PART ONE - OVERVIEW OF APPLICABLE EXEMPT ORGANIZATIONS LAW

The Staff compiled the following discussion of present law governing charitable organizations primarily from documents or publications prepared by the Staff of the Joint Committee on Taxation.[1]

a. Exemption requirements

1. Exempt purposes and dedication of assets for charitable purposes

In general

Organizations described in section 501(c)(3) (generally "charitable organizations" or "charities") generally are exempt from Federal income tax and are eligible to receive tax-deductible contributions. A charitable organization must be organized and operate exclusively to further one or more tax-exempt purposes constituting the basis of its tax exemption. Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[2] A charitable organization may lose its exemption for various reasons, including failure to operate exclusively for exempt purposes, impermissible private inurement or private benefit, political campaign activities, and substantial nonexempt business or lobbying activities.

Conservation and environmental protection as a charitable purpose

An organization that is organized and operates to promote conservation purposes or environmental conservancy may qualify for exempt status as a charitable organization. The IRS has issued several revenue rulings in this area.[3]

In Revenue Ruling 76-204, the IRS ruled that efforts to preserve and protect the natural environment for the benefit of the public serve a charitable purpose.[4] The organization in that

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[1] See *Description Of Present Law Relating To Charitable And Other Exempt Organizations And Statistical Information Regarding Growth And Oversight Of The Tax-Exempt Sector,* June 22, 2004 available at http://www.house.gov/jct/x-44-04.pdf, *Historical Development And Present Law Of The Federal Tax Exemption For Charities And Other Tax-Exempt Organizations,* April 19, 2005 available at http://www.house.gov/jct/x-29-05.pdf, and *Options To Improve Tax Compliance And Reform Tax Expenditures*, January 27, 2005 (Part VII) available at http://www.house.gov/jct/s-2-05.pdf.

[2] Sec. 509(a). The phrase "public charity" is not defined in the Code, but generally refers to a charitable organization described in section 501(c)(3) that is not a private foundation. In general, private foundations are subject to special rules (such as reporting requirements, excise tax rules, and charitable deduction limitations) that do not apply to public charities.

[3] *E.g.*, Rev. Rul. 67-292, 1967-1 C.B. 184 (ruling 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 a charitable organization); Rev. Rul. 70-186, 1970-1 C.B. 128 (ruling that an organization formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake to enhance its recreational features qualifies for exemption as a charitable organization).

[4] Rev. Rul. 76-204, 1976-1 C.B. 152. The facts of this ruling resemble certain aspects of TNC's mission and activities.

ruling was formed by scientists, educators, conservationists, and community representatives for the purpose of preserving the environment. It accomplished this purpose by acquiring and maintaining ecologically significant undeveloped land such as swamps, marshes, forests, wilderness tracts, and other natural areas. The organization worked closely with Federal, State, and local government agencies, and private organizations concerned with environmental conservation. It acquired the lands by various means, including by charitable gift, bequest, or purchase. Some of its lands were preserved in their natural state, and others were held and preserved by the organization until arrangements could be made to transfer title to the land to a government conservation agency. In such cases, depending upon the circumstances involving the organization's initial acquisition of the land (gift, bequest, or purchase), and the restrictions on the government acquirer, the organization either made an outright gift of the land to the government agency, or was reimbursed for its cost of the land. The organization received most of its funding from the general public. Under these circumstances, the IRS determined that the organization was organized and operated exclusively for charitable purposes.

Dedication of assets to charitable purposes

An organization is not organized exclusively for exempt purposes (and thus may be denied or lose exempt status) unless its assets are dedicated to an exempt purpose.[5] A charitable organization's assets will be considered dedicated to an exempt purpose if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized.[6] The IRS takes the position that a charitable organization's articles of organization must contain a dissolution clause that satisfies these requirements, unless the organization is organized under a State law that satisfies the dissolution provisions of Treasury Regulations section 1.501(c)(3)-1(b)(4).[7]

Organized and operated for a non-exempt purpose

An exempt organization must be operated exclusively for exempt purposes. This requirement may be violated if the organization conducts activities that are similar to those of a commercial enterprise. This applies to activities that are conducted directly by the exempt organization, and to activities of certain affiliates of the organization (e.g., joint ventures in which the exempt organization is a co-venturer). The presence of profit-making activities is not

[5] Treas. Reg. sec. 1.501(c)(3)-1(b)(4).

[6] *Id*.

[7] Rev. Proc. 82-2, 1982-1 C.B. 367 (providing which State nonprofit corporation statutes satisfy the dissolution provision, and explaining the application of the provision to inter vivos charitable trusts, testamentary charitable trusts, and unincorporated nonprofit associations). *See also* Rev. Proc. 2003-12, 2003-1 C.B. 316. The IRS provided a sample dissolution provision that may be used by charitable organizations to satisfy this provision. It reads: "[u]pon dissolution of [this organization], assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future Federal tax code, or shall be distributed to the Federal government, or to a state or local government, for a public purpose." Rev. Proc. 82-2, 1982-1 C.B. 367.

a per se bar to qualification as an exempt organization. For example, exempt organizations are permitted to conduct activities that are not related to their exempt purposes. However, they must pay unrelated business income tax on income derived from such unrelated activities. The IRS and the courts look to the nature of the activity that gives rise to commercial profits, and, in general, to the time and resources expended on the unrelated activity. Generally, however, unrelated trade or business activities may not comprise a substantial portion of the organization's total activities without jeopardizing the exempt status of the organization. An organization may qualify as an exempt entity if it operates a trade or business that is substantially related to the charitable, educational, or other purposes that constitute the basis for its exemption, and is not subject to unrelated business income tax on income from such an activity.

