 1381-1388. The cooperatives' net earnings or savings are distributed to the patrons on the basis of the amount of business transacted by them, in the form of patronage dividends. Patronage dividends are the profits of a cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative; the rebate must be made in an equitable fashion on the basis of the quantity or value of business done with the cooperative.

<sup>660</sup> Rev. Rul. 81-96, 1981-1 C.B. 359.

<sup>661</sup> Rev. Rul. 75-5, 1975-1 C.B. 166.

<sup>662</sup> Revenue Act of 1928, ch. 852, sec. 103(13), 45 Stat. 791; sec. 501(c)(16).

<sup>663</sup> Rev. Rul. 78-434, 1978-2 C.B. 179.

## State credit unions

Since 1951, there has been an exemption for credit unions without capital stock organized and operated for mutual purposes and without profit (not including Federal credit unions that are exempt as U.S. instrumentalities).<sup>664</sup> State law determines whether an organization formed under the laws of one of the States is a credit union for this purpose.<sup>665</sup> If an organization is not formed and does not operate under a State law governing credit unions, it generally is not a credit union.<sup>666</sup>

Before 1951, section 101(4) of the 1939 Code provided an exemption for domestic building and loan associations substantially all the business of which was confined to making loans to members (i.e., savings and loan institutions), and cooperative banks without capital stock organized for mutual purposes and without profit (i.e., mutual savings banks). Although section 101(4) did not explicitly refer to credit unions, the IRS considered many credit unions to be within the general meaning of cooperative banks for this purpose and, thus, treated credit unions as exempt from tax.<sup>667</sup>

In 1951, Congress amended section 101(4) by deleting the references to savings and loan institutions and mutual savings banks and replacing them with the present-law exemption for credit unions without capital stock organized and operated for mutual purposes and without profit. The legislative history of the Revenue Act of 1951 indicates that Congress eliminated the exemption for savings and loan institutions and mutual savings banks because they were similar to profit-seeking taxable financial corporations and, therefore, should be similarly taxed. However, the legislative history is silent with respect to the rationale for not likewise eliminating the exemption for credit unions on similar grounds.<sup>668</sup>

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<sup>664</sup> Sec. 501(c)(14)(A).

<sup>665</sup> Rev. Rul. 69-282, 1969-1 C.B. 155 (holding that an organization formed under a State's general corporation law was not a credit union even though its charter required "mutuality of lender and borrower in the sense that any person borrowing from the organization must be a member").

<sup>666</sup> *Id.*

<sup>667</sup> Opinion of the Attorney General, 31 O.A.G. 176 (1917).

<sup>668</sup> The legislative history to the Act states that the reason for elimination of exempt status for mutual savings banks and savings and loan associations was their departure from the principles and purposes of their formation, in that they had come to compete with many types of taxable financial institutions in the securities and real estate markets. S. Rep. No. 781, 82d Cong., 1<sup>st</sup> Sess. 27 (1951).

## Insurance

### Certain small property and casualty insurance companies

Since 1916, there has been an exemption for certain small property and casualty insurance companies.<sup>669</sup> In 1926, during a debate on such organizations, one Senator stated that such organizations are established “for mutual protection, they do not pay dividends, they do not run the great financial institutions of the country, as the ordinary fire and life insurance companies do now. They only provide for self-protection.”<sup>670</sup>

Until 1986, the exemption applied only to qualifying mutual companies, but in 1986, the provision was expanded to apply to qualifying stock companies as well. Under present law, in general, a property and casualty insurance company is exempt if (1) its gross receipts for the taxable year do not exceed \$600,000, and (2) the premiums received for the taxable year are greater than 50 percent of its gross receipts. To qualify for the exemption, the company must meet the definition of an insurance company, meaning that more than half of its business during the taxable year is from the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.<sup>671</sup> A special rule provides that a mutual property and casualty insurance company is eligible to be exempt if (a) its gross receipts for the taxable year do not exceed \$150,000, and (b) the premiums received for the taxable year are greater than 35 percent of its gross receipts, provided that no employee of the company or member of the employee's family is an employee of another company that is exempt from tax under section 501(c)(15).

### High-risk individuals health care coverage organizations

The Health Insurance Portability and Accountability Act of 1996 provided an exemption for nonprofit health care coverage organizations for high-risk individuals.<sup>672</sup> Section 501(c)(26) provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied. The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization (“HMO”).

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<sup>669</sup> 1916 Revenue Act, sec. 11(a)(10), 39 Stat. 766; sec. 501(c)(15).

<sup>670</sup> 67 Cong. Rec. 3431-32 (1926) (remarks of Senator Smith).

<sup>671</sup> Section 501(c)(15) was amended by the Pension Funding Equity Act of 2004, Pub. L. No. 108-218, sec. 206(a). Prior to the amendment, exemption generally was available if the company's net written premiums or direct written premiums (whichever is greater) for the taxable year did not exceed \$350,000.

<sup>672</sup> Pub. L. No. 104-191, sec. 341(a) (1996); sec. 501(c)(26).

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.<sup>673</sup>

The provision further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

#### State-sponsored workmen's compensation insurance organizations

The Health Insurance Portability and Accountability Act of 1996 provided an exemption for state-sponsored workmen's compensation insurance organizations.<sup>674</sup> To qualify for the exemption, the organization must have been established by a State before June 1, 1996, exclusively for the purpose of reimbursing its members for losses arising under the workmen's compensation acts. An organization will qualify for tax-exempt status only if the State requires that the organization's membership consist of all persons who issue insurance covering workmen's compensation losses in such State, and all persons and governmental entities who self-insure against such losses. The organization is required to operate on a nonprofit basis by returning surplus income to its members or workmen's compensation policyholders on a periodic basis and is required to reduce initial premiums in anticipation of investment income.

In tax years beginning after December 31, 1997, the tax exemption is also available to any organization (including a mutual insurance company) if it is created by State law and is organized and operated exclusively to (1) provide workmen's compensation insurance which is required by State law or with respect to which State law provides significant disincentives if the insurance is not purchased by an employer, and (2) provide related coverage which is incidental to the worker's compensation insurance. The organization must provide workers' compensation insurance to any employer in the State (or employees in the State or temporarily assigned out of State) which seeks the insurance and meets other reasonable requirements. The State must make a financial commitment with respect to the organization, either by extending full faith and credit of the State to the initial debt of the organization or by providing the organization its initial operating capital. The assets of the organization must revert to the State upon dissolution, unless State law does not permit the dissolution of the organization. The majority of the board of directors or oversight body of the organization must be appointed by the chief executive officer or other executive branch official of the State, by the State legislature, or by both.

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<sup>673</sup> The composition of the membership in the organization must be specified by the State. Sec. 501(c)(26)(C).

<sup>674</sup> Pub. L. No. 104-191, sec. 342(a); sec. 501(c)(27).

### Shipowners' protection and indemnity associations

Since 1921, there has been exemption for shipowners' protection and indemnity associations not organized for profit, and no part of the net earnings of which inures to the benefit of any private shareholder.<sup>675</sup> Such associations are, however, taxable as corporations on their net income from interest, dividends, and rents.

Shipowners' mutual associations are formed to provide insurance to their members. The member shipowners pay dues or premiums to the association, which, in turn, pays claims arising out of the use of its members' vessels. The IRS has ruled that the dues paid to the association are nontaxable and that if the association returns a surplus to its members, the prohibition on private inurement is not violated.<sup>676</sup> The dues or premiums paid by members to the association are deductible if they qualify as necessary and ordinary business expenses.<sup>677</sup>

### Arrangements to provide employee benefits

#### Qualified retirement plans

Since 1921, there has been exemption for trusts holding the assets of an employer-sponsored retirement plan that meets the qualification requirements of section 401(a) (a "qualified retirement plan").<sup>678</sup> Among such requirements is that the assets must be held for the exclusive benefit of the employees covered by the plan and their beneficiaries.

In addition to tax-exempt status for such a trust, qualified retirement plans are accorded special tax treatment under present law. Specifically, employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. Moreover, the employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee's income.

#### Governmental eligible deferred compensation plans

Since 1996, there has been exemption for trusts holding the assets of a deferred compensation plan maintained by a State or local governmental employer that meets the

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<sup>675</sup> Revenue Act of 1921, ch. 136, sec. 233(a), 42 Stat. 254; sec. 521.

<sup>676</sup> Rev. Rul. 70-566, 1970-2 C.B. 128.

<sup>677</sup> Rev. Rul. 55-189, 1955-1 C.B. 265.

<sup>678</sup> Sec. 501(a). Exemption from Federal income tax for qualified retirement plans was previously provided by section 165 of the Internal Revenue Code of 1939, section 165 of the Revenue Act of 1928, and section 219(f) of the Revenue Act of 1921.

requirements of section 457(b) (an “eligible deferred compensation plan”).<sup>679</sup> Among such requirements is that the assets must be held for the exclusive benefit of the employees covered by the plan and their beneficiaries.

Employees covered by an eligible deferred compensation plan maintained by a State or local governmental employer receive tax treatment similar to employees covered by a qualified retirement plan. That is, amounts deferred under the plan are not included in gross income until benefits are distributed, even though the plan is funded and the benefits are nonforfeitable.

#### Voluntary employees’ beneficiary associations

Since 1928, there has been exemption for voluntary employees’ beneficiary associations (“VEBAs”).<sup>680</sup> Legislative history provided that it was “desirable to provide specifically for their exemption from the ordinary corporation tax.”<sup>681</sup>

A VEBA is a trust or fund that provides for the payment of life, sick, accident or other similar benefits to members of such association or their dependents or designated beneficiaries, as long as there is no private inurement. The employees eligible for coverage by a VEBA must share an employment-based common bond. Typically, eligibility is determined on the basis of: (1) a common employer (or affiliated employers), (2) coverage under one or more collective bargaining agreements, (3) membership in a labor union, or (4) membership in one or more locals of a national or international labor union. In addition, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond.

Unlike most other types of exempt organizations, VEBAs are required to pay unrelated business income tax on gifts or grants, income from the performance of exempt functions, investment income, or other forms of passive income. Only a VEBA’s exempt function income is excluded from unrelated business income tax.<sup>682</sup> Certain amounts set aside for charitable and some other purposes may be included in a VEBA’s exempt function income and thereby excluded from taxation.<sup>683</sup>

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<sup>679</sup> Sec. 457(g) was added to the Code by sec. 1448(a) of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, as part of a requirement that the assets of an eligible deferred compensation plan maintained by a State or local governmental employer be held in trust.

<sup>680</sup> Revenue Act of 1928, ch. 852, sec. 103(16), 48 Stat. 814; sec. 501(c)(9).

<sup>681</sup> H.R. Rep. No. 2, 70<sup>th</sup> Cong., 1<sup>st</sup> Sess. 4 (1916).

<sup>682</sup> Sec. 512(a)(3).

<sup>683</sup> Sec. 512(3)(B).



Employer contributions to a VEBA are deductible (within limits). In many cases, the benefits provided to employees by a VEBA, such as health benefits, are excluded from gross income.

#### Teachers' retirement fund associations

Since 1928, there has been exemption for teachers' retirement fund associations of a purely local character.<sup>684</sup> The tax exemption is provided if: (1) there is no private inurement (other than through payment of retirement benefits) and (2) the income consists wholly of amounts received from assessments on the teaching salaries of members, and income from investments.

#### Supplemental unemployment benefit trusts

Since 1960, there has been exemption for certain trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits.<sup>685</sup> The plan must be established and maintained for the sole purpose of providing supplemental unemployment compensation benefits and must provide that the corpus and income of the trust generally cannot be used for any purpose other than providing such benefits.

Supplemental unemployment compensation benefits means: (1) benefits paid to an employee because of involuntary separation from employment (regardless of whether the separation is temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and (2) sick and accident benefits subordinate to the separation benefits. Such supplemental unemployment compensation benefits are frequently provided in conjunction with (or coordinated with) other benefits, such as State unemployment benefits.

The unrelated business income tax rules applicable to supplemental unemployment benefit trusts are similar to the special unrelated business income tax rules applicable to VEBAs, discussed above.

#### Funded pension trusts

Since 1969, there has been exemption for certain trusts forming part of a pension plan.<sup>686</sup> Section 501(c)(18) exempts trusts created before June 25, 1959, that form a part of a pension plan funded only by employee contributions. The plan must provide that the corpus or income of the trust generally cannot be used for any purpose other than providing plan benefits.

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<sup>684</sup> Revenue Act of 1928, ch. 852, sec. 103(17), 48 Stat. 814; sec. 501(c)(11).

<sup>685</sup> Pub. L. No. 86-667 (1960); sec. 501(c)(17).

<sup>686</sup> Pub. L. No. 91-172 (1969); sec 501(c)(18) (effective for taxable years beginning after 1969).

### Qualified group legal services plans

Section 501(c)(20) provided an exemption for an organization or trust, the exclusive function of which is to form part of a qualified group legal services plan as defined in section 120, which provided an exclusion for contributions and benefits provided under such a plan. The Tax Reform Act of 1976<sup>687</sup> added section 501(c)(20), as well as section 120, to the Code. Sections 520(c)(20) and 120 do not apply to taxable years beginning after June 30, 1992.<sup>688</sup> However, an organization or trust forming part of a group legal services plan may be eligible for exemption as a VEBA.

The unrelated business income tax rules applicable to qualified group legal services plans are similar to the special unrelated business income tax rules applicable to VEBAs and supplemental unemployment benefit trusts, discussed above.

### Black lung benefits trusts

The 1977 Black Lung Benefits Revenue Act provided an exemption for qualified black lung benefit trusts to facilitate the long-term financing of black lung benefits by employers.<sup>689</sup> No assets of a qualified black lung benefit trust may be used for, or diverted to, any purpose other than (1) to satisfy liabilities, or pay insurance premiums to cover liabilities, arising under the Black Lung Acts, (2) to pay administrative costs of operating the trust, (3) to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents (within certain limits) or (4) investment in Federal, State, or local securities and obligations, or in time demand deposits in a bank or insured credit union. Additionally, trust assets may be paid into the national Black Lung Disability Trust Fund, or into the general fund of the U.S. Treasury.

Contributions to a qualified black lung benefit trust are generally deductible to the extent such contributions are necessary to fund the trust.

### Withdrawal liability trusts

The Multiemployer Pension Plan Amendments Act of 1980 provided an exemption from Federal income tax for trusts that are established by plan sponsors of multiemployer plans for the purpose of paying withdrawal liability and withdrawal-type payments to such plans, as well as paying reasonable administrative expenses in connection with the operation of the trust.<sup>690</sup>

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<sup>687</sup> Pub. L. No. 94-455 (1976).

<sup>688</sup> Sec. 120(e).

<sup>689</sup> Pub. L. No. 95-227 (1978); sec. 501(c)(21).

<sup>690</sup> Pub. L. No. 96-364 (1980); sec. 501(c)(22).

### Employee trusts

The Single-Employer Pension Plan Amendments Act of 1986 (“SEPPAA”) provided an exemption for trusts established under section 4049 of the Employee Retirement Income Security Act of 1974 (“ERISA”), as in effect on the date of enactment of SEPPAA.<sup>691</sup> Section 4049 of ERISA provided for the creation of a trust in connection with the recovery from an employer that terminated its pension plan amounts needed to provide benefits in excess of the amount guaranteed by the Pension Benefit Guaranty Corporation. Section 4049 of ERISA was repealed by the Omnibus Budget Reconciliation Act of 1987.<sup>692</sup>

### The National Railroad Investment Trust

The Railroad Retirement and Survivor’s Improvement Act of 2001 provided an exemption for the National Railroad Retirement Investment Trust established under section 15(j) of the Railroad Retirement Act of 1974.<sup>693</sup> The purpose of the trust is to manage and invest certain assets of the Railroad Retirement System.

### **Title-holding corporations, single-parent and multiparent**

#### Title-holding corporations

Since 1916, there has been exemption for title-holding corporations (not trusts).<sup>694</sup> A title-holding corporation is an entity that serves one tax-exempt organization. Its purpose is to function as a subsidiary organization, hold title to property that would otherwise be held by the parent exempt organization, and remit any net income from the property to the parent.

In legislative history to the 1916 Act, the general observation was made that title-holding companies were difficult to secure tax returns from, and that the Treasury collected little or no revenue from them. Today, exempt organizations often form title holding corporations as subsidiaries to hold title to real estate, and in certain cases, other properties. Although such corporations originally were established to avoid State law restrictions on the holding of property by certain nonprofit organizations, they now are used to reduce a parent organization’s exposure to liability, to facilitate administration, or to increase borrowing power.<sup>695</sup>

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<sup>691</sup> Pub. L. No. 99-272 (1986); sec. 501(c)(24).

<sup>692</sup> Pub. L. No. 100-203 (1987).

<sup>693</sup> Pub. L. No. 107-90 (2001); sec. 501(c)(28).

<sup>694</sup> 1916 Revenue Act, sec. 11(a)(12), 39 Stat. 766; sec. 501(c)(2).

<sup>695</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, sec. 18.2 (8<sup>th</sup> ed. 2003).

