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EXTERNAL MEMORANDUM

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To: Interested Parties

From: Greg Maher
LISC Deputy General Counsel

Date: October 7, 1998

Re: Overview of Important Tax-Exemption Issues for Community Development Corporations (CDCs) as Charitable Entities

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This paper is meant to be a handy reference tool to further the understanding of CDCs and those working with them of a range of issues created by CDCs being exempt from federal corporate income tax. A great majority of CDCs are exempt from income tax under Section 501(c)(3) of the Internal Revenue Code (the "Code"). As a result, there are a host of federal laws, regulations and rulings which govern their operations and activities.

I will identify in this paper some of the more common issues I have encountered in my work at LISC, and provide some general insight and suggestions. A CDC should always, however, consider pursuing independent legal advice that addresses the specific situation the organization is encountering.

I. Charitable Standards for Low Income Housing

What is the safe harbor rule and how it being applied?

The final "safe harbor" rule was issued on May 13, 1996. It provides a safe harbor to low income housing providers **applying** for an **expedited** exemption ruling. The primary focus of the rule (known as Rev. Proc. 96-32) is on the income level of households renting or buying affordable housing. The basic prongs of the rule which must be satisfied are the following:

- For each project: (a) at least 75% of the units must be occupied by residents that are at or below 80% of median income for the area, <u>and</u> (b) either at least 20% of the units must be occupied by residents that are at or below 50% of median income for the area, <u>or</u> 40% of the units must be occupied by residents that are at or below 60% of the median income for the area. Up to 25 percent of the units may be provided to at market rates to persons having incomes in excess of the low-income limit.

- The project must actually occupied by the poor and distressed. One year transition period is considered by the IRS to be reasonable (generally for occupied structures being redeveloped).

- The housing must be affordable to charitable beneficiaries (limitation of percentage of income to be paid in rental for rental projects or toward mortgage payments in for-sale projects).

- If a project consists of multiple buildings and each building doesn't separately meet the requirements of the above three sections, then the buildings must share common grounds.

There are examples in the Rev. Proc. of projects that would qualify under the safe harbor. One example involving a for-sale development indicates that the IRS will allow higher income limits for for-sale projects (the example that qualifies has 40% of units being sold to households at or below 70% of AMI; 25% of units being sold to households at or below 80% of AMI; and 35% of units being sold to households at or below 115 % of AMI).

It is unclear how the safe harbor will be used. One recent example in Arkansas involved a CDC whose exemption application was being ruled on by a trainee unfamiliar with the safe harbor. It is not intended to supersede the previous rules on what qualifies as charitable housing activity, but only to help expedite applications. It can also not be used to challenge the exemption of a nonprofit already having tax-exempt status. However, it is safe to say that the rule will be looked to as a benchmark of charitability, as it is as complete a treatment of the standards as has been (and will be) seen in a while.

What is the "facts and circumstances test" for relieving poverty and how does it differ from the safe harbor?

Grounds independent of the safe harbor standards for satisfying a relief of poverty argument remain effective, however. In the Rev. Proc. creating the safe harbor, the IRS said that if the safe harbor cannot be satisfied, "an organization may demonstrate that it relieves the poor and distressed by reference to all the surrounding facts and circumstance" [1]

The IRS went on to say that "facts and circumstances that demonstrate relief of the poor may include, but are not limited to, the following:

- A substantially greater percentage of residents than required by the safe harbor with incomes up to 60% of the area's median income.
- Limited degree of deviation from the safe harbor percentages.
- Limitation of a resident's portion of rent or mortgage payment to ensure that the housing is affordable to low-income and very low-income residents.
- Participation in a government housing program designed to provide affordable housing.
- Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization's operations.
- The provision of additional social services affordable to the poor residents.
- Relationship with an existing 501(c)(3) organization active in low-income housing for at lease five years if the existing organization demonstrates control.
- Acceptance of residents who, when considered individually, have unusual burdens such as extremely high medical costs which cause them to be in a condition similar to persons within the qualifying income limits in spite of their higher incomes.
- Participation in a homeownership program designed to provide homeownership opportunities for families that cannot otherwise afford to purchase safe and decent housing.
- Existence of affordability covenants or restrictions running with the property."

[1] The IRS understands the term poor and distressed to mean those "unable to obtain the necessities of life without undue hardship" (Rev. Rul. 70-585).

Are there other ways that affordable housing which does not meet either relief of poverty test (i.e., the safe harbor or the facts and circumstances tests) can qualify as charitable?

The answer is yes, and it is an important and powerful tool to understand. The Rev. Proc. discusses "Exempt Purposes Other Than Relieving the Poor and Distressed." It states in part that "...organizations may qualify for exemption without having to satisfy the standards for relief of the poor and distressed by providing housing in a way that accomplishes ***any*** of the [following] purposes: **(1)** combating community deterioration; **(2)** lessening the burdens of government; **(3)** eliminating discrimination and prejudice, **(4)** lessening neighborhood tensions; and **(5)** relief of the distress of the elderly or physically handicapped."

This reference was an important reaffirmation of the applicability of the social welfare standards to the charitable analysis of housing. It is important to note that these standards are separate and distinct from a relief of poverty analysis.

Stemming community deterioration is the most common social welfare standard an urban or rural CDC will seek to satisfy in a project. Formerly it was the case that to make an argument that an area was deteriorated, and thus that a CDC was combating such deterioration, the organization would need to be operating in an area that was formally declared as blighted under a statute. However, in the IRS' Continuing Professional Education Technical Instructions Program Textbook (TIPT) for 1996, a chapter discussing Notice 93-1 (the early version of the safe harbor) went into some detail on "other charitable purposes," including combating community deterioration. In addition to stating that formal blight declaration is evidence of deterioration, the IRS said that the following factors also "tend to demonstrate deterioration as well as potential deterioration:

- Income level of the area residents. Lower income levels are more frequently associated with the inability of the residents to maintain their residences. Closely associated is the portion of the residents below the poverty level.
- Age of the housing stock. This is particularly relevant when viewed in combination with the income level of the residents.
- Higher unemployment in the area relative to the surrounding areas indicates a generally poorer economic base.
- Location in relationship to parks or other areas for diversion. Limited recreational facilities place heavy pressures on the infrastructure of a neighborhood and may accelerate decline.
- Percentage of abandoned, boarded up or permanently vacant structures; the size and age of the structures and the length of time they have been boarded up.
- The amount of crime in an area as compared to the rest of the city.
- The level of drug trafficking.
- The presence and amount of graffiti.
- The percentage of homes below city code standards."

II. Charitable Standards for Economic Development Activity

What charitable standards apply to economic development activity undertaken by a CDC on its own?

It depends on whether the activity will in any way involve a for-profit entity. In some cases the commercial activity will be undertaken by a nonprofit alone, which will own and operate the business without any involvement by a for-profit. In these cases, there are fewer requirements that need to be satisfied. In this case the IRS' concern with private benefit, which is discussed later in this memo, would not be present.

