NHSA 610 – Public Trust and Influence: Ethical, Legal and Public Policy Issues

The readings below will prepare you for the NHSA 610: Public Trust and Influence – Ethical, Legal and Public Policy Issues.

Reframing Human Services: Why and How.

Illinois Ex Rel. Madigan, Attorney General of Illinois vs. Telemarketing Associates, Inc, Et AL. (Recommended)

The Community is Speaking Loud and Clear

Ethics and Nonprofits

Excise Taxes on Excess Benefit Transactions Engaged in by Certain Tax-Exempt Organizations.

An Introduction to I.R.C. (Recommended

CARACCI and Cindy v. Commissioner of Internal Revenue (Recommended)

Excerpt from Revenue Ruling 87-41, 1987-1 CB 296 (IRS 20 Factor Test)

Form SS-8

Lobbying Issues (Recommended)

Excise Taxes on Excess Benefit Transactions Engaged in by Certain Tax-Exempt Organizations.

Katz, I., & Key, K. (2014). Reframing Human Services: Why and How. *Policy & Practice*.

Reframing Human Services: *Why and How*

By Irv Katz and Karen Heller Key

What does the public think of human services and why does it matter?

It matters because public officials collectively play the most prominent role in how we as a nation address human needs and provide human services. And while party affiliation and ideology are major factors in the decisions that public officials make, public sentiment—even when it is divided—represents the opinions of constituents, and those opinions matter a great deal to elected officials.

What citizens, and their elected officials, think about human services matters now more than ever, for a variety of reasons, all of which are very familiar to the readers of *Policy & Practice*. First and foremost, funding is stressed at all levels, as evidenced by the fact that the percentage of the gross domestic product (GDP) devoted to non-defense discretionary spending is at historically low levels (see Figure 1). Among the other factors that are readily apparent are sustained high levels of poverty and sustained un- and underemployment. These are just some of the economic indicators. There is also the aging of the population, the unmet challenges of many people with disabilities, lack of affordable housing, and more.

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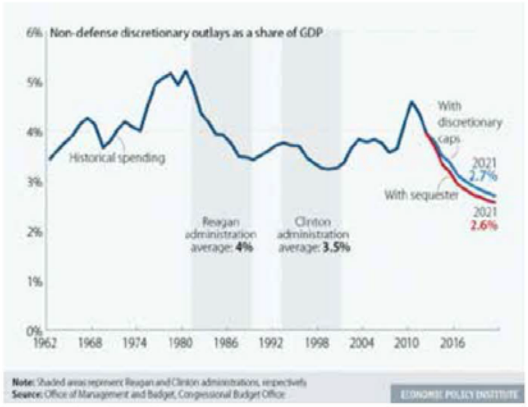
Figure 1



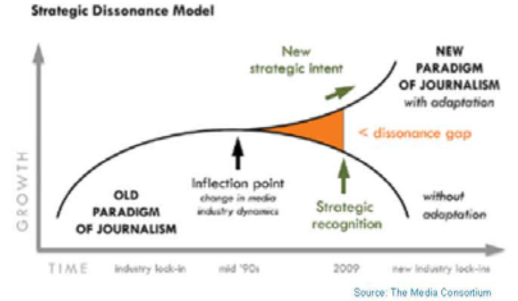
Why does it matter now? It matters because many aspects of our societal response to human needs, including human services, are at a point of inflection—a point at which changes in the external environment are so dramatic that current practices achieve diminishing returns and the choice for an industry or area of human endeavor is to either change course or become irrelevant. Consider journalism and mass media a dozen years ago and now. Today there are fewer daily newspapers, fewer readers, and the papers are smaller. Traditional broadcast media play a much smaller role than cable and web communications and even they are losing ground to streaming and instant media of all sorts available to us on a variety of devices 24/7. The factors leading to these changes—the technology explosion, changes in the media marketplace, etc.—transformed the communications landscape. New media emerged, replacing the old, and traditional media either changed or became irrelevant.

What are the factors causing a point of inflection for the human service "industry?" (See Figure 2.) The public funding crunch is a major factor, but there are others:

- While charitable giving, which funds a portion of human services, tends to rise in total from year to year, giving as a percentage of GDP has been fixed at plus-or-minus 2 percent for decades.
- Charitable dollars for human services and other causes are spread thin as the number of nonprofits rose dramatically over several decades.

Figure 2

Strategic Dissonance Model



- There are immense expectations of and pressures for entrepreneurial approaches and innovation, today. In the human services, such efforts tend to happen on a small scale and there are few dollars available for taking such innovations to scale. Put another way, major providers and systems must continue to serve the masses and simultaneously transform to become hyper-effective and highly efficient … without development capital.

Various states and localities and individual nonprofit agencies are considering or in the throes of transformation, but, given the very major interdependence of federal policy and dollars and the realities of the state, local, and agency levels, some degree of common understanding of desired outcomes and evidence-based strategies needs to happen nationwide. Otherwise, we have only "random acts of transformation," not changed systems.

As leaders in public and private nonprofit human services, we need to begin with the end in mind—with shared aims. What is it that we as a nation agree on, in terms of our goals and aspirations for all or the majority of children, families, older adults, and people with disabilities? To borrow from the Forum for Youth Investment's Ready By 21® construct, perhaps we agree as a nation that we want every youth ready for college (or post-secondary education), work, and life by young adulthood. Then as a nation, we would adopt that as a desired outcome and identify the strategies necessary to achieve that outcome.

The National Human Services Assembly (NHSA) and its members believe that there is an underlying sense of what the desired outcomes are for kids, families, older adults, and people with disabilities in America and that we can be bold enough to articulate and strive for them, collectively, between the two major forces in human services—the public authorities and the nonprofit agencies in the human services (or, we would suggest, human development) space. The American Public Human Services Association (APHSA) and its members have begun this work with the *Pathways* initiative.

Again, applying the construct of Ready By 21® to these four segments of the population; NHSA suggests that an overall outcome-focused framework for human development might look something like the following (see Figure 3, using Children & Youth). And from such a framework, evidence-based strategies could be identified and pursued in policy and practice.

NHSA and a growing number of its partners, including APHSA and several state and local human service coalitions, have concluded that examining the frame Americans use to understand "human services" is a critical step in the journey to identifying and achieving the over-arching outcomes we all want for all Americans. It is not just about common language, images, and messaging; it is about knowing the extent to which the people and leaders of the country understand, value, and envision the contributions of human services (or human development strategies, if you will).

Health care, which started out as a wide array of professions, disciplines, institutions, and practices, has come to be seen as a single, unified field or industry that is the subject of public discussion as we struggle with how we want it

Figure 3

Population-Level Outcome/Aspiration	Outcomes by Developmental Competency	Strategies
Children & Youth (e.g., Ready for college, work and life) Note: college or post-secondary education	**Learning**, e.g., age-appropriate proficiency **Working**, e.g., children know and follow career paths; have competencies in skills that cut across careers **Thriving**, e.g., children are healthy, nourished and fit **Connecting**, e.g., children relate positively to others, within and beyond family; participate in ways that build community **Leading**, e.g., children exhibit attitudes and behaviors of civic responsibility, exercise leadership	**Learning**, e.g., learning approach coordinated across formal and informal education settings **Working**, e.g., career exploration and experimentation, learning/reinforcement of cross-cutting skill acquisition in school and out of school **Thriving**, e.g., wellness, fitness and healthy eating integrated and specifically programmed in all aspects of learning, child care and play **Connecting**, e.g., family connection/engagement an element of periodic in- and out-of-school assessments; civic engagement and relationship building are integrated in learning **Leading**, e.g., personal and community leadership is practiced and integrated in formal learning and community activities

designed, financed, and delivered. NHSA believes that for the nation to make significant progress on meeting human needs (and preventing those needs and challenges that can be prevented) and on making it possible for the maximum number of Americans to achieve the best possible outcomes at every stage of the life cycle, human services/human development must become an aggregated whole as is now the case with health care.

There are two important early steps in this journey. One is for the public authorities with responsibility for human services and the nonprofit human service providers—and their intermediaries—to recognize and leverage their interdependence. The budding partnership between NHSA and APHSA reflects the growing recognition by both parts of the equation that we can and should strive together to transform human services.

The other crucial early element is understanding how "human services" as a construct or sector is "framed." By the term, framing, and its variations, we mean a disciplined approach to identifying and/or creating a mind-construct by which people understand a concept like human services. Framing is not about looking for words that sound better but doing the research necessary to find out what "average citizens" associate with, say, human services—what words, images, and metaphors they associate with it; how those associations compare with the reality; and testing and establishing alternative language and imagery that more accurately reflect the concept and that resonate with the millions of average citizens who care about the well-being and development of their families, neighbors, and co-workers.

The work of framing can get pretty complicated (especially as contrasted with mere messaging) because it relates to neuroscience and brain architecture. Neuroscientists have found that concepts are lodged in the brain as they were originally understood by an individual. Once lodged, a concept is pretty well fixed and all information received relating to the concept is viewed through the mind's frame for it. The scientists have found, in addition, that changing that frame is very, very difficult. Yet, framing specialists, who tend to come from a variety of the sciences (including neuroscience) and communications disciplines, indicate that what might be an inaccurate or undesirable frame can be replaced with another, if it is well crafted (i.e., resonates with values that really matter to the greater public) and repeated often over a considerable length of time. (This last aspect speaks to the importance of "all" in human services adopting and using the same language and imagery for human services and perhaps other core common concepts.)

Let's ask first how the sector understands human needs and human services. The "word cloud" in Figure 4 is meant to suggest what "we" in the sector (i.e., public authorities and providers of human services) mean by the term human services—a disaggregated mix of needs, programs, problems, strategies, populations, entitlements, and more.

Figure 4

That's the layman's version of how the experts view human services. Thanks to the understanding and support of The Kresge Foundation, NHSA engaged The FrameWorks Institute (TFI or FrameWorks) to find out how public understanding of human services compares with those of the experts, i.e., people associated with or a part of the human services.

FrameWorks, with its team of experts from nearly two dozen relevant disciplines and sciences, is among the leading experts and practitioners of the discipline of framing. Its methodology is rigorous (and can be found on its web site: *http://www.frameworksinstitute.org/methods.html*). Central to its methodology are in-depth interviews with samples of lay people and subject experts, whose responses are then synthesized and compared. By applying these steps and others,

See Human Services on page 35

HUMAN SERVICES continued from page 11

TFI has played a major role in crafting frames that enable society to understand many complex concepts; with terms they have developed, like brain architecture and toxic stress.

TFI and NHSA are pleased to share the report of the findings of the TFI human services perceptions research with readers of *Policy & Practice*. The report of the findings can be found at *http://bit.ly/1bRUC4v*. Let us summarize, at a very high level, for the purposes of this article. The terms, "the public" and "experts" refer to the interviewed samples of lay persons and people in the human service field. Note that this summary is presented by NHSA not TFI; the reader should read the full TFI report for a more in-depth presentation and interpretation.

- The public does not understand human services. To the extent that it does, it views human services as short-term, direct services only, while experts tend to include prevention and advocacy as a part of human services as well.
- Replacing "human services" with "well-being," the experts view well-being broadly related to fulfillment of human potential, while the public tends to define and think about well-being as, essentially, achieving financial self-sufficiency.
- Experts tend to think of structural causes for social needs, while the public tends to think of the individual's inadequacy or failing.
- On the matter of public funding, experts see the need but the public finds it problematic due to perceived corruption and inefficiency in government.
- Asked about who benefits from human services, the public thinks of the recipients of direct services, while the experts think that all benefit through a strengthened society.

They are different "world views." When it comes to gaining support for effective policies, practices, and funding, it is the public's perceptions that matter, particularly in contrast with those of the experts (i.e., people in the human service field). The frame in which the public holds this area of human activity is concrete (financial, the individual's failing and responsibility), it is conceived of as rightly centered on the family (as the locus of both blame and change) and is skeptical of government involvement, and it is about fixing problems, not developing people. For experts, it is more about the totality of human potential/development, the societal/ecological context of human needs, and community solutions, not just individual fixes.

FrameWorks identifies four "dominant American frames" that come into play in the public's take on human services:

- Individualism and "self-making" (i.e., our outcomes are a function of our willpower and choices)
- Well-being defined as financial autonomy
- Government as corrupt and ineffective
- Nonprofits as charities

None of these frames are affirming or encouraging for public authorities and nonprofit agencies striving to help people understand the value and contributions of human services and to transform human services so that they are more efficient and effective. Yet, they suggest that the field can seek ways to better connect with the public on shared beliefs/perceptions, such as more effectively communicating how getting people to financial autonomy is an integral part of human service strategies; and they suggest that there may be opportunities to help the public replace stereotypes relative to government and charity with information on how the sectors function and join forces to achieve positive outcomes for people and communities.

TFI also identifies recessive or non-dominant frames that Americans could access—and that the field can employ—to better understand the value in human services:

- Shared value—equality of opportunity, fairness between places
- Pragmatism—we can fix problems with common-sense, practical solutions
- Connectedness (social connections) matters
- The value of prevention

These frames and what they connote are arguably a part of whatever frame public- and nonprofit-sector human service leaders hold in common. TFI suggests that these concepts, though not dominant, are present in our culture and can be lifted up in the development of a new frame (and intermediate applications) for public understanding of human services (or, as NHSA wonders, perhaps a replacement term for human services, such as human development).

The journalist, Ian Frazier, captured our dilemma as human service policymakers, practitioners, and advocates in his recent article on homelessness in New York City in *The New Yorker* (October 28, 2013). Frazier notes that there are two philosophies in play in the public mind and public discourse, and which one is dominant depends on who holds the keys to Gracie Mansion. One philosophy is that homelessness is a behavior that has to be changed … through requirements, standards, and the like. The failing is with the individual, even if he or she is a child. The other philosophy is that homelessness is about people needing a stable place to live and that housing access and supply are what need to be fixed.

These conflicting views—of one aspect of the human condition that we as human service leaders are responsible for dealing with—reflect long-held frames. Because they appear as diametrically opposed views, "solutions" tend to the either/or, when causes and solutions may well exist on a continuum. Our challenge in this and other aspects of human needs is to help the public understand the facts of cause-effect-and-solution in the context of frames that reflect our shared values of equality of opportunity, pragmatism, prevention, connectedness, and more. Finding an appropriate and accurate frame for human services (or human development or whatever we end up labeling this important area of human endeavor), that resonates with the values and beliefs we share as a people, is a critical step in the journey to transform human services.

ILLINOIS EX REL. MADIGAN, ATTORNEY GENERAL OF ILLINOIS v. TELEMARKETING ASSOCIATES, INC., ET AL. (2003).

Syllabus

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Timber & Lumber Co.*, 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

ILLINOIS EX REL. MADIGAN, ATTORNEY GENERAL OF ILLINOIS *v.* TELEMARKETING ASSOCIATES, INC., ET AL.

CERTIORARI TO THE SUPREME COURT OF ILLINOIS

No. 01–1806. Argued March 3, 2003—Decided May 5, 2003

Respondents, Illinois for-profit fundraising corporations and their owner (collectively Telemarketers), were retained by VietNow National Headquarters, a charitable nonprofit corporation, to solicit donations to aid Vietnam veterans. The contracts between those parties provided, among other things, that Telemarketers would retain 85 percent of the gross receipts from Illinois donors, leaving 15 percent for VietNow. The Illinois Attorney General filed a complaint in state court, alleging, *inter alia*, that Telemarketers represented to donors that a significant amount of each dollar donated would be paid over to VietNow for specifically identified charitable endeavors, and that such representations were knowingly deceptive and materially false, constituted a fraud, and were made for Telemarketers' private pecuniary benefit. The trial court granted Telemarketers' motion to dismiss the fraud claims on First Amendment grounds. In affirming, the Illinois Appellate and Supreme Courts placed heavy weight on *Schaumburg* v. *Citizens for a Better Environment*, 444 U. S. 620, *Secretary of State of Md.* v. *Joseph H. Munson Co.*, 467 U. S. 947, and *Riley* v. *National Federation of Blind of N. C., Inc.*, 487 U. S. 781. Those decisions held that certain regulations of charitable solicitation barring fees in excess of a prescribed level effectively imposed prior restraints on fundraising, and were therefore incompatible with the First Amendment. The state high court acknowledged that this case involved no such prophylactic proscription of high-fee charitable solicitation. Instead, the court noted, the Attorney General sought to enforce the State's generally applicable antifraud laws against Telemarketers for specific instances of deliberate deception. However, the Illinois Supreme Court said, Telemarketers' solicitation statements were alleged to be false only because Telemarketers contracted for 85% of the gross receipts and failed to disclose this information to donors. The court concluded that the Attorney General's complaint was, in essence, an attempt to regulate Telemarketers' ability to engage in a protected activity based upon a percentage-rate limitation—the same regulatory principle rejected in *Schaumburg*, *Munson*, and *Riley*.

Held: Consistent with this Court's precedent and the First Amendment, States may maintain fraud actions when fundraisers make false or misleading representations designed to deceive donors about how their donations will be used. The Illinois Attorney General's allegations against Telemarketers therefore state a claim for relief that can survive a motion to dismiss. Pp. 8–21.

(a) The First Amendment protects the right to engage in charitable solicitation, see, *e.g.*, *Schaumburg*, 444 U. S., at 632, but does not shield fraud, see, *e.g.*, *Donaldson* v. *Read Magazine, Inc.*, 333 U. S. 178, 190. Like other forms of public deception, fraudulent charitable solicitation is unprotected speech. See, *e.g.*, *Schneider* v. *State (Town of Irvington)*, 308 U. S. 147, 164. This Court has not previously addressed the First Amendment's application to individual fraud actions of the kind at issue here. It has, however, three times held unconstitutional prophylactic laws designed to combat fraud by imposing prior restraints on solicitation when fundraising fees exceeded a specified reasonable level. Pp. 8–13.

(b) In those cases, *Schaumburg*, *Munson*, and *Riley*, the Court took care to leave a corridor open for fraud actions to guard the public against false or misleading charitable solicitations. See, *e.g.*, *Schaumburg*, 444 U. S., at 637. As those decisions recognized, there are differences critical to First Amendment concerns between fraud actions trained on representations made in individual cases and statutes that categorically ban solicitations when fundraising costs run high. Simply labeling an action one for "fraud," of course, will not carry the day. Had the State Attorney General's complaint charged fraud based solely on the percentage of donations the fundraisers would retain, or their failure to alert donors to fee arrangements at the start of each call, *Riley* would support swift dismissal. Portions of the Attorney General's complaint against Telemarketers were of this genre. But the complaint and annexed affidavits, in large part, alleged not simply what Telemarketers failed to convey. They also described what Telemarketers misleadingly represented. Taking into account the affidavits, and reading the complaint in the light most favorable to the Attorney General, that pleading described misrepresentations this Court's precedent does not place under the First Amendment's cover. First, the complaint asserted that

Telemarketers affirmatively represented that a significant amount of each dollar donated would be paid over to VietNow to be used for specific charitable purposes while in fact Telemarketers knew that 15 cents or less of each dollar would be available for those purposes. Second, the complaint essentially alleged that the charitable solicitation was a façade: Although Telemarketers represented that donated funds would go to VietNow's charitable purposes, the amount of funds paid over to the charity was merely incidental to the fundraising effort, which was made for Telemarketers' private pecuniary benefit. Fraud actions so tailored, targeting misleading affirmative representations about how donations would be used, are unlike the prophylactic measures invalidated in *Schaumburg*, *Munson*, and *Riley*. So long as the emphasis is on what the fundraisers misleadingly convey, and not on percentage limitations on solicitors' fees *per se*, fraud actions need not impermissibly chill protected speech. Pp. 13–16.