### Multiparent title holding organizations

An exemption for multiparent title holding organizations was added to the Code by the Tax Reform Act of 1986 to allow for the exemption of title-holding organizations with multiple parents.<sup>696</sup> Unlike a single parent title holding company (described above), a multiparent title holding organization is limited to holding real property and may be organized as a trust.

In general, a multiparent title-holding organization is a corporation or trust that is organized for the exclusive purposes of acquiring and holding title to real property,<sup>697</sup> collecting income from the property, and remitting the entire amount of income from the property (less expenses) to one or more qualified tax-exempt organizations that are shareholders of the title-holding corporation or beneficiaries of the title-holding trust.<sup>698</sup> The corporation or trust may have no more than 35 shareholders or beneficiaries and may have only one class of stock or beneficial interest.<sup>699</sup> Organizations that are eligible to acquire or hold interests in a multiparent title-holding organization are charitable organizations, qualified pension, profit-sharing, or stock bonus plans, governmental plans, and governments and agencies or instrumentalities.

### Veterans' organizations

#### Veterans' organizations

Congress added section 501(c)(19) to the Internal Revenue Code in 1972 to provide an exemption for veterans' organizations, but initially limited such exemption to organizations comprised principally of war veterans.<sup>700</sup> Congress amended section 501(c)(19) in 1982 to allow veterans' organizations not principally comprised of war veterans to qualify for exemption under that section.<sup>701</sup> Before the enactment of section 501(c)(19), a veterans' organizations generally qualified for exemption as a social welfare organization under section 501(c)(4). Some veterans'

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<sup>696</sup> Pub. L. No. 99-514 (1986); sec. 501(c)(25).

<sup>697</sup> Real property does not include any interest as a tenant in common (or similar interest) and does not include any indirect interest. Real property includes a direct interest and any personal property that is leased under, or in connection with, a lease of real property (with the condition that rent attributable to the leasing of the personal property for a year does not exceed 15 percent of the total rent for the year attributable to both the real and personal property under the lease). Sec. 501(c)(25)(F).

<sup>698</sup> Sec. 501(c)(25)(A)(iii).

<sup>699</sup> Sec. 501(c)(25)(A)(i), (ii).

<sup>700</sup> Pub. L. No. 92-418, sec. 1(a) (1972).

<sup>701</sup> Pub. L. No. 97-248, sec. 354(a) (1982).

organizations were recognized as social clubs under section 501(c)(7). Many veterans' organizations may continue to qualify for exemption under more than one section of the Code.<sup>702</sup>

A veterans' organization (as described in section 501(c)(19)) is as a post or organization of past or present members of the Armed Forces of the United States (1) that is organized in the United States or any of its possessions; (2) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (3) that meets certain membership requirements. The membership requirements are that (1) at least 75 percent of the organization's members are past or present members of the Armed Forces of the United States, and (2) substantially all of the remaining members are cadets or are spouses, widows, widowers, ancestors, or lineal descendants of past or present members of the Armed Forces of the United States or of cadets.<sup>703</sup> No more than 2.5 percent of an organization's total members may consist of individuals who are not veterans, cadets, or spouses, widows, or widowers of such individuals. Contributions to an organization described in section 501(c)(19) may be deductible for Federal income and gift tax purposes, provided that the organization is a post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, such a post or organization.<sup>704</sup> Contributions to veterans organizations incorporated by Act of Congress are deductible for estate tax purposes.<sup>705</sup>

A special rule excludes certain insurance premium income retained by section 501(c)(19) veterans' organizations from such an organization's unrelated business taxable income. The rule generally applies where the organization serves as a commissioned agent for an insurance company that provides coverage to the organization's members. To qualify for the special exclusion, the amount retained must be attributable to payments for life, sick, accident, or health insurance with respect to members or their dependents and be set aside for the purpose of providing for the payment of insurance benefits or for a purpose specified in section 170(c)(4), *i.e.*, exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. Any other premium amounts retained generally will be included in the organization's unrelated business taxable income.<sup>706</sup> This special exception does not apply to veterans' organizations exempt from tax under other sections of the Internal Revenue Code, such as section 501(c)(4).

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<sup>702</sup> See e.g., Treas. Reg. sec. 1.501(c)(19)-1(c)(1) (promotion of social welfare as defined under section 501(c)(4) is a recognized exempt purpose under section 501(c)(19)).

<sup>703</sup> Section 105 of the Military Family Tax Relief Act of 2003, Pub. L. No. 108-121, added ancestors or lineal descendants to the substantially all test.

<sup>704</sup> Secs. 170(c)(3), 2522(a)(4). These charitable deduction provisions are more limited than the exemption standard set forth in section 501(c)(19), which no longer restricts tax-exempt status under section 501(c)(19) to organizations of "war veterans."

<sup>705</sup> Sec. 2055(a)(4).

<sup>706</sup> Sec. 512(a)(4).

There are no restrictions on the lobbying and political activities of section 501(c)(19) veterans' organizations.<sup>707</sup>

#### Pre-1880 veterans organizations

Since 1982, there has been exemption for pre-1880 veterans organizations.<sup>708</sup> The exemption is available for any association organized before 1880, more than 75 percent of the members of which are present or past members of the United States armed forces and a principal purpose of which is to provide insurance and other benefits to veterans or their dependents.<sup>709</sup> Section 501(c)(23) organizations do not have to meet the additional membership requirement of section 501(c)(19) organizations -- i.e., the “substantially all” test.

### **Arrangements for individuals to save for health, retirement and education**

#### Archer medical savings accounts

The Health Insurance Portability and Accountability Act of 1996 provided an exemption for Archer medical savings accounts (“MSAs”).<sup>710</sup> An MSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage). Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs. Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not includible in gross income in the year earned (i.e., inside buildup is not taxable). Distributions from an Archer MSA for qualified medical expenses are not includible in gross income. Distributions not used for qualified medical expenses are includible in gross income and subject to an additional 15-percent tax unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

#### Health savings accounts

The Medicare, Prescription Drug, Improvement, and Modernization Act of 2003 provided an exemption for health savings accounts (“HSAs”).<sup>711</sup> An HSA is a tax-exempt trust

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<sup>707</sup> Other organizations have challenged this rule on constitutional grounds, though without success. See, e.g., *Branch Ministries v. Rossotti*, 40 F. Supp. 2d 15 (D.C. Dist. 1999), *aff'd*, 211 F.3d 137 (D.C. Cir. 2000).

<sup>708</sup> The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (1982); sec. 501(c)(23).

<sup>709</sup> Sec. 501(c)(23).

<sup>710</sup> Pub. L. No. 104-191, sec. 301 (1996); sec. 220.

<sup>711</sup> Pub. L. No. 108-173, sec. 1201 (2003); sec. 223.

or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage). Subject to certain limitations, contributions to an HSA are deductible in determining adjusted gross income if made by or on behalf of the individual and are excludable from gross income and wages if made by the employer (including contributions made through a cafeteria plan through salary reduction). Earnings on amounts in an HSA are not includible in gross income in the year earned (i.e., inside buildup is not taxable). Distributions from an HSA that are for qualified medical expenses are excludable from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent, unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

#### Individual retirement arrangements

The Employment Retirement Income Security Act of 1974 provided an exemption for individual retirement accounts (“IRAs”).<sup>712</sup> An IRA is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Contributions to an IRA are subject to limits. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income; distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

#### Qualified tuition programs

The Small Business Protection Act of 1996 provided an exemption for a qualified tuition program.<sup>713</sup> A qualified tuition program is defined as a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions designed to meet the educational needs of college students. Under a qualified tuition program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary, or in the case of a State program, may make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. Contributions to a qualified tuition program must be made in cash, and the program must have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary’s qualified higher education expenses.

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<sup>712</sup> Pub. L. No. 93-406, sec. 2002(b) (1974); sec. 408.

<sup>713</sup> Pub. L. No. 104-188, 1806(a) (1996); sec. 529.

Distributions from a qualified tuition program are not includible in the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a qualified tuition program exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary. Qualified tuition programs are subject to special estate, gift, and generation-skipping transfer tax rules.

#### Coverdell education savings accounts

Section 530 provides an exemption from Federal income tax for Coverdell education savings accounts. The Taxpayer Relief Act of 1997<sup>714</sup> added section 530 to the Code. Coverdell education savings accounts are certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. The aggregate annual contributions that can be made by all contributors to Coverdell education savings accounts for the same beneficiary is \$2,000 per year. In the case of contributors who are individuals, the maximum contribution limit is reduced for individuals with adjusted gross income between \$95,000 and \$110,000 (\$190,000 to \$220,000 in the case of married taxpayers filing a joint return).

Distributions from a Coverdell education savings account are not includible in the distributee's income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a Coverdell education savings account exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a Coverdell education savings account may be rolled over to another Coverdell education savings account of the same beneficiary or of a member of the family of that beneficiary.

#### Religious and apostolic organizations

Since 1936, there has been an exemption for certain religious or apostolic organizations.<sup>715</sup> The exemption is for religious and apostolic associations or corporations which conduct communal activities (such as farming) provided that the members claim their shares of the corporation's income on their own individual returns. Religious or apostolic organizations are described as religious or apostolic associations or corporations if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members. However, each

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<sup>714</sup> Pub. L. No. 105-34 (1997).

<sup>715</sup> Sec. 501(d).



member is required to include (at the time of filing their returns) in his or her gross income<sup>716</sup> his or her entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year.<sup>717</sup> Contributions to such an exempt association are not deductible for Federal income tax purposes, but the association may establish a charitable fund, the contributions to which may be deductible.

Prior to 1936, apostolic organizations were found not to qualify for tax exemption under the general rules for religious organizations due to the presence of commercial activities and private inurement. An excerpt from the legislative history states the following rationale to provide exemption:

It has been brought to the attention of the committee that certain religious and apostolic associations and corporations, such as the House of David and the Shakers, have been taxed as corporations, and that since their rules prevent their members from being holders of property in an individual capacity the corporations would be subject to the undistributed-profits tax. These organizations have a small agricultural or other business. The effect of the proposed amendment is to exempt these corporations from the normal corporations tax and the undistributed-profits tax, if their members take up their shares of the corporations' income on their own individual returns. It is believed that this provision will give them relief, and their members will be subject to a fair tax.<sup>718</sup>

### **Political organizations**

Section 527 provides a limited exemption from Federal income tax of “political organizations.” Political organizations are defined as a party, committee, association, fund, account, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) for an “exempt function.” An “exempt function” is defined, in turn, as influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed. A political organization will be subject to the highest rate of corporate income tax on its “political organization taxable income” defined as the organization’s gross

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<sup>716</sup> Any amount included in the gross income of the member is treated as a dividend received. Treas. Reg. sec. 1.501(d)-1(a); Rev. Rul. 57-574, 1957-2 C.B. 161.

<sup>717</sup> Sec. 501(d).

<sup>718</sup> 80 Cong. Rec. 9074 (1936).

income other than “exempt function income,”<sup>719</sup> less the deductions directly connected with the production of such includible gross income.<sup>720</sup>

The Tariff Schedules Amendments of 1975<sup>721</sup> added section 527 to the Code to clarify the tax status of political organizations. In general, the IRS had not required political organizations to file tax returns on the ground that the receipts of such organizations were from gifts that would not produce taxable income.<sup>722</sup> In 1974, however, the IRS ruled that campaign committees would be treated as taxable corporations (with contributions being nontaxable).<sup>723</sup> Congress intervened in 1975 to provide limited tax exempt status for political organizations, providing for exemption because:

political activity (including the financing of political activity) as such is not a trade or business which is appropriately subject to tax. However, where assets are not currently used by a political organization for political activities, but are invested for use at a later date, the income from the investment (less direct expenses incurred in earning that income) is to be subject to tax.<sup>724</sup>

### **Charitable remainder trusts**

Since 1969, there has been an exemption for charitable remainder trusts.<sup>725</sup> Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust’s

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<sup>719</sup> Exempt function income includes amounts received as (1) a contribution of money or other property; (2) membership dues; (3) proceeds from the conduct of bingo games as described in section 513(f)(2); and (4) proceeds from a political fund-raising or entertainment event or from the sale of political campaign materials other than amounts received in the ordinary course of a trade or business. Such amounts are required to be segregated in a separate account or accounts for the “exempt function” of the organization.

<sup>720</sup> Sec. 527(c)(1).

<sup>721</sup> Pub. L. No. 93-625 (1975).

<sup>722</sup> S. Rep. No. 93-1357, 93d Cong., 2d Sess. 25 (1974).

<sup>723</sup> Rev. Rul. 74-21, 1974-2 C.B. 14, *modified by* Rev. Rul. 74-475, 1974-2 C.B. 22.

<sup>724</sup> S. Rep. No. 93-1357, 93d Cong., 2d Sess. 25, 26 (1974).

<sup>725</sup> Pub. L. No. 91-172 (1969); sec. 664.

distributable net income for the year. Taxes imposed on the trust are required to be allocated to corpus.<sup>726</sup>

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred, (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus.<sup>727</sup>

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.<sup>728</sup>

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.<sup>729</sup>

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

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<sup>726</sup> Treas. Reg. sec. 1.664-1(d)(2).

<sup>727</sup> Sec. 664(b).

<sup>728</sup> Treas. Reg. sec. 1.664-1(d)(4).

<sup>729</sup> Sec. 664(d).

## VII. APPENDIX



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**Memorandum**

February 16, 2005

**TO:** Joint Committee on Taxation  
Attention: Roger Colinvaux

**FROM:** Erika Lunder  
Legislative Attorney  
American Law Division

**SUBJECT:** Non-Tax Benefits Provided to Organizations Described in IRC § 501(c)(3)

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This memorandum responds to your request for examples of non-tax benefits provided to the organizations described in IRC § 501(c)(3) by the federal government, California, Florida, Massachusetts, New York, and Pennsylvania.

We compiled this information by electronically searching the annotated U.S. Code, with the exception of Title 26, and the state codes. Two separate searches were conducted using the terms “501(c)(3)” and “501(a).” We also searched the annotated U.S. Code, with the exception of Title 26, and the unannotated versions of each state’s code using the root form of “charity” (i.e., charit!). Each search returned hundreds of hits, from which we excluded inapplicable examples and all tax-related benefits. We also excluded state statutes that implement federal requirements concerning unemployment compensation.

With respect to format, we have grouped the benefits into four general categories: (1) the organization is exempt from a provision of law; (2) the organization benefits from a special rule other than exemption; (3) the organization is able to receive property or non-grant money; and (4) the organization is eligible to participate in a program, which usually means the organization is eligible to receive grants. There is overlap among these categories, but each example is only listed once. It is important to note that the examples below are summaries of the statutes, and we have omitted most qualifications. For example, in most grant programs, the organization has to be organized for a specific purpose, e.g., to conserve wetlands. We generally did not include this level of specificity unless it was necessary to understand the statute.

Per your request, we have included non-tax benefits for nonprofit charitable organizations even though the benefit is not explicitly dependent on exempt status under IRC § 501(c)(3). As we have discussed, the term “nonprofit charitable organization” does not necessarily correspond with “IRC § 501(c)(3) organization.” None of the five states require under their nonprofit incorporation laws that the organization be recognized as tax-exempt under federal law. In order to recognize the potential differences between the two concepts,

we have made it a point to use the language from the statute. Thus, if the statute expressly mentions IRC § 501(c)(3), it is used in the example; otherwise, some form of the term “charitable organization” is used.

## **Federal Government**

### **Exempt From a Provision of Law**

#### 8 USC § 1642

There is a requirement to verify that a person applying for certain public benefits is a qualified alien eligible to receive the benefits. The verification requirement does not apply to nonprofit charitable organizations.

#### 11 CFR § 100.29

For purposes of federal election law, communications paid for by IRC § 501(c)(3) organizations are not “electioneering communications.”

#### 15 USC § 13c

The Robinson-Patman Antidiscrimination Act, which prohibits price discrimination, does not apply to purchases made by schools, colleges, universities, public libraries, churches, hospitals, and charitable institutions not operated for profit, so long as the purchase is for the organization’s own use.

#### 15 USC § 77c

Securities exempt from the Securities Act of 1933 include those issued by an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for profit, if no part of its earnings inures to the benefit of a private shareholder or individual, and those by a qualified fund (defined in 15 USC § 80a-3).

#### 15 USC § 78c

No IRC § 501(c)(3) charitable organization or its trustee, director, officer, employee or volunteer is a “broker,” “dealer,” “municipal securities broker,” “municipal securities dealer,” “government securities broker,” or “government securities dealer” solely because the organization or person buys, holds, sells, or trades in securities for the organization's account or a qualified fund (defined in 15 USC § 80a-3)

#### 15 USC § 78l

Securities that do not have to be registered include those of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for profit, if no part of its earnings inures to the benefit of a private shareholder or individual, and those by a qualified fund (defined in 15 USC § 80a-3).

#### 15 USC § 80a-3

Exempt from the definition of investment company is any company organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes if no part of its earnings inures to the benefit of a private shareholder or individual, or is or maintains a qualified pooled income fund, collective trust fund, collective investment fund, or similar fund maintained by a charitable organization. The term “charitable organization” means an organization described in IRC § 170(c)(1)-(5) or IRC § 501(c)(3).