The CDC needs to demonstrate that the activity relieves poverty through the creation of jobs that will be filled by unemployed, underemployed or disadvantaged residents, or that it meets one of the social welfare standards described above. The CDC should also be able to demonstrate the following:

- the ***primary*** intent or purpose of the CDC is not to make money for itself; however, a secondary purpose can be to earn income from the activity.
- if the economic development activity consists of a loan to another nonprofit, there should be some reasonably measurable evidence that the assistance is being offered on non-commercial terms (e.g., below conventional financing source interest rate, more flexible repayment terms, subordinate collateral position, below market rents, below market return on equity, etc.) to reflect not only the subordination of the CDC's desire for financial gain, but the need for the financing to make the project viable in contrast to a conventional financing source.

What charitable standards apply to economic development activity involving a CDC with a for-profit business?

First, the standards described in the previous question apply, as well as those discussed below. In most cases in which economic development is undertaken by CDCs, a for-profit business is in some way the recipient of the CDC's activity, or a partner with the CDC. In this scenario CDCs are typically participating through either **(1)** direct physical development (either alone or co-developing with another nonprofit or for-profit developer) of facilities to be leased to existing for-profit businesses or to start-up local businesses (e.g., the business incubator project), **(2)** providing technical and grant assistance and/or lending directly to another business (usually a for-profit entity) for creation or expansion, or **(3)** directly investing **(i)** as a partner in a joint venture partnership, or **(ii)** increasingly, as a member of a limited liability company ("LLC"). The goals of the project from the CDC's standpoint are usually the creation of local jobs that will be available to neighborhood residents, and the physical stabilization of the community, frequently through blight removal.

Unfortunately, however, the standards applying to the charitable qualification of economic development activity when a for-profit is involved are much less clear than the standards applying to housing activity.

There are three landmark rulings in this area form the 1970's, which I will briefly summarize:

A. Revenue Ruling 74-587

The issue before the IRS was whether a nonprofit organization organized to serve charitable purposes was in fact operating in a charitable manner by devoting its resources to programs designed to stimulate economic development in high density urban areas inhabited mainly by low income minority or other disadvantaged groups. Many businesses within these areas were struggling or had

ceased to operate because of a lack of access to capital, lack of business skills by the owners, and the general instability of the area. The nonprofit sought to combat these conditions by providing grants and working capital funds to for-profit and individual proprietors unable to obtain funds from conventional commercial sources because of either the nature of the area or the minority status of the business owners. Assistance was provided in the form of low cost loans or the purchase of an equity interest in the business. While the nonprofit did not participate in the day-to-day operations of the businesses assisted, it did monitor the organizations to see that the funds it contributed were being used properly and it did provide technical assistance where needed.

Rev. Rul. 74-587 stated that "Section 1.501(c)(3)-1(d)(2) of the Regulations defines the term 'charitable' as including the promotion of social welfare by organizations designed to relieve the poor and distressed or the underprivileged, to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration (emphasis supplied)."

The IRS ruled that the nonprofit met the operational test because it satisfied not only one of the factors, but several. The nonprofit operated charitably by promoting the social welfare of the community by (1) lessening prejudice and discrimination against minority groups (through demonstrating that disadvantaged residents of an impoverished area can operate businesses successfully if given the proper opportunity and guidance); (2 and 3) relieving poverty and lessening neighborhood tension and dissatisfaction (each by assisting businesses that will provide jobs to local residents); and (4) combating deterioration (by helping to establish businesses in the area and by rehabilitating existing businesses that had deteriorated).

As for lending directly to for-profit entities, Rev. Rul. 74-587 stated that the "recipients of loans and working capital in such cases are merely the instruments by which charitable purposes are sought to be accomplished." Two important items of note were the direct link between the relief of poverty and the providing of jobs available to local residents, and the link between the establishment of new or the rehabilitation of existing businesses and the combating of community deterioration. Rev. Rul. 74-587 did *not* say, however, that the independent social welfare definitions of what is charitable must *all* be satisfied to pass an operations test.

B. Revenue Ruling 76-419

Rev. Rul. 76-419 considered whether an organization operated exclusively for charitable purposes. The organization's stated objectives were the relief of conditions of poverty, dependency, chronic unemployment, and underemployment, and the reduction of community tensions in the economically distressed area in which it operated. Rather than assisting existing local businesses to expand or local entrepreneurs to create new business, it encouraged existing industrial enterprises located outside the neighborhood to open new facilities in the economically depressed neighborhood where it operated. The organization sought to further this goal by purchasing blighted land in the area and converting it into an industrial park. Lots were leased on terms favorable enough to attract industrial tenants. The tenants (i.e., the assisted businesses) were required by their leases to hire a significant number of unemployed persons in the area and to train them to obtain skills needed for employment in the jobs created. Businesses requiring underskilled workers were favored over those requiring more highly skilled workers, because the former "are of greater immediate benefit to the surrounding depressed community." The area was also declared a blighted community by the government based on its high unemployment and underemployment and since it consisted primarily of junk yards and vacant land with little industry.

The Rev. Rul. echoed a key factor stated in Rev. Rul. 74-587: the organization's program was not undertaken "with any motive or purpose of profit or gain but solely for the purpose of advancing the organization's declared objectives and goals."

The ruling also cited Regulation 1.501(c)(3)-1(d)(2) and the holdings in Rev. Rul. 74-587. It then concluded that the inducement of industrial enterprises to locate in an economically depressed area and the enterprises' hiring and training of underemployed and unemployed local residents (1) constituted the relief of poverty, and (2) lessened neighborhood tensions caused by the lack of job opportunities in the area. In addition, it found that the replacement of a blighted area with an

industrial park combated community deterioration. But there was no finding that *all* of these factors needed to be satisfied for the organization's activities to be deemed charitable.

C. Revenue Ruling 77-111

The IRS was presented with two requests for rulings in Rev. Rul. 77-111. The stated purpose of the first organization seeking review was to increase business patronage in a deteriorated area occupied mostly by minority residents, primarily through advertisements, outreach to the media, formation of a local businessmen's speaking bureau, and the setting up of a telephone service providing information to prospective shoppers.

The second organization's purpose was to revive retail sales in an area suffering from continued economic decline primarily caused by competing shopping centers outside the city. It proposed to do this by constructing a shopping center that would complement the area's existing retail facilities (which were presumably limited based on the economic decline that had occurred in the community). It purchased land for the construction of a department store and a shopping mall, which was then donated to the city which assembled it with other land it acquired through eminent domain. The large parcel was then leased back to the organization and a private developer, who actually constructed and leased the shopping center. Throughout the transactions, no financial gain was realized by the organization. In addition, the city required that a certain percentage of minorities be hired in the construction and operation of the center, as well as in the stores that would lease the space in the center.

Rev. Rul. 77-111 cited Rev. Rul. 74-587's fact pattern and stated that the organization described therein promoted the community "in three ways that are designed to be 'charitable:'" (1) lessening prejudice against minorities by assisting minority-owned businesses, (2) eliminating poverty by lessening neighborhood tensions by creating job opportunities, and (3) combating community deterioration by establishing new, and rehabilitating existing, businesses.