(c) The prohibitions invalidated in *Schaumburg*, *Munson*, and *Riley* turned solely on whether high percentages of donated funds were spent on fundraising. Their application did not depend on whether the fundraiser made fraudulent representations to potential donors. In contrast to the prior restraints inspected in those cases, a properly tailored fraud action targeting specific fraudulent representations employs no "'[b]road prophylactic rul[e],'" *Schaumburg*, 444 U. S., at 637 (citation omitted), lacking any "nexus . . . [to] the likelihood that the solicitation is fraudulent," *Riley*, 487 U. S., at 793. Such an action thus falls on the constitutional side of the line "between regulation aimed at fraud and regulation aimed at something else in the hope that it would sweep fraud in during the process." *Munson*, 467 U. S., at 969–970. The Attorney General's complaint has a solid core in allegations that home in on Telemarketers' affirmative statements designed to mislead donors regarding the use of their contributions. Of prime importance, to prove a defendant liable for fraud under Illinois case law, the State must show by clear and convincing evidence that the defendant knowingly made a false representation of a material fact, that such representation was made with the intent to mislead the listener, and that the representation succeeded in doing so. In contrast to a prior restraint on solicitation, or a regulation that imposes on fundraisers an uphill burden to prove their conduct lawful, the State bears the full burden of proof in an individualized fraud action. Exacting proof requirements of this order, in other contexts, have been held to provide sufficient breathing room for protected speech. See, *e.g.*, *New York Times Co.* v. *Sullivan*, 376 U. S. 254, 279–280. As an additional safeguard responsive to First Amendment concerns, an appellate court could independently review the trial court's findings. Cf. *Bose Corp.* v. *Consumers Union of United States, Inc.*, 466 U. S. 485, 498–511. What the First Amendment and this Court's case law emphatically do not require, however, is a blanket exemption from fraud liability for a fundraiser who intentionally misleads in calls for donations. While the percentage of fundraising proceeds turned over to a charity is not an accurate measure of the amount of funds used "for" a charitable purpose, *Munson*, 467 U. S., at 967, n. 16, the gravamen of the fraud action in this case is not high costs or fees, but particular representations made with intent to mislead. The Illinois Attorney General has not suggested that a charity must desist from using donations for legitimate purposes such as information dissemination, advocacy, and the like. Rather, the Attorney General has alleged that Telemarketers attracted donations by misleading potential donors into believing that a substantial portion of their contributions would fund specific programs or services, knowing full well that was not the case. Such representations remain false or misleading, however legitimate the other purposes for which the funds are in fact used. The Court does not agree with Telemarketers that the Attorney General's fraud action is simply an end run around *Riley*'s holding that fundraisers may not be required, in every telephone solicitation, to state the percentage of receipts the fundraiser would retain. It is one thing to compel every fundraiser to disclose its fee arrangements at the start of a telephone conversation, quite another to take fee arrangements into account in assessing whether particular affirmative representations designedly deceive the public. Pp. 16–19.

(d) Given this Court's repeated approval of government efforts to enable donors to make informed choices about their charitable contributions, see, *e.g.*, *Schaumburg*, 444 U. S., at 638, almost all States and many localities require charities and professional fundraisers to register and file regular reports on their activities, particularly their fundraising costs. These reports are generally available to the public and are often placed on the Internet. Telemarketers do not object on First Amendment grounds to these disclosure requirements. Just as government may seek to inform the public and prevent fraud through such requirements, so it may vigorously enforce antifraud laws to prohibit professional fundraisers from obtaining money on false pretenses or by making false statements. *Riley*, 487 U. S., at 800. High fundraising costs, without more, do not establish fraud, see *id.*, at 793, and mere failure to volunteer the fundraiser's fee when contacting a potential donee, without more, is insufficient to state a claim for fraud, *id.*, at 795–801. But these limitations do not disarm States from assuring that their residents are positioned to make informed choices about their charitable giving. Pp. 19–21.

198 Ill. 2d 345, 763 N. E. 2d 289, reversed and remanded.

Syllabus

GINSBURG, J., delivered the opinion for a unanimous Court. SCALIA, J., filed a concurring opinion, in which THOMAS, J., joined.

SUPREME COURT OF THE UNITED STATES

No. 01–1806

ILLINOIS EX REL. LISA MADIGAN, ATTORNEY GENERAL OF ILLINOIS, PETITIONER *v.* TELEMARKETING ASSOCIATES, INC., ET AL.

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF ILLINOIS

[May 5, 2003]

JUSTICE GINSBURG delivered the opinion of the Court.

This case concerns the amenability of for-profit fund-raising corporations to suit by the Attorney General of Illinois for fraudulent charitable solicitations. The controversy arises from the fundraisers' contracts with a charitable nonprofit corporation organized to advance the welfare of Vietnam veterans; under the contracts, the fundraisers were to retain 85 percent of the proceeds of their fundraising endeavors. The State Attorney General's complaint alleges that the fundraisers defrauded members of the public by falsely representing that "a significant amount of each dollar donated would be paid over to [the veterans organization] for its [charitable] purposes while in fact the [fundraisers] knew that . . . 15 cents or less of each dollar would be available" for those purposes. App. 9, ¶34. Complementing that allegation, the complaint states that the fundraisers falsely represented that "the funds donated would go to further . . . charitable purposes," App. 8, ¶29, when in fact "the amount . . . paid over to charity was merely incidental to the fund raising effort," which was conducted primarily "for the private pecuniary benefit of" the fundraisers, App. 9, ¶35.

The question presented is whether those allegations state a claim for relief that can survive a motion to dismiss. In accord with the Illinois trial and appellate courts, the Illinois Supreme Court held they did not. That court was "mindful of the opportunity for public misunderstanding and the potential for donor confusion which may be presented with fund-raising solicitations of the sort involved in th[is] case," *Ryan* v. *Telemarketing Associates, Inc.*, 198 Ill. 2d 345, 363, 763 N. E. 2d 289, 299 (2001); it nevertheless concluded that threshold dismissal of the complaint was compelled by this Court's decisions in *Schaumburg* v. *Citizens for a Better Environment,* 444 U. S. 620 (1980), *Secretary of State of Md.* v. *Joseph H. Munson Co.,* 467 U. S. 947 (1984), and *Riley* v. *National Federation of Blind of N. C., Inc.,* 487 U. S. 781 (1988). Those decisions held that certain regulations of charitable subscriptions, barring fees in excess of a prescribed level, effectively imposed prior restraints on fundraising, and were therefore incompatible with the First Amendment.

We reverse the judgment of the Illinois Supreme Court. Our prior decisions do not rule out, as supportive of a fraud claim against fundraisers, any and all reliance on the percentage of charitable donations fundraisers retain for themselves. While bare failure to disclose that information directly to potential donors does not suffice to establish fraud, when nondisclosure is accompanied by intentionally misleading statements designed to deceive the listener, the First Amendment leaves room for a fraud claim.

I

Defendants below, respondents here, Telemarketing Associates, Inc., and Armet, Inc., are Illinois for-profit fundraising corporations wholly owned and controlled by defendant-respondent Richard Troia. 198 Ill. 2d, at 347–348, 763 N. E. 2d, at 291. Telemarketing Associates and Armet were retained by VietNow National Headquarters, a charitable nonprofit corporation, to solicit donations to aid Vietnam veterans. *Id.*, at 348, 763 N. E. 2d, at 291. In this opinion, we generally refer to respondents, collectively, as "Telemarketers."

The contracts between the charity, VietNow, and the fundraisers, Telemarketers, provided that Telemarketers would retain 85 percent of the gross receipts from donors within Illinois, leaving 15 percent for VietNow. *Ibid.* Under the agreements, donor lists developed by Telemarketers would remain in their "sole and exclusive" control. App. 24, 93–94, 102, ¶65. Telemarketers also brokered contracts on behalf of VietNow with out-of-state fundraisers; under those contracts, out-of-state fundraisers retained between 70 percent and 80 percent of donated funds, Telemarketers received between 10 percent and 20 percent as a finder's fee, and VietNow received 10 percent. 198 Ill. 2d, at 348, 763 N. E. 2d, at 291. Between July 1987 and the end of 1995, Telemarketers collected approximately $7.1 million, keeping slightly more than $6 million for themselves, and leaving approximately $1.1 million for the charity. *Ibid.*[1]

In 1991, the Illinois Attorney General filed a complaint against Telemarketers in state court. *Id.*, at 348–350, 763 N. E. 2d, at 291–292.[2] The complaint asserted common-

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[1] The petition for certiorari further alleges that, of the money raised by Telemarketers, VietNow in the end spent only about 3 percent to provide charitable services to veterans. Pet. for Cert. 2, and n. 1; see IRS Form 990, filed by VietNow in 2000, available at http://167.10.5.131/Ct0601_0700/0652/1M11INDV.PDF (as visited April 10, 2003) (available in Clerk of Court's case file).

[2] References to the complaint in this opinion include all amendments

law and statutory claims for fraud and breach of fiduciary duty. *Ibid.* It alleged, *inter alia*, that the 85 percent fee for which Telemarketers contracted was "excessive" and "not justified by expenses [they] paid." App. 103, ¶72. Dominantly, however, the complaint concerned misrepresentation.

In the course of their telephone solicitations, the complaint states, Telemarketers misleadingly represented that "funds donated would go to further Viet[N]ow's charitable purposes." *Id.*, at 8, ¶29. Affidavits attached to the complaint aver that Telemarketers told prospective donors their contributions would be used for specifically identified charitable endeavors; typical examples of those endeavors include "food baskets given to vets [and] their families for Thanksgiving," *id.*, at 124, paying "bills and rent to help physically and mentally disabled Vietnam vets and their families," *id*, at 131, "jo[b] training," *id.*, at 145, and "rehabilitation [and] other services for Vietnam vets," *id.*, at 169. One affiant asked what percentage of her contribution would be used for fundraising expenses; she "was told 90% or more goes to the vets." *Ibid.* Another affiant stated she was told her donation would not be used for "labor expenses" because "all members are volunteers." *Id.*, at 111.[3] Written materials Telemarketers sent to each donor

to that pleading.

[3] Under Illinois law, exhibits attached to a complaint and referred to in a pleading become part of the pleading "for all purposes." Ill. Comp. Stat., ch. 735, §5/2–606 (1992); *Pure Oil Co.* v. *Miller-McFarland Drilling Co.*, 376 Ill. 486, 497–498, 34 N. E. 2d 854, 859 (1941); 3 R. Michael, Illinois Practice §23.9, p. 332–333, nn. 7–9 and accompanying text (1989) (collecting Illinois cases). Telemarketers' counsel stated at oral argument that the Illinois Supreme Court had "found as a matter of law that [the] affidavits were not part of the complaint." Tr. of Oral Arg. 40. We can locate no such finding in the court's opinion. Asked to supply a citation after argument, see Tr. of Oral Arg. 41, counsel directed us to the court's statement that "there is no allegation that

represented that contributions would "be used to help and assist Viet[N]ow's charitable purposes." *Id.*, at 8, ¶30.[4]

The 15 cents or less of each solicited dollar actually made available to VietNow, the Attorney General charged, "was merely incidental to the fund raising effort"; consequently, she asserted, "representations made to donors [that a significant amount of each dollar donated would be paid over to Viet[N]ow for its purposes] were knowingly deceptive and materially false, constituted a fraud[,] and were made for the private pecuniary benefit of [Telemarketers]." *Id.*, at 9, ¶¶ 34, 35.

Telemarketers moved to dismiss the fraud claims, urging that they were barred by the First Amendment. The

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[Telemarketers] made affirmative misstatements to potential donors." *Ryan* v. *Telemarketing Associates, Inc.*, 198 Ill. 2d 345, 348, 763 N. E. 2d 289, 291 (2001)); see Letter from William E. Raney to William K. Suter, Clerk of the Court (March 4, 2003). In so stating, the Illinois court overlooked, most obviously, the two affidavits attesting to Telemarketers' representations that "90% or more goes to the vets," and that there would be no "labor expenses." See App. 111, 169. In any event, the sentence fragment counsel identified falls short of showing, in the face of established Illinois case law, that the court "found" the affidavits annexed by the Illinois Attorney General *dehors* the complaint. Counsel's contention is further clouded by the Illinois Supreme Court's explicit notation that "the Attorney General ha[d] attached to his complaint the affidavits of 44 VietNow donors." 198 Ill. 2d, at 352, 763 N. E. 2d, at 293.

[4] Illinois law provides that "[i]n any solicitation to the public for a charitable organization by a professional fund raiser or professional solicitor[,] [t]he public member shall be promptly informed by statement in verbal communications and by clear and unambiguous disclosure in written materials that the solicitation is being made by a paid professional fund raiser. The fund raiser, solicitor, and materials used shall also provide the professional fund raiser's name and a statement that contracts and reports regarding the charity are on file with the Illinois Attorney General and additionally, in verbal communications, the solicitor's true name must be provided." Ill. Comp. Stat., ch. 225, §460/17(a) (2001).

trial court granted the motion,[5] and the dismissal order was affirmed, in turn, by the Illinois Appellate Court and the Illinois Supreme Court. The Illinois courts placed heavy weight on three decisions of this Court: *Schaumburg* v. *Citizens for a Better Environment,* 444 U. S. 620 (1980); *Secretary of State of Md.* v. *Joseph H. Munson Co.,* 467 U. S. 947 (1984); and *Riley* v. *National Federation of Blind of N. C., Inc.,* 487 U. S. 781 (1988). Each of the three decisions invalidated state or local laws that categorically restrained solicitation by charities or professional fundraisers if a high percentage of the funds raised would be used to cover administrative or fundraising costs. *Schaumburg,* 444 U. S., at 620; *Munson,* 467 U. S., at 947; and *Riley,* 487 U. S., at 781; see 198 Ill. 2d, at 359, 763 N. E. 2d, at 297.

The Illinois Supreme Court acknowledged that this case, unlike *Schaumburg, Munson,* and *Riley,* involves no prophylactic provision proscribing any charitable solicitation if fundraising costs exceeded a prescribed limit. Instead, the Attorney General sought to enforce the State's generally applicable antifraud laws against Telemarketers for "specific instances of deliberate deception." 198 Ill. 2d, at 358, 763 N. E. 2d, at 296 (quoting *Riley,* 487 U. S, at 803 (SCALIA, J., concurring)). "However," the court said, "the statements made by [Telemarketers] during solicitation are alleged to be 'false' only because [Telemarketers] retained 85% of the gross receipts and failed to disclose this information to donors." *Id.,* at 359, 763 N. E. 2d, at 297. The Attorney General's complaint, in the Illinois Supreme Court's view, was "in essence, an attempt to regulate [Telemarketers'] ability to engage in a protected activity based upon a percentage-rate limitation"—"the same regulatory principle that was rejected in

[5] The parties subsequently stipulated to the dismissal of all remaining claims. App. to Pet. for Cert. 30–31.

Schaumburg[,] *Munson*, and *Riley*." *Ibid.*

"[H]igh solicitation costs," the Illinois Supreme Court stressed, "can be attributable to a number of factors." *Ibid.* In this case, the court noted, Telemarketers contracted to provide a "wide range" of services in addition to telephone solicitation. *Ibid.* For example, they agreed to publish a newsletter and to maintain a toll-free information hotline. *Id.*, at 359–360, 763 N. E. 2d, at 297–298. Moreover, the court added, VietNow received "nonmonetary benefits by having [its] message disbursed by the solicitation process," and Telemarketers were directed to solicit "in a manner that would 'promote goodwill' on behalf of VietNow." *Id.*, at 361, 763 N. E. 2d, at 298. Taking these factors into account, the court concluded that it would be "incorrect to presume . . . [any] nexus between high solicitation costs and fraud." *Id.*, at 360, 763 N. E. 2d, at 298.

The Illinois Supreme Court further determined that, under *Riley*, "fraud cannot be defined in such a way that it places on solicitors the affirmative duty to disclose to potential donors, at the point of solicitation, the net proceeds to be returned to the charity." *Id.*, at 361, 763 N. E. 2d, at 298.[6] Finally, the court expressed the fear that if the complaint were allowed to proceed, all fundraisers in Illinois would be saddled with "the burden of defending the reasonableness of their fees, on a case-by-

[6] Contracts for fundraising campaigns in Illinois must be filed with the State's Attorney General, see Ill. Comp. Stat., ch. 225, §§460/2(a)(10) and 460/7 (2001), and those contracts must disclose all fundraiser fees, including any "stated percentage of the gross amount raised" to be retained by the fundraiser, §460/7(b); see §460/7(d). The filings are open for public inspection. §460/2(f). Illinois law also provides that fundraisers must disclose "the percentage to be received by the charitable organization from each contribution, if such disclosure is requested by the person solicited." §460/17(b). Telemarketers did not challenge these requirements.

case basis, whenever in the Attorney General's judgment the public was being deceived about the charitable nature of a fund-raising campaign because the fund-raiser's fee was too high." *Id.*, at 362, 763 N. E. 2d, at 299. The threatened exposure to litigation costs and penalties, the court said, "could produce a substantial chilling effect on protected speech." *Ibid.* We granted certiorari. 537 U. S. 999 (2002).

II

The First Amendment protects the right to engage in charitable solicitation. See *Schaumburg*, 444 U. S., at 632 ("charitable appeals for funds . . . involve a variety of speech interests—communication of information, the dissemination and propagation of views and ideas, and the advocacy of causes—that are within the protection of the First Amendment"); *Riley*, 487 U. S., at 788–789. But the First Amendment does not shield fraud. See, *e.g.*, *Donaldson* v. *Read Magazine, Inc.*, 333 U. S. 178, 190 (1948) (the government's power "to protect people against fraud" has "always been recognized in this country and is firmly established"); *Gertz* v. *Robert Welch, Inc.*, 418 U. S. 323, 340 (1974) (the "intentional lie" is "no essential part of any exposition of ideas") (internal quotation marks omitted). Like other forms of public deception, fraudulent charitable solicitation is unprotected speech. See, *e.g.*, *Schneider* v. *State (Town of Irvington)*, 308 U. S. 147, 164 (1939) ("Frauds," including "fraudulent appeals . . . made in the name of charity and religion," may be "denounced as offenses and punished by law."); *Donaldson*, 333 U. S., at 192 ("A contention cannot be seriously considered which assumes that freedom of the press includes a right to raise money to promote circulation by deception of the public.").

The Court has not previously addressed the First Amendment's application to individual fraud actions of the kind at issue here. It has, however, three times considered prophylactic statutes designed to combat fraud by imposing prior restraints on solicitation when fundraising fees exceeded a specified reasonable level. Each time, the Court held the prophylactic measures unconstitutional.

In *Schaumburg*, decided in 1980, the Court invalidated a village ordinance that prohibited charitable organizations from soliciting contributions unless they used at least 75 percent of their receipts "directly for the charitable purpose of the organization." 444 U. S., at 624 (internal quotation marks omitted). The ordinance defined "charitable purposes" to exclude salaries and commissions paid to solicitors, and the administrative expenses of the charity, including salaries. *Ibid.* The village of Schaumburg's "principal justification" for the ordinance was fraud prevention: "[A]ny organization using more than 25 percent of its receipts on fundraising, salaries, and overhead," Schaumburg submitted, "is not a charitable, but a commercial, for-profit enterprise"; "to permit [such an organization] to represent itself as a charity," the village urged, "is fraudulent." *Id.*, at 636.

The Court agreed with Schaumburg that fraud prevention ranks as "a substantial governmental interes[t]," *ibid.*, but concluded that "the 75-percent requirement" promoted that interest "only peripherally." *Ibid.* Spending "more than 25 percent of [an organization's] receipts on fundraising, salaries, and overhead," the Court explained, does not reliably indicate that the enterprise is "commercial" rather than "charitable." *Ibid.* Such spending might be altogether appropriate, *Schaumburg* noted, for a charitable organization "primarily engaged in research, advocacy, or public education [that uses its] own paid staff to carry out these functions as well as to solicit financial support." *Id.*, at 636–637. "The Village's legitimate interest in preventing fraud," the Court stated, "can be better served by measures less intrusive than a direct prohibition on solicitation," *id.*, at 637: "Fraudulent misrepresentations can be prohibited and the penal laws used to punish such conduct directly," *ibid.*

Four years later, in *Munson,* the Court invalidated a Maryland law that prohibited charitable organizations from soliciting if they paid or agreed to pay as expenses more than 25 percent of the amount raised. Unlike the inflexible ordinance in *Schaumburg,* the Maryland law authorized a waiver of the 25 percent limitation "where [it] would effectively prevent the charitable organization from raising contributions." 467 U. S., at 950–951, n. 2. The Court held that the waiver provision did not save the statute. *Id.,* at 962. "[No] reaso[n] other than financial necessity warrant[ed] a waiver," *Munson* observed. *Id.,* at 963. The statute provided no shelter for a charity that incurred high solicitation costs because it chose to disseminate information as part of its fundraising. *Ibid.* Nor did it shield a charity whose high solicitation costs stemmed from the unpopularity of its cause. *Id.,* at 967.

"[N]o doubt [there] are organizations that have high fundraising costs not due to protected First Amendment activity," the Court recognized; it concluded, however, that Maryland's statute was incapable of "distinguish[ing] those organizations from charities that have high costs due to protected First Amendment activities." *Id.,* at 966. The statute's fatal flaw, the Court said, was that it "operate[d] on [the] fundamentally mistaken premise that high solicitation costs are an accurate measure of fraud." *Ibid.* As in *Schaumburg,* the Court noted, fraud could be checked by "measures less intrusive than a direct prohibition on solicitation": Fraud could be punished directly and the State "could require disclosure of the finances of a charitable organization so that a member of the public could make an informed decision about whether to contribute." 467 U. S., at 961, and n. 9.

Third in the trilogy of cases on which the Illinois Supreme Court relied was our 1988 decision in *Riley.* The village ordinance in *Schaumburg* and the Maryland law in *Munson* regulated charities; the North Carolina charitable solicitation controls at issue in *Riley* directly regulated professional fundraisers. North Carolina's law prohibited professional fundraisers from retaining an "unreasonable" or "excessive" fee. 487 U. S., at 784 (internal quotation marks omitted). Fees up to 20 percent of the gross receipts collected were deemed reasonable; fees between 20 percent and 35 percent were deemed unreasonable if the State showed that the solicitation did not involve advocacy or dissemination of information. *Id.*, at 784–785. Fees exceeding 35 percent were presumed unreasonable, but the fundraiser could rebut the presumption by showing either that the solicitation involved advocacy or information dissemination, or that, absent the higher fee, the charity's "ability to raise money or communicate would be significantly diminished." *Id.*, at 785–786.