2. Private inurement and private benefit

Section 501(c)(3) provides that no part of a charitable organization's net earnings may inure to the benefit of any private shareholder or individual.[8] For this purpose, "private shareholder or individual" means persons having a personal and private interest in the activities of the organization.[9] This generally includes founders, trustees, directors, officers, key employees, and related family and organizations of these persons. There is no de minimis or incidental exception to the private inurement prohibition. Violation of the private inurement prohibition means that an organization does not qualify for exemption from Federal income tax as a charitable organization, and the IRS may seek revocation of the organization's exemption.[10]

An organization cannot qualify as an exempt charitable organization if it violates the private benefit doctrine. This doctrine generally provides that the exempt organization cannot operate to confer a benefit on private parties. The private benefit doctrine differs from the private inurement prohibition in that it is not limited in its application to providing benefits to insiders. In addition, the private benefit doctrine does not prohibit all private benefit. Incidental private benefit will not cause an otherwise exempt organization to fail to qualify or to lose its exempt status. The IRS and the courts generally look to whether the private benefit is incidental in both a quantitative and a qualitative sense.

b. Intermediate sanctions (excess benefit transaction tax)

1. In general

The Code imposes excise taxes on excess benefit transactions between disqualified persons and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[11] An excess benefit transaction generally is a

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[8] The private inurement prohibition also applies to organizations described in sections 501(c)(4), 501(c)(5), and 501(c)(6).

[9] Treas. Reg. sec. 1.501(a)-1(c).

[10] As an alternative to revocation of tax exemption, the IRS may assert intermediate sanctions to the extent that the inurement results in an "excess benefit transaction," as described below.

[11] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

transaction in which an economic benefit is provided by a charitable 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. The tax does not apply to fixed payments made by an organization to a disqualified person pursuant to a binding written contract between the organization and a person who was not a disqualified person immediately before entering into the contract (the "initial contract exception").[12] For example, the tax does not apply to a fixed payment compensation agreement between an exempt organization and an individual who is hired by the organization as its chief executive officer, if the individual was not a disqualified person with respect to the organization immediately before the parties executed the agreement.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization's organization managers, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[13] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[14]

2. Disqualified person

A disqualified person is any person in a position to exercise substantial influence over the affairs of the organization at any time in the five-year period before the excess benefit transaction occurred.[15] A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons. Disqualified person is defined separately for purposes of the self-dealing rules applicable to private foundations.

Persons holding certain powers, responsibilities, or interests are considered to be in a position to exercise substantial influence over the affairs of the organization. These include: (1) any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority; (2) any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization (generally includes a president, chief executive officer, or chief operating officer unless the person demonstrates otherwise); and (3) any person who, regardless of title, has ultimate responsibility for managing the finances of

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[12] Treas. Reg. sec. 53.4958-4(a)(3).

[13] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[14] Sec. 4958(d)(1).

[15] Sec. 4958(f)(1)(A); Treas. Reg. sec. 53.4958-3(a).

the organization (generally includes a treasurer or chief financial officer unless the person demonstrates otherwise).[16]

Certain persons are deemed not to have substantial influence over the affairs of the organization. These include employees receiving economic benefits of less than a specified amount in a taxable year and who are not family members of other disqualified persons or a substantial contributor to the organization.[17]

In all other cases, whether a person is a disqualified person depends upon all relevant facts and circumstances. Facts and circumstances tending to show substantial influence over the affairs of the organization include, but are not limited to, whether: (1) the person founded the organization; (2) the person is a substantial contributor to the organization; (3) the person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls; (4) the person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation of employees; (5) the person manages a discrete segment or activity of the organization that represents a substantial portion of the organization's activities, assets, income, or expenses, as compared to the organization as a whole; and (6) the person owns a controlling interest in an entity that is a disqualified person.[18]

Facts and circumstances tending to show that the person does not have substantial influence over the affairs of the organization include, but are not limited to: (1) the person is a contractor whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the contractor will not economically benefit either directly or indirectly (aside from customary fees received for the advice rendered); (2) the direct supervisor of the individual is not a disqualified person; (3) the person does not participate in any management decisions affecting the organization as a whole or a discrete segment of activity of the organization that represents a substantial portion of the organization's activities, assets, income or expenses, as compared to the organization as a whole; and (4) any preferential treatment based on the size of the person's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.[19]

3. Rebuttable presumption for certain arrangements

In certain cases, an exempt organization may avail itself of a rebuttable presumption procedure with respect to compensation arrangements and property transfers. Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if: (1) the arrangement or terms of

[16] Treas. Reg. sec. 53.4958-3(c).

[17] Treas. Reg. sec. 53.4958-3(d).

[18] Treas. Reg. sec. 53.4958-3(e)(2).

[19] Treas. Reg. sec. 53.4958-3(e)(2).

transfer are approved in advance by an authorized body of the organization composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transfer; (2) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (3) the authorized body adequately documented the basis for its determination concurrently with making that determination.[20] If these requirements are satisfied, the IRS may overcome the presumption if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.[21]

c. Unrelated business income tax

1. Types of unrelated business taxable income

Section 501(c)(3) organizations generally are not subject to Federal income tax on contributions received, on income from activities that are substantially related to the purpose of the organization's tax exemption, or on investment income.[22] Section 501(c)(3) organizations are subject to the unrelated business income tax on 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.[23] Certain types of income, however, 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.

Income constitutes unrelated business income if it is derived from a trade or business that is regularly carried on by the organization and if the activity is not substantially related to the organization's exempt purposes. The statutory definition of trade or business used for unrelated business income purposes includes any activity which is carried on for the production of income from the sale of goods or the performance of services.[24] Specific business activities of an organization will ordinarily be deemed to be regularly carried on if they manifest a frequency

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[20] Treas. Reg. sec. 53.4958-6(a).

[21] Treas. Reg. sec. 53.4958-6(b).

[22] Private foundations, however, are subject to an excise tax on their net investment income. Sec. 4940.