It went on, however, to find that the first organization's operations were non-charitable because its "overall thrust" was to accomplish business and not charitable purposes. More critical, however, was that while the organization in question did provide assistance to businesses that had difficulty obtaining conventional financing, it did not limit its assistance to businesses which were either minority-owned or which were experiencing difficulty because of being located in a deteriorated section of the community.

As for the second organization, it was found to be non-charitable because its activities resulted in significant benefits to the stores in the shopping center, and it did not restrict its activities to assisting minority-owned businesses or those businesses which would locate in the area because of the shopping center being developed with the organization's assistance.

A comprehensive treatment of the economic development standards was most recently presented in General Counsel Memorandum 39883, issued in 1992. The relevant excerpt from GCM 39883 is as follows:

"Based on the above revenue rulings and GCMs, a determination of whether a community development organization furthers charitable purposes requires an analysis of the following **three factors**: (1) whether assistance is being provided to help local businesses <u>or</u> to attract new local facilities of established outside businesses, (2) whether the type of assistance provided by the community development organization has non-commercial terms <u>and</u> the potential to revitalize the disadvantaged area, <u>and</u> (3) whether there is a nexus between the business entities assisted and relieving the problems of the disadvantaged area, <u>or</u> between the businesses and a disadvantaged group, like a minority, in the area...**with respect to the third factor**; the above revenue rulings and GCMs indicated that there are **three characteristics** that provide a nexus between the businesses assisted and relieving the problems of the disadvantaged area: (a) assistance recipients conducting their business in the economically disadvantaged area, (b) recipients not being otherwise able to obtain assistance from conventional sources because of the depressed nature of the area <u>or</u> affiliation of business participants with minority or other disadvantaged groups, <u>and</u> (c) assistance recipient

selection is based on which recipients will offer the greatest potential community benefit by virtue of either their current operations or their promises to take certain actions benefiting the depressed area (emphasis supplied)."

How should the standards governing economic development activity involving a CDC with a for-profit business be applied?

It's obvious that the standard described in GCM 39883 is convoluted. In an article I wrote in May of 1997 I discussed the difficulty of applying the GCM standard, and suggested the IRS needs to reexamine and reform the standards to make them more faithful to the Regulations and its prescription of independent social welfare standards.

How it should be applied in a given situation is a question for your legal counsel. However, I do believe a CDC should (1) focus on economic development as relieving poverty and stemming community deterioration, (2) be able to demonstrate that its *primary* intent is not to make money, (3) make its assistance available on noncommercial terms, and (4) make sure that the economic returns to any for-profit business involved with, or benefiting from, the development (i) are not pegged at above market rates (taking into account the nature of the market, however), and (ii) are not guaranteed by the CDC. A bit more discussion on relief of poverty and stemming community deterioration is warranted:

A. Relief of Poverty

Creating jobs accessible to local unemployed, underemployed or disadvantaged residents, and having these individuals ultimately fill the jobs, is central to showing that the supported activity relieves poverty. A "first source" hiring agreement executed between the nonprofit and the for-profit business can be an effective mechanism for steering at least a majority of the jobs created by the business activity to local residents, thereby relieving their poverty. In determining which businesses to assist, it is important to remember that Rev. Rul. 74-587 gave a *preference* to businesses that would provide training and employment opportunities for the unemployed and underemployed residents of the area. However, it did not make it a formal condition of assistance by requiring, for example, the execution of a first source hiring agreement. As discussed, in many cases such an agreement is simply not necessary.

Economic development of a retail nature can also have beneficial collateral effects. For example, bringing in large, established retail businesses often has the effect of marginally relieving the poverty of patrons supporting the stores by making high quality goods and services available at lower prices. This can function as a sort of pay raise, helping to stretch already tight household budgets. Likewise, technical assistance provided to local-hiring businesses which increases competitiveness, productivity, and the wages of employees, can have a direct impact on reducing poverty.

B. Stemming Community Deterioration

Often the economic development supported by CDCs which grows local businesses and creates new jobs can boost the income level of local residents, reduce unemployment, put to use abandoned, boarded up structures, and reduce the crime of an area, directly satisfying several of the factors cited by the IRS in the 1996 TIPT.

Revitalization of run-down commercial corridors in cities throughout the United States has consistently been supported by CDCs. The primary goal of most of these projects is to stem community deterioration and revitalize the area. One way this is accomplished is to strengthen the immediate retail sector, thereby achieving several specific revitalization goals: increasing the availability of much-needed goods and services not available or not easily available to local residents (grocery stores, large franchises, etc.), thus keeping money in the neighborhoods that is otherwise flowing out to more stable neighborhoods, often in adjoining suburban areas; and expanding the

local job base, also causing more money to remain in the neighborhoods and achieving a vital component for community renewal: regeneration of the local economy.

III. Examining Charitable Operations as a Whole

Section 501(c)(3) states that an exempt entity must be operated "exclusively" for charitable purposes. What does exclusively mean?

The Regulations state that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages *primarily* in activities that accomplish such purposes and will not be so regarded if more than an *insubstantial* part of its activities is not in furtherance of an exempt purpose. What that means is that an exempt organization such as a CDC can conduct an insubstantial amount of business that is not in furtherance of an exempt purpose and still obtain or retain its tax-exempt status.

Is there a percentage of business unrelated to charitable purpose that the IRS recognizes as acceptable?

There is much confusion over this question. The number most often thrown around is no more than 10% of the organization's revenue (a mirror of its activities) can come from any non-exempt activities it undertakes. However, the discussion below indicates that there is no authority for relying on a 10% rule.

How is the income received by the exempt organization from non-exempt activities classified?

Income of this nature is described as "unrelated business income" (UBI), and is governed primarily by sections 511-513 of the Code.

What two characteristics must be present before the income generated from the activity will give rise to UBI which is subject to tax?

First and most obviously, the activity must be "substantially unrelated " to the exempt purposes of the exempt organization. What this means is that there must be a lack of a "causal relationship" between the conduct of the business activity and the achievement of the tax-exempt purpose. This is sometimes a difficult time to draw.

Second, the business must be "regularly carried on." The regularly carried on test focuses on the frequency and continuity of the activity producing the income. If an activity was conducted throughout the year, for example, it would be deemed to regularly carried on. On the other hand, if a one-time activity produces income, such as a sale of real property or the sale of some kind of equipment or other materials, the business activity is not deemed to be regularly carried on. The IRS' concern here is that if an activity is regularly carried on and is commercial in nature, then the income produced should be on equal footing with the taxable earnings of a for-profit business.

What is the name of the tax that is incurred by the exempt organization with respect to UBI?

The tax is known as the "unrelated business income tax" (UBIT). UBIT is imposed on UBI at rates between 15% and 35% (the same as the basic federal corporate income tax rates), depending on the bracket as determined by the level of income.

Are there any cases in which UBI can avoid being subject to UBIT?