Relying on *Schaumburg* and *Munson*, the Court's decision in *Riley* invalidated North Carolina's endeavor to rein in charitable solicitors' fees. The Court held, once again, that fraud may not be inferred simply from the percentage of charitable donations absorbed by fundraising costs. See 487 U. S., at 789 ("solicitation of charitable contributions is protected speech"; "using percentages to decide the legality of the fundraiser's fee is not narrowly tailored to the State's interest in preventing fraud").

The opportunity to rebut the unreasonableness presumption attending a fee over 35 percent did not bring North Carolina's scheme within the constitutional zone, the Court explained. Under the State's law, "even where a prima facie showing of unreasonableness ha[d] been rebutted, the factfinder [still had to] make an ultimate determination, on a case-by-case basis, as to whether the fee was reasonable—a showing that the solicitation involved . . . advocacy or [the] dissemination of information [did] not alone establish that the total fee was reasonable."

Id., at 786.

Training on that aspect of North Carolina's regulation, the Court stated: "Even if we agreed that some form of a percentage-based measure could be used, in part, to test for fraud, we could not agree to a measure that requires the speaker to prove 'reasonableness' case by case based upon what is at best a loose inference that the fee might be too high." *Id.*, at 793. "[E]very campaign incurring fees in excess of 35% . . . [would] subject [fundraisers] to potential litigation over the 'reasonableness' of the fee," the Court observed; that litigation risk, the Court concluded, would "chill speech in direct contravention of the First Amendment's dictates." *Id.*, at 794. Especially likely to be burdened, the *Riley* opinion noted, were solicitations combined with advocacy or the communication of information, and fundraising by small or unpopular charities. *Ibid.* The Court cautioned, however, as it did in *Schaumburg* and *Munson*, that States need not "sit idly by and allow their citizens to be defrauded." 487 U. S., at 795. We anticipated that North Carolina law enforcement officers would be "ready and able" to enforce the State's antifraud law. *Ibid.*

Riley presented a further issue. North Carolina law required professional fundraisers to disclose to potential donors, before asking for money, the percentage of the prior year's charitable contributions the fundraisers had actually turned over to charity. *Id.*, at 795. The State defended this disclosure requirement as a proper means to dispel public misperception that the money donors gave to professional fundraisers went in greater-than-actual proportion to benefit charity. *Id.*, at 798.

This Court condemned the measure as an "unduly burdensome" prophylactic rule, an exaction unnecessary to achieve the State's goal of preventing donors from being misled. *Id.*, at 800. The State's rule, *Riley* emphasized, conclusively presumed that "the charity derive[d] no benefit from funds collected but not turned over to it." *Id.*, at 798. This was "not necessarily so," the Court said, for charities might well benefit from the act of solicitation itself, when the request for funds conveyed information or involved cause-oriented advocacy. *Ibid.*

The Court noted in *Riley* that North Carolina (like Illinois here) required professional fundraisers to disclose their professional status. *Id.*, at 799; see Ill. Comp. Stat., ch. 225, §460/17(a) (2001); *supra*, at 5, 7, nn. 4 and 6. That disclosure, the Court said, effectively notified contributors that a portion of the money they donated would underwrite solicitation costs. A concerned donor could ask how much of the contribution would be turned over to the charity, and under North Carolina law, fundraisers would be obliged to provide that information. *Riley*, 487 U. S., at 799 (citing N. C. Gen. Stat. §131C–16 (1986)). But upfront telephone disclosure of the fundraiser's fee, the Court believed, might end as well as begin the conversation: A potential contributor who thought the fee too high might simply hang up. *Id.*, at 799–800. "[M]ore benign and narrowly tailored options" that would not chill solicitation altogether were available; for example, the Court suggested, "the State may itself publish the detailed financial disclosure forms it requires professional fundraisers to file," and "[it] may vigorously enforce its antifraud laws to prohibit professional fundraisers from obtaining money on false pretenses or by making false statements." *Ibid.*

III

A

The Court's opinions in *Schaumburg*, *Munson*, and *Riley* took care to leave a corridor open for fraud actions to guard the public against false or misleading charitable solicitations. See *Schaumburg*, 444 U. S., at 637; *Munson*, 467 U. S., at 961, and n. 9; *Riley*, 487 U. S., at 795, 800.[7] As those decisions recognized, and as we further explain below, there are differences critical to First Amendment concerns between fraud actions trained on representations made in individual cases and statutes that categorically ban solicitations when fundraising costs run high. See Part III–B, *infra*. Simply labeling an action one for "fraud," of course, will not carry the day. For example, had the complaint against Telemarketers charged fraud based solely on the percentage of donations the fundraisers would retain, or their failure to alert potential donors to their fee arrangements at the start of each telephone call, *Riley* would support swift dismissal.[8] A State's Attorney General surely cannot gain case-by-case ground this Court has declared off limits to legislators.

Portions of the complaint in fact filed by the Attorney General are of this genre. See, *e.g.*, App. 103, ¶72 (asserting that Telemarketers' charge "is excessive" and "not justified by expenses [they] paid"); *id.*, at 86, ¶¶67H–67I (alleging statutory violations based on failure to disclose to prospective donors Telemarketers' percentage fee). As we earlier noted, however, see *supra*, at 4–5, the complaint and annexed affidavits, in large part, alleged not simply what Telemarketers failed to convey; they also described what Telemarketers misleadingly represented.

Under Illinois law, similar to the Federal Rules of Civil Procedure, "[w]hen the legal sufficiency of a complaint is

[7] We are therefore unpersuaded by Telemarketers' plea that they lacked fair notice of their vulnerability to fraud actions. See Brief for Respondents 46, 49–50.

[8] Although fundraiser retention of 85 percent of donations is significantly higher than the 35 percent limit in *Riley*, this Court has not yet accepted any percentage-based measure as dispositive. See *supra*, at 11–12 (quoting *Riley* v. *National Federation of Blind of N. C., Inc.*, 487 U. S. 781, 793 (1988)).

challenged by a . . . motion to dismiss, all well-pleaded facts in the complaint are taken as true and [the court] must determine whether the allegations . . ., *when interpreted in the light most favorable to the plaintiff*, are sufficient to establish a cause of action upon which relief may be granted." *Connick* v. *Suzuki Motor Co., Ltd.*, 174 Ill. 2d 482, 490, 675 N. E. 2d 584, 588 (1997) (emphasis added). Dismissal is proper "only if it clearly appears that no set of facts can be proved under the pleadings which will entitle the plaintiff to recover." 198 Ill. 2d., at 351, 763 N. E. 2d, at 293.

Taking into account the affidavits, and reading the complaint in the light most favorable to the Attorney General, that pleading described misrepresentations our precedent does not place under the First Amendment's cover. First, it asserted that Telemarketers affirmatively represented that "a significant amount of each dollar donated would be paid over to Viet[N]ow" to be used for specific charitable purposes—rehabilitation services, job training, food baskets, and assistance for rent and bills, App. 9, ¶34; *id.*, at 124, 131, 145, 163, 169, 187, 189—while in reality Telemarketers knew that "15 cents or less of each dollar" was "available to Viet[N]ow for its purposes." *Id.*, at 9, ¶34. Second, the complaint alleged, essentially, that the charitable solicitation was a façade: Although Telemarketers represented that donated funds would go to VietNow's specific "charitable purposes," App. 8, ¶29, the "amount of funds being paid over to charity was merely incidental to the fund raising effort," which was made "for the private pecuniary benefit of [Telemarketers] and their agents," App. 9, ¶35. Cf., *e.g.*, *Voices for Freedom*, CCH Trade Reg. Rep. ¶23,080 (1993) [1987–1993 Transfer Binder] (complaint against fundraisers who, *inter alia*, represented that "substantial portions of the funds from [the sale of commemorative bracelets] would be used to support a message center for the troops stationed in the Persian Gulf," but "did not use substantial portions of the bracelet-sales proceeds to support the message center").

Fraud actions so tailored, targeting misleading affirmative representations about how donations will be used, are plainly distinguishable, as we next discuss, from the measures invalidated in *Schaumburg*, *Munson*, and *Riley*: So long as the emphasis is on what the fundraisers misleadingly convey, and not on percentage limitations on solicitors' fees *per se*, such actions need not impermissibly chill protected speech.

B

In *Schaumburg*, *Munson*, and *Riley*, the Court invalidated laws that prohibited charitable organizations or fundraisers from engaging in charitable solicitation if they spent high percentages of donated funds on fundraising—whether or not any fraudulent representations were made to potential donors. Truthfulness even of all representations was not a defense. See *supra*, at 8–12. In contrast to the prior restraints inspected in those cases, a properly tailored fraud action targeting fraudulent representations themselves employs no "[b]road prophylactic rul[e]," *Schaumburg*, 444 U. S., at 637 (internal quotation marks and citation omitted), lacking any "nexus . . . [to] the likelihood that the solicitation is fraudulent," *Riley*, 487 U. S., at 793. Such an action thus falls on the constitutional side of the line the Court's cases draw "between regulation aimed at fraud and regulation aimed at something else in the hope that it would sweep fraud in during the process." *Munson*, 467 U. S., at 969–970. The Illinois Attorney General's complaint, in this light, has a solid core in allegations that home in on affirmative statements Telemarketers made intentionally misleading donors regarding the use of their contributions. See *supra*, at 4–5.

Of prime importance, and in contrast to a prior restraint on solicitation, or a regulation that imposes on fundraisers an uphill burden to prove their conduct lawful, in a properly tailored fraud action the State bears the full burden of proof. False statement alone does not subject a fundraiser to fraud liability. As restated in Illinois case law, to prove a defendant liable for fraud, the complainant must show that the defendant made a false representation of a material fact knowing that the representation was false; further, the complainant must demonstrate that the defendant made the representation with the intent to mislead the listener, and succeeded in doing so. See *In re Witt*, 145 Ill. 2d 380, 391, 538 N. E. 2d 526, 531 (1991). Heightening the complainant's burden, these showings must be made by clear and convincing evidence. See *Hofmann* v. *Hofmann*, 94 Ill. 2d 205, 222, 446 N. E. 2d 499, 506 (1983).[9]

Exacting proof requirements of this order, in other contexts, have been held to provide sufficient breathing room for protected speech. See *New York Times Co.* v. *Sullivan*, 376 U. S. 254, 279–280 (1964) (action for defamation of public official); *Bose Corp.* v. *Consumers Union of United States, Inc.*, 466 U. S. 485, 502, and n. 19 (1984) (noting "kinship" between *New York Times* standard and "motivation that must be proved to support a common-law action for deceit").[10] As an additional safeguard responsive

[9] In *Riley*, this Court expressed concern that case-by-case litigation over the reasonableness of fundraising fees would inhibit speech. 487 U. S., at 793–794. That concern arose in large measure because the North Carolina statute there at issue placed the burden of proof on the fundraiser. The Court has long cautioned that, to avoid chilling protected speech, the government must bear the burden of proving that the speech it seeks to prohibit is unprotected. See *Freedman* v. *Maryland*, 380 U. S. 51, 58 (1965), *Speiser* v. *Randall*, 357 U. S. 513, 525–526 (1958). The government shoulders that burden in a fraud action.

[10] Although this case does not present the issue, the Illinois Attorney General urges that a constitutional requirement resembling "actual malice" does not attend "*every* form of liability by charitable solicitors

to First Amendment concerns, an appellate court could independently review the trial court's findings. Cf. *Bose Corp.*, 466 U. S., at 498–511 (*de novo* appellate review of findings regarding actual malice). What the First Amendment and our case law emphatically do not require, however, is a blanket exemption from fraud liability for a fundraiser who intentionally misleads in calls for donations.

The Illinois Supreme Court in the instant case correctly observed that "the percentage of [fundraising] proceeds turned over to a charity is not an accurate measure of the amount of funds used 'for' a charitable purpose." 198 Ill. 2d, at 360, 763 N. E. 2d, at 298 (citing *Munson*, 467 U. S., at 967, n. 16). But the gravamen of the fraud action in this case is not high costs or fees, it is particular representations made with intent to mislead. If, for example, a charity conducted an advertising or awareness campaign that advanced charitable purposes in conjunction with its fundraising activity, its representation that donated funds were going to "charitable purposes" would not be misleading, much less intentionally so. Similarly, charitable organizations that engage primarily in advocacy or information dissemination could get and spend money for their activities without risking a fraud charge. See *Schaumburg*, 444 U. S., at 636–637; *Munson*, 467 U. S., at 963; *Riley*, 487 U. S., at 798–799.[11]

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who misrepresent the use of donations." Reply Brief 16–17, n. 11 (internal quotation marks omitted). We confine our consideration to the complaint in this case, which alleged that Telemarketers "acted with knowledge of the falsity of their representations." *Ibid.*

[11] *Amicus* Mothers Against Drunk Driving (MADD), for example, states that its mission is "to communicate the message 'Don't Drink and Drive.'" Brief for Public Citizen, Inc., et al. as *Amici Curiae* 13. Telephone solicitors retained by MADD "reach millions of people a year, and each call educates the public about the tragedy of drunk driving, provides statistics and asks the customer to always designate a sober driver." *Ibid.* (internal quotation marks and citation omitted). Solicita-

The Illinois Attorney General here has not suggested that a charity must desist from using donations for information dissemination, advocacy, the promotion of public awareness, the production of advertising material, the development or enlargement of the charity's contributor base,[12] and the like. Rather, she has alleged that Telemarketers attracted donations by misleading potential donors into believing that a substantial portion of their contributions would fund specific programs or services, knowing full well that was not the case. See *supra*, at 4–5, 15. Such representations remain false or misleading, however legitimate the other purposes for which the funds are in fact used.

We do not agree with Telemarketers that the Illinois Attorney General's fraud action is simply an end run around *Riley*'s holding that fundraisers may not be required, in every telephone solicitation, to state the percentage of receipts the fundraiser would retain. See Brief for Respondents 14–19. It is one thing to compel every fundraiser to disclose its fee arrangements at the start of a telephone conversation, quite another to take fee arrangements into account in assessing whether particular affirmative representations designedly deceive the public.

C

Our decisions have repeatedly recognized the legitimacy of government efforts to enable donors to make informed

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tions that described MADD's charitable mission would not be fraudulent simply because MADD devotes a large proportion of its resources to fundraising calls, for those calls themselves fulfill its advocacy/information dissemination mission.

[12] This Court has consistently recognized that small or unpopular charities would be hindered by limitations on the portion of receipts they could devote to subscription building. See *Secretary of State of Md.* v. *Joseph H. Munson Co.*, 467 U. S. 947, 967 (1984); *Riley*, 487 U. S., at 794.

choices about their charitable contributions. In *Schaumburg*, the Court thought it proper to require "disclosure of the finances of charitable organizations," thereby to prevent fraud "by informing the public of the ways in which their contributions will be employed." 444 U. S., at 638. In *Munson*, the Court reiterated that "disclosure of the finances of a charitable organization" could be required "so that a member of the public could make an informed decision about whether to contribute." 467 U. S., at 961–962, n. 9. And in *Riley*, the Court said the State may require professional fundraisers to file "detailed financial disclosure forms" and may communicate that information to the public. 487 U. S., at 800; see also *id.*, at 799, n. 11 (State may require fundraisers "to disclose unambiguously [their] professional status").

In accord with our precedent, as Telemarketers and their *amici* acknowledge, in "[a]lmost all of [the] states and many localities," charities and professional fundraisers must "register and file regular reports on activities[,] particularly fundraising costs." Brief for Respondents 37; see Brief for Independent Sector et al. as *Amici Curiae* 6–8. These reports are generally available to the public; indeed, "[m]any states have placed the reports they receive from charities and professional fundraisers on the Internet." Brief for Respondents 39; see Brief for Independent Sector et al. as *Amici Curiae* 9–10. Telemarketers do not object on First Amendment grounds to these disclosure requirements. Tr. of Oral Arg. 43.

Just as government may seek to inform the public and prevent fraud through such disclosure requirements, so it may "vigorously enforce . . . antifraud laws to prohibit professional fundraisers from obtaining money on false pretenses or by making false statements." *Riley*, 487 U. S., at 800. High fundraising costs, without more, do not establish fraud. See *id.*, at 793. And mere failure to volunteer the fundraiser's fee when contacting a potential donee, without more, is insufficient to state a claim for fraud. *Id.*, at 795–801. But these limitations do not disarm States from assuring that their residents are positioned to make informed choices about their charitable giving. Consistent with our precedent and the First Amendment, States may maintain fraud actions when fundraisers make false or misleading representations designed to deceive donors about how their donations will be used.

* * *

For the reasons stated, the judgment of the Illinois Supreme Court is reversed, and the case is remanded for further proceedings not inconsistent with this opinion.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 01–1806

ILLINOIS EX REL. LISA MADIGAN, ATTORNEY GENERAL OF ILLINOIS, PETITIONER *v.* TELEMARKETING ASSOCIATES, INC., ET AL.

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF ILLINOIS

[May 5, 2003]

JUSTICE SCALIA, with whom JUSTICE THOMAS joins, concurring.

The question presented by the petition for certiorari in this case read as follows: "Whether the First Amendment categorically prohibits a State from pursuing a fraud action against a professional fundraiser who represents that donations will be used for charitable purposes but in fact keeps the vast majority (in this case 85 percent) of all funds donated." Pet. for Cert. i. I join the Court's opinion because I think it clear from the opinion that if the *only* representation made by the fundraiser were the one set forth in the question presented ("that donations will be used for charitable purposes"), and if the *only* evidence of alleged failure to comply with that representation were the evidence set forth in the question presented (that the fundraiser "keeps the vast majority (in this case 85 percent) of all funds donated"), the answer to the question would be yes.

It is the teaching of *Riley* v. *National Federation of Blind of N. C., Inc.*, 487 U. S. 781, 793 (1988), and *Secretary of State of Md.* v. *Joseph H. Munson Co.*, 467 U. S. 947, 966 (1984), that since there is such wide disparity in the legitimate expenses borne by charities, it is not possible to establish a maximum percentage that is reasonable. It also follows from that premise that there can in general be no reasonable expectation on the part of donors as to what fraction of the gross proceeds goes to expenses. When that proposition is combined with the unquestionable fact that one who is promised, without further specification, that his charitable contribution will go to a particular cause must reasonably understand that it will go there *after* the deduction of legitimate expenses, the conclusion must be that the promise is not broken (and hence fraud is not committed) by the mere fact that expenses are very high. Today's judgment, however, rests upon a "solid core" of misrepresentations, *ante* at 16, that go well beyond mere commitment of the collected funds to the charitable purpose.

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"The Community is Speaking Loud and Clear": Susan G. Komen for the Cure, Planned Parenthood, and the Crisis of Public Opinion

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Abstract

On January 31, 2012, Planned Parenthood announced that longtime partner Susan G. Komen for the Cure would no longer provide grants to Planned Parenthood for breast cancer screening services. Planned Parenthood accused Komen of "succumbing to political pressure" from conservative groups who opposed Planned Parenthood because it provided abortion services. Komen denied this charge, claiming it had changed its grant-making criteria, but public outcry against Komen's decision was swift and fierce. Komen declared Planned Parenthood eligible again to receive grants three days later and faced a difficult task of restoring its reputation and donor support.

Keywords: nonprofits; crisis management; social media; Susan G. Komen for the Cure; Planned Parenthood; fundraising; public relations

Overview

At approximately 5 p.m. Eastern Time on Tuesday, January 31, 2012, thousands of constituents of women's health organization Planned Parenthood received an unexpected email alert from the organization's president, Cecile Richards (Sun & Kliff, 2012). "We are alarmed and saddened that the Susan G. Komen for the Cure Foundation appears to have succumbed to political pressure," Richards said in the press release ("'Alarmed,'" 2012, para. 2) that was posted online at the same time as the email blast (Sun & Kliff, 2012). Thousands more saw a similarly urgent message on their Facebook news and Twitter feeds: "ALERT: Susan G. Komen caves under anti-choice pressure, ends funding for breast cancer

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screenings at PP health centers," the tweet said with a link to the press release (Sun & Kilff, para. 23).

Background

Susan G. Komen for the Cure

Decades ago, Nancy G. Brinker promised her dying sister, Susan G. Komen, that she would do everything she could to end breast cancer. In 1982, that promise was fulfilled in the creation of Susan G. Komen for the Cure, now considered the "world's largest grassroots network of breast cancer survivors and activists" and a part of every major advancement in fighting the disease ("About Us," n.d., para. 2).