[23] Secs. 511 through 514. Tax-exempt corporations are taxed on their unrelated business taxable income at the regular corporate tax rates (sec. 511(a)). Charitable trusts and other tax-exempt trusts generally are subject to tax on their unrelated business taxable income under the rates generally applicable to taxable trusts (sec. 511(b)). 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.

[24] Sec. 513(c); Treas. Reg. sec. 1.513-1(b).

and continuity, and are pursued in manner, generally similar to comparable commercial activities of nonexempt organizations.[25] To determine whether the trade or business activity is substantially related to the organization's exempt purposes necessitates an examination of the relationship between the business activities which generate the particular income in question (i.e., producing or distributing the goods or performing the services) and the accomplishment of the organization's exempt purposes. A characterization of the income as exempt income, rather than as unrelated business income, generally requires that the conduct of the business activity that gives rise to the income have a causal relationship to the achievement of the organization's exempt purposes, and that the activity contribute importantly to the accomplishment of such exempt purposes.[26]

Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from debt-financed property. A special exception from unrelated business taxable income applies to certain gains or losses from the qualified sale, exchange, or other disposition of qualifying brownfield properties that are remediated and disposed of by an exempt organization, or by a qualifying partnership of which an exempt organization is a partner.[27]

In Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Supreme Court decided the standard to be applied in determining whether property is held "primarily" for sale to customers in the ordinary course of business. The Court interpreted "primarily" to mean "of first importance" or "principally".

IRS letter rulings detail factors to consider in determining whether the sale of property has been carried out in the regular course of business. These factors are: 1) purpose for which the property was acquired; 2) frequency, continuity, and size of sales, 3) extent of improvements to the property; 4) activities of owner in improving and disposing of property; 5) purposes for which the property is held; 6) proximity of purchase and land; 7) other, including local ordinances, land use laws, market factors, or master land use plans.[28]

If a trade or business regularly carried on by a partnership of which an exempt organization is a partner is an unrelated trade or business with respect to such organization, such organization must treat as unrelated business taxable income its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such income.[29]

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[25] Treas. Reg. sec. 1.513-1(c)(1).

[26] Treas. Reg. sec. 1.513-1(d).

[27] Sec. 512(b)(18) [sic19] (as added by section 702(a) of The American Jobs Creation Act of 2004, P.L. No. 108-357).

[28] See PLRS 200510029, 200243056, 200242041, and 200237027

[29] Sec. 512(c).

2. Determination of unrelated business taxable income

In general, unrelated business taxable income is the gross income derived by an exempt organization from an unrelated trade or business regularly carried on by it, less the deductions allowed that are directly connected with the carrying on of such trade or business.[30] An unrelated trade or business generally means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.[31]

In general, an expense is directly connected with the conduct of an unrelated business only if the expense has a proximate and primary relationship to the carrying on of that business.[32] If an organization derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such activities less the aggregate of the deductions allowed with respect to all such activities. Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and qualify for deduction to the extent they satisfy the requirements of section 162, section 167, or other relevant provisions of the Code. For example, depreciation of a building used entirely in the conduct of unrelated business activities is an allowable deduction to the extent otherwise permitted by section 167.

If facilities or personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities (i.e., dual use facilities or personnel), the expenses attributable to such facilities (e.g., depreciation and overhead expenses) or such personnel (e.g., salaries) must be allocated between the two on a reasonable basis.[33] The portion of any such item allocated to the unrelated trade or business must bear a proximate and primary relationship to that business activity in order to be deductible in computing unrelated business taxable income.

3. Income from debt-financed property

Certain types of income that otherwise are not treated as unrelated trade or business income (e.g., interest, dividends, rents, royalties, and gains from the sale or exchange of property) are treated as unrelated trade or business income if they are derived from debt-financed property.[34] Debt-financed property generally means any property that is held to produce income

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[30] Sec. 512. Treasury Regulations section 1.512(a)-1(a) provides that '[t]o be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by Chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business."

[31] Sec. 513.

[32] Treas. Reg. sec. 1.512(a)-1(a).

[33] Treas. Reg. sec. 1.512(a)-1(c).

[34] Sec. 512(b)(4).

and with respect to which there is acquisition indebtedness at any time during the taxable year. 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. 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 generally does not include indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption.[35]

Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

4. 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 rents, royalties, annuities, and interest 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, the constructive ownership rules of section 318 apply 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 includible in the 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 exempt from tax).

5. Income from Transactions with other Exempt Organizations

In general, net income derived by an exempt organization from providing services to another exempt organization constitutes unrelated business income.[36] There is no categorical or automatic exemption from unrelated business income for providing services to another, even if the service-provider and service-recipient organizations have similar exempt purposes. Providing managerial and consulting services on a regular basis for a fee is a trade or business

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[35] Other exceptions to acquisition indebtedness include obligations to pay certain types of annuities; 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; indebtedness incurred by certain qualified organizations to acquire or improve real property; and indebtedness incurred by certain small business investment companies. Sec. 514(c).

[36] Bruce R. Hopkins, The Law of Tax-Exempt Organizations, John Wiley & Sons, Inc. (8th ed.), 26.5(i)

regularly carried on for profit.[37] Where an organization provides commercial-type services to charitable organizations that control it, these services must be of an essential function for the charitable organizations and must be performed at substantially below cost to qualify as an exempt activity under section 501(c)(3).[i] Where the charitable organizations are unrelated, providing services even at cost lacks the donative element necessary to distinguish the services (consulting and management) from a regular trade or business ordinarily carried on for profit.[38] The Service has ruled that the provision of management services by an exempt organization to an affiliated organization was unrelated business income[39] and that providing management services to unaffiliated charitable organizations is inconsistent with exemption and may justify revocation of the service provider's exempt status as a charitable organization[40]. Exceptions to these general rules may apply in the case of certain services provided by an exempt organization to an affiliated or related exempt organization.

d. Deductibility of contributions made to section 501(c)(3) organizations

1. In general

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) or to a Federal, State, or local governmental entity.[41] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[42] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[43] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

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[37] Rev. Rul. 72-369, 1972-2 C.B. 245.