15 USC § 80a-3a

No charitable organization or its trustee, director, officer, employee or volunteer is required to register or be subject to regulation as a dealer, broker, agent, or investment adviser under the securities laws of any state because the organization or person buys, holds, sells, or trades in securities for its account or a qualified fund (defined in 15 USC § 80a-3)

15 USC § 80b-3

Exempt from the provision requiring the registration of investment advisors is any investment advisor that is a charitable organization described in IRC §§ 170(c)(1)-(5) or IRC § 501(c)(3). Also exempt is the organization's trustee, director, officer, employee, or volunteer if the person's advice, analyses, or reports are provided only to the organization and a few others.

15 USC § 1679a

For purposes of regulating credit repair organizations, IRC § 501(c)(3) organizations are exempt from the definition of "credit repair organization."

16 CFR § 310.6

Under the Telemarketing and Consumer Fraud and Abuse Prevention Act, telemarketers calling to solicit charitable contributions are not required to comply with provisions related to the national "do-not-call" registry, but are required to comply with other requirements.

18 USC § 1955

The prohibition on illegal gambling businesses does not apply to a bingo game, lottery, or similar game of chance conducted by an IRC § 501(c)(3) organization, if no part of the gross receipts inures to the benefit of a private shareholder, member, or employee of the organization, except as compensation for actual expenses incurred.

29 USC § 1803

Nonprofit charitable organizations and educational institutions are exempt from the Migrant and Seasonal Agricultural Worker Protection Act.

39 USC § 3009

Except for free samples clearly marked as such and merchandise mailed by a charitable organization soliciting contributions, the mailing of unordered merchandise or prohibited communications is an unfair method of competition and an unfair trade practice in violation of 15 USC § 45(a)(1).

## **Special Rules**

2 USC § 441i

Under federal election law, a federal candidate is restricted in the type of solicitations he or she may make, but a candidate may make a general solicitation of funds on behalf of certain IRC § 501(c)(3) organizations if the solicitation does not specify how the funds will or should be spent.

5 USC § 504; 28 USC § 2412

Prevailing parties in civil actions brought against the United States (including agencies and officials) may be awarded a judgment for costs and reasonable attorneys fees. "Party" includes any partnership, corporation, association, unit of local government, or organization, so long as, at the time the civil action was filed, the entity's net worth did not exceed

\$7,000,000 and it did not have more than 500 employees. However, IRC § 501(c)(3) organizations may be a party regardless of the organization's net worth.

8 USC § 1101

A “special immigrant” includes an individual who enters the country to work for a religious organization or an IRC § 501(c)(3) organization that is affiliated with a religious denomination.

11 USC § 303(a)

Nonprofit organizations may not be forced into involuntary liquidation or reorganization.

12 USC § 1709

Under the National Housing Mortgage Insurance Program, the general rule only allows the insurance of a mortgage that is secured by a 1 to 4-family dwelling if the mortgagor will occupy the dwelling as his or her principal or secondary residence. This limitation does not apply to IRC § 501(c)(3) organizations that intend to sell or lease the mortgaged property to low or moderate-income persons.

16 USC § 284c

The Wolf Trap National Park for the Performing Arts is eligible to receive federal loans. When paying the loans back, it may take a credit based on the market value of tickets contributed to IRC § 501(c)(3) organizations.

16 USC § 3372

It is unlawful for any person to import, export, transport, sell, receive, acquire, or purchase a prohibited wildlife species in interstate or foreign commerce. This generally does not apply to, among others, accredited IRC § 501(c)(3) wildlife sanctuaries.

20 USC § 1085

Under the Federal Family Education Loan Program, an eligible lender cannot generally have as its primary consumer credit function the making or holding of loans made to students. However, there are several exceptions to this rule, one of which is for a bank that is a wholly-owned subsidiary of an IRC § 501(c)(3) foundation and which makes loans only to undergraduate students who are less than age 23, although the portfolio of these loans cannot exceed \$5,000,000.

29 USC § 1052

Under ERISA, tax-exempt educational organizations have special minimum participation standards.

35 USC § 202

Under provisions addressing patent rights in inventions made with federal assistance, IRC § 501(c)(3) organizations may be able to elect to retain title to any subject invention. This rule also applies to small businesses.

39 CFR § 111.1

Religious, educational, scientific, philanthropic, agricultural, labor, fraternal, and veterans’ organizations are eligible for special postal rates so long as the organization is not organized for profit and none of its net income inures to the benefit of a private stockholder or individual.



42 USC § 300e-9

For the provision regulating employer contributions to certain health plans with an option of membership in a qualified health maintenance organization, the term “employer” does not include churches or qualifying IRC § 501(c)(3) organizations that are operated, supervised, or controlled by a church, convention or association of churches.

42 USC § 1395x

For purposes of the Social Security Act, a religious nonmedical health care institution must be described in IRC § 501(c)(3). There are special rules that apply to these institutions so that they and their patients may not be forced to take actions that violate their religious beliefs.

42 USC § 1397a

Under the Social Security Act, block grants are provided to states for payments for social services. Allowable expenditures include those for conferences or workshops and training or retraining through grants to IRC § 501(c)(3) organizations.

42 USC § 9607

In general, an IRC § 501(c)(3) organization is not liable, with respect to response costs at a facility on the National Priorities List, for municipal solid waste disposed of at the facility. The organization cannot have employed more than 100 individuals at the location that generated the waste during the year preceding the date it was notified of its potential liability.

42 USC §§ 14503, 14504, and 14505

The Volunteer Protection Act limits the liability of volunteers of IRC § 501(c)(3) organizations for their actions as volunteers.

49 USC § 13709

This section deals with claims that transportation was provided at rates less than the legal tariff rates. An IRC § 501(c)(3) organization is not liable for the difference between the legally-applicable tariff rate and the rate originally paid.

## **Eligible to Receive Property or Non-Grant Money**

2 USC § 117e

IRC § 501(c)(3) organizations may receive used or surplus House furniture.

5 USC § 7342

IRC § 501(c)(3) organizations are eligible to receive gifts and decorations that were given to Members of the Senate or employees of the Senate and are now being disposed of.

10 USC § 2012

Youth and charitable organizations are eligible for support and services from the military if the assistance is authorized by law or incidental to military training.

10 USC § 2580

IRC § 501(c)(3) religious organizations may receive donated military chapel personal property to replace property that was damaged or destroyed as a result of an act of arson or terrorism.

10 USC § 7542

The Secretary of the Navy may sell, at nominal prices, nonregulation and excess clothing to recognized charitable organizations for distribution to the needy.

16 USC § 18f-2

The Secretary of the Interior may dispose of museum objects and collections that are no longer needed to IRC § 501(c)(3) organizations.

29 USC § 169

An employee who has a religious objection to joining or financially supporting labor organizations may not be required to join or support an organization as a condition of employment. In lieu of paying dues and fees to the organization, the employee may be required to pay an equal amount to a nonreligious, nonlabor IRC § 501(c)(3) organization.

32 USC § 508

Members and units of the National Guard may provide services involving ground transportation, air transportation, administrative support services, technical training services, emergency medical assistance and services, and communications services to eligible youth and charitable organizations.

36 USC § 40706

On dissolution of the Corporation for the Promotion of Rifle Practice and Firearms Safety, certain assets may be distributed to IRC § 501(c)(3) organizations that perform functions similar to those in the Civilian Marksmanship Program.

36 USC § 80106

On dissolution of the General Federation of Women's Clubs, its assets may be distributed to IRC § 501(c)(3) organizations with purposes similar to those of the corporation.

40 USC § 550

Various federal agencies may sell or lease property assigned to the agency to IRC § 501(c)(3) organizations.

42 USC § 1472

The Secretary of Agriculture is authorized to make loans for low-income farm housing through the Farm Home Administration. In order to prepay the loan, the borrower must make a binding commitment to extend the low-income use of the property for a period of time. If this does not happen, the borrower is generally required to sell the property to a qualified nonprofit charitable organization.

44 USC § 318

The Public Printer may transfer or donate surplus publications and condemned Government Printing Office machinery, material, equipment, and supplies to IRC §§ 501(c)(3) and (c)(4) organizations.

46 USC Appx § 1158

The Secretary of Transportation may convey the government's right, title, and interest in an obsolete vessel of the National Defense Reserve Fleet to an IRC § 501(c)(3) organization.

## **Eligible to Participate in a Program (i.e., Receive Assistance)**

### 7 USC § 1726b

The administrator for the Agency for International Development may provide grants to IRC § 501(c)(3) organizations for the preparation of shelf-stable prepackaged foods and the establishment and maintenance of food stockpiles in the United States. The administrator may also provide grants to private volunteer organizations and international organizations for the rapid transportation, delivery, and distribution of shelf-stable prepackaged foods to individuals in foreign countries.

### 7 USC § 2008o

IRC § 501(c)(3) organizations are eligible for federal grants for activities related to historic barn preservation.

### 12 USC §§ 4141-4147

IRC § 501(c)(3) organizations are eligible for grants for projects relating to acquiring, rehabilitating, and managing rental or cooperative housing for low and moderate-income people.

### 15 USC § 656

Under the Women's Business Center Program, financial assistance is available to IRC § 501(c) organizations for projects addressing the concerns of small businesses owned and controlled by women.

### 15 USC § 1511d

IRC § 501(c) organizations are eligible for assistance under the Chesapeake Bay Fishery and Habitat Restoration Small Watershed Grants Program.

### 16 USC § 742f

The Secretary of the Interior may enter into cooperative agreements with IRC § 501(c)(3) organizations to implement projects for a refuge relating to such things as habitat maintenance and biological monitoring.

### 16 USC §§ 1447-1447f

Under the Regional Marine Research Program, IRC § 501(c)(3) organizations are eligible for grants from Regional Marine Research Boards.

### 16 USC § 2105

IRC § 501(c)(3) organizations are eligible for matching grants from the Secretary of the Interior for urban and community forestry projects.

### 16 USC §§ 2701- 2708

IRC §§ 501(c)(3) and (c)(4) organizations are eligible for financing for the development of small hydroelectric power projects in connection with existing dams that are not being used to generate electric power.

### 16 USC §§ 3451-3460

Under the Resource Conservation and Development Program, IRC § 501(c) organizations are eligible for technical and financial assistance.

16 USC § 3838q

Under the Grassland Reserve Program, the Secretary of Agriculture may transfer a title of ownership to a conservation easement to an IRC § 501(c)(3) organization.

16 USC §§ 5403 and 5406

IRC § 501(c)(3) organizations are eligible for grants under the National Maritime Heritage Program.

19 USC § 3391; 42 USC § 5177a

The Secretary of Agriculture may, if he or she determines that the implementation of the NAFTA Agreement or an emergency or disaster has caused low-income migrant or seasonal farmworkers to lose income, provide grants to IRC § 501(c)(3) organizations with experience in providing emergency services to these individuals.

20 USC § 1070 Note

Under the Community Scholarship Mobilization Act, IRC § 501(c)(3) organizations may receive an endowment grant for projects to improve graduation rates and postsecondary attendance in high-poverty areas.

20 USC § 1128a

The Secretary of Education may make grants to an American overseas research center that is a consortium of institutions of higher education in order to enable the center to promote postgraduate research, exchanges, and area studies. The center must be an IRC § 501(c)(3) organization.

20 USC § 1135

The Secretary of Education makes grants to academic departments and programs that provide courses of study leading to a graduate degree so that the institutions may provide assistance to graduate students. As part of this, higher education institutions that grant graduate degrees may submit joint proposals with certain IRC § 501(c)(3) non-degree granting institutions.

20 USC §§ 5502 and 5505

Under the National Environmental Education Program, IRC § 501(c)(3) organizations are eligible for grants for projects to design and demonstrate practices, methods, and techniques related to environmental education and training.

21 USC §§ 1531-1535

IRC § 501(c)(3) organizations are eligible for assistance under the Drug-Free Communities Support Program.

25 USC §§ 2206, 3662, and 3663

IRC § 501(c)(3) organizations are eligible for grants to provide civil and criminal legal assistance to Indians tribes, organizations, and individuals, and for other projects, such as developing tribal probate codes and providing estate planning services.

29 USC §§ 701-718

Under the Rehabilitation Act, community rehabilitation programs that assist disabled individuals with employment and are carried out by IRC § 501(c)(3) organizations are eligible for assistance.

29 USC §§ 2701-2706

Under the Workers Technology Skill Development Act, IRC §§ 501(c)(3), (c)(4) and (c)(5) organizations are eligible for grants for projects related to identifying and developing advanced workplace practices and technologies.

36 USC §§ 152601-152611

The Help America Vote Foundation may provide assistance to IRC § 501(c)(3) charitable and educational organizations to encourage student involvement in the voting process.

42 USC §§ 1395eee and 1396u-4

Under the Social Security Act, PACE providers must be IRC § 501(c)(3) organizations.

42 USC § 1485

IRC §§ 501(c)(3) and (c)(4) organizations are eligible for grants for projects dealing with housing for the elderly, the disabled, and low and medium-income families in rural areas.

42 USC §§ 1760 and 1784

For purposes of the school lunch programs and child nutrition provisions, “school” includes IRC § 501(c)(3) private schools and private residential child care institutions.

42 USC § 5197h

IRC § 501(c)(3) organizations are eligible for grants for projects addressing the status of emergency preparedness and disaster response awareness in minority communities.

42 USC § 5306 Note

Certain states must make available a portion of the amount allocated for the state under section 106(d) of the Housing and Community Development Act of 1974 to IRC § 501(c) organizations for activities designed to meet the water, sewage, and housing needs of the residents of colonias.

42 USC § 5601 et seq.

IRC § 501(c)(3) organizations are eligible for grants for a variety of purposes relating to juvenile delinquency prevention and services for runaway and homeless youth. Additionally, surplus federal facilities may be leased to IRC § 501(c)(3) organizations for use as homeless or transitional youth centers.

42 USC §§ 6371-6371j and 6372-6732i

IRC §§ 501(c)(3) and (c)(4) organizations are eligible for grants for projects identifying energy and cost savings that would come from building modification or maintenance, including the installation of energy conservation measures.

42 USC § 8013

IRC § 501(c)(3) organizations are eligible for assistance to expand the supply of supportive housing available for people with disabilities.

42 USC § 9660

IRC § 501(c)(3) organizations are eligible for grants for projects intended to develop and evaluate alternative or innovative health treatment technologies.

42 USC § 9926

IRC §§ 501(c)(3) and (c)(4) organizations are eligible for grants to provide technical and financial assistance to private employers to assist them in creating employment and business opportunities for certain individuals.

42 USC §§ 10701-10713

The State Justice Institute may provide grants to nonprofit organizations for projects to develop improved judicial administration in state courts.

## California

### Exempt From a Provision of Law

Cal. Bus. and Prof. Code § 4980.01

The provisions regulating marriage, family, and child counselors do not apply to an employee of a nonprofit charitable institution.

Cal. Bus. and Prof. Code § 7522

The provisions requiring licensing and registration for private investigators do not apply to a charitable philanthropic society or association that is organized and maintained for the public good and not for private profit.

Cal. Bus. and Prof. Code § 7582.2

The provisions requiring licensing and registration for private security services do not apply to a charitable philanthropic society or association that is organized and maintained for the public good and not for private profit.

Cal. Bus. and Prof. Code § 16100

While a town may impose license fees on the business activities it may regulate, no fee that is measured by the licensee's income or gross receipts can be imposed on a nonprofit organization that is exempt from tax under state or federal law.

Cal. Bus. and Prof. Code § 17500.3

The general rule is that it is unlawful to solicit a sale of goods or services at the residence of a prospective buyer, whether in person or by telephone, without expressly revealing that the purpose of the contact is to effect a sale. This rule does not apply to nonprofit charitable organizations.

Cal. Bus. and Prof. Code § 17510.3

Under the rules regarding solicitation for charitable purposes, if an organization making the solicitation represents a non-governmental organization with a name that includes "veteran" or "veterans" so that it would be reasonable to think the organization is composed of veterans, then the solicitor must give the total number of members in the organization. This rule does not apply to a community-based organization that provides direct services to veterans and their families and qualifies as an IRC § 501(c)(3) or 501(c)(19) organization. Also, no disclosure requirement applies to a volunteer who is under age 18 and receives no compensation of any type from a solicitation by an IRC § 501(c)(3) organization.

Cal. Bus. and Prof. Code § 17911

The chapter on fictitious business names does not apply to a nonprofit corporation or association.

Cal. Bus. and Prof. Code § 21662

Provisions regulating swap meets and open air markets do not apply to an event held less than three times a year that is organized for the exclusive benefit of a religious, educational, or charitable organization, if no part of the earnings inures to the benefit of a private shareholder or person participating in the organization or event.

Cal. Civil Code § 1742.6

Charitable organizations may be exempted from the disclosure requirements that arise for art dealers who are conducting a sale or auction of fine art.