Brinker was familiar with Planned Parenthood before Komen sent it grants for breast cancer screenings. In 1996, she served on a Planned Parenthood advisory board in Texas and received an award from the organization. Even at this time, pro-life organizations had criticized Brinker for her ties to Planned Parenthood (Loth, 2012). She was particularly a target because of her conservative political leanings. President George W. Bush had appointed her to positions in his administration (CNN Political Unit, 2012), and she was a "major donor" to his campaigns (Ryan, 2012a, para. 2). Those close to Brinker said she has hinted at pursuing a political career herself and has thus remained close to

Susan G. Komen for the Cure Fundraising Facts

- Has raised $1.9 billion to fund breast cancer awareness, prevention, and research efforts ("About Us," n.d.)
- Headquarters in Dallas, Texas, with 122 local affiliates nationwide ("About Us," n.d.)
- Susan G. Komen Race for the Cure Series occurs in more than 120 communities across the U.S. with more than 1 million participants ("Our People," n.d.)
- Brinker is credited with "pioneering cause-related marketing" in which corporations partner with charities to further promote the charity's cause ("Nancy G. Brinker," n.d., para. 3)
- Cause-related marketing provides Komen with $55 million annually in contributions (Flock, 2012a)

many of her Republican friends. Some of these conservative friends are involved with Komen and have "held increasingly greater sway with Brinker" in decision-making inside the organization in recent years (Goldman, 2012, para. 15). The Komen board of directors is indeed made up of many of Brinker's closest friends, who often do not question her decision-making (Goldman, 2012).

In addition to political allies on the board, the former secretary of state for Georgia, Karen Handel joined Komen in April 2011 as senior vice president for public policy ("Susan G. Komen for the Cure," 2011). At the time of her hire, Handel's pro-life views had been well known; she had run for Georgia governor in 2010 on a pro-life platform that promised to end state funding for Planned Parenthood (Aravosis, 2012a). When Komen decided to pull funding from Planned Parenthood, many remembered its leadership's pro-life and conservative background.

Planned Parenthood

The Planned Parenthood Federation of America, a nonprofit organization dedicated to providing sexual education and access to reproductive health care services, celebrated its 95th anniversary in October 2011. The advocacy arm of the organization is active in lobbying for policies that "enable Americans to access comprehensive reproductive and sexual health care, education, and information" ("Who We Are," n.d., para. 7).

Planned Parenthood Facts

- Includes 79 local affiliates and 800 health centers that operate nationwide (Radnofsky, Matthews, & West, 2012; "Who We Are," n.d.)
- One in every five women use a Planned Parenthood service for healthcare during her lifetime ("Who We Are," n.d.)
- Educational programs reach nearly 1.2 million youths and adults each year ("Who We Are," n.d.)
- Seventy-six percent of its services are to prevent unintended pregnancy ("Planned Parenthood at a Glance," n.d.)
- About 3 percent of its total services are abortions (Planned Parenthood at a Glance," n.d.)
- Provides nearly 770,000 Pap tests and 750,000 breast exams every year ("Planned Parenthood at a Glance," n.d.)
- Supporters have doubled to number six million under Richards' leadership ("Who We Are," n.d.)

Because of its health screening services, Planned Parenthood seems a natural partner to team up with a breast cancer grant-making giant like Komen.

In 2006, Cecile Richards joined Planned Parenthood as president of the Planned Parenthood Federation of America and the Planned Parenthood Action Fund, the advocacy arm of the organization. Like Brinker, Richards also has political ties—but with the opposite party. She is the daughter of the first female governor of Texas, Democrat Ann Richards, a well-known feminist and political activist (Holley, 2006). Cecile was also involved in politics, and before coming to Planned Parenthood, she served as deputy chief of staff for House Democratic Leader Nancy Pelosi ("Cecile Richards," n.d.).

Komen Faces Mounting Pro-Life Pressure

Since launching its partnership with Planned Parenthood, Komen had been faced with pressure from pro-life groups to drop funding for the organization because it provided abortion services. In 2011, Komen defended its funding of Planned Parenthood, releasing a statement that said Planned Parenthood is the only option for treatment for many poor, minority, and uninsured women and that Komen would continue funding where this need was present ("Our View," 2012). Statements further assured that "Komen funding is used exclusively to provide breast cancer programs" (Hartmann, 2011, para. 3). But criticism continued. In December 2011, LifeWay Christian Resources said it was pulling "Here's Hope Breast Cancer Bibles" from its shelves after learning $1 of each sale went to Komen ("LifeWay," 2011).

However, soon Komen showed pro-life influence. Quietly, on November 30, 2011, Komen posted a statement to its website saying it would no longer fund embryonic stem cell research centers. Komen had made grants to five such groups in 2010, including Johns Hopkins University School of Medicine and the U.S. National Cancer Institute. Coincidentally, bloggers said that Karen Handel also opposed stem-cell research in her platform while running for Georgia governor, and the new policy was adopted after her hire (Ertelt, 2012).

Within this climate, Komen hired the Ogilvy crisis management public relations team in summer 2011 to help "monitor media, support speaker programs, and provide issues counsel" on an eight-month retainer (Bruell, 2012a, para. 3). However, no one at Komen or Ogilvy indicated that Ogilvy had provided counsel to Komen regarding the Planned Parenthood policy change before the decision was made in October 2011 (Dietrich, 2012).

Research

Komen's Internal Debate to Defund Planned Parenthood

Hearing discontent from pro-life camps, Komen became concerned with losing the support of pro-life organizations and individuals (Belluck, Preston, & Harris, 2012). In addition to placing Komen on boycott lists (Crary, 2012b), "these people who are opposed to Planned Parenthood were threatening to disrupt our races or sponsors to our races," said John Hammarley, a former Komen senior official (Belluck, Preston, & Harris, 2012, para. 11). In early 2011, Hammarley said professional staff leadership within Komen "got together inside the organization to talk about what the options were, what the ramifications of staying the course, or of telling our affiliates they can't fund Planned Parenthood, or something in between" (Goldberg, 2012, para. 6). The officials decided that stopping funding to Planned Parenthood would "be worse from a practical standpoint, from a public-relations standpoint, and from a

Facts About Komen and Planned Parenthood's Relationship

- Komen and Planned Parenthood have been partners for nearly 20 years, with Komen providing about $9 million in funds during that time ("Andrea Mitchell," 2012)
- Komen began giving grants to Planned Parenthood in 2005 for breast cancer screening services support, primarily for low-income and uninsured women (Strauss, Szabo, & Grossman, 2012)
- Grants from Komen to Planned Parenthood benefitted 19 Planned Parenthood affiliates, totaling $700,000 in 2011 alone (Kliff, 2012a)
- Komen funds have allowed Planned Parenthood to provide 170,000 breast exams and 6,400 mammogram referrals ("'Alarmed,'" 2012)
- Komen's grants to Planned Parenthood represent less than 1 percent of $93 million in "community health grants that Komen provides" ("Komen Finds," 2012, para. 13)
- In 2010, cancer screenings made up 15 percent of Planned Parenthood's services (Roser, 2012)

mission standpoint" and advised the board not to cut funding (Goldberg, 2012, para. 6).

With Karen Handel's hiring in April, the issue was pushed again at the forefront of internal discussion (Goldberg, 2012). Komen leadership revisited this issue at its October board meeting (Belluck, Preston, & Harris, 2012) just after Planned Parenthood received an attack by pro-life advocates on another front. On September 15, 2011, Congressman Cliff Stearns (R-Fla.) sent Planned Parenthood a memo saying his subcommittee was investigating how the organization used its federal funding, which his colleagues in Congress charged as "ideologically motivated" because of Stearns' fierce pro-life stance ("Congresswoman McCollum," 2012, para. 3). With Stearns' investigation launched, Komen now had a reason to discontinue its partnership with Planned Parenthood, despite the warning from the professional staff.

Strategy

Komen's strategy was to tread carefully when making its new policy decision—so carefully that Komen announced the change quietly. At its October board meeting, Komen decided to adopt a policy that would exclude any organization under investigation from receiving any of Komen's grant funding (Belluck, Preston, & Harris, 2012). This policy "was specifically adopted with Planned Parenthood in mind," Komen sources said (Hobson, 2012, para. 7). In December 2011, Komen quietly notified Planned Parenthood that the new policy would end funding in 2012 to 17 of 19 Planned Parenthood centers that had previously received Komen grants (Harris & Belluck, 2012). Komen's president, Elizabeth Thompson, made the announcement by calling Cecile Richards by phone. Richards' subsequent letters to Nancy Brinker and the board chairman requested a meeting to talk about the change. The reply from Komen simply defended the change, and no meeting occurred (Crary, 2012a). "We didn't want to tell anyone except Planned Parenthood," Komen board member John D. Raffaelli told *The New York Times.* "The whole approach was to not issue press releases to do anything to hurt Planned Parenthood" (Belluck, Preston, & Harris, 2012, para. 17).

Timeline of Events Leading to Funding Cut

- 1982 - Nancy Brinker creates Susan G. Komen for the Cure.
- 2005 - Komen begins giving grants to Planned Parenthood centers.
- 2006 - Cecile Richards joins Planned Parenthood.
- Early 2011 - Komen professional staff consider the consequences of cutting funding to Planned Parenthood; they decide not to cut funding.
- April 2011 - Karen Handel is hired as senior vice president for public policy at Komen.
- September 15, 2011 - Rep. Cliff Stearns (R-FL) notifies Planned Parenthood that it is under investigation.
- October 2011 - Komen board of directors votes to end funding to any organization under investigation.
- December 2011 - Komen notifies Planned Parenthood that the organization will not be eligible for grants in 2012 according to Komen's new rule.
- January 31, 2012 - Planned Parenthood announces via press release and email blast that Komen is cutting funding to the organization. The Associated Press breaks the story to the public. Komen-Planned Parenthood funding issue is a trending topic on Twitter.

However, this strategy failed when Planned Parenthood decided to go public with the news and rally its constituents against the decision with email and social media blasts. The story became mainstream media when the Associated Press exclusive was released almost simultaneously (Sun & Kliff, 2012). Cecile Richards described in the story how her attempts to talk to Komen and defend Planned Parenthood's eligibility were rebuffed and said Komen "bowed to…bullying" from pro-life activists (Crary, 2012a, para. 10). Komen spokesperson Leslie Aun explained to the Associated Press that newly adopted funding criteria was to blame for the funding cutoff, assuring that the change was not to blame Planned Parenthood for any wrongdoing. If Stearns' investigation concluded by clearing Planned Parenthood of the accusations, the Komen grants would continue. She also denied that any political motives were behind the change. At this time, however, Stearns said he had yet to receive any of the requested paperwork from Planned Parenthood; thus, the investigation hadn't even begun (Crary, 2012a). Komen's timing for the funding cut therefore seemed premature, and the reasons for the cut seemed questionable.

By later that evening, Komen's strategy to keep the funding cut quiet had backfired. Thanks to Planned Parenthood's aggressive approach to spreading the news about the funding cut, the Komen-Planned Parenthood funding issue became one of the most talked-about topics on Twitter (Crary, 2012a).

"Planned Parenthood must've had a crisis plan in place because they organized very quickly. The messages were prepared so they weren't scrambling for who to push out the message, and who to respond," said NM Incite Vice President of Client Development Idil Cakim, an expert on social media strategy and observer of the crisis. "They plugged emotional cords effectively. It goes to show that Planned Parenthood had been communicating with their influencers—and sincerely communicating with them—because they were able to get people to stand up for them" (personal interview, 2012).

Execution

Faced with Planned Parenthood's aggressive crisis management plan, Komen had to abandon its original strategy to keep the policy change as a quiet decision. Instead, Komen had to respond to Planned Parenthood's accusations publicly and launch its own crisis management plan. After Aun spoke to the Associated Press to explain Komen's decision, Komen officials would not make her—or any other spokesperson—available to the press for further comment (Belluck, 2012). Not until the next day did anyone from Komen provide further explanation when Nancy Brinker released a YouTube video defending the organization's decision and denying that it was made for political reasons. "The scurrilous accusations being hurled at this organization are profoundly hurtful," she said (Morgan, 2012, para. 4).

However, Brinker's explanation in the video was slightly different than the one Aun gave to the Associated Press. Brinker said that Komen wanted to move in a different direction because Planned Parenthood doesn't directly provide mammograms and Komen wanted to fund organizations that had a more direct impact (Gee, 2012). Still refusing to speak with the media, Komen released a statement later that day (Flock, 2012a) to reiterate that the change in policy was "widely mischaracterized" and that Komen "implemented more stringent eligibility standards to safeguard donor dollars" as Brinker said in her video ("Statement from Susan G. Komen for

Timeline of Events During Komen's 24 Hours of Silence

January 31, 2012

- Associated Press story announces Komen cut funding to Planned Parenthood. Komen spokesperson Leslie Aun is quoted in the story (Crary, 2012a).
- Planned Parenthood announces cut via email and social media blasts (Sun & Kliff, 2012).
- Funding cut becomes one of most talked-about topics on Twitter (Crary, 2012a).
- First Congressional statements are released criticizing Komen's decision (Murray, 2012).
- Angry posts begin to appear on Komen's Facebook and Twitter pages (Crary, 2012b; McGregor, 2012).
- Bloggers become the first to suggest the funding cut was politically motivated (Marcotte, 2012; Sheppard, 2012).
- California Komen affiliates hold a conference call and decide not to support the decision (Kliff, 2012b).
- Corporate sponsors begin to receive critical comments via social media about their relationships with Komen (Miller, 2012).

February 1, 2012

- Op-eds appear in morning newspapers criticizing Komen's decision (Hirshman, 2012).
- Komen still does not answer media requests by the end of February 1 (Kliff & Sun, 2012).
- Nancy Brinker makes first comments defending Planned Parenthood decision via YouTube video. Komen breaks 24-hour social media silence around 10 p.m.

the Cure," 2012, para. 1, 3). The organization started tweeting again around 10 p.m. by providing links to Brinker's video after more than 24 hours of silence ("Statement from Susan G. Komen for the Cure," 2012).

On February 2, for the first time since the controversy started, Komen officials held a press conference via phone to reiterate messages in the YouTube video (Rovner, 2012). Brinker also made her first television news appearance on MSNBC to defend the decision. During her appearance, she denied the critical backlash visible on social media, claiming the response to Komen's decision had, in fact, been "very, very favorable" ("Andrea Mitchell," 2012, para. 36).

However, Brinker had missed an important opportunity to amend Komen's relationship with Planned Parenthood. Cecile Richards had appeared earlier on the same show and expressed a wish to continue working with Komen. However, no Komen representatives were present to discuss the offer, and Brinker did not directly address it during her segment on the show ("Andrea Mitchell," 2012; Wagner, 2012).

When Komen began to answer questions from the media, the organization faced accusations that it had been trying to silence criticism on its social media platforms. Facebook posters accused Komen of deleting negative comments on that platform and on other message boards, a charge denied by a Komen tweet and through Aun (Flock, 2012b). Commenting on Brinker's YouTube video was initially disabled, and Aun did not know why. She also said that the Komen blog was not working at the time due to "technical reasons" (Flock, 2012b, para. 5). Further public relations blunders befell Komen; Karen Handel's Twitter feed had retweeted an anti-Planned Parenthood sentiment: "Just like a pro-abortion group to turn a cancer orgs decision into a political bomb to throw. Cry me a freaking river" (Flock, 2012b, para. 5). Handel's retweet suggested politics was at the core of the debate, despite Komen's assurances otherwise. The tweet was later deleted from her feed (Flock, 2012b; Gray, 2012a).

"In looking at the chatter, the term 'abortion' was more often referenced along with Komen, while Planned Parenthood was more often associated with 'women's health,'" said Cakim. "Planned Parenthood elevated the discussion to an issue that was an attack on women's health, which applied to a much broader audience than abortion issues. Everyone knows that this is one of those backlash topics, and it was shortsightedness on Komen's part to think pulling their funding wouldn't be an issue" (personal interview, 2012).

Evaluation

The quality of Komen's crisis strategy and execution can be determined simply by looking at the reactions from its various constituents as voiced in social media, news outlets, and public statements. Public conversations and outcry over the funding cuts began to grow rapidly on social media as

Social Media Outcry by the Numbers

Twitter

- Anti-Komen to pro-Komen tweets numbered 80 to 1 (Miller, 2012).
- Twitter mentions focused on Komen at a rate of 2 to 1 (Miller, 2012).
- Komen saw a 32,731% increase in Twitter mentions the week after the story broke, averaging 457,301 per day, up from 1,399 in a typical day (Fleming & O'Connor, 2012).
- Total 1.3 million Twitter posts about Komen and Planned Parenthood over three days (Roser, 2012).

Facebook

- Average 20 negative posts about Komen every minute (Moire, 2012).
- Komen's Facebook page saw a 288 percent increase in negative posts with a 99 percent decrease in "likes" per comment (Fleming & O'Connor, 2012).
- Group called "Defund the Komen Foundation" had 18,645 likes as of February 3 (Bruell, 2012b).
- Popular profile images read, "Tell Komen not to throw PP under the bus," or "I still stand with PP" (Moire, 2012).

Other Platforms

- Online petition of support for Planned Parenthood gained 120,000 signatures ("Komen Finds," 2012).
- "Planned Parenthood Saved Me" Tumblr blog started on February 1 gained about 1,000 followers and 306 posts by February 15 (*Planned Parenthood Saved Me*, n.d.; Rivas, 2012).
- Popular Pinterest board post read, "Komen: Own your politics! Are you anti-choice or not? Be transparent so donors can make their choices" (Judd, 2012).

people questioned Komen's motives. Posters simply were not buying the idea that Komen's decision wasn't political (McGregor, 2012), and many former donors were denying any future support for Komen (Crary, 2012b). They created Facebook groups to protest Komen's decision (Kliff & Sun, 2012), and online petitions from MoveOn, Credo.org, and SignOn.org were widely circulated (Velez, 2012).

Public frustration appeared online in other ways. The nonprofit rating site, GuideStar, also saw an influx of 170 people who joined after the decision was made to give Komen a bad organizational review. They plunged Komen's rating to 1 star, the lowest possible, from 5. "I am so ashamed of what [Komen] has done," wrote one reviewer on GuideStar. "I had no idea that they were political....I am done. I will direct those $ to Planned Parenthood, an organization that I KNOW cares about women" (Morran, 2012, para. 6).

Not all of the chatter was negative. Family Research Council said that 15,000 emails from anti-abortion groups were sent to Komen in support (Rojas-Burke, 2012). Once Komen did join the social media conversation, it did not respond to posters on Facebook or Twitter ("Susan G. Komen," n.d.). Komen simply made statements to clarify its position on defunding Planned Parenthood.

Responses from Donors

On February 2, Brinker said donations to Komen had risen 100 percent since January 31 (Sun, Kliff, & Aizenman, 2012). Despite Brinker's positive announcement, most news reports described donors withdrawing their support from Komen. A Cleveland councilman said he would vote not to give a permit to Komen to hold a Race for the Cure in his city (Steer, 2012). The American Association of University Women canceled its annual participation in a Komen race (Sun, Kliff, & Aizenman, 2012), and the Legislative Women's Caucus said it would not hold its annual Komen-benefitting bake sale (Ryan, 2012b). One letter to the editor in a local newspaper best captured a majority of donor sentiment: "Shame on Komen Foundation. I for one have lost all my respect for them. I support Planned Parenthood" (Burnett, 2012, para. 7-8).

Meanwhile, other breast cancer organizations also reported increases in donations as people looked to direct support away from Komen (Leuty, 2012). These organizations included Planned Parenthood, who reported receiving $3 million (Weiderman, 2012) from 10,000 donors within 72 hours after Komen's decision to withdraw funding was announced (McCarthy, 2012).

Responses from Affiliates and Employees

The backlash felt by the local Komen organizations was strong. The Virginia affiliate said donors were pulling funds from the local organization, even though the affiliate didn't have any direct relationship with Planned Parenthood in the area (Simpson, 2012). The San Diego affiliate boosted security at its offices after getting threatening emails. Its executive director said that of the 400 emails it saw since January 31, only 2 were supportive. The affiliate's executive director also felt part of the mayhem was due to the fact that Komen's national office didn't have any kind of crisis communications policy in place because it was comprised of public health workers who didn't have experience in public relations (Kliff, 2012b).

Responses from Komen affiliates made it clear they had not bought into the decision, which had been made at the national level without consulting affiliates (Crary, 2012b). Almost immediately, Komen affiliates expressed dismay through statements on their Facebook profiles (Harris & Belluck, 2012). The next day, the Oregon affiliate, whose local Planned Parenthoods had not received any funding in the past, officially rejected the decision by sending a letter to Komen headquarters (Terry, 2012). By February 3, affiliates in Aspen, Colorado, and Connecticut said they would continue to fund their Planned Parenthood partners despite the national ruling ("Komen's Bad Call," 2012). "The community is speaking loud and clear about what needs to go on here," said a Wisconsin affiliate official, urging Komen to overturn the decision (Wahlberg, 2012, para. 10).

Resignations of officials also showed division in the Komen ranks. On February 2, reports surfaced that Mollie Williams, managing director of community health programs, had resigned immediately in protest of the board's decision to cut funding (Hobson, 2012). At Komen since 2006, she had overseen 2,000 community health organizations and $93 million in grant money (Belluck, Preston, & Harris, 2012). Other officials at affiliates resigned in protest ("Komen's Bad Call," 2012), while radiologist Kathy Plesser, a member of the Komen medical advisory board, also threatened to quit if the decision was not reversed (Bassett & Belkin, 2012). Komen did not directly address any of the complaints or resignations.