The answer is yes, and they are known as the UBIT exceptions. The basic concept behind the UBIT exceptions is that if income is derived by an exemption organization in a "passive" manner, it is usually not obtained as the result of competitive activity. Thus, it should not be taxed because it is not "active" in nature and did not result from commercial competition. Here are the most common UBI exceptions to UBIT liability:

- Annuities
- Dividends
- Interest
- Rents
- Royalties

Special rules apply to some of these exceptions. In addition, under Section 512(b)(4) of the Code, unrelated debt-financed income which flows from "unrelated debt-financed property" (UDFP), as determined by Section 514 of the Code, is not an exception to UBI. UDFP is property that is held to produce income and with respect to which there is "acquisition indebtedness." One exception to UDFP is property where at least 85% of its use is substantially related – aside from the need of the organization for income or funds – to the exercise or performance of its tax-exempt purpose. This is an important exception for nonprofits, for example, because it's what allows the rental income from a property which a nonprofit acquires and develops using debt, and then continues to own and manage, to be exempt from UBIT.

The 1997 Budget Reconciliation Act contained one change of note in the area of activities conducted through a taxable affiliate. Previously, under Section 512(b)(13) of the Code, if an exempt organization "controlled" 80% or more of the taxable organization, certain specified payments to the exempt parent were UBI subject to UBIT if the affiliate took business deductions against those payments. Many exempt organizations got around this restriction by setting up exempt affiliates that it controlled, neither of which would have more than 80% of the voting stock of a third for-profit affiliate, which would make certain payments to one of the affiliates. The BRA lowered the percentage of control triggering UBIT liability from 80% to no more than 50%, *by vote or value.* Specified payments subject to UBIT are defined in Section 512(b)(13(C) as interest, annuity, royalty or rent payments. These payments are subject to UBIT in spite of the exclusion normally afforded these payments. However, if an argument can be made that the payments flow from income generated from a activity related to the exempt parent's charitable mission, then the payments should not be UBI in the first place. However, attorneys should note this change when setting up a for-profit affiliate of an exempt parent.

How much UBI can an exempt organization receive and not jeopardize its tax-exempt status?

This question is the flip side of the exclusivity of operations question posed above. In other words, how insubstantial can the non-exempt activities be, as represented by the level of UBI generated

from these activities. As mentioned, there is no support for the 10% rule described above. Rather, the answer is somewhat surprising and often overlooked by attorney and accountant advisors.

Rev. Ruling 64-182 stated that an organization that principally derived its income from an office building that it owned, operated, and maintained (UBI, although not subject to UBIT) qualified for exemption because it carried on "a charitable program commensurate in scope with its financial resources."

GCM 34682 (1971) reaffirmed the holding of Rev. Rul. 64-182 and contained the following passages:

"...there is no quantitative limitation on the 'amount' of unrelated business an organization may engage in under Section 501(c)(3)...there is no categorical rule as to the amount or the percentage of an organization's income or resources that must be expended for charitable use in any given period in order to fulfill the operational requirements of charitable status...if an organization is carrying on a real and substantial charitable program reasonably commensurate with its resources, that is just about the most conclusive evidence one could have as to charitable purpose of an organization in the administration of its properties."

In Technical Advice Memorandum (TAM) 9636001 the IRS ruled that an educational institution that had a publishing division unrelated to the mission of the school and which generated over 50% of school income, could remain tax-exempt. The net income generated by the publishing division was UBI subject to UBIT, but TAM 9636001 applied the commensurate test to find that the organization itself remained exempt. Again, this was consistent with the holding of Rev. Rul. 64-182 but nonetheless surprised many practitioners. What saved the exemption for the organization was the fact that the operation of the school was considered a substantial exempt activity that preserved the charitable operation finding of the overall institution.

If UBI is subject to UBIT, how is the tax paid to the IRS?

If you believe that your organization has incurred UBIT, then it must file a Form 990-T, which is the tax form for exemption organizations which owe UBIT, and include the tax that is due and owed. In addition, there should be a notation made on Form 990, which asks for information on income producing property, of any UBI. There should then be an indication of what exception the CDC believes the income falls into. If the IRS was to ever disagree, they would have a three year period to dispute it, as opposed to an unlimited period of time if the information was never disclosed.

Does filing a Form 990-T increase the likelihood of an audit by the IRS?

Filing a Form 990-T should not increase the likelihood of an audit. A number of years ago there was an random audit of various organizations which had filed Form 990-T's. However, the EO Division of the IRS each year largely sticks to its work plan, which usually does not include an audit of such organizations. A random audit outside the work plan is always a possibility.

IV. The Private Inurement and Private Benefit Doctrines - How to Get the IRS' Attention

What is the private inurement doctrine?

Section 501(c)(3) prohibits using a tax-exempt organization for the private gain of an individual, defines a charitable organization (as opposed to religious, educational, scientific, etc.) as organized and operated primarily for *charitable* purposes, "no part of the net earnings of which shall inure to the benefit of any individual..." The concept of private inurement inherent in the organization of a stock corporation is completely contrary to an organization receiving 501(c)(3) status. Therefore, any activity undertaken by a 501(c)(3) organization that serves a private rather than a public interest is violative of the nature of a charitable organization.

Example: Prior to becoming a board member of the Neighborhood CDC, Mr. Smith bought some vacant land on speculation (the "Parcels") in the Neighborhood for a total purchase price of $30,000. He subsequently joined the board of Neighborhood CDC, which became interested in acquiring the Parcels as sites for new house construction. The market price of the Parcels had clearly fallen to between $15,000 and $10,000. At the time the sale was proposed, Mr. Smith owed outstanding mortgage debt on the property of approximately $20,000. A sale of the Parcels for $20,000 was proposed by Mr. Smith to the Board. Mr. Smith did not adequately disclose his conflict to his fellow Board members, and was an influential member of the Board. He voted in favor of the sale at a meeting in which the bare minimum for a quorum was present. Mr. Smith then executed the purchase and sale agreement on behalf of *both* parties to the transaction, and completed the conveyance

Analysis: This case, which actually occurred in a LISC program, was a clear violation of the private inurement prohibition of Section 501(c)(3) of the Code. Although Mr. Smith did not make money on the sale of the Parcels compared to what he paid for them, he was enriched by using the Neighborhood CDC - to which he owed a fiduciary duty - to relieve himself of a debt obligation he otherwise would have had to pay. In the process, Neighborhood CDC paid more for the Parcels than it should have, and was used for the private benefit of Mr. Smith.

Remedy: Mr. Smith should reimburse Neighborhood CDC the difference between the market value of the Property and the sales price, as well as any other out of pocket expenses Neighborhood CDC experienced in connection with the sale. Mr. Smith might also be personally liable to pay an excise tax under section 4958 of the Code (the recently enacted “Intermediate Sanctions”).

What remedy can the IRS pursue if private inurement is found?