[38] Rev. Rul. 72-369, 1972-2 C.B. 245. See also Rev. Rul. 69-528, 1969-2 C.B. 127 (an organization regularly carrying on an investment services business that would be an unrelated trade or business if carried on by any of the exempt organizations on whose behalf it operates is not exempt).

[39] Technical Advice Memorandum 9811001

[40] Technical Advice Memorandum 9822004

[41] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[42] Secs. 170(b) and (e).

[43] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal es tate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of $250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.[44]

2. Donative intent, dual character transfers, and significant public benefit

Donative intent requirement and dual character gifts

A charitable deduction for a transfer to a charitable organization is allowable only if it is a "contribution or gift."[45] The "sine qua non" of a charitable contribution is a transfer of money or property without adequate consideration.[46] The burden of proof is on the taxpayer to show that all or a portion of the payment is a contribution or gift.

No part of a payment to a charitable organization that is in consideration for goods or services is a contribution or gift within the meaning of section 170(c), unless (1) the taxpayer intends to make a payment in an amount that exceeds the fair market value of the goods or services, and (2) actually makes a payment in an amount that exceeds the fair market value of the goods or services.[47] The charitable deduction for a payment a taxpayer makes partly in consideration for goods or services may not exceed the excess of the amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer, over the fair market value of the goods or services the organization provides in return.[48]

Courts and the IRS have provided guidance on the deductibility of "dual character" gifts or contributions such as this. Revenue Ruling 67-246 sets forth guidance for instances involving the sale by a charitable organization of a privilege or benefit (such as admission to events), combined with the solicitation by such organization of a gift or donation in addition to the sale. The ruling states that as a general rule, if a transaction involving a payment is in the form of a purchase of an item of value, the presumption arises that no gift has been made for charitable contribution purposes, the presumption being that the payment in such case is the purchase price. The ruling further states that the burden is on the taxpayer to establish that the amount paid is not the purchase price of the privileges or benefits and that part of the payment, in fact, does qualify as a gift. In showing that a gift has been made, an essential element of proof is that the portion of the payment claimed as a gift represents the excess of the total amount paid over the value of the consideration. Another element that is important to establish that a gift was made is evidence

[44] Sec. 170(f)(8).

[45] Sec. 170(c).

[46] *U.S. v. American Bar Endowment*, 477 U.S. 105, 118 (1986).

[47] Treas. Reg. sec. 1.170A-1(h).

[48] *Id*.

that the payment in excess of the value received was made with the intention of making a gift. The ruling states that "[w]hile proof of such intention may not be an essential requirement under all circumstances and may sometimes be inferred from surrounding circumstances, the intention to make a gift is, nevertheless, highly relevant in overcoming doubt in those cases in which there is a question whether an amount was in fact paid as a purchase price or as a gift."[49] In *American Bar Endowment*, the United States Supreme Court upheld the the two-part "dual payment" test established by the IRS in Revenue Ruling 67-246.[50]

The IRS applies the section 170 and Revenue Ruling 67-246 to conservation easements in Notice 2004-41. The IRS advises taxpayers "who (1) transfer an easement on real property to a charitable organization, or (2) make payments to a charitable organization in connection with a purchase of real property from the charitable organization" that "the Service intends to disallow such deductions and may impose penalties and excise taxes. Furthermore, the Service may, in appropriate cases, challenge the tax-exempt status of a charitable organization that participates in these transactions. In addition, this notice advises promoter and appraisers that the Service intends to review promotions of transactions involving these improper deductions, and the promoters and appraisers may be subject to penalties."[51]

Significant public benefit doctrine

If the donor receives, or can reasonably expect to receive, sufficiently substantial financial or economic benefits in excess of those that would inure to the general public, no deduction under section 170 is allowable. For example, a taxpayer that pledged and paid an amount of money to a county government on the condition that the county hard-surface the roads in the vicinity of the taxpayer's property was not entitled to a charitable deduction, because the taxpayer could reasonably expect to receive benefits substantially greater than those that would

[49] The IRS went on to state that "the organization conducting the activity should employ procedures which make clear not only that a gift is being solicited in connection with the sale of the admissions or other privileges related to the fund-raising event, but also, the amount of the gift being solicited." *See also* Rev. Rul. 68-432, 1968-2 C.B. 104 (stating that in cases involving payments in the form of membership dues to a charitable organization, the IRS will give due consideration to the possible separation on a uniform basis of that portion of the total payment that may properly be treated as a charitable contribution whenever the discrepancy between the size of the membership contribution and the potential monetary benefit is so great as to make it reasonably clear that the payment is of a "dual character").

[50] *See* Rev. Rul. 76-185, 1976-1 C.B. 60, involving payments made by a taxpayer to contractors to finance the restoration and maintenance of a state-owned historic mansion and its surrounding grounds in exchange for a right to reside on the premises for 15 years. The IRS ruled that the taxpayer was entitled to a charitable contribution deduction to the extent the payments exceeded the monetary value of all benefits received or expected to be received by the taxpayer. The IRS stated that if the transferor receives, or can reasonably expect to receive, a financial or economic benefit that is substantial but less than the amount of the transfer, then the transaction may involve both a purchase and a gift, and may entitle the taxpayer to a contribution deduction for the gift portion if the other requirements of section 170 are satisfied. *See also* Rev. Rul. 76-232, 1976-1 C.B. 62, ruling that taxpayers who donated amounts to a charitable organization and participated in a weekend marriage seminar were entitled to deduct as a charitable contribution the excess of the amount donated over the monetary value of the benefits and privileges received; taxpayers were under no obligation to donate any amount in order to participate in the seminar.