Responses from Politicians

Almost immediately after the Associated Press story was released, the first congressional statement appeared disapproving of the decision (Murray, 2012), and Rep. Mike Honda (D-Calif.) even personally called Brinker to say he was disappointed (Speier, 2012). Nearly 20 Congressmen released statements about the decision, dividing opinion along party lines with Democrats against the change, and Republicans for it. On February 1, Rep. Jackie Speier (D-Calif.) took the House floor to denounce Komen, promising that she would no longer be affiliated and urged everyone to call Komen and tell them "to stick to what they know" (Speier, 2012, para. 8).

Politicians even organized to ask Komen to reconsider. On February 2, 26 Democratic Senators signed a letter to Brinker asking Komen to reverse its decision (Roan, 2012). Twenty-two House members signed a letter also asking for a reversal (Bassett & Belkin, 2012). Taking his support even further, New York Mayor Michael Bloomberg pledged to match donor funds 1 to 1 up to $250,000 to benefit Planned Parenthood specifically to offset the loss of funding from Komen (CNN Wire Staff, 2012). Suddenly, Komen's non-political decision had been thrown fully into the political arena.

Responses from Sponsors

While Komen imparted its 24 hours of social media silence, the most recent post on its Facebook page took the brunt of anti-Komen sentiment (Miller, 2012). That post happened to be a statement welcoming Energizer as the newest $1 million sponsor, and the public was now promising to boycott Energizer because of its affiliation with Komen (McCullough, 2012). On its own Facebook page, Energizer posted a note with a statement that promised Energizer officials "are constantly evaluating the charitable organizations with whom we partner," while comments urged them to remove their company's partnership with Komen ("Energizer," n.d., para. 2). Two days later, Energizer announced it was making a donation to a cancer center in the company's hometown "to show you our appreciation for your passion and to further our commitment to this cause" ("Energizer," n.d., para. 1). The company did not, however, revisit the Komen partnership issue directly in its social media or communications.

Other Komen corporate sponsors also tried to distance themselves from the backlash. Many didn't return journalists' calls for comment on the situation (Mathews, Radnofsky, & West, 2012). By February 3, American Airlines, Ford Motors, and Yoplait had all confirmed to the media that they were committed to their relationship with Komen (Nichols, 2012). Many reports indicated Komen faced no pressure from its sponsors to reconsider the decision (Crary, 2012b).

In looking at the websites and Facebook profiles of Komen's Race for the Cure national sponsors, the researcher found that no sponsors posted comments about their relationships with Komen in either location. Some, like Yoplait, provided a way for consumers simply to voice their frustrations by setting up a special page called "Your Thoughts…" and directing consumers to post their comments about Komen there. "We're continuing to listen to your comments, and are taking them into account as we discuss the best way for Yoplait to champion women's lives. Because this situation was a surprise to us as much as it was to you, we thank you for being patient," the page said ("Yoplait," n.d., para. 1). Others like Honest Tea did not even address the Komen-related comments posted to its wall ("Honest Tea," n.d.).

Responses from the Media

Bloggers were the first to question Komen's assertion that the decision was not political. Slate was the first to blame pro-life pressure for causing Komen to change course (Marcotte, 2012) while Mother Jones was the first to connect pro-life Karen Handel's arrival at Komen to the sudden change in policy (Sheppard, 2012). Other blogs showed support for Komen. One urged people to email Komen to thank it for pulling its funding from Planned Parenthood and provided a link to make a donation to Komen as a show of gratitude (Erickson, 2012).

At this time, news editorials also appeared questioning Komen leadership's political ties, especially those of Handel (Harris & Belluck, 2012). By February 2, "three sources with direct knowledge of the Komen decision" told *The Atlantic* that the criteria were adopted specifically with Planned Parenthood in mind (Hobson, 2012, para. 7). One day later, news reports would cite anonymous sources claiming that Handel was indeed behind the change in policy (Crary, 2012b), and blogs began calling for her to resign (Blue Texan, 2012). Soon Mother Jones brought to light another inconsistency in Komen's policy: Penn State University had been under investigation since November 2011 for accusations of covering up child sexual abuse, but Komen had not withdrawn its funding from the university (Serwer & Sheppard, 2012). With this report, Komen's credibility took another blow.

By their February 3 morning editions, many major U.S. newspapers had published op-eds about the situation. Of 15 op-eds found in newspapers from February 2 to 3, 14 were negative toward Komen's decision. *The Boston Globe* went so far so as to question the truthfulness of Komen's statements and called for a full explanation ("In Rejecting," 2012). Only one piece, written by *Wall Street Journal Online*, gave Komen support for changing its policies. Komen will "show itself to be rather brave if it does not back down amid the abuse it is now taking," it said (Taranto, 2012, para. 8).

Outcomes: Komen Reverses Course

By February 3, Komen's decision to remove funding from Planned Parenthood and the aftermath of public outcry began to be painted as "a public relations debacle," wrote *The Philadelphia Inquirer* (McCullough, 2012, para. 1). Others observed that "Brinker struggled to contain the damage" to Komen's brand brought on by the overwhelming and passionate opinion against the organization's decision (Williams & Myers, 2012, para. 8). As *The New York Times* wrote, Komen's reputation "suffered a grievous, perhaps mortal, wound this week" ("A Painful Betrayal," 2012, para. 1).

In this climate, Komen decided to reverse course once again. By midday, Komen released a new statement apologizing for "recent decisions that cast doubt upon our commitment to our mission" ("Statement from Susan G. Komen Board," 2012, para. 1). It said that Komen had refined its grant-making criteria to prevent funding to an organization under investigation that "must be criminal and conclusive in nature" and said that it would continue funding Planned Parenthood's existing grants and "preserve their eligibility to apply for future grants" ("Statement from Susan G. Komen Board," 2012, para. 2-3). "It is time for everyone involved to pause, slow down, and reflect on how grants can most effectively and directly be administered" ("Statement from Susan G. Komen Board," 2012, para. 4).

The statement said Komen intended to reach out to affiliates and supporters to begin moving forward and allow them to retain the right to make their own funding decisions ("Statement from Susan G. Komen Board," 2012). However, Komen officials were "unavailable for comment on how they came to change their plans" beyond the released statement (Crary, 2012c, para. 7).

Karen Handel's Resignation

On February 7 at about 10:30 a.m. Eastern Time, the *Atlanta Journal Constitution* broke the story that Karen Handel has resigned as vice president for public policy after less than one year on the job (Sebastian, 2012). In a statement on the Komen website, the organization said it "made mistakes in how we have handled the recent decisions and take full accountability" before saying Brinker had accepted Handel's resignation ("Statement from Susan G. Komen Founder," 2012, para. 2). Handel's letter stood firm on Komen's point that the decision to end funding to Planned Parenthood was not based on "political ideology," yet "the controversy related to Planned Parenthood has long been a concern to our organization" (Bookman, 2012, para. 5). She also "openly admitted her role in the matter" but assured that the decision to end Planned Parenthood grants "was fully vetted by every appropriate level within the organization" (Bookman, 2012, para. 4-5). These statements were in conflict with earlier statements from Brinker, who denied Handel was behind the funding cut (Henry, 2012).

Responses from Constituents

The public's reactions to the decision reversal indicated Komen still had a long way to go to contain the public outburst. Those who were happy with initial decision, particularly pro-life groups, were now upset (Holt & Myers, 2012). The Catholic Family and Human Rights Institute (C-FAM) released statement saying pro-lifers should not support Komen and that it didn't believe the new statement is actually a reversal (Ruse, 2012). Even board member John Raffaelli said to *The Washington Post* that the statement was not necessarily a reversal in policy unless Planned Parenthood received additional funding in the future (Blue Texan, 2012). Because there were no guarantees for future funding, Komen's apology seemed hollow and disingenuous to some (Gray, 2012b).

Even with the announcement, Komen donors had the strongest lingering emotions. Komen supporters felt "sense of betrayal," wrote the *Tampa Tribune* (Shedden, 2012, para. 4). Donors felt they could no longer support Komen because of what seemed like political motives (Roser, 2012). For others, Komen's reputation took a hit. "It just feels like it's all tarnished now. Honestly, I'm not sure what they can do to change that," said a Komen donor to the Associated Press (Noveck, 2012, para. 3). Citing a lack of trust in Komen, some donors said the original funding reversal "raised red flags" about the organization (Vargas, 2012, par. 13) and that they would instead give money to other organizations that support breast cancer research and treatment (Szabo & Strauss, 2012).

The outcomes of Komen's decision and strategy may be best described by the Komen affiliates who experienced it. The West Virginia affiliate said it feared the repercussions from the controversy, particularly the loss of funds from donors who would go elsewhere, ultimately hurting what it could do in the community (Nyden, 2012). Perhaps the director of the San Diego affiliate said it best to *The Washington Post*: "We don't know if the money will come back. It's going to be a hard sell because it's a trust issue. There are some relationships that are, perhaps, irrevocably damaged" (Kliff, 2012b, para. 14-15).

Analysis & Discussion

The communications crisis that followed Komen's funding decision demonstrates what happens when an organization is not prepared to handle a politically charged decision. Even if Komen was not politically motivated to change its funding criteria, it should have been prepared to dissuade the public from drawing this conclusion—and it should have better anticipated the counter-strategy of a politically affiliated partner like Planned Parenthood. Komen's actions and strategies can be examined to determine where it failed to prepare for this political debate. This discussion will focus on a few key areas where the organization strayed from acting according to public relations standards that may have helped them better navigate this crisis.

Getting the Story Straight

Komen and its officials should have come out with the full and honest story from the start. Komen's strategy to keep the decision quiet appeared untrustworthy in the eyes of the public once Planned Parenthood brought it to light. By not notifying the public, Komen looked like it was hiding its decision and appeared to be deceiving its donors and constituents. The public now doubts Komen's honesty in matters beyond this controversy. Telling the truth is so important to public relations that it is one of the Page Principles, ethical standards developed by public relations pioneer Arthur W. Page and used to guide the practice today ("The Page Principles," n.d.).

One of Komen's most apparent miscues was the numerous and sometimes contradictory reasons it gave for changing its funding policy. At first, spokeswoman Leslie Aun and CEO Nancy Brinker gave two different reasons for the decision to cut funding to Planned Parenthood. The inconsistency did not give the public an accurate picture of the reason for cutting funding to Planned Parenthood and made them skeptical of the true motivations. Once the funding cut was reversed, many bloggers and media outlets wondered what the wording "criminal and conclusive in nature" really meant for Planned Parenthood because Komen did not make any guarantees to fund the organization. Because it seemed like Komen was still hiding the full story, it questioned the sincerity of Komen's statement of reversal. Lastly, although Brinker first said Handel had nothing to do with the reversal, Handel admitted she was behind the change when she resigned.

One way Komen can restore trust is to show its constituents with action that it wants to restore the relationship with Planned Parenthood, another Page Principle ("The Page Principles," n.d.). While many affiliates said they will fund Planned Parenthood anyway, the Komen leadership will only convince the public that it really has reversed course if it reaches out to Planned Parenthood leadership and shows support in other visible ways like grant-making or joint fundraising. Otherwise, the reversal statement will seem hollow.

Listening to Constituents

Komen missed many opportunities to engage its constituents even before the controversy erupted. Professional staff determined that defunding Planned Parenthood was not practical, unwise from a brand management standpoint, and untrue to Komen's mission. If Komen's board of directors questioned this advice, they could have looked further into the matter by arranging focus groups of donors or volunteers to gauge public opinion on this decision. Instead, the board went ahead and changed the policy without consulting its constituents, who felt betrayed.

As the social media conversation was heating up, Komen responded with silence. Rather than engaging the public in conversation, Komen did not show the public it was listening to its concerns and anger over the decision, another important Page Principle ("The Page Principles," n.d.). Instead, it pushed its own message out via YouTube and media appearances in a one-way conversation model. Komen's deleting Facebook posts from angry constituents further created this one-way conversation and perception that Komen were trying to control the message. Komen could have acted like Planned Parenthood, which urged constituents to donate to make up for the lost funds, created social media buttons, and generated conversation with its constituents (Sun & Kliff, 2012).

Komen could benefit from asking its donors what they think of the Komen brand going forward and what the donors need and want to see from Komen before they are willing to support the organization again. Opening the lines of two-way communication with the public will help restore relationships that were lost during the crisis, particularly by using social media to engage these members of the public and respond to their criticisms. This way, Komen will earn respect and even loyalty to those social media users who are active and involved in the conversation. Komen may also have a better feel for public opinion and thus be able to more quickly and efficiently react to controversies with this knowledge.

Employees as Spokespeople

Komen was met with criticism from its own affiliates after announcing Planned Parenthood was no longer eligible for grants. Komen should have engaged these constituents in the decision-making process from the start, which may have helped the affiliates to understand the rationale for the change and may have been more supportive, thus influencing the public positively. Instead, the affiliates were critical of the decision rather than being ambassadors for the Komen brand during the crisis.

After a number of affiliates expressed concern over the policy change and some outright refused to follow the new rules, Komen will need to restore the trust of its own employees and volunteers. The Page Principles remind public relations officials that "a company's true character is expressed by its people" ("The Page Principles," n.d., para. 7). Disgruntled and insubordinate employees reveal a poor organizational character.

Managing for the Future

Komen's decision-making during the crisis revealed a lack of concern for long-term health of the organization. One Page Principle urges organizations to "eliminate practices that create difficulties" and to "generate goodwill" ("The Page Principles," n.d., para. 5). However, Komen decided to institute a practice (defunding Planned Parenthood) that actually created difficulties and bred ill will between the organizations.

When changing a policy that affects a major partner like Planned Parenthood, Komen should have attempted to gauge donor feelings about the policy change before implementing it to ensure all potential difficulties were anticipated. Komen neither arranged focus groups nor asked its Ogilvy PR team to research the matter. Perhaps this research would have advised it not to implement the criteria change or helped Komen anticipate the public outcry to follow. Second, Komen did not try to work with Planned Parenthood to explain the change and instead refused Planned Parenthood's requests to meet about the decision. These actions instead increased tensions between the organizations.

By learning from the mistakes made and finding out what it will take to win back support, Komen could inform leadership of changes and new practices that would bring back donors and public trust and ensure that another crisis like this does not happen again.

Discussion Questions

1. What should an organization strive to do in a situation of conflict between stakeholders, like the one Komen faced between Planned Parenthood and pro-life activist groups?

2. Was Komen wise to make the criteria change in private? What could it have done differently?

3. How could Komen have involved its stakeholders (donors, grant recipients, affiliates, the general public, corporate sponsors) in the discussion about the criteria change?

4. What strategies could Komen have used to communicate with its stakeholders to prevent or lessen the backlash it received over its decision?

5. How could Komen have better engaged its stakeholders through social media?

6. What should Komen do moving forward to restore a positive image to its brand?

7. How can Komen rebuild relationships that have been damaged?

8. How can Komen restore trust among its stakeholders?

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Ethics and Nonprofits

By Deborah L. Rhode & Amanda K. Packel | Illustration by Richard Mia

Unethical behavior remains a persistent problem in nonprofits and for-profits alike. To help organizations solve that problem, the authors examine the factors that influence moral conduct, the ethical issues that arise specifically in charitable organizations, and the best ways to promote ethical behavior within organizations.

THOSE WHO WORK ON ISSUES OF ethics are among the few professionals not suffering from the current economic downturn. The last decade has brought an escalating supply of moral meltdowns in both the for-profit and the nonprofit sectors. Corporate misconduct has received the greatest attention, in part because the abuses are so egregious and the costs so enormous. Chief contenders for most ethically challenged include former Merrill Lynch & Co. CEO John Thain, who spent $1.22 million in 2008 to redecorate his office, including the purchase of a $1,400 trash can and a $35,000 antique commode, while the company was hemorrhaging losses of some $27 billion.[1]

Still, the corporate sector has no monopoly on greed. Consider EduCap Inc., a multibillion-dollar student loan charity. According to Internal Revenue Service records, the organization abused its tax-exempt status by charging excessive interest on loans and by providing millions in compensation and lavish perks to its CEO and her husband, including use of the organization's $31 million private jet for family and friends.[2]

Unsurprisingly, these and a host of other scandals have eroded public confidence in our nation's leadership. According to a *CBS News* poll, only a quarter of Americans think that top executives are honest. Even executives themselves acknowledge cause for concern. The American Management Association Corporate Values Survey found that about one third of executives believed that their company's public statements on ethics sometimes conflicted with internal messages and realities. And more than one third of the executives reported that although their company would follow the law, it would not always do what would be perceived as ethical.

Employee surveys similarly suggest that many American workplaces fail to foster a culture of integrity. Results vary but generally indicate that between about one-quarter and three-quarters of employees observe misconduct, only about half of which is reported.[3] In the 2007 National Nonprofit Ethics Survey, slightly more than half of employees had observed at least one act of misconduct in the previous year, roughly the same percentages as in the for-profit and government sectors. Nearly 40 percent of nonprofit employees who observed misconduct failed to report it, largely because they believed that reporting would not lead to corrective action or they feared retaliation from management or peers.[4]

Public confidence in nonprofit performance is similarly at risk. A 2008 Brookings Institution survey found that about one third of Americans reported having "not too much" or no confidence in charitable organizations, and 70 percent felt that charitable organizations waste "a great deal" or a "fair amount" of money. Only 10 percent thought charitable organizations did a "very good job" spending money wisely; only 17 percent thought that charities did a "very good job" of being fair in decisions; and only one quarter thought charities did a "very good job" of helping people.[5] Similarly, a 2006 Harris Poll found that only one in 10 Americans strongly believed that charities are honest and ethical in their use of donated funds. Nearly one in three believed that nonprofits have "pretty seriously gotten off in the wrong direction." These public perceptions are particularly troubling for nonprofit organizations that depend on continuing financial contributions.

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Addressing these ethical concerns requires a deeper understanding of the forces that compromise ethical judgment and the most effective institutional responses. To that end, this article draws on the growing body of research on organizational culture in general, and in nonprofit institutions in particular. We begin by reviewing the principal forces that distort judgment in all types of organizations. Next, we analyze the ethical issues that arise specifically in the nonprofit sector. We conclude by suggesting ways that nonprofits can prevent and correct misconduct and can institutionalize ethical values in all aspects of the organization's culture.

Causes of Misconduct

Ethical challenges arise at all levels in all types of organizations—for-profit, nonprofit, and government—and involve a complex relationship between individual character and cultural influences. Some of these challenges can result in criminal violations or civil liability: fraud, misrepresentation, and misappropriation of assets fall into this category. More common ethical problems involve gray areas—activities that are on the fringes of fraud, or that involve conflicts of interest, misallocation of resources, or inadequate accountability and transparency.

Research identifies four crucial factors that influence ethical conduct:

- Moral awareness: recognition that a situation raises ethical issues
- Moral decision making: determining what course of action is ethically sound
- Moral intent: identifying which values should take priority in the decision
- Moral action: following through on ethical decisions. [6]

People vary in their capacity for moral judgment—in their ability to recognize and analyze moral issues, and in the priority that they place on moral values. They also differ in their capacity for moral behavior—in their ability to cope with frustration and make good on their commitments.

Cognitive biases can compromise these ethical capacities. Those in leadership positions often have a high degree of confidence in their own judgment. That can readily lead to arrogance, overoptimism, and an escalation of commitment to choices that turn out to be wrong either factually or morally.[7] As a result, people may ignore or suppress dissent, overestimate their ability to rectify adverse consequences, and cover up mistakes by denying, withholding, or even destroying information.[8]

A related bias involves cognitive dissonance: People tend to suppress or reconstrue information that casts doubt on a prior belief or action.[9] Such dynamics may lead people to discount or devalue evidence of the harms of their conduct or the extent of their own responsibility. In-group biases can also result in unconscious discrimination that leads to ostracism of unwelcome or inconvenient views. That, in turn, can generate perceptions of unfairness and encourage team loyalty at the expense of candid and socially responsible decision making.[10]

A person's ethical reasoning and conduct is also affected by organizational structures and norms. Skewed reward systems can lead to a preoccupation with short-term profits, growth, or donations at the expense of long-term values. Mismanaged bonus systems and compensation structures are part of the explanation for the morally irresponsible behavior reflected in Enron Corp. and in the recent financial crisis.[11] In charitable organizations, employees who feel excessive pressure to generate revenue or minimize administrative expenses may engage in misleading conduct.[12] Employees' perceptions of unfairness in reward systems, as well as leaders' apparent lack of commitment to ethical standards, increase the likelihood of unethical behavior.[13]

A variety of situational pressures can also undermine moral conduct. Psychologist Stanley Milgram's classic obedience to authority experiment at Yale University offers a chilling example of how readily the good go bad under situational pressures. When asked to administer electric shocks to another participant in the experiment, about two-thirds of subjects fully complied, up to levels marked "dangerous," despite the victim's screams of pain. Yet when the experiment was described to subjects, none believed that they would comply, and the estimate of how many others would do so was no more than one in 100. In real-world settings, when instructions come from supervisors and jobs are on the line, many moral compasses go missing.