The answer now is different now than it had been for many years. Prior to 1996 the IRS’ only recourse was to do nothing, or to take steps to revoke the tax-exempt status of the organization, a draconian measure. However, on July 30, 1996, Section 4958 of the Code was passed as part of the Taxpayer Bill of Rights 2. The basic rules of Section 4958, which is entitled “taxes on excess benefit transactions” and which is commonly known as “intermediate sanctions,” allow for the imposition of economic sanctions on “disqualified persons” who engage in “excess benefit transactions.” Disqualified persons are those in a position to exercise “substantial influence over the affairs of the corporation” at any time during the five (5) year period prior to the transaction. Preliminary regulations providing more guidance on intermediate sanctions were issued on July 30, 1998.

The sanction is an excise tax levied against the person disqualified of 25% of the amount of the excess benefit transaction, and 200% of the transaction if it is not corrected within the statutory correction period. In addition, a 10% excise tax can be assessed on “organization managers” who knowingly participated in the transaction, unless such participation was not willful and was due to reasonable cause.

What is the private benefit doctrine?

The private benefit doctrine is related to the concept of private inurement, but it is broader in application. If violated it can jeopardize an organization’s tax-exempt status. As opposed to the private inurement rule, the prohibition against private benefit is not limited to situations in which

benefits accrue to insiders, i.e., it is not limited to those having a personal and private interest in the activities of the organization. The purposes of an activity must be sufficiently benefiting the public in order to comply with the private benefit doctrine.

V. When to Consider Conducting an Activity Through an Affiliate

When should a CDC considering setting up an affiliate to conduct an activity?

There are cases in which a CDC should consider conducting a particular activity through a new affiliate corporation, as opposed to within the umbrella of the CDC. When an affiliate corporation is formed, however, it not only takes certain resources to set up but if it is going to be conducted as a legitimately separate entity - which is the goal - there are ongoing resources that will be needed to maintain the corporation's separate existence, board, board meetings, books and records, financial statements, audit, etc. These should always be weighed against the potential benefit a separate legal structure will provide to the parent CDC.

Outlined below are some of the common cases in which a CDC should consider this option:

A. To Protect the Assets of the CDC from Liability.

This usually make sense only if the CDC has significant assets to protect, and if the activity is new and the CDC believes the risk of liability is increased. For example, if a CDC with a large balance sheet that traditionally engages in housing development decides to branch out to business incubator development, it might want to conduct the new activity through an affiliate.

The question of whether a CDC affiliate is a truly separate corporation, thereby affording the parent protection from its acts, is largely a question of fact. What follows is a comprehensive "laundry list" of factors various courts have considered in deciding "piercing the corporate veil" (i.e., ignoring the corporate wall between the CDC and its affiliate) cases in the for-profit context:

(1) is the CDC the sole or majority member (i.e., in for-profit parlance, the "parent") of the affiliate?; **(2)** does the parent limit outside financing of the affiliate? **(3)** does the parent loan money to the affiliate in other than an arm's length manner?; **(4)** does the parent provide cash management for the affiliate? **(5)** does the parent keep tight control on the affiliate's expenditures?; **(6)** does the parent require that the affiliate centrally report all financial transaction?; **(7)** does the affiliate have separate capitalization?; **(8)** to what extent are there common directors, officers and employees of the parent and the affiliate?; **(9)** are there separate meetings of members and directors of the affiliate?; **(10)** does the parent and the affiliate have similar business operations and/or departments?; **(11)** are contracts between the parent and the affiliate at "arms length (commercially reasonable); **(12)** are separate books and records maintained?; **(13)** are officers and/or directors of the parent permitted to determine the policies or decisions of the affiliate?; **(14)** was an employee, officer or director of the parent causally connected to the contract or tort which caused litigation?; **(15)** does the public generally regard the two corporations as one?; **(16)** did the parent know of the affiliate's activity, help its activity, know of affiliate's inability to carry out an activity, and/or was able to control the activities of the affiliate?; **(17)** are the affiliate's executives' salaries set or approved by the parent?; **(18)** does the parent hire/fire/promote affiliate employees?; **(19)** are employees transferred between affiliates by the parent?; **(20)** does the parent coordinate a company-wide employee benefit program?; **(21)** does the parent set company-wide employee benefits?; **(22)** do the parent and affiliate have common professional and financial services?; **(23)** are the parent and affiliate presented to the public as a single business entity?; and **(24)** can the affiliate be "cleanly severed" from the parent?

If a separate corporation is set up and conducted as such, the CDC should be able to successfully defend a "piercing the corporate veil" lawsuit and thereby avoid liability stemming from the affiliate's activity.

B. To Protect the Tax-Exempt Status of the CDC.

Another reason for a CDC to conduct a particular activity through an affiliate is to protect its tax-exempt status. If a CDC plans a business activity similar to one offered on the commercial market and not otherwise charitable, and it could potentially constitute a substantial portion of the CDC's activities, if it is done "in-house" it could jeopardize the organization's tax-exempt status (keep in mind, however, the discussions of "substantial" and the "reasonably commensurate rule" discussed in Section III, above).

For example, if a CDC decided to raise revenue by launching a property management arm to manage buildings affordable only to middle income families (i.e., not in furtherance of its charitable purposes), and this activity became a "substantial part" of the CDC's activities, not only would the revenue received from such activities be subject to income tax (UBIT), but the tax-exempt status of the CDC could be endangered.

If, however, the activity was conducted through a for-profit affiliate, it could generate revenue which could be transferred to the CDC (after payment of income tax), and the CDC's tax-exempt status would be protected because the activity of its affiliate would not be considered carried out by the CDC.

C. To Concentrate Resources and Attention on a New Activity.

Although not technically legal in nature, this is a common reason a CDC will consider conducting an activity through an affiliate. Setting up an affiliate with a separate board and staff to carry out a new activity will often create a sharper focus and closer oversight, and also facilitate proper staffing, thereby increasing the chance that the desired goal will be achieved.

For example, if a tax-exempt, community-based organization historically focusing on drug rehabilitation and health issues decides to move into affordable housing development, though this activity may be charitable and (if its Certificate of Incorporation is drafted broadly enough) within the scope of the organization's permitted activities, it might make more sense to have the activity conducted by an affiliate.

A distinct corporation with a partially or completely different board of directors and staff creates an entity which can concentrate more intently on a new task. In many cases, the new activity will present the non-profit with a distinct challenge. A separate Board will be able to devote time and energy to the new activity in a way that a Board overseeing a range of activities cannot. Greater emphasis will be placed on hiring staff to accomplish the goals of the new corporation, thereby more effectively furthering the mission of the parent.

Part of the decision-making process by the CDC will involve its assessment of whether it has the in-house experience, staff and extent of work (i.e., to generate sufficient fees) to undertake an activity through an affiliate. It must also honestly decide whether an activity conducted in-house will conflict with any corporate goals. The alternative to in-house, however, is not always setting up an affiliate to conduct the activity. For example, with property management, contracting for management may make more sense and is in fact much more common.

D. To Avoid Muddling the Mission of the CDC.

A second reason a CDC might set up an affiliate is if a proposed activity might conflict with a fundamental mission of the corporation. Certain activity mixes can cause a philosophical problem for a CDC. For example, if a non-profit whose main activity is tenant advocacy wants to manage a couple of low income buildings it has acquired and rehabilitated, it might be more suitable to have the activity accomplished through an affiliate. This could relieve the internal tension created at the CDC by its struggle to reconcile two potentially conflicting activities.