[51] Notice 2004-41

inure to the general public.[52] Under this doctrine, no deduction is permitted unless there is a significant public benefit resulting from the contribution. A similar requirement applies with respect to perpetual conservation restrictions. The Treasury Regulations provide that if, as a result of the donation of such a restriction, the donor or a related person receives, or can reasonably expect to receive, financial or economic benefits that are greater than those that will inure to the general public from the transfer, then no charitable deduction is allowable.[53] This requirement focuses on the relationship between the benefits received or expected to be received by the taxpayer as compared to those to be provided to the general public, rather than on the comparison between the amount of the payment made by the taxpayer and the value of any benefit to be received by the taxpayer, which is the focus of dual character gifts.

3. Contributions of noncash property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[54] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[55] (An exception to the partial interest rule applies for qualified conservation contributions, described below.)[56] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined

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[52] Rev. Rul. 76-257, 1976-2 C.B. 52.

[53] Treas. Reg. sec. 1.170A-14(h)(3)(i).

[54] For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3) (property for the care of the ill, the needy, or infants). Similar deductions are provided by sections 170(e)(4) (contributions of scientific property and equipment) and 170(e)(6) (contributions of computer technology used for educational purposes).

[55] Sec. 170(f)(3).

[56] Sec. 170(h).

in accordance with the bargain sale rules.[57] If a taxpayer pays more than fair market value for property acquired from a charitable organization, the excess above fair market value may be deductible assuming that the donor intended to make a gift of such excess.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach an appraisal summary to the tax return.[58] In the case of contributions of art valued at $20,000 or more, taxpayers are required to attach the appraisal to the tax return. Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[59] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[60]

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use. If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value over $5,000 (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282), and furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.[61]

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[57] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

[58] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000).

[59] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[60] Treas. Reg. sec. 1.170A-13(c)(3).

[61] Sec. 6050L(a)(1).

4. Contributions of conservation easements

Qualified conservation contributions

Section 170(h) provides special rules that apply to charitable contributions of qualified conservation contributions, which include conservation easements and façade easements. Qualified conservation contributions are not subject to the “partial interest” rule, which generally bars deductions for charitable contributions of partial interests in property. Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.[62] Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. 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.

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[63] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[64]

Conservation purposes

Public recreation or education

Under Treasury Regulations, a donation satisfies the conservation purpose of preservation of land areas for recreation or education if there is substantial and regular use of the property by the general public.[65] There is no requirement that the preservation of the land area

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[62] Charitable contributions of interests that constitute the taxpayer’s entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer. Priv. Ltr. Rul. 8626029 (March 25, 1986).

[63] Treas. Reg. sec. 1.170A-14(e)(2).

[64] Treas. Reg. sec. 1.170A-14(e)(2).

[65] Treas. Reg. sec. 1.170A-14(d)(2)(i).

be made pursuant to a governmental policy or that the area be certified by a governmental unit as worthy of conservation efforts.

Protection of a significant habitat or ecosystem

Treasury Regulations provide that the donation of a qualified real property interest to protect a significant natural habitat in which a fish, wildlife, or plant community, or similar ecosystem normally lives will satisfy the conservation purpose requirement.[66] Whether a donation satisfies the conservation purpose requirement generally depends on the type of animal or plant life that exists on the property being protected. If a property is a habitat for any endangered species of plant or animal life, a restriction protecting that habitat likely satisfies the conservation purpose requirement. Administrative rulings provide that if a particular species has been identified as unique to a particular place or is approaching an endangered or other protected status, protection of the habitat will suffice.

Preservation of open space

A conservation purpose includes the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is (1) for the scenic enjoyment of the general public; or (2) pursuant to a clearly delineated Federal, State, or local government conservation policy.[67] Scenic enjoyment is evaluated by considering all pertinent facts and circumstances germane to the contribution. The factors identified in the regulations include the compatibility of the land use with other land in the vicinity, the degree of contrast and variety provided by the visual scene, the harmonious variety of shapes and textures, and the consistency of the proposed scenic view with a methodical state scenic identification program. Some examples of donations that have satisfied the scenic enjoyment requirements in private letter rulings include conservation easements on a ranch that provided views of a natural vista from adjacent roads; rolling farmland interspersed by wooded areas and steep slopes that could be seen from an adjacent road; land that provided views of a pond and the ocean from the highway; and property that provided a view of a pond in a heavily developed area.

Treasury Regulations provide that the purpose of preserving open space pursuant to a clearly delineated government policy is satisfied by donations that further a specific conservation purpose identified by public representatives.[68] A general declaration of conservation goals by a single official or legislative body is not sufficient, although the government policy need not be a certification program that identifies particular lots or small parcels of individually owned property.[69] For example, a governmental program according preferential tax assessment or preferential zoning for certain property deemed worthy of protection for conservation purposes

[66] Treas. Reg. sec. 1.170A-14(d)(3)(i).

[67] Treas. Reg. sec. 1.170A-14(d)(4)(i).

[68] Treas. Reg. sec. 1.170A-14(d)(4)(iii).

[69] *Id*.

constitutes a significant commitment by a government, and accordingly satisfies the requisite standard.[70]

Preservation of historic property

Section 170(h) defines conservation purpose to include the preservation of an historically important land area or a certified historic structure.[71] For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify under this provision.[72] If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.[73]

5. Valuation of conservation easements

Valuation standards

The value of a conservation restriction granted in perpetuity generally is determined under the "before and after approach." Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.[74] Courts generally apply this standard by looking at the objective uses of the property. At least one court, however, has examined the subjective intentions of the contributing taxpayer to apply this standard.[75]

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[70] *Id*.