Variations of Milgram's study also documented the influence of peers on individual decision making. Ninety percent of subjects paired with someone who refused to comply also refused to administer the shocks. By the same token, 90 percent of subjects paired with an uncomplaining and obedient subject were equally obedient. Research on organizational behavior similarly finds that people are more likely to engage in unethical conduct when acting with others. Under circumstances where bending the rules provides payoffs for the group, members may feel substantial pressure to put their moral convictions on hold. That is especially likely when organizations place heavy emphasis on loyalty and offer significant rewards to team players. For example, if it is common practice for charity employees to inflate expense reports or occasionally liberate office supplies and in-kind charitable donations, other employees may suspend judgment or follow suit. Once people yield to situational pressures when the moral cost seems small, they can gradually slide into more serious misconduct. Psychologists label this "the boiled frog" phenomenon. A frog thrown into boiling water will jump out of the pot. A frog placed in tepid water that gradually becomes hotter will calmly boil to death.

Moral blinders are especially likely in contexts where people lack accountability for collective decision making. That is often true of boards of directors—members' individual reputations rarely suffer, and insurance typically insulates them from personal liability. A well-known study by Scott Armstrong, a professor at the Wharton School of the University of Pennsylvania, illustrates the pathologies that too often play out in real life. The experiment asked 57 groups of executives and business students to assume the role of an imaginary pharmaceutical company's board of directors. Each group received a fact pattern indicating that one of their company's most profitable drugs was causing an estimated 14 to 22 "unnecessary" deaths a year. The drug would likely be banned by regulators because a competitor offered a safe medication with the same benefits at the same price. More than four-fifths of the boards decided to continue marketing the product and to take legal and political actions to prevent a ban. By contrast, when a different group of people with similar business backgrounds were asked for their personal views on the same hypothetical, 97 percent believed that continuing to market the drug was socially irresponsible.[14]

These dynamics are readily apparent in real-world settings. Enron's board twice suspended conflict of interest rules to allow CFO Andrew Fastow to line his pockets at the corporation's expense.[15] Some members of the United Way of the National Capital Area's board were aware of suspicious withdrawals by CEO Oral Suer over the course of 15 years, but failed to alert the full board or take corrective action.[16] Experts view the large size of some governing bodies, such as the formerly 50-member board of the American Red Cross, as a contributing factor in nonprofit scandals.[17]

> PUBLIC CONFIDENCE IN NONPROFIT PERFORMANCE IS AT RISK. ONLY ONE IN 10 STRONGLY BELIEVED THAT CHARITIES ARE HONEST AND ETHICAL IN THEIR USE OF DONATED FUNDS.

Other characteristics of organizations can also contribute to unethical conduct. Large organizations facing complex issues may undermine ethical judgments by fragmenting information across multiple departments and people. In many scandals, a large number of professionals—lawyers, accountants, financial analysts, board members, and even officers—lacked important facts raising moral as well as legal concerns. Work may be allocated in ways that prevent decision makers from seeing the full picture, and channels for expressing concerns may be inadequate.

Another important influence is ethical climate—the moral meanings that employees give to workplace policies and practices. Organizations signal their priorities in multiple ways, including the content and enforcement of ethical standards; the criteria for hiring, promotion, and compensation; and the fairness and respect with which they treat their employees. People care deeply about "organizational justice" and perform better when they believe that their workplace is treating them with dignity and is rewarding ethical conduct. Workers also respond to moral cues from peers and leaders. Virtue begets virtue, and observing integrity in others promotes similar behavior.

Ethical Issues in the Nonprofit Sector

These organizational dynamics play out in distinctive ways in the nonprofit sector. There are six areas in particular where ethical issues arise in the nonprofit sector: compensation; conflicts of interest;

publications and solicitation; financial integrity; investment policies; and accountability and strategic management.

Compensation. Salaries that are modest by business standards can cause outrage in the nonprofit sector, particularly when the organization is struggling to address unmet societal needs. In a March 23, 2009, *Nation* column, Katha Pollitt announced that she "stopped donating to the New York Public Library when it gave its president and CEO Paul LeClerc a several hundred thousand-dollar raise so his salary would be $800,000 a year." That, she pointed out, was "twenty times the median household income." Asking him to give back half a million "would buy an awful lot of books—or help pay for raises for the severely underpaid librarians who actually keep the system going." If any readers thought LeClerc was an isolated case, she suggested checking Charity Navigator for comparable examples.

The problem is not just salaries. It is also the perks that officers and unpaid board members may feel entitled to take because their services would be worth so much more in the private sector. A widely publicized example involves William Aramony, the former CEO of United Way of America, who served six years in prison after an investigation uncovered misuse of the charity's funds to finance a lavish lifestyle, including luxury condominiums, personal trips, and payments to his mistress.[18] Examples like Aramony ultimately prompted the IRS to demand greater transparency concerning nonprofit CEO compensation packages exceeding certain thresholds.[19]

Nonprofits also face issues concerning benefits for staff and volunteers. How should an organization handle low-income volunteers who select a few items for themselves while sorting through noncash contributions? Should employees ever accept gifts or meals from beneficiaries or clients? Even trivial expenditures can pose significant issues of principle or public perception.

Travel expenses also raise questions. Can employees keep frequent flyer miles from business travel? How does it look for cash-strapped federal courts to hold a judicial conference at a Ritz-Carlton hotel, even though the hotel offered a significantly discounted rate? The Panel on the Nonprofit Sector recommends in its *Principles for Good Governance and Ethical Practice* that organizations establish clear written policies about what can be reimbursed and require that travel expenses be cost-effective. But what counts as reasonable or cost-effective can be open to dispute, particularly if the nonprofit has wealthy board members or executives accustomed to creature comforts.

Conflicts of Interest. Conflicts of interest arise frequently in the nonprofit sector. The Nature Conservancy encountered one such problem in a "buyer conservation deal." The organization bought land for $2.1 million and added restrictions that prohibited development such as mining, drilling, or dams, but authorized construction of a single-family house of unrestricted size, including a pool, a tennis court, and a writer's cabin. Seven weeks later, the Nature Conservancy sold the land for $500,000 to the former chairman of its regional chapter and his wife, a Nature Conservancy trustee. The buyers then donated $1.6 million to the Nature Conservancy and took a federal tax write-off for the "charitable contribution." [20]

Related conflicts of interest arise when an organization offers preferential treatment to board members or their affiliated companies. In another Nature Conservancy transaction, the organization received $100,000 from SC Johnson Wax to allow the company to use the Conservancy's logo in national promotion of products, including toilet cleaner. The company's chairman sat on the charity's board, although he reportedly recused himself from participating in or voting on the transaction.[21]

These examples raise a number of ethical questions. Should board members obtain contracts or donations for their own organizations? Is the board member's disclosure and abstention from a vote enough? Should a major donor receive special privileges, such as a job or college admission for a child? In a recent survey, a fifth of nonprofits (and two-fifths of those with more than $10 million in annual expenses) reported buying or renting goods, services, or property from a board member or an affiliated company within the prior two years. In three-quarters of nonprofits that did not report

> ONE OF THE MOST CRITICAL STEPS NONPROFITS CAN TAKE TO PROMOTE ETHICAL CONDUCT IS TO ENSURE THAT THEY HAVE ADEQUATE ETHICAL CODES AND EFFECTIVE COMPLIANCE PROGRAMS.

any such transactions, board members were not required to disclose financial interests in entities doing business with the organization, so its leaders may not have been aware of such conflicts.[22]

Despite the ethical minefield that these transactions create, many nonprofits oppose restrictions because they rely on insiders to provide donations or goods and services at below-market rates. Yet such quid pro quo relationships can jeopardize an organization's reputation for fairness and integrity in its financial dealings. To maintain public trust and fiduciary obligations, nonprofits need detailed, unambiguous conflict of interest policies, including requirements that employees and board members disclose all financial interest in companies that may engage in transactions with the organization. At a minimum, these policies should also demand total transparency about the existence of potential conflicts and the process by which they are dealt with.

Publications and Solicitation. Similar concerns about public trust entail total candor and accuracy in nonprofit reports. The Red Cross learned that lesson the hard way after disclosures of how it used the record donations that came in the wake of the 9/11 terrorist attacks. Donors believed that their contributions would go to help victims and their families. The Red Cross, however, set aside more than half of the $564 million in funds raised for 9/11 for other operations and future reserves. Although this was a long-standing organizational practice, it was not well known. Donor outrage forced a public apology and redirection of funds, and the charity's image was tarnished.[23]

As the Red Cross example demonstrates, nonprofits need to pay particular attention to transparency. They should disclose in a clear and non-misleading way the percentage of funds spent on administrative costs—information that affects many watchdog rankings of nonprofit organizations. Transparency is also necessary in solicitation materials, grant proposals, and donor agreements. Organizations cannot afford to raise funds on the basis of misguided assumptions, or to violate public expectations in the use of resources.

Financial Integrity. Nonprofit organizations also face ethical dilemmas in deciding whether to accept donations that have any unpalatable associations or conditions. The Stanford Institute for Research on Women and Gender, for example, declined to consider a potential gift from the Playboy Foundation. By contrast, the ACLU's Women's Rights Project, in its early phase, accepted a Playboy Foundation gift, and for a brief period sent out project mailings with a Playboy bunny logo.[24] When Stanford University launched an ethics center, the president quipped about what level of contribution would be necessary to name the center and whether the amount should depend on the donor's reputation. If "the price was right," would the university want a Ken Lay or a Leona Helmsley center on ethics?

Recently, many corporations have been attempting to "green" their image through affiliations with environmental organizations, and some of these groups have been entrepreneurial in capitalizing on such interests. The Nature Conservancy offered corporations such as the Pacific Gas and Electric Co. and the Dow Chemical Co. seats on its International Leadership Council for $25,000 and up. Members of the council had opportunities to "meet individually with Nature Conservancy staff to discuss environmental issues of specific importance to the member company."[25]

There are no easy resolutions of these issues, but there are better and worse ways of addressing them. Appearances matter, and it sometimes makes sense to avoid affiliations where a donor is seeking to advance or pedigree ethically problematic conduct, or to impose excessive restrictions on the use of funds.

Investment Policies. Advocates of socially responsible investing argue that nonprofit organizations should ensure that their financial portfolio is consistent with their values. In its strongest form, this strategy calls for investing in ventures that further an organization's mission. In its weaker form, the strategy entails divestment from companies whose activities undermine that mission. The issue gained widespread attention after a Jan. 7, 2007, *Los Angeles Times* article criticized the Bill & Melinda Gates Foundation for investing in companies that contributed to the environmental and health problems that the foundation is attempting to reduce.

Many nonprofit leaders have resisted pressure to adopt socially responsible investing principles on the grounds that maximizing the financial return on investment is the best way to further their organization's mission, and that individual divestment decisions are unlikely to affect corporate policies. Our view, however, is that symbols matter, and that similar divestment decisions by large institutional investors can sometimes influence corporate conduct. Hypocrisy, as French writer François de La Rochefoucauld put it, may be the "homage vice pays to virtue," but it is not a sound managerial strategy. To have one set of principles for financial management and another for programmatic objectives sends a mixed moral message. Jeff Skoll acknowledged as much following his foundation's support of *Fast Food Nation*, a dramatic film highlighting the adverse social impacts of the fast-food industry. "How do I reconcile owning shares in [Coca-Cola and Burger King] with making the movie?" he asked.[26] As a growing number of foundations recognize, to compartmentalize ethics inevitably marginalizes their significance. About a fifth of institutional investing is now in socially screened funds, and it is by no means clear that these investors have suffered financial losses as a consequence.[27]

Accountability and Strategic Management. By definition, nonprofit organizations are not subject to the checks of market forces or majoritarian control. This independence has come under increasing scrutiny in the wake of institutional growth. In 2006, after a $30 billion gift from Warren Buffet, the Gates Foundation endowment doubled, making it larger than the gross domestic product of more than 100 countries. In societies where nonprofits serve crucial public functions and enjoy substantial public subsidies (in the form of tax deductions and exemptions), this public role also entails significant public responsibilities. In effect, those responsibilities include fiduciary obligations to stakeholders—those who fund nonprofits and those who receive their services—to use resources in a principled way. As a growing body of work on philanthropy suggests, such accountability requires a well-informed plan for furthering organizational objectives and specific measures of progress. A surprising number of nonprofits lack such strategic focus. Many operate with a "spray and pray" approach, which spreads assistance across multiple programs in the hope that something good will come of it. Something usually does, but it is not necessarily the cost-effective use of resources that public accountability demands.

Money held in public trust should be well spent, not just well-intentioned. But in practice, ethical obligations bump up against significant obstacles. The most obvious involves evaluation. Many nonprofit initiatives have mixed or nonquantifiable outcomes. How do we price due process, wilderness preservation, or gay marriage?

Although in many contexts objective measures of progress are hard to come by, it is generally possible to identify some indicators or proxies. Examples include the number and satisfaction of people affected, the assessment of experts, and the impact on laws, policies, community empowerment, and social services. The effectiveness of evaluation is likely to increase if organizations become more willing to share information about what works and what doesn't. To be sure, those who invest significant time and money in social impact work want to feel good about their efforts, and they are understandably reluctant to spend additional resources in revealing or publicizing poor outcomes. What nonprofit wants to rain on its parade when that might jeopardize public support? But sometimes at least a light drizzle is essential to further progress. Only through pooling information and benchmarking performance can nonprofit organizations help each other to do better.

| PROMOTING ETHICAL DECISION MAKING |

Although no set of rules or organizational structures can guarantee ethical conduct, nonprofits can take three steps that will make it more likely.

Ensure Effective Codes of Conduct and Compliance Programs. One of the most critical steps that nonprofits can take to promote ethical conduct is to ensure that they have adequate ethical codes and effective compliance programs. Codified rules can clarify expectations, establish consistent standards, and project a responsible public image. If widely accepted and enforced, codes can also reinforce core values, deter misconduct, promote trust, and reduce the organization's risks of conflicting interests and legal liability.

> WHERE THERE IS NO CONSENSUS ABOUT ETHICALLY APPROPRIATE CONDUCT, LEADERS SHOULD STRIVE FOR A DECISION-MAKING PROCESS THAT IS TRANSPARENT AND RESPONSIVE.

Although the value of ethical codes and compliance structures should not be overlooked, neither should it be overstated. As empirical research makes clear, the existence of an ethical code does not of itself increase the likelihood of ethical conduct. Much depends on how standards are developed, perceived, and integrated into workplace functions. "Good optics" was how one manager described Enron's ethical code, and shortly after the collapse, copies of the document were selling on eBay, advertised as "never been read." [28]

A recent survey of nonprofit organizations found that only about one third of employees believed that their workplace had a well-implemented ethics and compliance program. This figure is higher than the corresponding figure for the business (25 percent) and government (17 percent) sectors, but still suggests ample room for improvement.[29] Part of the problem lies with codes that are too vague, inflexible, or narrow. Only about half of nonprofit organizations have conflict of interest policies, and fewer than one third require disclosure of potentially conflicting financial interests.[30] A related difficulty is compliance programs that focus simply on punishing deviations from explicit rules, an approach found to be less effective in promoting ethical behavior than approaches that encourage self-governance and commitment to ethical aspirations.[31]

To develop more effective codes and compliance structures, nonprofit organizations need systematic information about how they operate in practice. How often do employees perceive and report ethical concerns? How are their concerns addressed? Are they familiar with codified rules and confident that whistle-blowers will be protected from retaliation? Do they feel able to deliver bad news without reprisals?

Promote Effective Financial Management. Another step that nonprofits can take to foster ethical behavior and promote public trust is to use resources in a socially responsible way. In response to reports of bloated overhead, excessive compensation, and financial mismanagement, watchdog groups like Charity Navigator have begun rating nonprofits on the percentage of funds that go to administration rather than program expenditures. Although this rating structure responds to real concerns, it reinforces the wrong performance measure, distorts organizational priorities, and encourages disingenuous accounting practices. Groups with low administrative costs may not have the scale necessary for social impact. The crucial question that donors and funders should consider in directing their resources is the relative cost-effectiveness of the organization. Yet according to a 2001 study by Princeton Survey Research Associates, only 6 percent of Americans say that whether a program "makes a difference" is what they most want to know when making charitable decisions. Two-thirds expect the bulk of their donations to fund current programs and almost half expect *all* of their donations to do so. Such expectations encourage charities to provide short-term direct aid at the expense of building long-term institutional capacity.

Moreover, the line these donors draw between "overhead" and "cause" is fundamentally flawed. As Dan Pallotta notes in *Uncharitable*, "the distinction is a distortion." All donations are going to the cause, and "the fact that [a dollar] is not going to the needy now obscures the value it will produce down the road" by investing in infrastructure or fundraising capacity. Penalizing charities for such investments warps organizational priorities. It also encourages "aggressive program accounting," which allocates fundraising, management, and advertising expenses to program rather than administrative categories. Studies of more than 300,000 tax returns of charitable organizations find widespread violation of standard accounting practices and tax regulations, including classification of accounting fees and proposal writing expenses as program expenditures.[32]

To address these issues, nonprofit organizations need better institutional oversight, greater public education, and more transparent and inclusive performance measures. Ensuring common standards for accounting and developing better rating systems for organizational effectiveness should be a priority.

Institutionalize an Ethical Culture. In its *National Nonprofit Ethics Survey*, the Ethics Resource Center categorizes an organization as having a strong ethical culture when top management leads with integrity, supervisors reinforce ethical conduct, peers display a commitment to ethics, and the organization integrates its values in day-to-day decision making. In organizations with strong ethical cultures, employees report far less misconduct, feel less pressure to compromise ethical commitments, and are less likely to experience retaliation for whistle-blowing.[33] This survey is consistent with other research, which underscores the importance of factoring ethical concerns into all organizational activities, including resource allocation, strategic planning, personnel and compensation decisions, performance evaluations, auditing, communications, and public relations.

Often the most critical determinant of workplace culture is ethical leadership. Employees take cues about appropriate behavior from those at the top. Day-to-day decisions that mesh poorly with professed values send a powerful signal. No organizational mission statement or ceremonial platitudes can counter the impact of seeing leaders withhold crucial information, play favorites with promotion, stifle dissent, or pursue their own self-interest at the organization's expense.

Leaders face a host of issues where the moral course of action is by no means self-evident. Values may be in conflict, facts may be contested or incomplete, and realistic options may be limited. Yet although there may be no unarguably right answers, some will be more right than others—that is, more informed by available evidence, more consistent with widely accepted principles, and more responsive to all the interests at issue. Where there is no consensus about ethically appropriate conduct, leaders should strive for a decision-making process that is transparent and responsive to competing stakeholder interests.

Nonprofit executives and board members also should be willing to ask uncomfortable questions: Not just "Is it legal?" but also "Is it fair?" "Is it honest?" "Does it advance societal interests or pose unreasonable risks?" and "How would it feel to defend the decision on the evening news?" Not only do leaders need to ask those questions of themselves, they also need to invite unwelcome answers from others. To counter self-serving biases and organizational pressures, people in positions of power should actively solicit diverse perspectives and dissenting views. Every leader's internal moral compass needs to be checked against external reference points.

Some three decades ago, in commenting on the performance of Nixon administration officials during the Watergate investigation, then-Supreme Court Chief Justice Warren Burger concluded that "apart from the morality, I don't see what they did wrong." [34] That comment has eerie echoes in the current financial crisis, as leaders of failed institutions repeatedly claim that none of their missteps were actually illegal. Our global economy is paying an enormous price for that moral myopia, and we cannot afford its replication in the nonprofit sphere. ■

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Excise Taxes on Excess Benefit Transactions Engaged in by Certain Tax-Exempt Organizations. (1996).

Notice 96-46 (IRS NOT), 1996-39 I.R.B. 7, 1996-2 C.B. 212, 1996 WL 516229

Internal Revenue Service (I.R.S.)
Notice

EXCISE TAXES ON EXCESS BENEFIT TRANSACTIONS
ENGAGED IN BY CERTAIN TAX-EXEMPT ORGANIZATIONS

Released: September 12, 1996
Published: September 23, 1996

***1** Taxes on excess benefit transactions. This notice describes new Code section **4958** excise taxes on excess benefits transactions engaged in between certain tax-exempt organizations and their disqualified persons. It also specifies the tax return form to be used in paying these taxes and prescribes the time for their payment.

This notice summarizes certain aspects of Taxpayer Bill of Rights 2 related to excise taxes on excess benefit transactions involving organizations described in § 501(c)(3) (except private foundations) and § 501(c)(4). Taxpayer Bill of Rights 2, Pub.L. No. 104-168, 110 Stat. 1452, (TBOR2) was enacted July 30, 1996. This notice also provides guidance with respect to the filing of returns for these excise taxes, and solicits comments to be considered in drafting future guidance. See Notice 96-47, page 8, this Bulletin, for aspects of TBOR2 related to the express prohibition of private inurement for § 501(c)(4) organizations, and Notice 96-48, page 9, this Bulletin, for disclosure requirements for, and increases in certain penalties on, exempt organizations generally.