E. To Secure "Community Housing Development Organization" ("CHoDO") Status.

If a CDC has a membership that is exclusively tied to a particular religion, or the activities of the organization are not clearly separated from the religious activities of its members, it may have difficulty in qualifying as a CHoDO and being eligible to receive part of the 15% set-aside of HOME funds for CHoDOs. This may happen when a church begins housing development activity (either itself or through an affiliate), and participation is so closely tied to church membership, that the housing development can be viewed merely as an appendage of the religious practice of the church sponsor. In this instance, creating an affiliate having a Board membership not only of church members, but also of interested, independent, low income community members, can increase the chance that the affiliate organization will secure CHoDO status and be eligible for receipt of HOME funds.

F. To Preserve Allocations Generating Desired Returns in LIHTC Projects.

For tax credit projects sponsored by CDCs, tax considerations underlie the decision to form an affiliate. The primary reason LIHTC projects feature a for-profit subsidiary of the CDC as the general partner of the project partnership is due to certain rules in the Code.

The general partner of a typical LIHTC project partnership has a right to share 50% in any back-end sale proceeds. If the general partner of the project partnership was a tax-exempt corporation (e.g., the CDC), because of the Section 168 tax-exempt leasing rules, the flow of credits and losses (75% as tax credits, 25% as losses) is not as advantageous as it is if the general partner is a taxable corporation. This tax rule is the driving force behind the CDC spinning off a for-profit affiliate to act as general partner of the project partnership.

It is important to note that the above reasons are not mutually exclusive. Depending on the circumstances, more than one factor may justify the CDC's creation of an affiliate.

If a CDC is the sole member of a non-profit affiliate or the sole stockholder of a for-profit affiliate, it controls the affiliate by electing its Board of Directors at an annual meeting (and filling vacancies as they arise). Though as illustrated above there may be many advantages to creating an affiliate, this means of control over an activity is obviously less direct than if it was conducted in-house by the CDC.

VI. Issues with Joint Ventures between Tax-Exempt CDCs and For-profit Entities

Can a joint venture partnership be legally formed under the nonprofit law of a state?

There is no such thing as a nonprofit partnership, since partnerships technically must have a profit motive. There can, however, be a partnership or limited liability company which exclusively has nonprofit members, and therefore does not distribute profits to private parties due to the nature of the individual partners. In this regard you may need to remind a CDC having a strong philosophical bent against having any of its activities appear to be for-profit, that if it belongs to a joint venture, the entity will technically be classified as a for-profit entity. This is the case even if the CDC participates directly in the venture.

Can a joint venture obtain tax-exempt status?

As you might expect from the above answer, the answer is no.[2]

What is the fundamental conflict between the purposes of, and restrictions on, a nonprofit and a for-profit?

This has been discussed above, but again, the CDC must be organized and operated for substantially charitable purposes and therefore cannot be operated for private benefit. A for-profit, on the other hand, is organized precisely for the opposite reason – the prospect of a private benefit to investors is the motivating force behind putting their capital at risk in support of the business venture. That being said, however, a joint venture between the two is legally permissible, as long as several criteria are met, one being that the project is substantially in furtherance of the CDC's charitable purposes.

Can a nonprofit be a general partner of a partnership?

Until 1982 the IRS took the position that a tax-exempt organization's participation as a general partner in a limited partnership is *inherently incompatible* with its exclusive operation for charitable purposes.[3] Since 1980 the IRS has used a two prong analysis to determine whether participation by an otherwise exempt organization in a partnership as a general partner adversely affects Section 501(c)(3) qualification.

First, whether participation by an organization furthers its exempt purpose, and second whether the partnership arrangement allows the organization to act exclusively in furtherance of an exempt purpose. As for the second part of the test, a reserve or guarantee of/against operating losses,

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[2] A recent piece written by a well-known attorney in the exempt organization field suggested that there is no reason why an LLC should not be able to obtain tax-exempt status due to its limitation of liability and avoidance of putting general capital at risk; however, that is not the current law.

[3] In 1982 a case called Plumstead Theatre Society v. Commissioner was handed down by the Tax Court regarding an organization operated to produce theatrical plays. The court concluded that the organization's serving as a general partner of a limited partnership was not inconsistent with exemption because the organization (i.e., the partnership) possessed the characteristics of a nonprofit theater rather than a for-profit theater. Among the important factors cited by the court was the fact that the general partner had no obligation to return the investor's capital from its own funds, and since the investor limited partners had no control over the operation of the exempt organization, the partnership did not operate for the private interests of the limited partners.

profits or fees; the return of capital; or indemnification by the exempt organization in favor of the for-profit is evidence of the furthering of the private interests of the investor, and generally will cause concern with the IRS).

The acceptability of an exempt organization being the managing member of a limited liability company formed to support charitable economic development was confirmed in a ruling issued by the IRS in May of last year.

On March 4, 1998, Rev. Rul. 98-15 was released. The ruling focused on whole hospital joint ventures between exempt organizations and for-profit entities. However, the IRS has made clear that the principles of the ruling are intended to apply beyond the hospital context. Releasing joint venture guidance had been an item in Treasury's business plan for three years. Rev. Rul. 98-15 will be a source of significant advisement in the joint venture area for years to come. In spite of some views of protest in recent legal literature, the ruling clearly reaffirmed the holding of the Plumstead Theatre case. Prior to Rev. Rul. 98-15, the IRS had never issued a ruling of precedent affirming the basic finding of Plumstead Theatre that an exempt organization could be the general partner of a partnership under the right circumstances. Rev. Rul. 98-15 not only affirmed that, but it emphasized the importance of the exempt organization's maintaining sufficient control over the operations of the joint venture. The ruling contains two examples, one with a fact pattern obviously passing muster, the other with a fact pattern obviously failing the test.

In spite of being generally well received, Rev. Rul. 98-15 has created some confusion which will not be quickly quelled. For example: (1) can it provide useful guidance for the many joint venture structures that fall within the obvious positive and negative fact pattern examples contained in the ruling, (2) with respect to an organization that invests only a small portion of its assets (as opposed to all its assets) in a joint venture structure not passing muster, is loss of tax-exempt status the only permitted result, or will only unrelated business income tax liability be triggered (this is particularly an issue in light of the fact that a small investment by an exempt organization via a non-controlling role, such as through a limited partner investment, might *only* cause unrelated business income tax liability without *any* jeopardy to the entity's exempt status), (3) how will the ruling's explicitly required elevation of an exempt organization's responsibility to further charitable purposes square with the general partner's fiduciary duty under state partnership law to act in the best interests of limited partners.

Does the CDC or its affiliate have to be the general partner or managing member of the joint venture?

As mentioned, since 1982 the IRS has moved to the position that a nonprofit could be the general partner of a partnership if certain safeguards were present. However, say a proposed project was clearly charitable, but that the CDC failed the Plumstead "control" test in that it was not the general partner or managing member and therefore did not have general control of the business under partnership law (and consequently, could not cause the partnership to act exclusively in furtherance of charitable purposes).[4] It's possible this could be an acceptable structure.