Cal. Civil Code § 1789.12

For purposes of regulating credit service organizations, the term “credit service organization” does not include IRC § 501(c)(3) organizations that are not private foundations.

Cal. Civil Code § 1812.67

The provisions regulating contracts for dance studio lessons do not apply to IRC § 501(c)(3) organizations that receive funds from the California Arts Council.

Cal. Civil Code § 1812.300

The provisions regulating membership camping contracts do not apply to IRC § 501(c)(3) organizations.

Cal. Corp. Code § 25100

Securities exempt from registration requirements include those of an issuer organized exclusively for educational, benevolent, fraternal, religious, charitable, social, or reformatory purposes and not for pecuniary profit, if no part of the net earnings of the issuer inures to the benefit of a private shareholder or individual. The exemption does not apply if the promoter intends to make a profit. Also exempt from the requirements are “life income contracts” that are issued by an issuer organized exclusively for educational, benevolent, fraternal, religious, charitable, social, or reformatory purposes.

Cal. Corp. Code § 25102

Securities transactions exempt from registration requirements include sales of securities made to qualified purchasers. Qualified purchasers include IRC § 501(c)(3) organizations. Also exempt is the offer or sale of a viatical or life settlement contract if issued by an IRC § 501(c)(3) organization.

Cal. Financial Code § 3372

For an individual who is an executive officer of a bank or a director or executive officer of a company, the company is deemed to be a related interest of that individual for certain sections of Regulation O. However, this rule does not apply to an extension of credit by a bank to a nonprofit company engaged in religious, charitable, educational, scientific, literary, social, or recreational purposes, so long as the individual does not receive compensation in excess of \$1,000 per year for serving as director or executive officer.

Cal. Financial Code § 12104

For the provisions regulating check sellers, bill payers, and proraters, nonprofit community service organizations are exempt from requirements imposed on proraters.

Cal. Food and Ag. Code § 62093

The giving of any dairy product, service, or article for the purpose of securing or retaining the market milk business of a customer is an unlawful trade practice. This rule does not apply if the donee is a bona fide charity.

Cal. Health and Safety Code § 18897

For the provisions regulating organized camps, the term “organized camp” does not include a charitable or recreational organization that complies with the rules and regulations for recreational trailer parks.

Cal. Insurance Code § 14022

The Insurance Adjusters Act does not apply to nonprofit charitable organizations.

Cal. Insurance Code § 15008

The Public Insurance Adjusters Act does not apply to nonprofit charitable organizations.

Cal. Labor Code §§ 1308 and 1308.2

Charitable corporations are exempt from the registration requirement that arises when employing minors under the age of 16 in door-to-door sales.

Cal. Labor Code § 1720.4

Under the provisions regulating public works, the term “public works” does not include work performed by a volunteer performing services for an IRC § 501(c)(3) organization.

Cal. Labor Code § 2051

In the provisions regulating car washes, the term “employer” does not include any charitable, youth, service, veteran, or sports organization that conducts car washing on an intermittent basis to raise funds for charitable, education, or religious purposes.

Cal. Penal Code § 186.22a

A building or place used by members of a criminal street gang for the purpose of the commission of a crime is a nuisance that will be enjoined and abated. However, no nonprofit or charitable organization that is conducting its affairs with ordinary care or skill will be abated.

Cal. Public Utilities Code § 5353

The provisions regulating charter-party carriers of passengers do not apply to transportation services provided by an IRC § 501(c)(3) organization that are incidental to the operation of a youth camp.

Cal. Vehicle Code § 286

For purposes of regulating vehicle dealers, the term “dealer” does not include IRC § 501(c)(3) organizations that sell donated vehicles.



## **Special Rules**

Cal. Bus. and Prof. Code § 5442.13

Notwithstanding other provisions of law, an IRC § 501(c)(3) educational academy may have an advertising display in Los Angeles.

Cal. Bus. and Prof. Code § 6072

A contract with the state for legal services that exceeds \$50,000 must include a certification that the law firm agrees to make a good faith effort to provide, during the duration of the contract, a minimum number of hours of pro bono legal services. Pro bono legal services include services to charitable, religious, civic, community, governmental, and educational organizations to address the economic, health, and social needs of persons who are indigent or of limited means.

Cal. Bus. and Prof. Code § 23357.3

A beer manufacturer may conduct beer tastings off its premises if the event is sponsored by a nonprofit organization and the people attending the event are affiliated with the sponsor.

Cal. Bus. and Prof. Code § 23363.2

A distilled spirits manufacturer not licensed in California may designate a California licensee to conduct tastings of distilled spirits off the licensee's premises if the event is sponsored by a nonprofit organization and the people attending the event are affiliated with the sponsor.

Cal. Bus. and Prof. Code § 23396.2

A wine, food and art cultural museum in Napa County that is operated by an IRC § 501(c)(3) organization is eligible for a general license to sell wine and food.

Cal. Bus. and Prof. Code § 24045.1

A temporary on-sale general license may be issued to an organization formed for a specific charitable or civic purpose for the sale of distilled spirits, wine, and beer for consumption on the premises where sold.

Cal. Bus. and Prof. Code § 24045.4

Special temporary off-sale general licenses are available to IRC § 501(c)(3) nonprofit corporations to sell donated alcoholic beverages at auction.

Cal. Bus. and Prof. Code § 24045.6

Special temporary on-sale or off-sale wine licenses are available to IRC §§ 501(c)(3) and 501(c)(6) corporations.

Cal. Bus. and Prof. Code § 24045.7

Special on-sale alcoholic licenses are available to IRC § 501(c)(3) theater companies.

Cal. Bus. and Prof. Code § 24045.85

Special on-sale alcoholic licenses are available to IRC § 501(c)(3) symphony associations.

Cal. Bus. and Prof. Code § 24045.14

On-sale general alcohol licenses may be granted to IRC § 501(c)(3) maritime museum associations.

Cal. Bus. and Prof. Code § 24045.16

An IRC § 501(c)(3) charitable arts trust that meets specific requirements is eligible for an on-sale public eating place license.

Cal. Civil Code § 815.3

IRC § 501(c)(3) organizations with environmental purposes are eligible to hold conservation easements.

Cal. Civil Code § 1714.25

A nonprofit charitable organization or food bank that receives and distributes food without charge that is fit for human consumption at the time it was distributed is not liable for any injury or death due to the food unless the injury or death is a direct result of the negligent, reckless, or intentional misconduct of the organization.

Cal. Corp. Code §§ 5047.5 and 24001.5

In general, no cause of action for monetary damages arises against a person serving without compensation as a director or officer of a nonprofit corporation on account of any negligent act or omission occurring within the scope of that person's duties if the person was acting in good faith, in a manner that the person believed to be in the best interest of the corporation, and in the exercise of his or her policymaking judgment. These sections only apply to IRC §§ 501(c)(3) and 501(c)(6) organizations.

Cal. Corp. Code § 5239

In general, a volunteer director or executive officer of a nonprofit corporation is not liable for injuries caused by the person's negligent act or omission so long as the act or omission was within the scope of the person's duties, was performed in good faith, and was not reckless, wanton, intentional, or grossly negligent. The damages caused by the act or omission must be covered pursuant to a liability insurance policy or the organization must show it made a good faith effort to get the insurance.

Cal. Fish and Game Code § 7151

IRC § 501(c)(3) organizations may receive a free sportfishing licence.

Cal. Education Code § 51520

During school hours, and within one hour before and after school, pupils at a public school may not be solicited on school premises to subscribe or contribute to, to become members of, or to work for any organization not under the control of school authorities. This rule does not apply if the organization is a nonpartisan charitable organization organized by an act of Congress or under the laws of the state, the purpose of the solicitation is nonpartisan and charitable, and the solicitation has been approved by school authorities.

Cal. Education Code § 69982

Under the Golden State Scholarships Trust Act, contributions by IRC § 501(c)(3) organizations operating scholarship programs for the benefit of beneficiaries to be named when the scholarships are awarded are not subject to maximum contribution limits.

Cal. Gov. Code §§ 831.2, 831.25, 831.4, 831.5, and 831.7

IRC § 501(c)(3) land trusts that preserve open space or increase opportunities for the public to enjoy access to and the use of natural resources are limited in their potential liability for injuries occurring on their property.

Cal. Gov. Code §§ 53075.6 and 53075.61; Cal. Public Utilities Code § 5411.5  
Peace officer and public employees may impound taxicabs that do not have proper permits or are otherwise in violation of the law. However, a vehicle owned or operated by an IRC § 501(c)(3) organization that serves youth or senior citizens and provides transportation incidental to its programs or services may not be impounded.

Cal. Insurance Code § 10270.2

Blanket insurance includes a policy issued to a religious, charitable, recreational, educational, athletic or civic organization that provides benefits to members, employees, or participants for death or dismemberment or for hospital, medical, surgical, or nursing expenses resulting from activities sponsored or supervised by the organization.

Cal. Insurance Code § 11580.1

No policy of automobile liability insurance may be issued, amended, or renewed if it excludes from coverage the operation of an insured motor vehicle by the named insured in the performance of volunteer social service transportation for a nonprofit charitable organization. Also, no policy of insurance may be canceled by an insurer solely because the named insured is performing these volunteer services.

Cal. Insurance Code §§ 11580.2 and 11580.25

No motor vehicle will be classified as a common carrier, livery, or for-hire vehicle solely because the named insured is performing volunteer social service transportation for a nonprofit charitable organization.

Cal. Military and Veterans Code § 999.51

IRC § 501(c)(3) veterans' service agencies are eligible for certification as a small business under the Small Business Procurement and Contract Act.

Cal. Probate Code § 2104

A nonprofit charitable corporation may be appointed as a guardian or conservator of a person or estate.

Cal. Probate Code § 15604

An IRC § 501(c)(3) charitable corporation may be appointed as trustee of a trust.

Cal. Public Resources Code § 41904

A city, county, district, or regional agency may structure its fees for solid waste handling or disposal services so that charitable reusers are exempt or pay reduced fees. Charitable reusers are IRC § 501(c)(3) organizations that reuse and recycle donated goods or materials and receive more than 50 percent of their revenues from the handling and sale of those donated goods or materials.

Cal. Public Utilities Code § 530

Common carriers may transport persons for charitable purposes for free or at reduced rates.

Cal. Vehicle Code § 5060

IRC § 501(c)(3) organizations may apply to participate in the special interest license plate program.

## **Eligible to Receive Property or Non-Grant Money**

Cal. Civil Code § 987

Artists have a cause of action for the physical alteration or destruction of their works of fine art. If punitive damages are awarded, the court will donate the punitive damages to a charitable or educational fine arts organization.

Cal. Education Code §§ 17546, 60510, and 81452

School property may be donated to charitable organizations if it is of insufficient value to defray the costs of arranging a sale.

Cal. Education Code § 38134

School facilities and grounds may be used by nonprofit organizations and clubs or associations organized to promote youth and school activities.

Cal. Fish and Game Code § 1002

Fishing permits may be granted to a student who is regularly enrolled in a commercial fishing class and to the class's faculty. All the fish taken must be either sold to a person licensed to receive fish from commercial fishermen or donated to a charitable institution.

Cal. Fish and Game Code § 12161

Birds, mammals, fish, reptiles, or amphibia that are seized due to illegal activity may be donated to a charitable institution if the animal is worth less than \$100.

Cal. Fish and Game Code § 12162

If a seizure of birds, mammals, fish, reptiles, or amphibia occurs and it cannot be determined who took, possessed, sold, imported, or transported them contrary to law, then the animals may be sold or donated to a charitable institution.

Cal. Fish and Game Code § 12164

Any bird or mammal confiscated from a person convicted of trespassing may be donated to a charitable institution.

Cal. Food and Ag. Code § 450.40

Avocados in the state's custody may be donated to nonprofit charitable organizations.

Cal. Food and Ag. Code § 884

Perishable food in the state's custody may be donated to nonprofit charitable organizations.

Cal. Food and Ag. Code §§ 58887 and 59807

With respect to marketing orders, any portion of a surplus pool may be donated to a charitable organization under proper safeguards to insure that none of the commodity will compete with the unrestricted portion of the commodity.

Cal. Gov. Code §§ 1151, 1157.2, and 21265

State employees and retirees may authorize deductions to be made from their wages or retirement payments for charitable contributions.

Cal. Gov. Code §§ 3515.7, 3502.5, 3546.3, 3584, and 71814; Public Utilities Code § 99566.2

Employees with religious objections to supporting employee organizations may be required to pay an amount equal to the organization's fees to a charitable organization.

Cal. Gov. Code § 25372

A county may donate or lease any surplus real or personal property to IRC § 501(c)(3) organizations.

Cal. Gov. Code § 51075

IRC § 501(c)(3) organizations are eligible to hold conservation easements under the Open-Space Easement Act.

Cal. Penal Code § 502.01

Property that was forfeited because it was used in committing telecommunications or computer crimes may be distributed to nonprofit charitable organizations.

Cal. Street and Highways Code § 118.7

The state may transfer environmental mitigation property located within the city limits of Huntington Beach to an IRC § 501(c)(3) organization that is organized for conservation purposes.

### **Eligible to Participate in a Program (i.e., Receive Assistance)**

Cal. Education Code § 8448

IRC § 501(c)(3) organizations are eligible for grants under the Child Care and Development Services Act.

Cal. Education Code § 13020

IRC § 501(c)(3) organizations are eligible for grants under the California Civil Liberties Public Education Grant Program.

Cal. Education Code § 20052

IRC § 501(c)(3) organizations are eligible for grants under the California Cultural and Historical Endowment Act.

Cal. Education Code § 56404

IRC § 501(c)(3) organizations are eligible to receive funding to establish Family Empowerment Centers on Disability.

Cal. Fish and Game Code § 1390

IRC § 501(c)(3) organizations are eligible for grants under the California Riparian Habitat Conservation Program.

Cal. Gov. Code § 66905.9

IRC § 501(c)(3) organizations are eligible for grants from the California Tahoe Conservancy.

Cal. Gov. Code § 68058

IRC § 501(c)(3) organizations are eligible for grants under the Fresno Metropolitan Projects Act.

Cal. Gov. Code § 95502

IRC § 501(c)(3) organizations are eligible for contracts as nonprofit facilitators under the California Savings and Asset Project.

Cal. Health and Safety Code §§ 33741, 34377, 52100, and 52101

Multifamily rental housing bonds may be issued to provide loans to IRC § 501(c)(3) organizations to finance the acquisition, construction, rehabilitation, refinancing, or development of multifamily rental housing.

Cal. Health and Safety Code § 50650.5

Mutual housing developments owned and operated by IRC § 501(c)(3) organizations are eligible for financial assistance under the CALHome Program.

Cal. Health and Safety Code § 50781

IRC § 501(c)(3) organizations are eligible for assistance from the Mobilehome Park Purchase Fund.

Cal. Health and Safety Code § 50836

The California Housing Insurance Fund may use its resources to assist IRC § 501(c)(3) corporations, redevelopment agencies, local finance agencies, and certain for-profit corporations.

Cal. Health and Safety Code § 50843

IRC § 501(c)(3) organizations are eligible for matching grants under the Local Housing Trust Fund Matching Grant Program.

Cal. Health and Safety Code § 129010

IRC § 501(c)(3) organizations may participate in the Health Facility Construction Loan Insurance Program.

Cal. Health and Safety Code § 130200

IRC § 501(c)(3) organizations are eligible for a state contract to establish a Parkinson's Disease Community Outreach, Diagnosis, and Treatment Project.

Cal. Penal Code § 4024.2

IRC § 501(c)(3) organizations are eligible to participate in prison work release programs.

Cal. Penal Code § 13825.4

Community-based organizations and nonprofit agencies may receive funding under the California Gang, Crime, and Violence Prevention Partnership Program.

Cal. Public Resources Code § 5004.5

IRC § 501(c)(3) community-based organizations are eligible for grants under the California Youth Soccer and Recreation Development Program.

Cal. Public Resources Code § 5079.01

IRC § 501(c)(3) organizations are eligible for grants from the California Heritage Fund.

Cal. Public Resources Code § 5095.5

IRC § 501(c)(3) organizations are eligible for grants under the State Urban Parks and Healthy Communities Act.

Cal. Public Resources Code § 5096.348

IRC § 501(c)(3) youth service organizations are eligible for grants under the Murray-Hayden Urban Parks and Youth Service Program.

Cal. Public Resources Code § 5096.605

IRC § 501(c)(3) public benefit corporations are eligible for grants under the California Clean Water, Clean Air, Safe Neighborhood Parks, and Coastal Protection Act.

Cal. Public Resources Code § 5642

IRC § 501(c)(3) public benefit corporations are eligible for grants under the Urban Park Act.

Cal. Public Resources Code § 5752

IRC § 501(c)(3) organizations are eligible for grants under the California River Parkways Act.

Cal. Public Resources Code § 5902

IRC § 501(c)(3) organizations are eligible for grants under the California Wildlife, Coastal, and Park Land Conservation Act.

Cal. Public Resources Code § 10221

IRC § 501(c)(3) organizations are eligible to participate in the Agricultural Land Stewardship Program.