[71] The conservation purpose standard for historically important land is that the area be: (1) an independently significant land area including any related historic resources that meets the National Register Criteria for Evaluation; (2) an area within a registered historic district including any buildings on the land areas that can reasonably be considered as contributing to the significance of the district; and (3) an area (including related historic resources) adjacent to a property listed individually in the National Register of Historic Places (but not within a registered historic district) in a case where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property. Treas. Reg. sec. 1.170A-14(d)(5)(ii). The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution. *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); *Richmond v. U.S.*, 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

[72] Treas. Reg. sec. 1.170A-14(d)(5)(iii).

[73] Treas. Reg. sec. 1.170A-14(d)(5)(i).

[74] Treas. Reg. sec. 1.170A-14(h)(3).

[75] *McLennan v. U.S.*, 24 Cl. Ct. 102 (1991) (highest and best use refers to "the most profitable and probable use" of the property; although the property could be subdivided into eight parcels, the taxpayer's "strong aversion to development" meant that a valuation based on an assumption of subdividing the entire property was "untenable" and "directly contradicts [taxpayers'] clear intention to preserve their land from development;" found that the reasonable

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.[76] In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.[77] If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.[78] In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.[79]

Valuation-related penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[80] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times the amount determined to be the correct value.[81] Present law does not impose substantial or gross valuation misstatement penalties on an appraiser that conducted an appraisal that was used by a taxpayer to support the value claimed on the taxpayer's return. However, the Secretary may disqualify an appraiser from practicing before the IRS under certain circumstances.[82]

6. Donor Advised Funds

The IRS has described a donor advised fund as separate accounts established by a charity for a donor whereby the donor may exercise a right to make a recommendation on either uses of the account, such as providing advice about how to invest, or distributions from the account,

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and probable use of the property was as an undivided country estate, not as a subdivision, and that the easement did not affect the highest and best use of the land).

[76] Treas. Reg. sec. 1.170A-14(h)(3)(i).

[77] *Id*.

[78] *Id*.

[79] Treas. Reg. sec. 1.170A-14(h)(3)(ii).

[80] Sec. 6662(b)(3) and (h).

[81] Sec. 6662(e) and (h).

[82] 31 U.S.C. sec. 330(c) (after notice and opportunity for a hearing to any appraiser with respect to whom a penalty for aiding and abetting understatement of tax liability has been assessed, the Secretary may provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Treasury or the IRS, and bar such appraiser from presenting evidence or testimony in any such proceeding).

such as providing advice about how to make expenditures.[83] In recent years, the use of donor advised funds maintained by charities has grown dramatically. These funds general permit a donor to claim a current charitable deduction for amounts contributed to the charity, whether cash or noncash property, and to provide ongoing advice regarding the investment or distribution of such amounts, which are maintained by the charity in a separate fund or account. Several financial institutions have formed organizations for the purpose of offering donor advised funds, and many existing charities now operate donor advised funds as a means to raise funds through contributions.

There presently is no clear definition of donor advised fund. However, in its private letter rulings, the IRS has stated that a donor advised fund must have appropriate control and ownership over the donated assets, and that the IRS applies the material restriction or condition provisions (relating to the termination of private foundation status) in Treasury Regulations section 1.507-2(a)(8) to measure the level of such control. The IRS has used this control standard to determine whether the donor advised fund has sufficient dominion and control over the funds contributed such that the organization that operates the fund may be treated, for tax purposes, as the owner of the assets.[84] If a donor retains too much control over the donated asset, there has not been a completed gift for purposes of the charitable contribution deduction. Donor advised funds also raise issues regarding the retention of control by a donor in a manner that circumvents the private foundation rules, by establishing the fund with a public charity.

e. Tax-exempt financing

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.[85] Accordingly, section 501(c)(3) organizations have access to tax-exempt financing through State and local governments. This generally does not include financing for unrelated business activities of such organizations.[86] 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.

f. Joint Ventures

1. Overview

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, a subsidiary of another

[83] Instructions to Form 1023 (Rev. Oct. 2004), p. 10

[84] E.g., Priv. Ltr. Rul. 200150039

[85] Sec. 145.

[86] Sec. 145(a).

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.[87] An exempt organization also may participate in joint ventures involving partnerships or limited liability companies.

A leading commentator has defined a joint venture as "an association of persons or entities jointly undertaking a particular transaction for mutual profit,"[88] and divided joint ventures involving exempt organizations 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).[89] The fourth category includes what has been described as the "whole-hospital" joint venture, a structure in which an exempt hospital system transfers all of its assets, including a hospital facility, to a partnership or limited liability company in exchange for an ownership interest in the joint venture entity.

The Federal income tax consequences to an exempt organization and to the other participants in a joint venture generally depend upon a variety of circumstances, including the type of State law entity (if any) used for the joint venture, the activities to be conducted, the extent to which the exempt organization maintains control over the activities of the joint venture, the size of the joint venture's activities compared to the exemp t organization's other activities, the terms of the organizational documents and related agreements, and whether the exempt organization receives fair market value in exchange for its financial and other contributions to the venture. In addition, because charitable organizations generally are subject to special rules that do not apply to many other types of exempt organizations (e.g., the private inurement prohibition, excess benefit transaction tax rules, and impermissible private benefit), a charity's involvement in a joint venture must consider its unique status as a charitable organization.[90] In certain cases, an exempt organization may jeopardize its exempt status by participating in a joint venture.[91]

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 (e.g., the IRS took the position a

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[87] *Moline Properties, Inc. v.Commissioner*, 319 U.S. 436 (1943).

[88] Michael I. Sanders, *Joint Ventures Involving Tax-Exempt Organizations*, John Wiley & Sons, 2d. ed., 2.

[89] *Id*., 2004 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), 3.

[90] Social welfare organizations described in section 501(c)(4) also are subject to certain of these special rules, such as the private inurement prohibition and the excess benefit transaction tax rules.

[91] 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.

charity could not participate as a limited partner in a partnership managed by a for-profit general partner) to one that acknowledges that charities may participate in joint ventures if they satisfy certain requirements. 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 others who participate in the joint venture. 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.