[4] LISC has needed to examine this issue in the context of a franchise economic development project in which the basic business ownership vehicle was an LLC, which early on had the local entrepreneur as the managing member of the LLC and the CDC as only a member. This was driven by the anticipated need of the franchiser to have the person who would be running the business and going through the training program be the person in control of the day-to-day operation of the franchise.

The issue of whether inserting rights of intervention for the CDC in the Operating Agreement could work as a solution to the problem was examined. A distinction was made between delegating to the managing member with and without constraint. Certain matters, such as the daily operation of the franchise business, would be delegated without constraint by

How do I know if the work of the joint venture is charitable?

The standards applying to determining whether the joint venture's underlying activities are charitable are those described above in Section I.

What does the joint venture's organizational document (limited partnership agreement or operating agreement) need to say about the charitable nature of the project?

From the for-profit's standpoint, and from state partnership law standpoint, absolutely nothing. Quite often the agreement will state simply that the purpose of the partnership is to acquire, develop and dispose of real property and do and perform any and all other activities as authorized under state law.

However, from a CDC's standpoint, I think it's important to include in the organizational document not only the charitable goals of the venture (e.g., relief of poverty, elimination of prejudice and discrimination, stemming of community deterioration), but also what activities are planned to achieve those goals (e.g., development of rental or for-sale housing affordable to low income households; creation of jobs to be filled by unemployed residents; providing of financing and technical assistance to minority entrepreneurs; establishment of new businesses in a deteriorated area). Normally the for-profit should not be concerned about adding this - even though it's unusual language - because these points should have been previously discussed or at the very least should be understood as the goals of the venture (and, for example, under the LIHTC, will be required to comply with Section 42 of the Code).

VII. Educational and Political Activities - Rules and Distinctions

Is an exempt organization permitted to engage in voter registration activities?

As long as the CDC is not a private foundation, conducting voter registration is an acceptable activity with certain caveats. However, the voter registration drive must be directed to the public at large, and cannot be targeted to a group of people with a particular political orientation. Voter registration conducted by itself, without any accompanying oral and/or written presentation or information intending to edify the registrant, is the purest form of voter registration and is acceptable.

Voter registration accompanied by education of the registrants about particular issues or legislation, or about particular legislators or candidates, is likely to garner more scrutiny, and is subject to the limitations described below.

One major issue involving voter registration involves the proposed funding source for the CDC's voter registration campaign. If the proposed source of funds is money received from (1) a private

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the non-managing CDC to the entrepreneur managing member. Other items, such as the right to change the location of the business or the first source hiring provision of the Operating Agreement, could not be done without the consent of the CDC. In addition, the CDC would have the right to take corrective action, such as removing the managing member, if it proceeded without obtaining the CDC's prior written consent as to those items. In that way, the CDC could ensure the LLC didn't deviate from the Operating Agreement terms critical to maintaining the continuing charitability of the activity. Presently, however, there is no precedent to rely on if arguing the legitimacy of this structure with the IRS.

foundation, or (2) LISC, and the source of LISC's funds for the program action is from a private foundation, if the funds are used to finance voter registration activity they may be deemed a "taxable expenditure" by the contributing foundation and subject to a tax, payable by the foundation, equal to ten percent (10%) of the amount of the expenditure. This will be the case, however, only if the foundation knew or should have known ahead of time that its funds were to be used or were likely to be used for this purpose.[5]

If, however, the CDC receives contributions from individuals and corporations not subject to the taxable expenditure rules, these funds can be used to fund voter registration activities by the CDC without any adverse consequences to the funders, or the CDC. Therefore, there are three key points to emphasize: **(1)** voter registration by itself, or in conjunction with legitimate, non-partisan voter education, is an acceptable activity for a CDC to engage in, **(2)** funding the activity with private foundation funds (either directly or through LISC) may cause a tax to be incurred on the private foundation, and **(3)** non-private foundation funding sources can be used without creating adverse consequences for either the CDC or the funding source.

Is an exempt organization permitted to engage in voter education activities?

As one commentator has written, there is "a tension between the concepts of political campaign activities and voter education activities." The general rule is that activities meant to inform and educate voters, presented in a non-partisan manner, are permitted. This is true even if the information advocates a particular position as long as a full and fair exposition of the pertinent facts is also presented to permit the public to form its own opinion or conclusion independent of that presented by the organization.

By its nature this is a grayer area than voter registration. Rather than citing a lot of specific revenue ruling and regulations, it might be more helpful to list examples of activities found by the IRS to be both acceptable and unacceptable.

Some examples of **acceptable** cases are the following:

- an organization that prepares and disseminates a compilation of the voting records of all members of Congress on a wide variety of major subjects, as long as there is no editorial comment and no approval or disapproval of the voting records is implied;
- an organization that publishes the responses to its questionnaire on a wide variety of subjects from all candidates for an office, as long as no preference of a candidate is expressed;
- an organization that operates a broadcast station providing equal air time to political candidates;
- an organization that publishes a newsletter containing the voting records of congressional incumbents on selected issues (a 1980 ruling (subsequent to the 1978 Revenue Ruling noted below which describes similar activity as *un*acceptable));[6] and

[5] Section 4945(d)(2) of the Code states that "...for purposes of this section, the term 'taxable expenditure' means any amount paid...by a private foundation – except as provided in subsection (f), to influence the outcome of any specific public election, **or to carry on, directly or indirectly, any voter registration drive** (emphasis added). Subsection (f) referred to in Section 4945(d)(2) contains four (4) tests which must be met to avoid taxable expenditure consequences, only one of which most CDCs would cause the foundation to meet. Therefore, taxable expenditure consequences to private foundation funders (either directly or indirectly, through LISC) would be difficult to avoid if the foundation knew its funds were to be used for this purpose.

[6] The discussion of this ruling by Bruce Hopkins in "The Law of Tax-Exempt Organizations" is as follows: "The IRS indicated that the format and content of the publication need not be neutral, in that each incumbent's voter and the

- an organization that issues "report cards" on the voting of legislators, in which the voting record of the legislator receives a "+" if it coincides with the organization's position on the matter voted upon, and a "–" if it does not (importantly, the organization's report card did not appeal for any candidate's election or defeat).

Some examples of **unacceptable** cases are the following:

- an organization that endorses particular candidates for office, or political parties, and/or urges voters to vote for particular candidates or those of a particular party;

- an organization that publishes candidates' answers to questions that indicate a bias on the issues; an organization that publishes a voter guide reflecting the voting records of members of Congress on selected issued of interest to the organization (a 1978 ruling; see, however, above case from 1980 and accompanying footnote); and

- a religious ministry organization engaging in legislative activities and intervening in political campaigns, by means of publications and broadcasts that attack candidates and incumbents (presidents and members of Congress) considered too liberal, and which endorses conservative officeholders.