Cal. Public Resources Code § 10280.5

IRC § 501(c)(3) organizations are eligible for grants under the Agricultural Protection Planning Grant Program.

Cal. Public Resources Code § 25411

IRC §§ 501(c)(3) and (c)(4) organizations are eligible for energy conservation assistance.

Cal. Public Resources Code § 30910

IRC §§ 501(c)(3), (c)(4), and (c)(5) organizations are eligible for grants under the Watershed, Clean Beaches, and Water Quality Act.

Cal. Public Resources Code §§ 31013 and 31402.3

IRC § 501(c)(3) organizations are eligible for grants from the State Coastal Conservancy Fund.

Cal. Public Resources Code § 32504

IRC § 501(c)(3) organizations are eligible for grants from the San Joaquin River Conservancy.

Cal. Public Resources Code § 32553

IRC § 510(c)(3) organizations are eligible for grants from the Baldwin Hills Conservancy.

Cal. Public Resources Code § 32632

IRC § 501(c)(3) organizations are eligible for grants from the San Diego River Conservancy.

Cal. Public Resources Code § 33204.2

IRC § 501(c)(3) organizations are eligible for grants from the Santa Monica Mountains Conservancy.

Cal. Public Resources Code § 33302

IRC § 501(c)(3) organizations are eligible for grants from the Sierra Nevada Conservancy.

Cal. Public Resources Code § 33601

IRC § 501(c)(3) organizations are eligible for grants from the Coachella Valley Mountains Conservancy.

Cal. Public Utilities Code § 280.5

IRC § 501(c)(3) organizations are eligible for grants to fund community technology programs under the Digital Divide Grant Program.

Cal. Public Utilities Code § 884

IRC § 501(c)(3) organizations that work to bring technology to areas with limited or no access may receive grants under the Nonprofit Community Technology Program.

Cal. Unemployment Insurance Code § 14004

IRC § 501(c)(3) organizations are eligible for funding under the California Community and Faith Based Initiative.

Cal. Water Code § 79078

IRC §§ 501(c)(3) and 501(c)(5) organizations are eligible for grants under the Watershed Protection Program.

Cal. Water Code § 79148.2

IRC §§ 501(c)(3) and 501(c)(5) organizations are eligible for grants under the Coastal Nonpoint Source Control Program.

Cal. Water Code § 79505

IRC § 501(c)(3) organizations are eligible for grants to participate in the CALFED Bay-Delta Program (environmental program for the San Francisco Bay/Sacramento-San Joaquin Delta Estuary ecosystem).

Cal. Welfare and Institutions Code § 14088.18

Under the Primary Care Provider Case Management Program, IRC §§ 501(c)(3) and 501(c)(25)(c)(iii) organizations that provide health care to the medically underserved are eligible for a one-time interest-bearing loan, repayable at the Pooled Money Investment Account rate.

Cal. Welfare and Institutions Code § 18238

IRC § 501(c)(3) organizations that provide self-employment training, technical assistance, and access to microloans to individuals seeking to become self-employed are eligible to participate in the Microenterprise Demonstration Project.

## **Florida**

### **Exempt From a Provision of Law**

Fla. Stat. § 316.615

A bus operated by an IRC § 501(c)(3) organization is exempt from the color, pupil-warning-lamp-system, stop-arm, and crossing-arm requirements for school buses if the bus does not pick up pupils from home or deliver pupils to home and the bus is not operated by or under the purview of the state or a political subdivision.



Fla. Stat. § 316.2045

It is unlawful, without proper authorization or a lawful permit, for any person to willfully obstruct the free, convenient, and normal use of a public street, highway, or road in order to solicit. This rule does not apply to IRC § 501(c)(3) organizations for activities on streets or roads not maintained by the state.

Fla. Stat. § 320.64

A motor vehicle license can be suspended or revoked if the licensee sells a vehicle to a retail consumer except through a motor vehicle dealer holding a franchise agreement for the vehicle's line-make. This rule does not apply if the buyer is a charitable nonprofit organization.

Fla. Stat. § 468.383

The provisions regulating auctioneers do not apply to auctions conducted by charitable, civic, and religious organizations.

Fla. Stat. § 475.011

Provisions regulating real estate brokers and sales associates do not apply to a trustee for a trust with a charitable or philanthropic purpose.

Fla. Stat. § 479.16

Outdoor signs owned by and related to the facilities and activities of churches and civic, fraternal and charitable organizations may be exempt from the requirement to obtain a permit.

Fla. Stat. § 484.059

The licensing requirements that apply to the fitting and dispensing of hearing aids do not apply to any person engaged in recommending hearing aids as part of a program conducted by a public charitable institution supported primarily by voluntary contributions, so long as the organization does not dispense or sell hearing aids or accessories.

Fla. Stat. § 489.503

The provisions regulating electrical and alarm system contracting do not apply to the monitoring of a personal emergency response system by a charitable corporation acting in accordance with a contractual agreement with the state so long as the organization does not perform any other service requiring certification or registration.

Fla. Stat. § 499.012

Under the provisions regulating the wholesale distribution of prescription drugs, the term "wholesale distribution" does not include, to the extent otherwise permitted by law, the sale, purchase, or trade of a prescription drug by an IRC § 501(c)(3) charitable organization to a nonprofit affiliate of the organization, or the donation of a prescription drug by a health care entity to an IRC § 501(c)(3) organization that is authorized to possess prescription drugs.

Fla. Stat. § 501.022

In provisions regulating home solicitation sales, the permit requirement does not apply to solicitors, salespersons, or agents making calls or soliciting orders on behalf of religious, charitable, scientific, educational and veterans' organizations that are exempt from the state sales tax.

Fla. Stat. § 501.059

In general, a telephone solicitor or person who offers for sale any consumer information that includes telephone numbers must screen and exclude those numbers which appear on the do-not-call list. This rule does not apply to directory assistance and telephone directories sold by telephone companies or IRC § 501(c)(3) organizations.

Fla. Stat. § 501.604

The Florida Telemarketing Act generally does not apply to a person soliciting for religious, charitable, political, or educational purposes. A person soliciting for other noncommercial purposes is exempt only if that person is soliciting for a nonprofit IRC § 501(c)(3) or (6) corporation.

Fla. Stat. § 517.051

Securities are exempt from the registration requirement if issued by a corporation organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, if no part of its net earnings inures to the benefit of a private stockholder or individual.

Fla. Stat. § 538.03

The provisions regulating secondhand dealers do not apply to secondhand goods transactions involving a religious or charitable organization, other than a secondary metals recycler.

Fla. Stat. § 538.22

The provisions regulating secondary metals recyclers do not apply to purchases of regulated metals property from charitable, philanthropic, religious, fraternal, civic, patriotic, social, and school-sponsored organizations.

Fla. Stat. § 546.006

An amusement ride or amusement attraction that is owned and operated by a nonprofit religious, educational, or charitable organization is generally exempt from the Amusement Ride and Attraction Insurance Act.

Fla. Stat. § 561.501

Organizations exempt under IRC §§ 501(c)(3), (4), (5), (6), (7), (8,) or (19) are exempt from the surcharge on the sale of liquor.

Fla. Stat. § 689.19

Reverter and forfeiture provisions of unlimited duration in the conveyance of real estate are deemed an unreasonable restraint on alienation and contrary to public policy. This rule does not apply to conveyances made to educational, literary, scientific, religious, public utility, public transportation, and charitable organizations.

Fla. Stat. § 689.225

The rule against perpetuities does not apply to a nonvested property interest held by a charity if the interest is preceded by an interest held by another charity, government, or governmental agency or subdivision.

Fla. Stat. § 817.7001

For purposes of regulating credit service organizations, the term “credit service organization” does not include IRC § 501(c)(3) organizations.

Fla. Stat. § 849.0931

Under the bingo rules, IRC § 501(c) organizations that are engaged in charitable, civic, community, benevolent, religious, or scholastic works or other similar activities may conduct bingo games without having to return all the money in the form of prizes. If a game is conducted by a condominium association, cooperative association, homeowners' association, or mobile home owners' association and there are net proceeds remaining, then the proceeds may be donated to an IRC § 501(c) organization.

Fla. Stat. § 849.094

Operators of game promotions (e.g., a contest, game of chance or gift enterprise that is conducted with the sale of consumer products or services and in which the elements of chance and prize are present) are prohibited from certain activities. The term “operator” does not include a charitable nonprofit organization.

Fla. Stat. § 849.0935

Organizations described in IRC §§ 501(c)(3), (4), (7), (8), (10), and (19) are exempt from criminal statutes that prohibit conducting drawings by chance.

## **Special Rules**

Fla. Stat. § 155.40

If a county, district, or municipal hospital is sold or leased to a nonprofit Florida corporation or enters into a lease with a nonprofit Florida corporation for purposes of operating the hospital, one of the terms of the contract must be that the nonprofit entity is an IRC § 501(c)(3) organization.

Fla. Stat. §§ 253.025 and 259.041

Appraisal reports dealing with the acquisition of state lands are confidential for a period of time. However, the reports may be disclosed to IRC § 501(c)(3) environmental organizations when joint acquisition of the property is contemplated or when the organization enters into a written agreement with the state to purchase and hold the property for subsequent resale to the state. Additionally, the state may use appraisals obtained by an IRC § 501(c)(3) organization.

Fla. Stat § 255.60

The state or a political subdivision may contract for public services work outside the competitive bidding process rules if the contractor or supplier is an IRC § 501(c)(3) organization that is organized as a charitable youth organization for at-risk youths enrolled in a work-study program.

Fla. Stat. § 259.101

Under the Florida Preservation 2000 Act, certain criteria must be considered for evaluating whether the state should acquire coastal lands. These include the value of acquiring coastal high-hazard parcels; the value of acquiring beachfront parcels to provide public access and recreational opportunities in highly developed urban areas; and the value of acquiring parcels whose development would adversely affect coastal resources. When an IRC § 501(c)(3) environmental organization sells land to the state, such land is deemed to meet the criteria if the land had met one or more of the criteria at the time the organization purchased it.

Fla. Stat. § 316.72

An educational, recreational, religious, or charitable organization may own, operate, rent, or lease a bus with features that normally characterize a school bus so long as it is consistent with other provisions of law.

Fla. Stat. § 376.3072

An owner or operator of a petroleum storage system may be insured under the Florida Petroleum Liability and Restoration Insurance Program. If the owner is a charitable institution and the application was filed before January 1, 1995, then the owner is eligible for \$300,000 of restoration costs, less a deductible.

Fla. Stat. § 376.82.

An IRC § 501(c)(3) national land conservation corporation that purchases title to property for the purpose of conveying it to a governmental entity for conservation, historical preservation, park or similar purposes is not liable for penalties or remediation costs in connection with environmental contamination found in the soil or groundwater of the property. This rule does not apply if the corporation caused the original deposit or release of the environmental contaminants, or if the organization does not provide the state and local pollution control program access to the land for investigation, remediation, or monitoring purposes.

Fla. Stat. § 386.203

For purposes of state law limiting indoor smoking in the workplace, the term “enclosed indoor workplace” does not include any facility owned or leased by organizations described in IRC §§ 501(c)(3), (4), (7), (8), (10), (19) and 501(d) so long as the facility is used exclusively for noncommercial activities performed by members and their guests.

Fla. Stat. § 393.15.

The general rule is that any loan granted by the Community Resources Development Trust fund must be repaid within 5 years. A program that operates as an IRC § 501(c)(3) corporation and wishes to seek forgiveness of its loan may submit a statement and, if the statement is approved, the state will forgive 20% of the loan's principal granted after June 30, 1975.

Fla. Stat. § 403.706

Under the provisions addressing local governments’ solid waste responsibilities, counties and municipalities may grant a solid waste fee waiver to nonprofit organizations engaged in the collection of donated goods for charitable purposes that have a recycling or reuse rate of at least 50%.

Fla. Stat. Chapter 406

Charitable organizations may claim dead bodies.

Fla. Stat. §§ 413.032-413.037

Under the Blind Services Program, qualified nonprofit agencies that employ blind or disabled individuals are generally preferred sources for state procurement.

Fla. Stat. §§ 455.214, 456.015, 458.3124, 458.317, 459.0075, and 464.0205; Fla. Stat. § 497.143 (effective October 1, 2005)

Florida has various statutes that allow retired individuals to obtain a limited license to provide services in his or her prior profession. The general rule is that the recipient may

practice only in the employ of public agencies or institutions or IRC § 501(c)(3) organizations, and provide services only to the indigent, underserved, or critical-need populations within the state.

Fla. Stat. § 496.419

IRC § 501(c)(3) organizations are subject to a lesser fine for violating the rules regulating the solicitation of funds.

Fla. Stat. § 550.70

The chapter regulating certain games does not prohibit any fronton, jai alai plant, or facility from being used to conduct amateur jai alai or pelota contests or games by a charitable, civic, or nonprofit organization if only players other than those usually used in jai alai contests or games are permitted to play and if adults and minors may participate as players or spectators.

Fla. Stat. § 561.20

A special alcohol license may be issued to a performing arts center to allow alcohol consumption on its premises so long as the consumption generally occurs only in conjunction with an artistic, educational, cultural, promotional, civic, or charitable event.

Fla. Stat. § 601.50

The Department of Citrus may permit the sale or shipment of citrus fruit without the issuance of an inspection certificate and without the grade being shown on the container if the fruit is to be used for charitable or unemployment relief purposes.

Fla. Stat. § 617.0833

Under the nonprofit corporation laws, loans may generally not be made by a corporation to its directors or officers or to any entity in which its directors or officers is a director or officer or holds a substantial financial interest. This rule does not apply to a loan by an IRC § 501(c)(3) corporation to another IRC § 501(c)(3) corporation.

Fla. Stat. § 617.0834

In general, an officer or director of an IRC § 501(c)(3), (4), (5), or (6) organization is not personally liable for monetary damages for any statement, vote, decision, or failure to take an action regarding organizational management or policy, unless there was a breach of duty.

Fla. Stat. § 626.99287

The general rule is that if a viatical settlement contract is entered into within the 2-year period commencing with the date of issuance of the insurance policy or certificate to be acquired, the contract is void and unenforceable. However, such a contract is not void if the owner of the policy is an IRC § 501(c)(3) charitable organization.

Fla. Stat. § 627.404

An IRC § 501(c)(3) charitable organization may own or purchase life insurance on an insured who consents to the ownership or purchase of that insurance.

Fla. Stat. § 704.06

Conservation easements may be acquired by a charitable corporation or trust whose purposes include protecting the environment or preserving sites or properties of historical, architectural, archaeological, or cultural significance.

Fla. Stat. § 709.08

An IRC § 501(c)(3) charitable or religious organization that has qualified as a court-appointed guardian prior to January 1, 1996, may act as an attorney in fact.

Fla. Stat. § 732.281

Upon the admission to probate of any will in which an educational, religious, or charitable institution is named as a beneficiary, the personal representative must notify the institution by registered mail.

Fla. Stat. § 744.309

A nonprofit corporation organized for religious or charitable purposes may be appointed guardian for a ward.

Fla. Stat. § 768.136

A bona fide charitable or nonprofit organization that accepts, collects, transports, or distributes any canned or perishable food that is apparently fit for human consumption from a good faith donor or gleaner for free distribution is not subject to criminal penalty or civil damages arising from the condition of the food. This rule does not apply if the injury was caused by the gross negligence, recklessness, or intentional misconduct of an agent of the organization.

Fla. Stat. § 817.311

It is a misdemeanor to wear or display a badge, button, insignia or other emblem, or to use the name of or claim to be a member of a benevolent, fraternal, social, humane, or charitable organization if the organization is entitled to the exclusive use of the name and emblem, unless the wearer is entitled to do so.

Fla. Stat. § 1002.33

Charter schools that are operated by IRC § 501(c)(3) corporations are eligible for up to a 10-year charter, subject to approval by the district school board.

Fla. Stat. § 1009.98

Under Florida's prepaid college program, IRC § 501(c)(3) organizations may purchase advance payment contracts for an approved scholarship program.

## **Eligible to Receive Property or Non-Grant Money**

Fla. Stat. § 40.24

The IRC § 501(c)(3) organization specified by the guardian ad litem program is eligible to receive donations of jurors' compensation.

Fla. Stat. § 106.141

Any candidate with surplus funds in his/her campaign account must distribute the funds by returning pro rata contributions to contributors, donating the funds to an IRC § 501(c)(3) organization, or giving limited amounts to political party, state campaign trust fund, general revenue fund of state or local subdivision, or certain office accounts. If the money is given to an office account, any amounts left over may be given to an IRC § 501(c)(3) organization or general revenue fund of the state or a local subdivision.

Fla. Stat. § 110.181

Organizations must have IRC § 501(c)(3) status to participate in Florida State Employee's Charitable Campaign.

Fla. Stat. §§ 273.01 and 273.005

Surplus state-owned tangible personal property may be given to charitable organizations exempt under IRC § 501.

Fla. Stat. § 370.061

Property confiscated for being illegal saltwater products, illegally taken saltwater products, or illegal fishing gear may be given to charitable institutions.