I. In General

Section 1311(a) of TBOR2 creates new § **4958**, which imposes excise taxes on excess benefit transactions. An excess benefit transaction subject to tax under § **4958** is any transaction in which an economic benefit is provided by an organization described in § 501(c)(3) (except for a private foundation) or § 501(c)(4) directly or indirectly to, or for the use of, any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. A disqualified person is any person who was, at any time during the 5-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of the organization. Disqualified persons also include family members and certain entities in which at least 35 percent of the control or beneficial interests are held by persons described in the preceding sentence. An organization manager is an officer, director, trustee, or any individual having powers or responsibilities similar to those of an officer, director, or trustee.

Section **4958** imposes three taxes. The first tax is equal to 25 percent of the excess benefit amount, and is to be paid by any disqualified person who engages in an excess benefit transaction (§ **4958**(a)(1)). The second tax is equal to 200 percent of the excess benefit amount, and is to be paid by any disqualified person if the excess benefit transaction is not corrected within the taxable period (§ **4958**(b)). The third tax is equal to 10 percent of the excess benefit amount, and is to be paid by any organization manager who knowingly participates in an excess benefit transaction (§ **4958**(a)(2)). With respect to any one excess benefit transaction, the maximum amount of this third tax may not exceed $10,000.

II. Effective Date for Excise Taxes

The new § **4958** excise taxes apply to excess benefit transactions occurring on or after September 14, 1995. They do not apply, however, to any benefit arising from a transaction pursuant to any written contract that was binding on September 13, 1995, and continued in force through the time of the transaction.

III. Returns for Payment of Excise Taxes

Charities and other persons liable for certain Chapter 41 or Chapter 42 excise taxes must file returns on Form 4720 to calculate and report the taxes due. The Treasury Department will issue regulations providing that disqualified persons and organization managers (or their 35 percent controlled entities) liable for § 4958 excise taxes on excess benefit transactions are required to file an annual return on Form 4720. For excess benefit transactions that occurred after September 13, 1995, in a taxable year ending before December 31, 1996, the persons liable for payment of the excise taxes must use the 1995 Form 4720 to calculate and report those taxes. The Service will revise Form 4720 for taxable years ending on or after December 31, 1996.

The Treasury Department will also issue regulations which will provide that returns on Form 4720 for taxable years ending after September 13, 1995, and on or before July 30, 1996 (the date of TBOR2's enactment), will be due on December 15, 1996. Returns for taxable years ending after July 30, 1996, will be due on the 15th day of the fifth month following the close of that taxable year.

The person filing should clearly mark the top of the 1995 Form 4720 that it is for payment of § 4958 excise taxes. Use Part II-A, columns (a), (b), and (h) to report information about the person(s) liable and the amount of the tax; use Schedule A columns (b), (c), (e), and (f) (if a transaction with a disqualified person, using the 25 percent tax rate), or (b), (c), (e), and (g) (if a transaction with an organization manager, using the 10 percent tax rate) to provide other information requested about the transaction.

IV. Reporting Requirements for § 4958 Excise Taxes

Section 1312(a) of TBOR2 amends § 6033(b) to require § 501(c)(3) organizations to report the amounts of the taxes paid under § 4958 with respect to excess benefit transactions involving the organization, as well as any other information the Secretary may require concerning those transactions. Section 6033(f) is also amended to impose the same filing requirements on § 501(c)(4) organizations. These amendments only apply to returns for taxable years beginning after July 30, 1996. Accordingly, affected organizations do not have to include information on taxes paid under § 4958, or any other information that may be required with respect to excess benefit transactions, on their returns for taxable years beginning before July 31, 1996.

V. Comments on Future Guidance Invited

The Service invites comments on the amendments made by § § 1311(a) and 1312 of TBOR2 (new § 4958 and reporting requirements related to those excise taxes). The Service will consider these comments in drafting future guidance. In order to issue this guidance promptly, the Service requests that written comments be submitted by December 12, 1996. Send submissions to: CC:DOM:CORP:R (Notice 96-46), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 96-46), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet directly to the IRS internet site at http:// www.irs.ustreas.gov/prod/tax_ regs/comments.html.

The principal author of this notice is Phyllis Haney of the Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this notice contact Ms. Haney on (202) 622-6070 (not a toll-free call).

Notice 96-46 (IRS NOT), 1996-39 I.R.B. 7, 1996-2 C.B. 212, 1996 WL 516229

Brauer, L., Tyson, T., Henzke, L., & Kawecki, D. (2002). An Introduction to I.R.C. 4958 (Intermediate Sanctions).

H. AN INTRODUCTION TO I.R.C. 4958 (INTERMEDIATE SANCTIONS)

by
Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke and Debra J. Kawecki

Introduction

On January 10, 2001, the Treasury Department issued temporary regulations under I.R.C. 4958, which imposes excess taxes on excess benefit transactions involving organizations exempt under I.R.C. 501(c)(3) and 501(c)(4). These regulations are important to the exempt organization community and to the Exempt Organization Division of the Tax Exempt and Government Entities (TE/GE) Division, which has the responsibility for ensuring compliance with I.R.C. 4958. The temporary regulations will be effective until January 9, 2004.

This article reviews these temporary regulations to assist examiners in examining excess benefit transactions. It should be read with the temporary regulations, including the regulations' many helpful examples. The appendices provide additional tools. In addition, EO Technical personnel are ready to assist examiners at any step in an examination.

Appendix 1 (I.R.C. 4958 in Steps) is a checklist to help examiners identify and analyze excess benefit transactions. *Appendix 2* (Rebuttable Presumption Checklist - Compensation), and *Appendix 3* (Rebuttable Presumption Checklist - Property) are guides to satisfying the requirements for establishing the rebuttable presumption under Regs. 53.4958-6T.

This article is divided into five sections:

Section A – Definitions
1. Applicable Tax-Exempt Organization
2. Disqualified Person
3. Organization Manager

Section B – Excess Benefit Transactions, Etc.
1. Excess Benefit Transactions
2. Revenue Sharing
3. Rebuttable Presumption

Section C – Imposition of Taxes and Correction
1. Effective Date
2. Occurrence
3. 25% Tax
4. 200% Tax

5. 10% Tax
6. Correction
7. Abatement
8. Period of Limitations
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Section D – Administrative Matters
1. Revocation
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Section E – Fringe Benefits
1. Fringe Benefits Taxation Generally
2. Overview of I.R.C. 4958 and Fringe Benefits
3. In-Depth Discussion of I.R.C. 132
4. Fringe Benefits Subject to Other Statutory Exclusions
5. Treatment of Fringe Benefits Not Excludable from Income
6. Valuation of Fringe Benefits
7. Employment Tax Treatment of Fringe Benefits

Section F – Conclusion

Discussion

A. Definitions

1. Applicable Tax Exempt Organization. Regs. 53.4958-2T.

I.R.C. 4958 imposes excise taxes on *excess benefit transactions* between *disqualified persons* and tax-exempt organizations described in either I.R.C. 501(c)(3) or I.R.C. 501(c)(4). These organizations are referred to as "applicable tax exempt organizations." This article will usually refer to an "applicable tax-exempt organization" simply as an *organization.*

An *organization* includes an entity that was tax-exempt under I.R.C. 501(c)(3) or I.R.C. 501(c)(4) any time in the five-year period before the *excess benefit transaction occurred.* This rule is called the "Lookback Rule," and the five-year period is the "Lookback Period." But if the *excess benefit transaction occurred* before September 14, 2000, the Lookback Period begins on September 14, 1995, the effective date of I.R.C. 4958, and ends on the date the *excess benefit transaction occurred.*

However, the following are not *organizations*:

i. A private foundation.

ii. A governmental entity that is not subject to taxation.

iii. A foreign organization tax-exempt under I.R.C. 501(c)(3) or I.R.C. 501(c)(4) that receives substantially all of its support from sources outside the U.S.

iv. An I.R.C. 501(c)(3) or I.R.C. 501(c)(4) entity whose exemption was never recognized or was revoked. However, if revocation was based on the presence of private inurement or impermissible private benefit, the entity would be an *organization* during the revocation period. Also, an entity whose exemption was revoked could be an *organization* based on the Lookback Rule.

2. Disqualified Person. Regs. 53.4958-3T.

A *disqualified person* is any person in a position to exercise *substantial influence* over the affairs of the *organization* at any time in the Lookback Period. To be a *disqualified person*, it is not necessary that the person actually exercise *substantial influence*, only that the person be in a position to exercise *substantial influence*.

Family members of the *disqualified person* and entities controlled by the *disqualified person* are also *disqualified persons*. For this purpose, control is defined as owning more than 35% voting power.

i. Substantial Influence. Regs. 53.4958-3T(c). Persons who hold any of the following powers, responsibilities, or interests are considered to be in a position to exercise *substantial influence* over the affairs of the *organization*.

a. A voting member of the governing body.

b. Regardless of title, a person who has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration or operation of the *organization* (such as president, chief executive officer or chief operating officer).

c. Regardless of title, a person who has ultimate responsibility for managing the finances of the *organization* (such as the treasurer or chief financial officer).

If ultimate responsibility resides with two or more individuals who may exercise this responsibility together or individually, then each individual is in a position to exercise *substantial influence*.

ii. No Substantial Influence. Regs. 53.4958-3T(d). Certain persons are considered as <u>not</u> being in a position to exercise *substantial influence* over the affairs of the *organization*, such as:

a. I.R.C. 501(c)(3) and I.R.C. 501(c)(4) organizations.

b. Employees of the *organization* who receive economic benefits in a taxable year of less than a specified amount. (For 2001, this amount is $85,000, but is subject to change each year.). But these employees must not be:

(1) Family members of *disqualified person;*
(2) Persons who are considered to be in a position to exercise *substantial influence* over the affairs of the *organization*; <u>or</u>
(3) Substantial contributors to the *organization*.

iii. Facts and Circumstances. Any other person may or may not be *disqualified person*, depending on the facts and circumstances.

a. The following are examples of facts and circumstances tending to show that a person <u>has</u> *substantial influence* over the affairs of the *organization*. Regs. 53.4958-3T(e)(2).

(1) The person founded the *organization*.
(2) The person is a substantial contributor to the *organization*.
(3) The person's compensation is based primarily on revenues derived from *organization* activities 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 for employees.
(5) The person manages a discrete segment or activity of the *organization* that represents a substantial portion of its activities, assets, income or expenses.
(6) The person owns a controlling interest (measured by either vote or value) in a corporation, partnership or trust that is a *disqualified person*.

(7) The person is a non-stock organization controlled directly or indirectly by one or more *disqualified persons*.

b. The following are examples of facts and circumstances tending to show that a person does not have *substantial influence* over the affairs of the *organization.* Regs. 53.4958-4T(e)(3).

(1) The person has taken a *bona fide* vow of poverty as an employee, agent, or on behalf, of a religious organization.
(2) The person is an independent contractor whose sole relationship to the *organization* is providing professional advice and the person:
   (i) Has no decision making authority, and
   (ii) Will derive no direct or indirect benefit from the transaction except for customary fees for professional advice.
(3) The direct supervisor of the person is not a *disqualified person.*
(4) The person does not participate in any management decisions affecting the *organization* as a whole or affecting a discrete segment of the *organization* that represents a substantial portion of its activities, assets, income or expenses of the *organization*, as compared to the *organization* as a whole.
(5) Any preferential treatment a person receives based on the size of the person's donation is:
   (i) Also offered to all other donors making comparable contributions, and
   (ii) Offered as part of a solicitation intended to attract a substantial number of contributions.

Where there are affiliated *organizations*, the determination of whether a person has *substantial influence* is made separately for each *organization.* A person may be a *disqualified person* regarding transactions with more than one *organization.*

3. Organization Manager. Regs. 53.4958-1T(d)(2).

An *organization manager* is an officer, director, or trustee of an *organization*, or any individual having powers or responsibilities similar to officers, directors or trustees, regardless of the individual's title.

A person is an officer of an *organization* if that person is specifically designated as such in the *organization's* certificate of incorporation, bylaws, or other organizational documents, or who regularly exercises authority to make administrative or policy decisions for the *organization.*

An independent contractor who acts solely in a capacity as an attorney, accountant, or investment manager or advisor is not an officer of an *organization.* Nor is a person who has authority to merely recommend particular administrative or policy decisions, but not to implement them.

However, if a person who is not an officer, director, or trustee of an *organization* is a member of a committee of the *governing body* of the *organization*, and the committee is attempting to invoke the *rebuttable presumption* under Regs. 53.4958-6T, based on the committee's actions, this person is considered as an *organization manager*.

B. Excess Benefit Transactions, Etc.

1. Excess Benefit Transactions. Regs. 53.4958-4T.

An *excess benefit transaction* is a transaction in which:

- An economic benefit is provided by an *organization*, directly or indirectly, to or for the use of a *disqualified person*, and
- The value of the economic benefit provided by the *organization* exceeds the value of the consideration received by the *organization* in return for providing the benefit.

To determine if an *excess benefit transaction occurred*, include all consideration and benefits exchanged between or among the *disqualified person*, the *organization*, and all entities it controls.

A transaction that is accomplished indirectly, such as through the use of a controlled entity or through an intermediary, is an *excess benefit transaction* if the transaction would have been an *excess benefit transaction* had the *organization* engaged in it directly with the *disqualified person*. "Control" occurs if the *organization* has 50 percent or more control over the other entity.

Any economic benefit received by a *disqualified person* from the assets of an *organization* is considered to be provided by the *organization* even if the transfer was not authorized under the *organization's* regular procedures. So, amounts embezzled by a *disqualified person* from an *organization* are considered an *excess benefit transaction*.

i. Fixed Benefits under an Initial Contract. Regs. 53.4958-4T(a)(3).

Initial Contract Exception. I.R.C. 4958 does not apply to *fixed payments* made by an *organization* to a *disqualified person* pursuant to an *initial contract*. This exception (also referred to as the "First Bite Rule") applies only to the fixed, not the variable, component of an *initial contract*.

a. Initial Contract. An *initial contract* is a *binding written contract* between an *organization* and a person who was not a *disqualified person* immediately before entering into the contract.

(1) An *initial contract* is treated as a new contract and is no longer subject to the First Bite Rule when:

(i) The contract provides that it may be terminated or cancelled by the *organization* (except for substantial non-performance) without the *disqualified person's* consent, and

(ii) Without substantial penalty to the *organization*.

(2) The new contract is treated as a new contract as of the earliest date any termination or cancellation would be effective.

(3) If the *organization* and the *disqualified person* make a *material change* to an *initial contract*, it is treated as a new contract as of the date the *material change* is effective.

(i) A *material change* includes an extension or renewal of the contract (except for an extension or renewal resulting from the exercise of an option) or a more than incidental change to the amount payable under the contract.

(ii) Any new contract is tested under the above definition to determine whether it is an *initial contract*.

b. Fixed Payment. A *fixed payment* is an amount of cash or other property specified in the contract, or determined by a *fixed formula* specified in the contract, that is paid or transferred in exchange for the provision of specified services or property.

(1) A *fixed payment* does not include any amount paid to a person under a reimbursement or similar arrangement where any person has discretion regarding the amounts incurred or reimbursed.

(2) A *fixed formula* may incorporate an amount that depends upon future *specified events or contingencies,* but no one can have discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus). A *specified event or contingency* may include the amount of revenues generated by

(or other objective measure of) one or more activities of the *organization*.

c. The Initial Contract Exception does not apply to *fixed payments* made in a year unless the *disqualified person* substantially performs his or her obligations in that year under the contract.

ii. Disregarded Benefits. Regs. 53.4958-4T(a)(4).

Certain economic benefits are disregarded for purposes of I.R.C. 4958, such as:

a. In-kind fringe benefits excluded from gross income under I.R.C. 132 (except certain liability insurance premiums, payments or reimbursements).

b. Certain benefits provided to volunteers, members or donors.

c. Benefits provided to a charitable beneficiary.

d. Benefits provided to or for the use of a governmental unit for exclusively public purposes.

Even though not listed in the Temporary Regulations, to provide consistent treatment of benefits provided in cash and in kind, pending final I.R.C. 4958 regulations, expense reimbursements paid under an "accountable plan" under Regs. 1.62-2(c)(2) may be disregarded.

iii. Valuation. Regs. 53.4958-4T(b)(1)(i).

In an *excess benefit transaction*, the general rule for the valuation of property, including the right to use property, is *fair market value*.

Fair market value is the price property, or the right to use property, would change hands between a willing buyer and a willing seller. Neither party can be under any compulsion to buy, sell, or transfer property or the right to use property. Both parties must have a reasonable knowledge of the relevant facts.

iv. Compensation. Regs. 53.4958-4T(b)(1)(ii).

The *fair market value* of economic benefits received for the performance of services is *reasonable compensation*.

a. *Reasonable compensation* is the value of services that would ordinarily be paid for like services by a like enterprise under like circumstances. The rules under I.R.C. 162 apply in determining if the compensation a *disqualified person* received was reasonable.

The fact that a bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining if the compensation is *reasonable*.

State or local legislature or court approval of a particular compensation package would be a factor, though not in itself conclusive, in determining if compensation was *reasonable*.

Except for fringe benefits excludable from gross income under I.R.C. 132, compensation includes all economic benefits (including taxable fringe benefits) provided by an *organization* to or for the *disqualified person* in exchange for the performance of services, regardless of how they are treated for federal income tax purposes.

b. Examples of economic benefits included in determining if compensation is *reasonable* are:

(1) All forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments and deferred and non-cash compensation.

(2) The payment of liability insurance premiums, or the payment or reimbursement by the *organization*, for the following items (unless excludable from gross income as a *de minimis* fringe benefit under I.R.C. 132(a)(4)):

(i) Any penalty, tax or expense of correction owed under I.R.C. 4958.

(ii) Any expense not reasonably incurred in a civil proceeding arising out the performance of services for the organization.

(iii) Any expense resulting from an act, or failure to act, where the person has acted *willfully* and without *reasonable cause.*

(3) All other compensatory benefits, whether or not included in gross income for income tax purposes.

(4) Taxable and nontaxable fringe benefits. (See Section E.)

(i) Fringe benefits excludable from gross income under I.R.C. 132 are disregarded.

(ii) Expense reimbursements paid under an "accountable plan" under Regs. 1.62-2(c)(2) may also be disregarded, pending final regulations.

(5) Certain expense allowances or reimbursements paid under a "nonaccountable plan" under Regs. 1.62-2(c)(3).

(6) Foregone interest on loans.

c. Fixed Payment. Determining the *reasonableness* of a *fixed payment* under a contract considers the facts and circumstances that existed when the organization and the *disqualified person* entered the contract.

d. Non-Fixed Payment. Determining the *reasonableness* of a non-fixed payment considers all facts and circumstances up to and including those occurring on the date of payment. However, it does not consider circumstances existing when the Service questions the payment.

e. Prior Years. In some circumstances, determining the *reasonableness* of compensation for one year may take into account services performed by the *disqualified person* in prior years.

f. Intent to Treat as Compensation. Regs. 53.4958-4T(c).

(1) An economic benefit provided to a *disqualified person* that is treated as compensation is considered together with other compensatory benefits to determine if the total compensation provided by the *organization* is reasonable.

(2) An economic benefit provided to a *disqualified person* that is <u>not</u> treated as compensation is considered as an *excess benefit transaction*, unless the *disqualified person* can establish that it was properly excludable from income for income tax purposes, or it involved a legitimate non-compensatory transaction with the *organization*.

(3) An economic benefit provided to a *disqualified person* is not treated as compensation unless the *organization* clearly

demonstrates its *intent* to treat the benefit as compensation when the benefit was transferred. *Intent* is demonstrated by written *substantiation* that is *contemporaneous* with the transfer of the economic benefit.

(i) *Contemporaneous substantiation* can be demonstrated by:

(a) The ***organization*** reporting the benefit as compensation on an original or amended Form W-2, 1099 or 990. But the amended form must be filed before the Service has started an audit of the *organization* or the *disqualified person*; or

(b) The ***disqualified person*** reporting the benefit as income on an original or amended Form 1040. But the amended Form 1040 must be filed before the Service has started an audit of the *organization* or the *disqualified person*; or

(c) Other written *contemporaneous* evidence demonstrating that the *authorized body* or an officer authorized to approve compensation has approved a transfer as compensation in accordance with established procedures. For example:

(I) An approved written employment contract executed on or before the date of transfer.

(II) Documentation satisfying the documentation requirements for the *rebuttable presumption* indicating that an authorized body approved the transfer as compensation for services on or before the date of transfer.

(d) In the case of fringe benefits that are claimed to be excludable from income, any written evidence that the benefits were intended as compensation is sufficient substantiation (for example: a contract; board minutes; an employee handbook; or an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefit is excludable from income.)