2. Partnership or Limited Liability Company Joint Ventures

A partnership (including a limited liability company treated as such for Federal tax purposes) is a pass-through entity, with its income, gains, losses, deductions, and credits allocated to its partners in accordance with the partnership agreement. The partners then report their respective distributive shares of the partnership's tax items on their Federal income tax returns. An exempt organization's distributive share of a 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 a partnership of which an exempt organization is a partner 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.[92] 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.[93]

3. Evolution of law regarding joint ventures involving exempt organizations and for-profit partners

Pre-1982 law. The IRS once 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.[94]

[92] Sec. 512(c)(1).

[93] Sec. 512(b)(13)(D)(ii).

[94] *See*, General Counsel Memorandum 36293 (May 30, 1975) (joint profit motive of partnership made it incompatible with charitable purpose of the exempt entity), and Priv. Ltr. Rul. 7820058 (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).

Plumstead Theatre. *In Plumstead Theatre Society v. Commissioner*,[95] 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. In that case, the court employed a two-part test to determine that the exempt organization could remain exempt: (1) did the partnership's activities further the charitable purposes of the exempt organization, and (2) did the structure of the partnership protect the exempt organization against potential conflicts between its fiduciary duties to its for-profit partners and its charitable mission. Based on an examination of the facts and circumstances of the case, the court determined that the exempt organization could protect against impermissible private benefit and private inurement, and operate exclusively to further its charitable purposes, even if it participated in a joint venture with for-profit limited partners. This decision rejected the IRS position of a per se prohibition against such arrangements.

Housing Pioneers. In *Housing Pioneers v. Commissioner*,[96] the court held that a low-income housing 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. Accordingly, the court denied the exempt organization exempt status on the basis that it substantially furthered non-exempt purposes and private interests. In a different low-income housing joint venture, however, the IRS ruled that a charitable organization's participation as a co-general partner in a limited partnership did not adversely affect its exempt status.[97] In that private ruling, the IRS upheld the general partner's 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.

Revenue Ruling 98-15. In 1998, the IRS issued guidance regarding its position on a particular type of transaction, a "whole-hospital" joint venture. Revenue Ruling 98-15[98] used two examples with significantly different facts and circumstances to illustrate the IRS's position regarding the effect a whole-hospital joint venture had on the exempt status of the participating charitable organization. Both examples involved a public charity that contributed all of its assets to a limited liability company in exchange for a membership interest in the limited liability company. Thus, after the contribution, the charity's sole asset was its membership interest in the limited liability company. In both examples, a for-profit corporation contributed assets to the limited liability company in exchange for a membership interest that was proportionate to its financial contribution. However, the two examples differed importantly with respect to 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. Also, the terms of the management agreement employed in each of the two examples differed materially. In one example, the charity had 60 percent of the board membership, controlled approval of major

[95] *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980), 675 F.2d 244 (9th Cir. 1982).

[96] *Housing Pioneers v. Commissioner*, TCM 1993-120, *aff'd* 49 F.3d 1395 (9th Cir. 1995).

[97] Priv. Ltr. Rul 9736039.

[98] Rev. Rul. 98-15, 1998-1 C.B. 718.

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 held 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.

Redlands and *St. David's*. The control standard established in *Plumstead Theatre* and developed further in Revenue Ruling 98-15 and subsequent private letter rulings was the focal point of two recently litigated cases involving exempt organizations and for-profit investors in health care joint ventures. In *Redlands*,[99] the United States Tax Court and the Ninth Circuit Court of Appeals determined that a nonprofit subsidiary of a tax-exempt hospital system failed to retain control of a joint venture ambulatory surgery center, and thus was not entitled to exempt status as a charitable organization because the joint venture did not operate to further the subsidiary's exempt purposes. In *St. David's*,[100] an exempt organization contributed all of its health care facilities to a partnership joint venture with a for-profit health care system. The for-profit system contributed assets to the joint venture, and a subsidiary of the for-profit partner provided management services to the joint venture. In the litigation, the IRS agreed that the joint venture provided substantial charity care, but contended that the exempt organization did not retain sufficient control over the venture to ensure that charity care would continue to be provided in the future. Ultimately, a jury determined that the exempt organization did retain sufficient effective control of the venture to ensure that the joint venture's operations would substantially further charitable purposes. *Redlands* and *St. David's*, like Revenue Ruling 98-15, 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.

Revenue Ruling 2004-51. Following the judicial decisions in *Redlands* and *St. Davids*, the IRS issued Revenue Ruling 2004-51[101] to provide guidance regarding ancillary joint ventures (i.e., joint ventures in which the participating exempt organization did not contribute all 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

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[99] *Redlands Surgical Services, Inc. v. Commissioner*, 113 T.C. 47 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001).

[100] *St. David's Health Care System v. U.S.* No. A-01-CA-046 JN (W.D. Texas) (June 7, 2002); 349 F.3d 232 (5th Cir. 2003); remanded _____.

[101] Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

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.[102]

4. Joint ventures among exempt organizations

Exempt organizations may come together to form corporate or partnership joint ventures. 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. Exempt organizations also might use corporate or partnership entities to conduct the venture. If a corporation is used, the generally applicable corporate tax rules apply to the arrangement. If the organizations form a limited liability company or State law partnership to hold the investment or to conduct the activity, the general principles of partnership taxation apply to the arrangement.

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. 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

[102] 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).

organization for these purposes, in order to ensure that charitable purposes are served and that charitable assets remain dedicated to charitable purposes.[103]

5. Private inurement and excess benefit transaction taxes in joint ventures

Organizations described in section 501(c)(3) and (c)(4) are subject to the private inurement prohibition and the excess benefit transaction tax rules. These rules apply to such an organization's participation in a joint venture, whether the joint venture is taxed as a partnership or a corporation, and in other related organization structures in which the organization participates. Under these requirements, a charitable, educational, 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. Similarly, if the organization participates in a joint venture that forms a corporation or a limited liability company, the arrangement must be examined for compliance with the private inurement and excess benefit transaction rules.