Fla. Stat. § 372.73

Confiscated game and freshwater fish may be given to a hospital or charitable institution.

Fla. Stat. § 550.0351

Charities exempt under the IRC are eligible to receive proceeds from special "charity days" horseracing, dogracing, or jai alai events.

Fla. Stat. § 562.44

Alcoholic beverages and raw materials used for the manufacture of alcoholic beverages that are seized and forfeited under the Beverage Law may be donated to charitable institutions with a legitimate use for the property.

Fla. Stat. § 705.105

Law enforcement agencies may donate unclaimed evidence or unclaimed tangible personal property that was lawfully seized to charitable organizations.

Fla. Stat. § 705.103

Lost or abandoned property on public property may be donated to charitable organizations.

Fla. Stat. § 1006.41

Educational instructional materials that are unserviceable or surplus may be donated to public education programs and to charitable organizations.

### **Eligible to Participate in a Program (i.e., Receive Assistance)**

Fla. Stat. § 68.099

IRC § 501(c)(3) organizations are eligible for state contracts to provide funding for civil legal assistance to the poor.

Fla. Stat. § 159.27

Schools owned by IRC § 501(c)(3) organizations qualify for financing under the Florida Industrial Development Bond Program.

Fla. Stat. § 159.608

IRC § 501(c)(3) organizations are eligible for grants from housing finance authorities.

Fla. Stat. § 163.05

IRC § 501(c)(3) organizations are eligible for state contracts under the Small County Technical Assistance Program.

Fla. Stat. § 163.457

IRC § 501(c)(3) community-based development organizations may seek assistance under the Community Redevelopment Program.

Fla. Stat. § 259.105

IRC § 501(c)(3) environmental organizations are eligible for grants under the Florida Forever Act for the acquisition of community-based projects, urban open spaces, parks, and greenways.

Fla. Stat. §§ 265.603 and 265.606

IRC §§ 501(c)(3) and (c)(4) organizations are eligible for matching funds under the Cultural Endowment Program.

Fla. Stat. § 265.608

IRC § 501(c)(3) science museums are eligible for grants from the Cultural Institutions Trust Fund.

Fla. Stat. § 265.609

IRC § 501(c)(3) youth and children's museums are eligible for grants from the Cultural Institutions Trust Fund.

Fla. Stat. §§ 265.701 and 265.702

IRC §§ 501(c)(3) and (c)(4) corporations are eligible for grants for the acquisition, renovation, and construction of cultural facilities.

Fla. Stat. § 370.25

IRC § 501(c)(3) organizations are eligible for grants under the Artificial Reef Program.

Fla. Stat. § 380.503

IRC § 501(c)(3) organizations are eligible for grants or loans from the Florida Communities Trust.

Fla. Stat. § 413.615

Under the Florida Endowment for Vocational Rehabilitation Act, a corporation, trust, association, or foundation organized and operated exclusively for charitable, educational, or scientific purposes is eligible to receive grants from the endowment fund.

Fla. Stat. § 420.530

The Florida Housing Finance Corporation must contract with an IRC § 501(c)(3) corporation, representing a mix of stakeholders concerned with housing conditions faced by migrant and seasonal farmworkers, in order to establish the State Farmworker Housing Pilot Loan Program.

Fla. Stat. § 420.631

Under the Urban Homesteading Act, IRC § 501(c)(3) organizations may be appointed by a local government to administer the urban homesteading program for single-family housing.

Fla. Stat. § 445.004

IRC §§ 501(c)(3) and (c)(4) organizations are eligible for grants under the First Jobs/First Wages Program to run after-school programs.



Fla. Stat. § 446.609

Under the Jobs for Florida's Graduates Act, the Florida Endowment Foundation may make grants to organizations that are organized and operated exclusively for charitable, educational, or scientific purposes.

Fla. Stat. § 581.185

IRC § 501(c)(3) organizations are eligible for grants to support programs designed to protect and monitor endangered or threatened native flora.

Fla. Stat. § 1004.51

IRC §§ 501(c)(3) and (c)(4) organizations may receive assistance under the Community and Faith-based Organizations Initiative or the Community Library Technology Access Partnership Program.

Fla. Stat. § 1004.52

Under the Community Computer Access Grant Program, IRC §§ 501(c)(3) and (c)(4) organizations are eligible for grants to purchase computers to assist youths living in distressed areas.

## **Massachusetts**

### **Exempt From a Provision of Law**

ALM GL ch. 21E, § 5

An owner of sites or vessels from which there is a release or threat of release of oil or hazardous material is liable for various costs and damages. A charitable corporation that holds a conservation restriction, agricultural preservation restriction, watershed preservation restriction, or affordable housing restriction is not an "owner" if certain qualifications are met.

ALM GL ch. 31, § 48

Superintendents and assistant superintendents of charitable institutions are exempt from civil service rules unless federal standards for a merit system of personnel administration apply.

ALM GL ch. 40, § 57

A city or town may revoke various business licenses or permits if the business has not paid its taxes, fees, etc. However, this rule does not apply to licences for sales of articles for charitable purposes.

ALM Spec L ch. S57, § 3

Under the chapter on rent and eviction control in certain cities and towns, the term "controlled rental units" does not include units in a hospital, convent, monastery, asylum, public institution, or college or school dormitory that is operated exclusively for charitable or educational purposes or to units in a nonprofit nursing home or charitable home for the aged.

ALM GL ch. 55, § 11

The rules prohibiting a person or political committee from soliciting candidates and officeholders from accepting gifts do not apply to the soliciting or making of gifts for charitable or religious purposes.

ALM GL ch. 90, § 1A

Ambulances owned and operated by hospitals or other institutions supported by public or private donations for charitable purposes are exempt from registration requirements.

ALM GL ch. 93, § 14G

Under the Unfair Sales laws, various provisions do not apply to the advertising or offering to sell merchandise that is advertised or offered for sale for charitable purposes or to relief agencies.

ALM GL ch. 93, § 68A

For purposes of regulating credit services organizations, the term “credit service organization” does not include IRC § 501(c)(3) organizations.

ALM GL ch. 93, § 73

No physician or otolaryngologist may sell hearing aids to a person to whom the physician or otolaryngologist has provided services pursuant to section 72, or have a membership, employment, co-ownership, or proprietary interest in or with a business that sells hearing aids to such person. This rule does not apply to a nonprofit charitable organization, clinic, hospital or health care facility.

ALM GL ch. 94A, § 4

The restrictions on buying milk do not apply to a school, hospital, infirmary or similar charitable institution that is wholly supported by federal or state funds.

ALM GL ch. 94A, § 14

The restrictions on distributing and selling milk do not apply to sales to schools, colleges, universities, libraries, churches, hospitals, and charitable institutions.

ALM GL ch. 100, § 11

The provisions regulating auctioneers do not apply to auctions held or conducted by a member of a charitable, educational, religious, or other nonprofit organization.

ALM GL ch. 101, § 15

The provisions regulating hawkers and peddlers do not apply to persons selling articles for charitable purposes.

ALM GL ch. 101, § 16

The sale by hawkers or peddlers of jewelry, furs, wines or spirituous liquors, small artificial flowers or miniature flags is prohibited. However, this rule does not apply to the sale of low-value costume jewelry made by a nonprofit or charitable organization.

ALM GL ch. 110A, § 402

Securities exempted from various registration and filing requirements include securities issued by an issuer organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes, or as a chamber of commerce or trade or professional association.

ALM GL ch. 121A, § 9

The provisions addressing limitations on dividends in urban redevelopment corporations do not apply to charitable corporations so long as all surplus earnings are employed in urban redevelopment projects.

ALM GL ch. 140, § 46A

For the purposes of regulating employment agencies, the term “employment agency” does not include any agency operated by a religious or charitable organization or an accredited educational institution, so long as no part of its earnings inures to the benefit of a private shareholder or individual.

ALM GL ch. 140, § 198

The rules restricting the attendance of individuals under the age of 15 from establishments where dances occur do not apply to a dance given by a charitable or religious society or a public or private school.

ALM GL ch. 140, § 21E

In general, organizations are required to have a license to dispense food and beverages to its stockholders or members and their guests. This requirement does not apply to literary, benevolent, charitable, scientific, and religious corporations.

ALM GL ch. 140, § 54

Charitable organizations do not have to pay the license fee imposed by a city or town on collectors and dealers of junk, old metals, or second hand articles.

ALM GL ch. 140, §§ 181 and 182

The provisions requiring a license for theatrical exhibitions, public shows, public amusements and exhibitions do not apply to exhibitions by religious societies in their usual places of worship that are for a religious or charitable purpose.

ALM GL ch. 143, § 3R

The provision regulating locks in apartment buildings does not apply to dormitories of charitable, educational, and philanthropic institutions.

ALM GL ch. 147, § 23

The provision requiring licenses for persons engaged in a private detective business or the business of a watch, guard or patrol agency does not apply to a charitable, philanthropic or law enforcement agency, so long as the agency is promoted and maintained for the public good and not for private profit.

ALM GL ch. 147, § 39

In general, no contestant younger than 18 or older than 35 may engage in boxing or sparring matches or exhibitions, with exceptions for boxers who are or have been world boxing champions. The prohibition does not apply to matches or exhibitions sponsored and conducted by recognized boys’ clubs, youth organizations, schools or colleges, municipal or state park or recreational departments, or incorporated private nonprofit boxing teams; however, any boxer over age 35 may only participate in matches or exhibitions for fund-raising for charitable organizations.

ALM GL ch. 149, § 1

Under the chapter on labor and industries, the term “employee” does not include, for purposes of the provisions prohibiting wage discrimination based on sex, employees of a social club or a fraternal, charitable, educational, religious, scientific or literary association.

ALM GL ch. 151, § 1A

The section dealing with overtime pay does not apply to a long list of services, including those where employees are employed in a hospital, sanatorium, convalescent or nursing home, infirmary, rest home or charitable home for the aged; in a nonprofit school or college; or in a summer camp operated by a nonprofit charitable corporation.

ALM GL ch. 151, § 2

Under the minimum fair wages provisions, the term “occupation” does not include work by persons being rehabilitated or trained under rehabilitation or training programs in charitable, educational or religious institutions, or work by members of religious orders.

ALM GL ch. 151D, § 7

The chapter regulating health, welfare and retirement funds does not apply to retirement plans established by educational, charitable, or religious organizations.

ALM GL ch. 159, § 15

In general, no common carrier can provide free intrastate travel, but this does not apply to travel for charitable purposes.

ALM GL ch. 167A, § 1

For the provisions regulating bank holding companies, the term “company” does not include a nonprofit corporation or association that is organized and operated exclusively for religious, charitable or educational purposes, so long as no substantial part of its activities is carrying on propaganda or otherwise attempting to influence legislation.

ALM GL ch. 175, § 118

For the provisions regulating life insurance, corporations incorporated for educational, charitable, benevolent, or religious purpose are not “life insurance companies.”

ALM GL ch. 180, § 4A

No person, other than an attorney or a nonprofit charitable corporation, may render credit counseling services that consist of creating a plan whereby an individual turns over an agreed amount of income to a nonprofit credit counseling corporation, which then distributes it to creditors in accordance with the plan.

ALM GL ch. 255E, § 2

IRC §§ 501(c)(3) and (c)(4) organizations with the purpose of assisting low and moderate income households in the purchase or rehabilitation of family residences are exempt from the prohibition against acting as a mortgage broker or mortgage lender for residential property without being licensed. Also exempt is any charitable organization originally created by a last will and testament before January 1, 1950, that makes no more than 12 mortgage loans during a year.

## **Special Rules**

ALM GL ch. 6, § 168A; ALM GL ch. 276, § 100

Reports on probation and parole cases are not public records, but they are accessible to educational and charitable corporations as determined by the appropriate authority.

ALM GL ch. 10, § 27

No person, other than a fraternal, veterans' or charitable organization, may be licensed as an agent to sell lottery tickets or shares if the person engages in business exclusively as a lottery sales agent. Under ALM GL ch. 10, § 27A, a licensee under this section is eligible for a license to conduct the game of Keno.

ALM GL ch. 10, § 38

Fraternal, charitable, religious, and veterans' organizations are eligible for a license to conduct the game of beano. Under ALM GL ch. 10, § 37, an organization that is licensed to conduct the game of beano is eligible for a license to sell lottery tickets.

ALM GL ch. 40, § 51

The general rule is that no town or officer may disclose the names of persons who receive veterans benefits except to other government officials. However, a duly incorporated charitable corporation must be informed, upon its request, as to whether or not a designated person has received such benefits.

ALM GL ch. 44B, § 12

A real property interest that is purchased with monies from the Community Preservation Fund is bound by a permanent deed restriction limiting the use of the interest to the purpose for which it was acquired. The deed restriction runs with the land and is enforceable by the city or town or the commonwealth, but may also run to the benefit of a nonprofit charitable corporation or foundation selected by the city or town with the right to enforce the restriction.

ALM GL ch. 75, § 36B; ALM GL ch. 111, § 12

A charitable corporation may request the state or the University of Massachusetts medical school to analyze drugs, poisons, chemicals, etc., so long as the analysis is to be used for law enforcement purposes.

ALM GL ch. 90, § 33

Certain vehicles sponsored or used by charitable organizations (e.g., a bloodmobile) may be registered without having to pay a fee.

ALM GL ch. 90, § 71

Special purpose motor vehicles and trailers that are owned by charitable corporations and assigned to emergency disaster services may receive free license plates and be equipped with sirens, etc.

ALM GL ch. 101, § 12A

A town or city may grant charitable organizations a special license to conduct temporary or transient business, in which case the organization is not subject to state licensing requirements.

ALM GL ch. 101, § 33

A town or city may grant charitable organizations a special temporary license to sell flags, badges, medals, buttons, flowers, souvenirs, and similar small articles.

ALM GL ch. 114, § 43A

Cemeteries may only be owned or operated by political subdivisions, churches, religious or charitable societies, and cemetery associations.

ALM GL ch. 118E, § 14

Nursing homes are eligible to enter into negotiated rate contracts that recognize the acquisition cost, or the portion which exceeds the allowable basis, as the allowable basis of fixed assets where there has been a change of ownership; but, among other requirements, the new owner must be an IRC § 501(c)(3) hospital or organization affiliated with a nonprofit hospital.

ALM GL ch. 140, § 137A

Charitable organizations with the purpose of protecting animals must be given a free kennel license by the town clerk.

ALM GL ch. 140, § 151

Rather than have a city position of dog officer, a city may enter into a contract with a domestic charitable corporation with the purpose of protecting animals to perform the duties required of dog officers.

ALM GL ch. 175, § 123A

A charitable institution described in IRC § 501(c)(3), (c)(6), (c)(8), or (c)(9) is deemed to have an insurable interest in the life of any donor.

ALM GL ch. 180, § 6C

In general, a director, officer or incorporator of a charitable corporation is not liable for the performance of his or her duties if he or she acts in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation, and with the level of care of an ordinarily prudent person in a similar position.

ALM GL ch. 184, § 23

Restrictions that affect the title or use of real property and are unlimited as to time are limited to 30 years after the date of deed or probate of the will creating them, except in cases of gifts or devises for public, charitable, or religious purposes.

ALM GL ch. 184, § 23b

Any condition, restriction or prohibition that limits the use of real property on the basis of race, color, religion, national origin or sex is void. This rule does not apply to a limitation on the basis of religion on the use of real property held by a religious organization or by an organization operated for charitable or educational purposes that is operated, supervised or controlled by or in connection with a religious organization.

ALM GL ch. 184, § 30

No restriction on property shall be enforced unless it is determined that the restriction is an actual and substantial benefit to a person claiming the right of enforcement. There is a presumption against that finding, but the presumption does not apply in certain cases of gifts or devises for public, charitable, or religious purposes.

ALM GL ch. 184, § 32

If certain qualifications are met, no conservation restriction, agricultural preservation restriction, watershed preservation restriction, affordable housing restriction, or preservation restriction held by a charitable corporation is unenforceable on account of (1) lack of privity of estate or contract or lack of benefit to particular land; (2) the benefit being assignable or being assigned to a governmental body or charitable corporation or trust with like purposes;

or (3) the governmental body or the charitable corporation or trust having received the right to enforce the restriction by assignment.

ALM GL ch. 184A, § 4

The statutory Rule Against Perpetuities does not apply to a nonvested property interest held by a charity or government if the nonvested property interest is preceded by an interest held by another charity or government.

ALM GL ch. 231, § 85K

For nonprofit organizations, if a tort was committed in the course of an activity carried on to accomplish its charitable purposes, liability is limited to \$20,000, exclusive of interest and costs. The limitation does not apply if the activities were primarily commercial. Additionally, a person who serves as a director, officer or trustee of an educational institution that is an IRC § 501(c)(3) organization and who is not compensated for such services is not liable solely by reason of such services for any act or omission resulting in damage or injury to another, so long as he or she was acting in good faith and within the scope of official functions and duties. The limitation does not apply if the damage or injury was caused by willful or wanton misconduct or if the cause of action arises out of the person's operation of a motor vehicle.