Important factors permitting the publication of voting records in newsletters are that the publications are sent only to the members of the organization and are not widely distributed to the public during an election campaign and are not intended to influence a particular election. Also, another critical factor is that the records are not accompanied by endorsements of candidates and/or the urging of the election or defeat of particular candidates.

Another item important to note is that organizations will only be held accountable for what their directors, officers, employees or agents do in the capacity of representing the organization. These persons are free to advocate for candidates with voters on their own time. However, the activities of directors, officers, employees and agents in this area should be made known to, and monitored by, CDCs, because the outside activities will be imputed to the CDC if it has, directly or indirectly, authorized or ratified the acts.

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organization's views on selected legislative issues can be reported, and the publication may indicate whether the incumbent supported or opposed the organization's view. Nonetheless, the IRS considered the following factors as demonstrating the absence of political campaign activity: **(1)** the voting records of all incumbents will be presented, **(2)** candidates for reelection will not be identified, **(3)** no comments will be made on an individual's overall qualifications for public office, **(4)** no statements expressly or impliedly endorsing or rejecting any incumbent as a candidate for public office will be offered, **(5)** no comparison of incumbents with other candidates will be made, **(6)** the organization will point out the inherent limitations of judging the qualifications of an incumbent on the basis of certain selected votes, by stating the need to consider such unrecorded matters as performance on subcommittees and constituent service, **(7)** the organization will not widely distribute its compilation of incumbent's voting records, **(8)** the publication will be distributed to the organization's normal readership (who numbered in this case only a few people nationwide) and **(9)** no attempt will be made to target the publication toward particular areas in which elections are occurring, nor to time the date of publication to coincide with an election campaign.

Is an exempt organization permitted to engage in lobbying activities?

First, a general description of lobbying. Lobbying is shorthand for an "attempt to influence legislation," which for federal purposes includes local, state and federal legislation and expenditures under such legislation, but does not include executive orders or regulations of independent regulatory agencies. Meeting first hand, or having oral or written correspondence with elected officials and their staffs is the most obvious example of this kind of lobbying.

Another kind of lobbying known as grassroots lobbying is conducted by attempting to influence elected officials' positions on legislation through influencing the public itself. The goal is to create public support or opposition for legislation which will translate into pressure on the elected official to take a position consistent with the lobbying group's. This approach has been utilized by LISC and many CDCs over the last several years to mobilize support for the Low Income Housing Tax Credit.

Contrary to some people's belief, lobbying by a Section 501(c)(3) organization is permitted under the Code. There are, however, restrictions imposed on the level of permitted lobbying. The annual lobbying undertaken by an exempt organization should be reported on its annual Form 990 tax return filed with the IRS.

What are the limits imposed on an exempt organization's lobbying activities?

There are two tests used to limit the amount of annual lobbying an exempt organization can undertake.

One is known as the “substantial part test,” and is a qualitative limitation derived from the language of Section 501(c)(3) of the Code which states that no substantial part of the activities of a 501(c)(3) organization may constitute the "carrying on [of] propaganda, or otherwise attempting to influence legislation." This is a facts and circumstances test that looks at the level of lobbying in light of the organization's overall activities. In the absence of much specific guidance from the IRS, the test is rather nebulous and difficult to apply.

For that reason, many exempt organizations which undertake lobbying have chosen to apply the second method, known as the “expenditure test,” by electing to file what's known as a section 501(h) election. The election is made by filing a simple form with the IRS. Up-to-date records must be maintained by the organization (this is one quid pro quo for making the election) detailing the costs incurred by the organization in lobbying, including the proportionate salary amounts of any employees engaged in lobbying. The annual expenditure limits are the following: 20% of the first $500,000 expended by the organization for an exempt purpose; 15% of the next $500,000 expended for an exempt purpose; 10% of the next $500,000 expended for an exempt purpose; and 5% of any remaining expenditures. However, there is a total cap of $1 million on the annual expenditures on lobbying permitted by an tax-exempt organization.

Is an exempt organization permitted to engage in political campaign activities?

These activities, also referred to as electioneering, are <u>not</u> permissible. The prohibition stems from the language of Section 501(c) (3) which states that an organization "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." While there is no specific guidance in the regulations, the IRS has stated that the prohibition is absolute. It is therefore unwise to undertake any political campaign activity, since there is no room for it according to the IRS and it will perhaps above all other activities garner the IRS' scrutiny.

VIII. Tax-Exemption Documents

What is an organization's responsibility to maintain its Form 1023 Application for Recognition of Exemption?

The letter from the IRS determining an organization's tax-exempt status requires the organization to inform the IRS if its activities have changed since submission of its 1023 Application. An organization may explore several options to comply with this requirement. First, it should check the original 1023 carefully to make sure there is not a description of anticipated operations that could cover the activities the organization believes is beyond the more specific language in the 1023. Second, the organization should use the annual Form 990 as a way to inform the IRS of any new activity it has undertaken in the last year. In this way it will establish a disclosure record with the IRS of any activities that are not specifically reflected in the 1023 Application. A third option is to send a letter to the IRS describing the new activity and request an amended letter ruling.

What should an organization do if it cannot locate its 1023 Application?

Under the Taxpayer Bill of Rights passed in 1996, each 501(c)(3) organization must send a copy of its 1023 Application to a member of the public which requests to receive a copy. If an organization cannot locate its 1023, it should make a request to the IRS under the Freedom of Information Act to receive a copy. If the IRS cannot provide a copy, then the organization can at least demonstrate that it tried in good faith to obtain one.

What is the importance of the letter from the IRS determining a 501(c)(3) organization's exempt status and non-private foundation status?

These are extremely important letters, and care should be taken to safeguard the original and make a sufficient number of copies for distribution when required. Though the letters are short and are sometimes of poor quality after many years sitting in a file, they are the only outside evidence an organization can use to demonstrate that it does not owe income tax. If the determination letters are lost or misplaced, a FOIA request can be made to the IRS asking for duplicate copies.

What is the importance of the Form 990 Tax Return?

Not only is this the document in which an exempt organization provides annual financial information to the IRS, but it also reveals information about the organization's lobbying activities, its public support test compliance, any UBI activity, and any new activities it has undertaken in the previous year. The Form 990, then, is the central tool for disclosure and reporting to the IRS of information about a public charity.

In addition, after passage of the Taxpayer Bill of Rights 2 passed in 1996, all public charities are required to provide copies of their 990's, with all supporting schedules, to any member of the public who requests it in person at most offices of the corporation, as well as those requesting it in writing. The organization can charge a reasonable fee covering the cost of photocopying the return and delivering it. This provision was passed primarily in response to the need to provide easier access to information about nonprofit organizations after some of the well-publicized scandals of this decade.

IX. IRS Operations

Who at the IRS is responsible for overseeing tax-exempt organizations?

The IRS has a special division called the Exempt Organizations Division (EO Division), which is responsible for monitoring all tax-exempt entities under Section 501 of the Code, which currently amounts to over 1.2 million organizations, not including 501(c)(3) religious corporations (i.e., churches). The EO Division is not primarily a revenue-collecting body; rather, it's main mission is monitoring compliance with the rules and regulations creating exemption from federal income tax.