The section 4958 excess benefit transaction taxes apply whether the excess benefit is provided directly or indirectly by the exempt organization. The legislative history to section 4958 states that the organization managers and disqualified persons will be subject to the tax even if the excess benefit is provided indirectly through an entity controlled by the exempt organization (e.g., a taxable for-profit subsidiary). For example, 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.

g. Annual reporting requirements

1. Form 990

Section 501(c)(3) organizations (as well as other organizations exempt from taxation under section 501(a)) are required to file an annual return, stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe.[104]

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[103] Treas. Reg. sec. 1.501(c)(3)-1(b)(4) (a charity's assets must be distributed to another charity or to a governmental unit for charitable or public purposes upon the dissolution of the charity).

[104] Sec. 6033(a).

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.[105]

Section 501(c)(3) organizations that are classified as public charities must file Form 990, *Return of Organization Exempt From Income Tax* if it has gross receipts in excess of $100,000 and net assets in excess of $250,000.[106] Public charities must also complete and attach, Schedules A and to its annual Form 990. Schedule A requests information on payments to employees and independent contractors as well as payments for lobbying and political activities among other things. An organization "must list on Part I [Schedule B] every contributor who, during the year, gave the organization directly or indirectly, money, securities, or any other type of property aggregating $5,000 or more for the year".[107]

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 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 is currently revising Form 990.

2. Form 990-T & Form 4720

A section 501(c)(3) organization that is subject to the unrelated business income tax and that has $1,000 or more of gross unrelated business taxable income must file Form 990-T. Public charities that make an election under section 501(h) regarding permitted lobbying expenditures and that incur tax for excess lobbying expenditures must file Form 4720. Form 4720 also is required to be filed (by public charities or private foundations, as the case may be)

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[105] Sec. 6033(a)(2)(A); Treas. Reg. sec. 1.6033-2(a)(2)(i) and (g)(1).

[106] 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.

[107] Instructions, Form 990 Schedule B, *Schedule of Contributors*

with respect to any taxes owed for self-dealing (sec. 4941), undistributed income (sec. 4942), excess business holdings (sec. 4943), investments that jeopardize charitable purposes (sec. 4944), taxable expenditures (sec. 4945), political expenditures (sec. 4955) and excess benefit transactions (sec. 4958).

3. Penalties for Late Filing or Incomplete Information Returns

If an exempt organization does not timely and completely file the information return (e.g., Form 990 for a public charity) or does not furnish the correct information, it must pay $20 for each day the failure continues ($100 a day for large organizations, i.e., ones with gross receipts exceeding one million dollars for the taxable year).[108] The maximum penalty for each return will not exceed the lesser of $10,000 ($50,000 for a large organization) or five percent of the gross receipts of the organization for the year. The penalty will not be imposed if the organization can show the failure was due to reasonable cause. There also are penalties for willful failures and for filing fraudulent returns and statements.[109]

4. Penalties for Late Filing or Incomplete Tax Returns

In general, exempt organizations that have gross unrelated business taxable income of at least $1,000 for the taxable year are required to file Form 990-T.[110] Such organizations may be subject to penalties for filing late returns or failing to pay tax when due. The penalty for late filing of a Form 990-T is five percent of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25 percent of the unpaid tax.[111] The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or $100. The penalty for late payment of taxes is usually one-half of one percent of the unpaid tax for each month the tax is unpaid, not to exceed 25 percent of the unpaid tax. Failure to file and failure to pay penalties will not be imposed if the organization can show the failure was due to reasonable cause. Penalties can be imposed for negligence, substantial understatement of tax, and fraud.[112] There also are penalties for willful failure to file and for filing fraudulent returns and statements.[113]

Organizations required to file Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code, may be liable for

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[108] Sec. 6652(c)(1)(A).

[109] Secs. 7203, 7206, and 7207.

[110] Sec. 6012; Treas. Reg. sec. 1.6012-2(e). Organizations liable for the proxy tax on lobbying and political expenditures also are required to file Form 990-T. The proxy tax is treated as an income tax for purposes of applicable filing and payment requirements and penalties. Sec. 6033(e)(2)(C).

[111] Sec. 6651(a).

[112] Secs. 6662 and 6663.

[113] Secs. 7203, 7206, and 7207.

penalties for failure to file or to pay tax.[114] There also are penalties for willful failure to file returns, supply information, or pay tax,[115] and for filing fraudulent returns and statements.[116]

4. Penalties for failure to satisfy inspection and disclosure requirements

Organizations must make Form 990, along with Schedules A and B available for public inspection.[117] However, section 6104(d) prohibits the disclosure of names or addresses of contributors to the organization; thus, an organization must redact such information before making Schedule B available for public inspection.

A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is $20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is $10,000. There is no maximum penalty amount for failing to make the exemption application available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of $5,000.[118]

5. Form 8283

Taxpayers must submit a Form 8283 to the donee organization for acknowledgement of receipt of noncash contributions greater than $500. The donee organization must return the signed form to the donor before the donor can claim a deduction for the contribution. Prior to submitting to the donee for signature, the taxpayer must provide the taxpayer's name and identifying number along with a description of the donated property.

6. Form 8282

Donee organizations use Form 8282 to report information to the IRS about dispositions of certain charitable deduction property made within 2 years after the donor contributed the

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[114] Sec. 6651.

[115] Sec. 7203.

[116] Secs. 7206 and 7207.

[117] Sec 6104(d)

[118] Sec. 6685.

property.[119] An organization is penalized $50 for each occurrence of non-filing or incomplete filing.[120]

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[i] Rev. Rul. 71-529, 1971-1 C.B. 234.

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[119] Instructions, Form 8282, *Donee Information Report*

[120] Sec. 6721.