ALM GL ch. 231, § 85V

In general, nonprofit associations that conduct sports programs (and their officers, directors, trustee, and members serving without compensation, and their volunteers) are not liable for an action in tort resulting from the program. The immunity does not apply to intentional or grossly negligent acts.

ALM GL ch. 231, § 85W

A person who serves without compensation as an officer, director, or trustee of an IRC § 501(c)(3) organization is generally not liable for civil damages as a result of acts or omissions relating solely to the performance of his or her duties. This limitation does not apply to acts or omissions that were intentional or grossly negligent, were committed in the course of activities primarily commercial in nature, or arose out of the person's operation of a motor vehicle.

ALM GL ch. 266, § 71A

No person, society, association or corporation may knowingly assume, adopt or use the name of a benevolent, humane, fraternal, charitable or labor organization, or a name so nearly resembling that name as to be a colorable imitation thereof or calculated to deceive persons.

ALM GL ch. 270, § 22

Under the rules limiting smoking in public places, smoking is allowed on the premises of a membership association, which is a nonprofit entity that has been established and operates for a charitable, philanthropic, civic, social, benevolent, educational, religious, athletic, or recreational purpose.

ALM GL ch. 271, § 7A

Only the following organizations may promote, operate, or conduct a raffle or bazaar: charitable, religious, educational and veterans' organizations, fraternal or fraternal benefit societies, civic or service clubs, and nonprofit clubs or organizations organized and operated exclusively for pleasure, recreation and other nonprofit purposes.

## **Eligible to Receive Property or Non-Grant Money**

ALM GL ch. 30B, § 15

A governmental body may, unless otherwise prohibited by law, dispose of tangible property that is no longer useful but has resale or salvage value to an IRC § 501(c)(3) organization at less than fair market value.

ALM GL ch. 33, § 122

Armories or air installations may be used temporarily for meeting or activities by various types of charitable organizations.

ALM Spec L ch. S67, § 8

The Massachusetts Water Resources Authority may donate lost or abandoned property worth less than \$150 to charitable organizations.

ALM Spec L ch. S71, § 14A

The Massachusetts Parking Authority may donate lost or abandoned property worth less than \$3 to charitable organizations.

ALM Spec L ch. 73, § 23

The Massachusetts Port Authority may donate lost or abandoned property worth less than \$3 to charitable organizations.

ALM GL ch. 81A, § 20

The Massachusetts Turnpike Authority may donate lost or abandoned property worth less than \$3 to charitable organizations.

ALM GL ch. 90, § 8D

The registrar of motor vehicles may, on behalf of a charitable institution, accept gifts, contributions and bequests of funds for the purpose of furthering the promotion of anatomical sciences.

ALM GL ch. 154, § 8; ALM GL ch. 180, § 17B

Voluntary charitable contributions may be withheld from employees' salaries.

ALM GL ch. 255, § 31D

For cleaners, tailors, etc., if an account is past due for a certain period of time, the person may donate the items to a charitable corporation.

## **Eligible to Participate in a Program (i.e., Receive Assistance)**

ALM GL ch. 23G, § 42

IRC § 501(c)(3) organizations are eligible to apply for grants and loans from the Regional Tourism Facilities Fund for the construction, expansion, renovation or repair of cultural, entertainment, regional tourism, and other commercial facilities.

ALM GL ch. 69, § 36

IRC § 501(c)(3) organizations are eligible to seek grants to promote the use of educational services of museums and other cultural organizations by schools and community organizations.



ALM GL ch. 121A, § 3

Charitable corporations are eligible to receive assistance for the purpose of rehabilitating housing under the Urban Redevelopment Corporation Program.

ALM GL ch. 132A, § 111/2

IRC § 501(c)(3) organizations are eligible for grants to acquire interests in lands suitable for purposes of conservation or recreation.

ALM GL ch. 211D, § 6

The committee for public counsel services must enter into contractual agreements with bar associations or charitable organizations for the purpose of providing counsel to indigent defendants.

## **New York**

### **Exempt From a Provision of Law**

NY Agriculture and Markets Law § 61

Consumers must be given notice of the use of oleomargarine in public eating places, but the term “public eating place” does not include religious, charitable, or private camps.

NY Agriculture and Markets Law § 96-c

The provisions addressing the licensing of slaughterhouses generally do not apply to any person who donates and any charitable or nonprofit organization that possesses, prepares or serves game or wild game pursuant to law.

NY Agriculture and Markets Law § 217

For purposes of the licensing requirements for food salvagers, the term “food salvager” does not include a person who donates farm salvage to a charitable nonprofit organization.

NY Agriculture and Markets Law § 244

Under the Licensing of Farm Products Dealers provisions, the licensing, bonding and stated grape price provisions do not apply to charitable nonprofit organizations that receive donated farm salvage for distribution purposes.

NY Alcoholic Beverage Control Law § 64-b

The provision restricting the unlicensed sale of liquor at bottle clubs does not apply to nonprofit religious, charitable, and fraternal organizations.

NY Arts and Cultural Affairs Law §§ 23.08 and 23.09

The provision requiring ticket sellers who make advance ticket sales to deposit money in a timely manner or post a letter of credit with the state does not apply to a ticket distributor who is a nonprofit educational, charitable, or tax-exempt organization that sells tickets to an event produced or presented by the organization.

NY Arts and Cultural Affairs Law § 35.05

The provisions regulating the use of child models do not apply to the employment or use of a child model by a charitable organization.

NY Banking Law § 141

An IRC § 501(c)(3) organization is not a “company” for purposes of regulating bank holding companies.

NY Banking Law § 579

Only nonprofit corporations may engage in the business of budget planning without first obtaining a license.

NY General Business Law § 171

For purposes of regulating employment agencies, exempt from the definition of “employment agency” are organizations operated by or under the exclusive control of a bonafide nonprofit educational, religious, charitable, or eleemosynary institution.

NY General Business Law § 399-pp

Nonprofit corporations and charitable organizations are exempt from the registration and bonding requirements in the Telemarketing and Consumer Fraud and Abuse Prevention Act.

NY General Municipal Law § 190-a

While licenses are generally required to conduct raffles, some organizations may conduct raffles without one. These include religious, charitable, educational, fraternal and service organizations, and organizations of veterans or volunteer firemen.

NY Insurance Law § 1101

A transaction effected by mail from outside the state by an unauthorized foreign insurer who is licensed to transact the business of insurance in its domicile is not “doing an insurance business” in New York if it is a transaction by a nonprofit life insurance company operated exclusively for the purpose of aiding a charitable, religious, educational or scientific institution by issuing insurance or annuity contracts directly from its home office. The company cannot have not agents or representatives in New York.

NY Insurance Law § 1108

Charitable annuity societies may be exempted from insurance licensing and other requirements.

NY Insurance Law § 3221(e)

The provision regulating group policies that provide hospital or surgical expense insurance for other than specific diseases or accidents does not apply to a group policy issued to a policyholder whose principal activities are located outside the state by a nonprofit life insurance company operated exclusively for the purpose of aiding charitable, religious, missionary, education, and philanthropic institutions by issuing insurance contracts only to or for the benefit of the institutions.

NY Labor Law § 133

The provisions prohibiting the employment of minors do not apply to a minor who is employed in the occupation in which he or she has completed a work training program of a nonprofit organization.

NY Labor Law §§ 190 and 191

The general rule is that manual workers must be paid weekly. However, religious, charitable, and educational corporations may pay employees according to the terms of employment so long as it is not less frequently than semi-monthly.

NY Labor Law § 651

For purposes of the Minimum Wage Act, the term “employee” does not include services performed as a volunteer, learner or apprentice by an organization organized and operated exclusively for religious, charitable or educational purposes, so long as no part of its net earnings inures to the benefit of any private shareholder or individual.

NY Labor Law § 701

Under the New York State Labor Relations Act, the term “employee” does not include (1) an individual who participates in and receives rehabilitative or therapeutic services in a charitable nonprofit rehabilitation facility or sheltered workshop or (2) an individual employed in a charitable nonprofit rehabilitation facility or sheltered workshop who has received rehabilitative or therapeutic services and whose capacity to perform the work is substantially impaired by physical or mental deficiency or injury.

NY Labor Law § 870-m

The permit requirements for an amusement device, viewing stand or tent operated in a carnival, fair or amusement park do not apply to the use of a viewing stand or tent owned, leased or operated by a religious, charitable, educational, fraternal, service, veteran or volunteer firemen organization.

NY Legislative Law § 1-c

Under the Lobbying Act, the term “gift” means anything of value given to a public official, but does not include complimentary attendance, including food and beverage, at charitable events.

NY Public Health Law § 225

A charitable organization is not in violation of any law, including the sanitary code, for the possession, preparation, distribution or service of game or wild game that was donated pursuant to section 11-0917 of the environmental conservation law.

NY Public Health Law §§ 1393 and 1406

Under provisions regulating camps for children, there are exemptions from the fees for camps operated for charitable, philanthropic, or religious purposes.

NY Public Health Law § 1399-n

Under the laws restricting smoking in public places, smoking is allowed in membership associations, which are nonprofit entities created or organized for a charitable, philanthropic, educational, political, social or other similar purpose.

NY State Finance Law § 162

Two preferred sources that are exempt from the state competitive procurement provisions are commodities and services produced by a qualified charitable nonprofit agency for the blind and an agency for severely disabled persons.

## **Special Rules**

NY Alcoholic Beverage Control Law §§ 33.15 and 99-a.

An organization eligible under IRC § 170 may get a special 24-hour permit to sell alcoholic beverages.

NY Alcoholic Beverage Control Law § 92

Special permits for the purchase of alcohol can be issued to an officer of a hospital, museum, laboratory, art, charitable, educational, or similar public institution.

NY Alcoholic Beverage Control Law § 98

Charitable and nonprofit organizations have an easier burden to get special a 24-hour caterer's permit.

NY Civil Practice Law and Rules § 8602

Certain prevailing parties in suits against the state are able to be awarded costs and fees. Eligible parties include any partnership, corporation, association, real estate developer, or organization with less than 100 employees, but any IRC § 501(c)(3) organization is eligible, regardless of the number of employees.

NY Education Law § 667

Students enrolled in many types of schools are eligible for tuition assistance program awards, including those enrolled in IRC § 501(c)(3) business schools.

NY Education Law § 695-e

IRC § 501(c)(3) organizations may open family tuition accounts to fund scholarships for persons whose identity will be determined upon disbursement.

NY Environmental Conservation Law §§ 49-0303 and 49-0305

IRC § 501(c)(3) corporations that are organized for the conservation or preservation of real property may hold conservation easements.

NY Executive Law § 296

A religious or denominational organization, or an organization operated for charitable or educational purposes that is operated by or in connection with a religious organization, may limit employment or sales or rental of housing accommodations to persons of the same religion or denomination.

NY Family Court Act §§ 422, 428, 522, 671, and 827

There are several family law statutes that allow an incorporated charitable or philanthropic society with a legitimate interest in a petitioner to file to open a proceeding, such as a support proceeding or paternity proceeding, or to receive from the court a certificate stating that a warrant for a respondent has been issued.

NY Executive Law § 432; General Municipal Law § 476

Only certain organizations are allowed to conduct bingo games. These include religious, charitable, educational, fraternal, civic and service organizations.

NY General Municipal Law § 186

Organizations authorized to conduct games of chance include religious, charitable, educational, fraternal, and service organizations and organizations of veterans or volunteer firemen.

NY Insurance Law § 1110

The Superintendent of Insurance may issue a special permit to make annuity agreements with donors to a nonprofit charitable, religious, missionary, educational, or philanthropic

organization. The permit authorizes the organization to receive gifts of cash and other property conditioned upon its agreement to pay an annuity to the donor or his or her nominee.

NY Insurance Law § 3205

Charitable, educational and religious corporations may procure a life insurance contract upon a person and may designate itself, or cause to have itself designated, as the beneficiary of the contract.

NY Insurance Law § 3435

For IRC § 501(c)(3) organizations, group coverage for homogeneous groups formed for purposes other than obtaining insurance may be approved for the kinds of insurance authorized by Insurance Law § 1113, except those authorized in paragraphs one, two, three, sixteen, seventeen, eighteen, twenty-one, twenty-two, twenty-three and twenty-five of such subsection, so long as the policies are available to all eligible members of the group.

NY Judiciary Law § 489

No person or co-partnership engaged in the business of collection and adjustment of claims and no corporation or association may solicit, buy, or take an assignment of a bond, promissory note, bill of exchange, book debt, or any claim or demand with the intent of bringing an action or proceeding thereon. This rule does not affect an assignment taken by a corporation organized for religious, benevolent, or charitable purposes.

NY N-PCL § 720-a

In general, no person serving without compensation as a director, officer or trustee of an IRC § 501(c)(3) organization is liable to any person other than that entity solely because of his or her conduct in that office, unless the person's conduct was intentional or grossly negligent.

NY Public Service Law § 92

While no telegraph or telephone corporation may generally give free or reduced service for the transmission of messages between points within the state, there are exceptions, including one for persons or corporations exclusively engaged in charitable and eleemosynary work.

NY Public Service Law § 225

The general rule is that cable television rates that are discriminatory or preferential as between similarly-situated subscribers are void. However, reduced rates or free service to educational and charitable institutions are not considered unduly discriminatory or preferential.

NY State Finance Law § 179-q

Under the provisions addressing prompt contracting and interest payments for nonprofit organizations, IRC § 501(c)(3) organizations are the primary group of “nonprofit organizations.”

NY Transportation Law § 103

Common carriers are generally prohibited from giving free tickets for intrastate travel. This prohibition does not apply to, among others, persons exclusively engaged in charitable and eleemosynary work.

## **Eligible to Receive Property or Non-Grant Money**

NY Education Law § 414

Schoolhouses and grounds may be used for meetings, entertainments and occasions where admission fees are charged if the proceeds are for educational or charitable purposes.

NY General Business Law § 399-bb

Retail dry cleaning institutions may donate abandoned items to a bona fide charitable organization, church, or other nonprofit organization.

NY Judiciary Law § 4261

Whenever the purpose for which an unincorporated association organized for a special or local purpose has been fully carried out, the supreme court may order that the funds or property be given to a charitable, religious, benevolent, or educational organization.

NY Military Law § 18

Obsolete state property may be donated to educational, patriotic, and charitable organizations.

NY State Finance Law § 201; Retirement and Social Security Law § 110-d; General Municipal Law § 93-b

Voluntary contributions to federated community campaigns may be deducted from state employees' wages and retired employees' retirement allowances.

## **Eligible to Participate in a Program (i.e., Receive Assistance)**

NY Arts and Cultural Affairs Law § 3.07

The State Council on the Arts may provide financial assistance to nonprofit cultural organizations for the rehabilitation of existing buildings.

NY Arts and Cultural Affairs Law § 20.03

A nonprofit cultural organization is eligible for financing for projects involving constructing and rehabilitating facilities under the New York State Cultural Resources Act. The organization must show one of the following proofs of nonprofit status: IRC § 501(c)(3) status, filing with the state board of regents pursuant to section two hundred sixteen of the education law, or filing with the secretary of state to register as a charitable organization.

NY Education Law § 220

In the provisions relating to the University of the State of New York, when the board of regents revokes the charter of or dissolves an educational corporation, any money left after the payment of debts and the expenses of liquidation may be used for educational, religious, benevolent, and charitable purposes.

NY Environmental Conservation Law § 27-1316

IRC § 501(c)(3) organizations that may be affected by an inactive hazardous waste disposal site remedial program are eligible for grants to do such things as obtain technical assistance about the nature of the hazard, develop a remedial program, and advise affected residents.

NY Environmental Conservation Law § 27-1417

Under the Brownfield Cleanup Program, IRC § 501(c)(3) organizations with members affected by the site are eligible for grants to do such things as obtain technical assistance about the hazard, develop remedial programs, and advise affected residents.

NY Environmental Conservation Law § 52-0101 et seq.

IRC § 501(c)(3) organizations are eligible for assistance for projects including hazardous waste site remediation and historic preservation under the provisions implementing the Environmental Quality Bond Act of 1986.

NY Environmental Conservation Law § 56-0501 et seq.

IRC § 501(c)(3) organizations are eligible for grants for a variety of environmental projects under the provisions implementing the Clean Water/Clean Air Bond Act of 1996.

NY General Municipal Law §§ 854, 858, 859-b, and 862-a

IRC § 501(c)(3) continuing care retirement communities are eligible for financial assistance.

NY General Municipal Law § 970-r

IRC § 501(c)(3) organizations whose mission is promoting the reuse of Brownfield sites are eligible for grants.

NY Judiciary Law § 849-a

Nonprofit organizations that administer community dispute resolution centers are eligible for grants under the Community Dispute Resolution Centers Program.

NY Private Housing Finance Law § 572

Nonprofit and charitable corporations with the purpose of improving housing for persons of low income are eligible to utilize development funds under the Housing Development Fund Companies Program.

NY Private Housing Finance Law § 921

Nonprofit and charitable organizations are eligible for grants under the Urban Initiatives Program.

NY Private Housing Finance Law § 1101

Nonprofit and charitable organizations with the purpose of improving housing for persons of low income are eligible for grants under the Low Income Housing Trust Fund Program.

NY Private Housing Finance Law § 1106-a

Nonprofit and charitable organizations with the purpose of improving housing for persons of low income are eligible for grants under the Low Income Turnkey/Enhanced Housing Trust Fund Program.

NY Private Housing Finance Law § 1111

Nonprofit and charitable organizations with the purpose of improving housing for persons of low income are eligible for grants under the Affordable Home Ownership Development Program.

NY Private Housing Finance Law § 1121

Nonprofit and charitable organizations with the purpose of improving housing are eligible for grants under the Manufactured Home Cooperative Fund Program.

NY Public Health Law § 4604-a

IRC § 501(c)(3) organizations are eligible for industrial development agency financing in connection with continuing care retirement communities.

NY Social Services Law § § 42 and 43

Nonprofit and charitable organizations are eligible for financial assistance under the Homeless Housing and Assistance Program.

NY Social Services Law § 43

The state may enter into homeless housing and assistance contracts with municipalities, who may then enter into contracts with nonprofit corporations and charitable organizations to undertake the establishment of homeless housing projects.

NY Social Services Law § 45-a

Nonprofit and charitable organizations are eligible for grants under the Single Room Occupancy Support Services Program.

NY Social Services Law § 131-v

To the extent consistent with federal law, a social services official may contract with a nonprofit corporation or charitable organization to provide temporary emergency shelter for eligible homeless households in dwelling units owned or leased, and operated by the corporation or organization.

NY Social Services Law § 482-b

IRC § 501(c)(3) organizations are eligible for grants under the Statewide Settlement House Program.

## **Pennsylvania**

### **Exempt From a Provision of Law**

3 P.S. § 2372

Charitable and religious institutions are exempt from the requirement to pay the licensing fee that accompanies an application to operate a garbage feeding business or plant.

3 P.S. § 6510

Food establishments owned by IRC § 501(c)(3) organizations are exempt from most of the provisions dealing with food employee certification. Also exempt are food establishments managed on a not-for-profit basis by a religious, charitable, fraternal, veterans, civic, or agricultural association.

4 P.S. § 213

The provisions regulating the resale of tickets do not apply to fund-raising activities performed by or on behalf of IRC § 501(c)(3) organizations.

10 P.S. §§ 362 and 363

Laws regulating insurance do not apply to the issuance of a qualified charitable gift annuity by a charity described in IRC § 170(c).



18 P.S. § 5903

The provisions addressing the display of obscene and other sexual materials and performances do not apply to a historical society or museum accorded charitable status by the federal government or to libraries.

18 P.S. §§ 7328 and 7329

IRC § 501(c)(3) organizations are exempt from certain prohibitions on activities at bottle clubs.

22 P.S. § 25

The Private Detective Act does not apply to any incorporated charitable or philanthropic society or association that is organized and maintained for the public good and not for private profit.

35 P.S. § 5203

Manufacturers of stuffed toys manufactured in the state or intended for sale or use in the state must register and pay a fee. Charitable organizations may be exempted from having to pay the fee.

43 P.S. § 333.105

Exempt from the Minimum Wage Act are activities of an educational, charitable, religious or nonprofit organization where the employer-employee relationship does not in fact exist or where the services are rendered gratuitously.

43 P.S. § 536

Under the provisions regulating employment agencies, charitable institutions making no charge for employment services are not "private employment agents."

43 P.S. § 954

Under the Pennsylvania Human Relations Act, the term "employer" generally does not include religious, fraternal, charitable or sectarian organizations, except those supported by governmental appropriations. However, with respect to discriminatory practices based on race, color, age, sex, national origin or non-job related handicap or disability, the term "employer" does include religious, fraternal, charitable and sectarian organizations employing at least four people in the state.

43 P.S. § 1301.103

Under the provisions regulating seasonal farm labor, the term "farm labor contractor" does not include any nonprofit charitable organization or educational institution.

53 P.S. § 37621

The provisions allowing third-class cities to regulate transient retail merchants do not apply to the sale of donated goods, wares, and merchandise if the proceeds are to be used for charitable purposes.

53 P.S. § 47901

Boroughs may not charge a fee for transient retail licenses for the sale of donated goods, wares, and merchandise if the proceeds are to be used for charitable purposes.

53 P.S. § 57901

First-class townships may regulate transient retail businesses, except the sale of donated goods, wares, and merchandise if the proceeds are to be used for charitable purposes.

53 P.S. § 66532

Second-class townships may license and regulate transient merchants conducting business within the township, except the sale of donated goods, wares, or merchandise if the proceeds are to be used for charitable purposes.

53 P.S. § 66701

A township may procure land by purchase, gift, devise, or the exercise of eminent domain and erect or use buildings on it for township purposes. However, no land or property used for a educational or charitable institution, seminary or place of public worship may be taken.

62 P.S. § 520

State contracts with charitable agencies for supplies manufactured by and services performed by persons with disabilities are exempt from the competitive bidding requirements.

63 P.S. § 391.3

For purposes of regulating the wholesale distribution of prescription drugs, the term “wholesale distribution” does not include, to the extent otherwise permitted by law, the sale, purchase or trade of a drug or an offer to sell, purchase or trade a drug by an IRC § 501(c)(3) organization to its nonprofit affiliate.

63 P.S. § 734.3

Under the provisions regulating auctions and auctioneers, the requirement to obtain a license does not apply to auctions conducted by or on behalf of a charitable organization so long as the person conducting the sale does not receive compensation.

63 P.S. § 818.12

It is unlawful for a vehicle manufacturer, factory branch, or distributor to sell or exchange with a second or final stage manufacturer, retail consumer, or end user unless the transaction is through a licensed new vehicle dealer. This rule does not apply to sales to charitable organizations.

63 P.S. § 818.32

Any licensed vehicle dealer may participate in public vehicle shows, off-premise sales, and exhibitions, so long as the event is within the dealer's relevant market area. This rule does not apply to vehicle shows held as part of an event operated to benefit an IRC § 501(c)(3) organization.

69 P.S. § 2612

Under the Unused Property Market Act, an unused property market does not include an event that is organized for the exclusive benefit of religious, education, and charitable organizations.

70 P.S. § 1-202

Exempt from the securities registration requirements are securities of organizations that are organized for educational, benevolent, fraternal, religious, charitable, social, athletic or reformatory purposes and not for pecuniary profit, if no part of its net earnings inures to the benefit of a private shareholder or individual. This exemption does not apply if the promoter

intends to make a profit from any business or activity associated with the organization or operation of the organization.

70 P.S. § 1-203

Exempt from the securities registration requirements are transactions involving an offer or sale of an evidence of indebtedness of an issuer organized exclusively for educational, benevolent, fraternal, religious, charitable, social, athletic, or reformatory purposes and not for pecuniary profit, if no part of its net earnings inures to the benefit of any private shareholder or individual.

73 P.S. § 216

The provisions regulating unfair sales do not apply to retail or wholesale sales where merchandise is sold for charitable purposes or to relief agencies.

73 P.S. § 2011

Charitable and non-profit organizations are exempt from the license requirement for door-to-door sales to solicit magazine subscriptions.

73 P.S. §§ 2242 and 2245

Under the Telemarketer Registration Act, the definition of "telemarketer" does not include educational institutions, hospitals, public library organizations, IRC tax-exempt senior citizen centers and nursing homes, parent/teacher organizations, and any charitable organization that receives contributions of no more than \$25,000 annually. The exception does not apply if the organization uses professional fundraisers. The term "telephone solicitation call" does not include a call made on behalf of an IRC § 501(c)(3), (5), or (8) organization or a veteran's organization. Additionally, while it is generally a violation of law to not reduce any sale of goods or services made during a telemarketing call to a written contract, this rule does not apply to sales or solicitations by or on behalf of IRC § 501(c)(3) organizations.

73 P.S. § 2182

Under the provisions regulating credit services organizations, the term "credit services organization" does not include IRC § 501(c)(3) organizations.

## **Special Rules**

9 P.S. § 202

Caretaker organizations generally owe no duty of care to keep a historic burial place safe for entry or use by others or to give warning of a dangerous condition, use, structure or activity on the premises. A caretaker organization is an IRC § 501(c)(3) organization that owns or assumes responsibility for the restoration and maintenance of a historic burial place.

10 P.S. §§ 303 and 304

Charitable organizations are eligible to apply for a license to conduct bingo games.

10 P.S. §§ 313 and 314

Charitable organizations are eligible to apply for a license to conduct games of chance.

10 P.S. §§ 353, 354 and 355

Any bona fide charitable or religious organization that receives, in good faith, donated food for ultimate distribution to needy individuals is not subject to liability arising from the food's condition, so long as the organization reasonably inspects the food at the time of donation

and distribution and, in the case of wildlife, reasonably processes, prepares and distributes the food.

22 P.S. § 501

A nonprofit corporation that maintains a cemetery or building open to the public or is organized for the prevention of cruelty to children, aged persons, or animals may apply to the court of common pleas for the appointment of designated persons to act as policemen for the corporation.

24 P.S. § 6901.318

IRC § 501(c)(3) organizations may establish a scholarship program through the Tuition Account Program.

32 P.S. § 5505

Under the Pennsylvania Conservation Corps Act, projects for corpsmember development and training may include fee-for-service projects, and community-based IRC § 501(c)(3) organizations are eligible to participate.

35 P.S. § 448.806

An IRC § 501(c)(3) organization that provides or coordinates the provision of volunteer services for Medicare-certified hospice providers in the hospice delivery systems of its community, used “hospice” in its name prior to January 1, 1990, and registered with the Department of State pursuant to P.L. 1200, No. 202 may continue to use its name without reregistering.

35 P.S. §§ 6027.3-6027.4

IRC § 501(c)(3) corporations with environmental conservation or preservation purposes are not liable under the state environmental laws in several situations. For example, an organization is not liable unless it or its employees or agents directly cause or exacerbate a release of a regulated substance on or from its property.

40 P.S. § 512

An IRC § 501(c)(3) charitable organization may own or purchase life insurance on an insured who consents to the ownership or purchase of that insurance.

40 P.S. § 756.3

Blanket accident and sickness insurance is defined to include a policy or contract issued in the name of a religious, charitable, recreational, educational, or civic organization that covers participants in activities sponsored by the organization.

42.P.S. § 8332.1

In general, a nonprofit association (and its employees and volunteers) that conducts a sports program is not liable for civil damages as a result of acts or omissions in conducting the program, unless its conduct falls substantially below the standards generally practiced and accepted in like circumstances by similar associations.

42 P.S. § 8332.2

In general, no person who serves without compensation as an officer, director or trustee of an IRC § 501(c)(3) organization is liable for civil damages as a result of acts or omissions relating solely to the performance of his or her duties. This rule does not apply if the person's

conduct falls substantially below the standards generally practiced and accepted in like circumstances by similar persons.

42 P.S. § 8332.4

In general, volunteers of IRC §§ 501(c)(3), (4), and (6) organizations are not liable for civil damages as a result of acts or omissions in rendering such services, unless the person's conduct falls substantially below the standards generally practiced and accepted in like circumstances by similar persons.

42 P.S. § 8332.6

An anti-drug or town-watch volunteer of an IRC § 501(c)(3) organization is generally immune from civil liability for damage caused by acts or omissions done as a volunteer, unless the person's conduct falls substantially below the standards generally practiced and accepted in like circumstances by similar persons.

42. P.S. § 8338

In general, a person is not subject to civil or criminal liability arising from the nature, age, packaging or condition of food that the person donated in good faith to a nonprofit organization for distribution to needy individuals if the food is apparently fit for household consumption or use.

42 P.S. § 8340

Any charitable agency or organization supervising or administering an approved restitution or community service program is immune from civil action for damages brought by or on behalf of a person involved in the program or for damages caused by a person involved in the program. This rule does not apply if the conduct was intentional, grossly negligent, or reckless.

43 P.S. § 955

A religious organization, charitable or educational organization operated by a religious organization, or private or fraternal organization may give preference in hiring to persons of the same religion or denomination or to members of such private or fraternal organization.

47 P.S. §§ 1-102 and 4-408.4

Certain IRC § 501(c)(3) organizations are eligible to obtain special occasion permits which allow them to sell alcoholic beverages during the same hours as restaurant liquor license holders and to sell any type of alcohol for consumption off their premises.

52 P.S. § 641

A coal mining operation must supply anthracite fuel coal to a hospital, poorhouse, charitable institution, school building, church, place of religious worship, or public building located within the municipality in which the operation is conducted.

53 P.S. §§ 57006 and 67304

No street or road may be laid out and opened through any grounds occupied by a building used as a place for public worship, public or parochial school, or educational or charitable institution or seminary, without the consent of the owner.

53 P.S. § 57703

In providing for, regulating, and protecting and extending its system of water distribution, a township may occupy streets, roads or highways and may take, injure or destroy private

property. However, property belonging to or used as a cemetery or a place of public worship, public or parochial school, or educational or charitable institution or seminary may not be taken, injured or destroyed.

53 P.S. § 57803

Townships may appropriate private property and land that was granted or dedicated to public use and is no longer used for that purpose in order to build public buildings. No land or property used for a cemetery, public or parochial school, educational or charitable institution, seminary, or place of public worship may be taken.

63 P.S. § 818.5

Charitable nonprofit organizations may sell vehicles at wholesale vehicle auctions.

71 P.S. §§ 2403 and 2404

Under the Religious Freedom Protection Act, a state agency generally may not substantially burden a person's free exercise of religion, including any burden which results from a rule of general applicability. The term "person" includes a church, association of churches or other religious order, body or institution exempt under IRC §§ 501(c)(3) or (d).

75 P.S. § 1336

Dealer registration plates may be used on vehicles that are loaned to charitable organizations for use in charitable activities.

## **Eligible to Receive Property or Non-Grant Money**

6 P.S. § 33.6

A cleaner, launderer, or shoe repairer may donate unclaimed property to IRC § 501(c)(3) organizations.

16 P.S. § 2311

Counties may convey all or a part of the title and interest in buildings, with or without the land, to charitable institutions.

24 P.S. § 7-707

School boards may sell and convey real estate to IRC § 501(c)(3) organizations for the accepted consideration, which may include payment partly in cash and partly in the form of a purchase money mortgage and bond to be paid in a period in excess of 5 years from the date of the mortgage.

24 P.S. § 7-775

School boards may lease school buildings or athletic fields to any reputable organization or group of persons for charitable purposes.

32 P.S. § 5053

Under the Conservation and Preservation Easements Act, IRC § 501(c)(3) organizations are eligible to hold conservation or preservation easements.

43 P.S. §§ 301 and 1301.206

Voluntary contributions to charitable institutions may be deducted from an employee's, including a seasonal farmworker's, wages.

43 P.S. § 1102.5; 71 P.S. § 575

If an employee has a religious objection to paying a fair share fee, then the equivalent of the fee may be paid to a nonreligious charity.

72 P.S. § 1301.9

Bicycles held by a municipality for more than 90 days may be donated to a charitable organization.

73 P.S. § 2105

Under the Fine Arts Preservation Act, an artist has an action to recover damages for damage to his or her work. If punitive damages are awarded, the court will select a charitable or educational fine arts organization to receive the damages.

### **Eligible to Participate in a Program (i.e., Receive Assistance)**

3 P.S. § 914.5

Under the Supplemental Agricultural Conservation Easement Purchase Program, a land trust, which must be an IRC § 501(c)(3) organization that includes the acquisition of agricultural or other conservation easements in its stated purpose, may receive reimbursement for expenses associated with conservation easements (e.g., legal services and appraisals).

16 P.S. §§ 2130 and 5330

A sanitarium for the treatment of persons afflicted with tuberculosis is eligible for funding if it is engaged in charitable work.

16 P.S. § 2399.55

IRC § 501(c)(3) organizations are eligible for grants from a county's regional asset fund for the support and upkeep of regional assets.

24 P.S. § 6250.702-A

IRC § 501(c)(3) organizations are eligible for grants under the Critical Job Training Program.

27 P.S. §§ 6103 and 6105

IRC § 501(c)(3) organizations are eligible for grants under the Environmental Stewardship and Watershed Protection Program.

32 P.S. § 2013

IRC § 501(c)(3) organizations are eligible for grants from the Keystone Recreation, Park and Conservation Fund.

42 P.S. § 4903

IRC § 501(c)(3) organizations that provide free civil legal services are eligible for grants under the Access to Justice Act.

53 P.S. § 56547

Townships may appropriate money to support incorporated hospitals engaged in charitable work.

62 P.S. § 2090.16

IRC § 501(c)(3) organizations are eligible for funding under the Neighborhood Housing Services Act.

62 P.S. § 4023

IRC § 501(c)(3) organizations that provide free civil legal services are eligible for distributions under the Interest on Lawyers' Trust Accounts Act.

62 P.S. §§ 4042-4043

IRC § 501(c)(3) regional food banks are eligible for grants under the State Food Purchase Program.

73 P.S. § 400.2901

IRC § 501(c)(3) organizations are eligible for grants under the Customized Job Training Program.