(ii) If the *organization* did not report the benefit as required, but the failure to report was due to *reasonable cause*, the requirement of *intent* would be satisfied. *Reasonable cause* (*see* I.R.C. 301.6724-1 of the regulations) can be established if:

(a) There were significant mitigating factors with respect to the failure to report, or

(b) The failure to report arose from events beyond the organization's control.

Also, the filer of the form must establish that the filer acted in a responsible manner both before and after the failure occurred.

2. Revenue Sharing. Regs. 53.4958-5T.

Certain revenue sharing transactions between a *disqualified person* and an *organization* can result in *excess benefit transactions*. This occurs when an economic benefit provided to or for the use of a *disqualified person* is determined in whole or in part by the revenues of one or more activities of the *organization*, but only if the transaction results in inurement under I.R.C. 501(c)(3) or I.R.C. 501(c)(4).

The temporary regulations do not discuss this kind of *excess benefit transaction*. Until final regulations on revenue sharing transactions are issued, it will be evaluated under the same principles that apply to all *excess benefit transactions* between a *disqualified person* and an *organization*, regardless whether the *disqualified person's* compensation is computed by reference to revenues of the *organization*.

3. Rebuttable Presumption. Regs. 53.4958-6T.

If an *organization* meets the following three requirements, payments it makes to a *disqualified person* 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*. Failure to meet the three requirements does not, however, automatically mean the transaction is an *excess benefit transaction*.

The three requirements for establishing the *rebuttable presumption* are:

i. Approval in Advance by an Authorized Body. Regs. 53.4958-6T(a)(1).

The compensation arrangement, or the terms of the property transfer, must be approved in advance by an *authorized body* of the *organization* or by an entity it controls. The *authorized body* must be composed entirely of individuals who do not have a *conflict of interest* for the compensation arrangement or the property transfer.

a. Authorized Body. Regs. 53.4958-6T(c)(1).

Usually, an *authorized body* is the organization's governing body, such as its board of directors, board of trustees, or an executive committee.

If permitted by state law, an *authorized body* may also be others who are authorized by the governing body to act on its behalf. This body must follow procedures specified by the governing body in approving compensation arrangements or property transfers.

When an *authorized body* is reviewing a transaction, an individual is not included on the *authorized body* if that individual meets only to answer questions and otherwise recuses himself from the meeting.

b. Conflict of Interest. Regs. 53.4958-6T(c)(1)(iii).

A member of an *authorized body* does not have a *conflict of interest* for a compensation arrangement or property transfer if the member meets all these requirements:

(1) The member is neither the *disqualified person* who participated in or economically benefited from the transaction, nor is a member of the *disqualified person's* family.

(2) The member is not in an employment relationship that is subject to the direction or control of any *disqualified person* participating in or economically benefiting from the transaction.

(3) The member does not receive compensation or other payments subject to approval by any *disqualified person* participating in or economically benefiting from the transaction.

(4) The member has no financial interest affected by the transaction.

(5) The member does not approve a transaction providing benefits to a *disqualified person* participating in the transaction under consideration, who in turn approved or will approve another transaction providing benefits to the member.

ii. Reliance on Comparable Data. Regs. 53.4958-6T(c)(2).

The *authorized body* obtained and relied on appropriate data for comparability before making its determination.

An *authorized body* has appropriate data for comparability if, considering the knowledge and expertise of its members, it has information sufficient to determine if the compensation is *reasonable* or the property transfer is at *fair market value*.

a. Compensation. If compensation, relevant information includes:

(1) Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions.

(2) The availability of similar services in the geographic area.

(3) Current compensation surveys compiled by independent firms.

(4) Actual written offers from similar institutions competing for the services of the *disqualified person*.

b. Property Transfers. If property transfers, examples of relevant information are:

(1) Current independent appraisals of the value of the property that will be the subject of the property transfer with the *disqualified person*.

(2) Offers received as part of an open and competing bidding process.

c. Small Organizations. For certain small *organizations* reviewing compensation arrangements, the *authorized body* is considered to have appropriate data for comparability if it has data on compensation paid by three comparable organizations in the same or similar communities.

A small *organization* is one having gross receipts of less than $1 million per year. A small *organization* may calculate its annual gross receipts based on its average gross receipts in the three prior taxable years. But if a small *organization* is controlled by or controls another entity, the annual gross receipts of all *organizations* must be aggregated.

iii. Documentation. Regs. 53.4958-6T(c)(3).

The *authorized body adequately documented* the basis for its determination *concurrently* with making that determination.

a. Adequately Documented. For a determination by an *authorized body* to be *adequately documented*, the records must note all the following items:

(1) The terms of the transaction approved and the date approved.

(2) The members of the *authorized body* present during debate and those who voted.

(3) The comparability data relied on and how it was obtained.

(4) Any actions taken by a member of the *authorized body* who had a *conflict of interest* for the transaction.

(5) If the *authorized body* determined that the reasonable compensation or that the *fair market value* varied from the range of comparable data obtained, the basis for this determination.

b. Concurrently. For a determination by an *authorized body* to be *adequately documented concurrently*, records must be prepared by the next meeting or 60 days after final action by the *authorized body* is taken, whichever occurs later. Within a reasonable time thereafter, the records must be reviewed and approved by the *authorized body* as reasonable, accurate and complete.

iv. Fixed Payments. For *fixed payments*, the *rebuttable presumption* applies to all payments made or transactions completed under a contract as long as the above three requirements were met when the *disqualified person* and the *organization* entered into the contract.

v. Non-Fixed Payments.

a. For *non-fixed payments*, a *rebuttable presumption* cannot arise until:

(1) The exact amount of the payment is determined, or a fixed formula for calculating the payment is specified; and

(2) The three *rebuttable presumption* requirements above are met.

b. However, if the *authorized body* approves an employment contract with a *disqualified person* that includes a *non-fixed payment* (such as a discretionary bonus) up to a specified cap, the *rebuttable presumption* would be established if:

(1) Before approving the contract, the *authorized body* obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the *disqualified person* would represent *reasonable* compensation;

(2) The maximum amount payable under the contract, taking into account both fixed and *non-fixed payments*, does not exceed this amount; and

(3) The three *rebuttable presumption* requirements above are met.

vi. Rebutting the Presumption. Regs. 53.4958-6T(b).

a. The *rebuttable presumption* may be rebutted if the Service develops sufficient contrary evidence to rebut the probative value of the comparability data relied on by the *authorized body*.

b. For a *fixed payment*, rebuttal evidence is limited to evidence relating to facts and circumstances existing when the *disqualified person* and the *organization* entered the contract under which the payment is made. For all other payments, rebuttal evidence may include facts and circumstances up to and including the date of payment.

vii. Checklists. Appendix 2 and Appendix 3, Rebuttable Presumption Checklists, are guides for establishing the *rebuttable presumption*. These checklists are for organizations' convenience only and are not required to establish the *rebuttable presumption*.

C. Imposition of Taxes and Correction

1. Effective Date. Regs. 53.4958-1T(f).

I.R.C. 4958 applies to all *excess benefit transactions occurring* on or after September 14, 1995. But I.R.C. 4958 does not apply to *excess benefit transactions* that *occurred* under a written contract binding on September 13, 1995 and at all times thereafter before the *excess benefit transactions occurred.* (This rule is often referred to as the "Binding Contract Exception.")

However, if after September 13, 1995, the binding written contract is *materially changed*, it is treated as a new contract that was entered into as of the effective date of the *material change*. In that event, *excess benefit transactions* that *occurred* under this new contract would be subject to I.R.C. 4958.

A *material change* includes an extension or renewal of the contract or a more than incidental change to any payment under the contract. But it does not include any extension or renewal that results from the person contracting with the *organization* or unilaterally exercising an option expressly granted by the contract.

2. Occurrence. Regs. 53.4958-1T(e).

Besides determining whether the Binding Contract Exception applies to an *excess benefit transaction*, when an *excess benefit transaction* occurred is important for several reasons:

i. The Five-Year Lookback Period for determining if an organization is an *applicable tax-exempt organization* and if a person is a *disqualified person* begins when the *excess benefit transaction* occurred.

ii. Correction. (See Section C.6. below.)

The *correction period* and the *taxable period* each begins when the *excess benefit transaction* occurred.

a. When *correction* involves the return of property, the deemed cash payment made by the *disqualified person* is based on the fair market value of the property when the *excess benefit transaction* occurred, or when the property is returned, whichever is lesser.

b. Interest on the excess benefit begins to accrue when the *excess benefit transaction* occurred.

c. The applicable Federal rate (AFR) used in calculating interest on the excess benefit is the AFR for the month when the *excess benefit transaction* occurred.

d. The period from when the *excess benefit transaction* occurred to the *correction date* is used to determine the appropriate term of the AFR.

The general rule is an *excess benefit transaction occurred* when the *disqualified person* received the economic benefit from the *organization* for federal income tax purposes.

Compensation. When a contract provides for a series of compensation or other payments to a *disqualified person* in the *disqualified person's* taxable year, any *excess benefit transactions* for these payments *occurred* on the last day of the *disqualified person's* taxable year. But if the payments continue for only part of the taxable year, any *excess benefit transaction occurred* on the last payment date in the series.

Benefits provided under a qualified pension, profit-sharing, or stock bonus plan *occurred* on the date the benefit was vested.

When an *organization* transferred property to a *disqualified person* that was subject to a substantial risk of forfeiture, or transferred to a *disqualified person* rights to future compensation or property, (such as benefits under a nonqualified deferred compensation plan), the *excess benefit transaction occurred* when the property, or the rights to future compensation or property, was no longer subject to a substantial risk of forfeiture. However, if the *disqualified person* elected under I.R.C. 83 to include an amount in gross income in the taxable year of transfer, the *excess benefit transaction occurred* when the *disqualified person* received the economic benefit from the *organization* for Federal income tax purposes.

An *excess benefit transaction* involving benefits under a deferred compensation plan that vested in any taxable year of the *disqualified person occurred* on the last day of the *disqualified person's* taxable year.

3. 25% Tax. Regs. 53.4958-1T(c)(1).

I.R.C. 4958 creates a two-tier excise tax structure on *excess benefit transactions*. The "First-Tier Tax" or "Initial Tax" is 25% of the excess benefit resulting from each *excess benefit transaction* between an *organization* and a *disqualified person*.

The 25% tax is payable by the *disqualified person* who received the excess benefit from the *excess benefit transaction*. If more than one *disqualified person* is liable for the 25% tax, all are *jointly and severally* liable for the tax.

Joint and several liability means that all or a portion of the 25% tax may be assessed against and collected from one or more of the *disqualified persons* who received an excess benefit from the *excess benefit transaction*. However, the total tax collected would not exceed 100% of the 25% tax. Under certain circumstances, the 25% tax may be abated.

4. 200% Tax. Regs. 53.4958-1T(c)(2).

If the 25% tax is imposed on an *excess benefit transaction* and the *disqualified person* does not *correct* the excess benefit within the *taxable period*, the 200% tax would be imposed on the *excess benefit transaction*. The "Second-Tier Tax" or "Additional Tax" is 200% of the excess benefit resulting from each *excess benefit transaction* between an *organization* and the *disqualified person*.

So, a *disqualified person* liable for the 25% tax may avoid the 200% tax by properly *correcting* all the excess benefit (and interest) within the *taxable period*. But if a *disqualified person* does not *correct* all the excess benefit (and interest), the 200% would be imposed only on the uncorrected portion of the excess benefit.

The 200% tax is payable by the *disqualified person* who received the excess benefit from the *excess benefit transaction*. If more than one *disqualified person* is liable for the 200% tax, all the *disqualified persons* are *jointly and* severally liable for the tax. However, the total tax collected would not exceed 100% of the 200% tax. Under certain circumstances, the 200% tax may be abated.

5. 10% Tax. Regs. 53.4958-1T(d).

I.R.C. 4958 imposes a tax of 10% of the excess benefit on the *participation* of an *organization manager* in an *excess benefit transaction* between an *organization* and a *disqualified person*. The 10% tax applies if:

i. The 25 percent tax has been imposed on the *disqualified person*;

ii. The *organization manager knowingly participated* in the *excess benefit transaction*, and

iii. The *organization manager's participation* was *willful* and not due to *reasonable cause*.

The Service has the burden of proof in establishing that an *organization manager participated knowingly* and the *organization manager's participation* was *willful* and was not due to *reasonable cause*.

The 10% is payable by the *organization manager* who *participated* in the *excess benefit transaction*. The maximum aggregate amount of 10% tax that may be imposed on an *organization manager* for each *excess benefit transaction* is $10,000. So, if more than one *organization manager knowingly participated* in an *excess benefit transaction*, $10,000 is the maximum amount of 10% tax that may be collected from all the *organization managers* collectively, for their *participation* in that particular *excess benefit transaction*. If more than one *organization manager* is liable for the 10% tax, all the *organization managers* are *jointly and severally liable* for the tax. However, the total tax collected cannot be more than 100% of the 10% tax. If the 25% tax imposed on the *disqualified person* were abated, the 10% tax would be abated automatically.

An *organization manager* who is also a *disqualified person* can be liable for the 25% tax as well as the 10% tax if he or she benefited from the *excess benefit transaction*.

The following are the standards for *knowing participation:*

i. Participation. Regs. 53.4958-1T(d)(3). *Participation* in an *excess benefit transaction* includes affirmative action and silence or inaction where the *organization manager* is under a duty to speak or act. However, an *organization manager* is not considered to have *participated* in an *excess benefit transaction* where the *organization manager* has opposed the transaction in a manner consistent with fulfillment of the *organization manager's* responsibilities to the *organization*.

ii. Knowing. Regs. 53.4958-1T(d)(4)(i). An *organization manager participates* in an *excess benefit transaction* knowingly if the *organization manager*:

   a. Has actual knowledge of sufficient facts so that based solely on these facts, the transaction would be an *excess benefit transaction*,

   b. Is aware the particular transaction may constitute an *excess benefit transaction*, and

   c. Negligently fails to make reasonable attempts to determine if the transaction is an *excess benefit transaction*, or is aware it is an *excess benefit transaction*.

   d. Exceptions to Knowing. Even though a transaction is subsequently determined to be an *excess benefit transaction*, an *organization manager's participation* in the transaction is not considered *knowing* if:

(1) After making full disclosure of the facts to an appropriate professional, the *organization manager* relies on the professional's reasoned written opinion regarding the elements of the transaction within the professional's expertise (Regs. 53.4958-1T(d)(4)(iii)), or

(2) The *organization manager* relies on the fact that the requirements for the *rebuttable presumption* of reasonableness have been satisfied (Regs. 53.4958-1T(d)(4)(iv)).

iii. Willful. Regs. 53.4958-1T(d)(5). Participation by an *organization manager* in an *excess benefit transaction* is *willful* if it is voluntary, conscious and intentional. To be *willful*, no motive to avoid the 10% tax is necessary. *Participation* by an *organization manager* is not *willful* if the *organization manager* does not know the transaction is an *excess benefit transaction*.

iv. Reasonable Cause. Regs. 53.4958-1T(d)(6). An *organization manager's participation* is due to *reasonable cause* if the *organization manager* has exercised responsibility for the *organization* with ordinary business care and prudence.

6. Correction. Regs. 53.4958-7T.

A *disqualified person* may *correct* an *excess benefit transaction* by:

i. Undoing the excess benefit to the extent possible, and
ii. Taking any additional measures necessary to place the *organization* in a financial position not worse than the position it would have been if the *disqualified person* had been dealing with the *organization* under the highest fiduciary standards.

Generally, a *disqualified person corrects* an *excess benefit transaction* by paying cash to the *organization* equal to the *correction amount*. But a *disqualified person* will not achieve *correction* if the *disqualified person* engaged in one or more transactions with the *organization* to circumvent the *correction* requirements.

The *disqualified person* may, if the *organization* agrees, make *correction* by returning to the *organization* the specific property it had previously transferred to the *disqualified person* in the *excess benefit transaction*. In that case, the *disqualified person* is treated as making cash payment to the *organization* equal to the lesser of the fair market value of the property on the date:

i. The property is returned, or

ii. The *excess benefit transaction occurred.*

If the payment resulting from the return of the property is less than the *correction amount*, *the disqualified person* must make additional cash payment to the *organization* equal to the difference. On the other hand, if the payment resulting from the return of the property exceeds the *correction amount*, the *organization* may make, but is not required to make, a cash payment to the *disqualified person* equal to the difference. But any *disqualified person* who received an excess benefit from the *excess benefit transaction* may not participate in the *organization's* decision whether to accept the return of the specific property.

Correction Amount. The *correction amount* is the sum of the excess benefit and the interest on the excess benefit.

Interest. The amount of interest is determined by multiplying the excess benefit by the appropriate interest rate. Interest is compounded annually and is computed from the date the *excess benefit transaction occurred* to the date of *correction*. The interest rate must be at least the applicable Federal rate (AFR), compounded annually, for the month when the *excess benefit transaction occurred.* The period from when the *excess benefit transaction occurred* to the date of *correction* is used to determine the appropriate term of the AFR (short-term, mid-term or long-term).

Exemption Revoked. If the *organization* was tax-exempt under I.R.C. 501(c)(3), but it no longer exists or is not tax-exempt under I.R.C. 501(c)(3) on the date of *correction*, the *disqualified person* should make *correction* to another I.R.C. 501(c)(3) organization under the dissolution clause in the *organization's* organizational documents. However, the recipient I.R.C. 501(c)(3) organization must not be related to the *disqualified person*.

If the *organization* was tax-exempt under I.R.C. 501(c)(4), but it no longer exists or is not tax-exempt under I.R.C. 501(c)(4) on the date of *correction*, the *disqualified person* should make *correction* to a successor I.R.C. 501(c)(4) organization. If there is no successor tax-exempt organization, the *disqualified person* should make *correction* to any I.R.C. 501(c)(3) or I.R.C. 501(c)(4) organization that is not related to the *disqualified person*.

7. Abatement. Regs. 53.4958-1T(c)(2)(iii).

Under certain circumstances, the Service may abate the 25% tax and must abate the 200% tax. By providing for abatement, the tax law encourages *disqualified persons* to *correct* excess benefits rather than the Service collecting the 25% tax and the 200% tax.

The rules for abatement of the 25% tax appear in I.R.C. 4962(a) and the rules for abatement of the 200% tax appear in I.R.C. 4961(a).

i. 25% Tax. I.R.C. 4962.

The Service will not impose the 25% tax on an *excess benefit transaction* between a *disqualified person* and an *organization* if the *disqualified person*:

a. Has *corrected* the *excess benefit transaction* in the *correction period*, <u>and</u>

b. Can establish that the *excess benefit transaction* with the *organization* was due to *reasonable cause* and not to *willful neglect*.

If the 25% tax has already been imposed, the Service will not assess the tax, or if the 25% tax has already been assessed, the tax and interest will be abated.

c. Correction Period. Regs. 53.4963-1(e).

The *correction period* <u>begins</u> when the *excess benefit transaction* between a *disqualified person* and *organization occurs*, and <u>ends</u> 90 days after the Service mails a notice of deficiency to the *disqualified person* that includes the 200% tax. (A notice of deficiency is also known as a "Statutory Notice" or a "90-Day Letter.")

This 90 day period is extended while a petition involving I.R.C. 4958 taxes is pending in the U.S. Tax Court. This period may also be extended for any additional time the Service determines is reasonable and necessary to bring about *correction* of the excess benefit.

d. Reasonable Cause

Reasonable cause is not defined in I.R.C. 4962(a), nor is it defined in measurable terms elsewhere in the Code or regulations where a reasonable cause standard is imposed. There are guides, however, in the regulations and in many court cases that have considered if particular circumstances amounted to *reasonable cause*.

Regs. 53.4941(a)-1(b)(5) provides that a foundation manager's participation in an act of self-dealing is due to *reasonable cause* if he exercised his responsibility for the foundation with "ordinary business care and prudence." Reg. 301.6651-1(c) provides that a failure to pay tax will be considered to be due to *reasonable cause* to the extent the taxpayer satisfactorily shows he or she exercised "ordinary business care and prudence" in providing for the payment of the tax liability, but was either unable to pay or would have suffered an undue hardship if the liability had been paid on the due date.

In U.S. v. Boyle, 469 U.S. 241 (1985), the executor of an estate exercised "ordinary business care and prudence" by engaging an attorney to file the estate tax return, but it was not *reasonable cause* to rely on the attorney to file the return timely. In John W. Madden, Jr. et al. v. Commissioner, T.C.M. 1997-395, the reliance by foundation managers on the advice of the CEO of a management company was not "ordinary business care and prudence."

Also, Regs. 53.4958-1T(d)(6) provides that an *organization manager's knowing participation* in an *excess benefit transaction* is due to *reasonable cause* if the *organization manager* has exercised responsibility for the *organization* with "ordinary business care and prudence."

Regs. 301.6724-1 provides that the penalty for a failure relating to an information reporting requirement is waived if the failure is due to "reasonable cause and is not due to willful neglect." Under this regulation, one element of "reasonable cause" is that the filer acted in a "responsible manner." This term means the filer exercised reasonable care, which is that standard of care a reasonably prudent person would use under the circumstances in the course of its business. Regs. 301.6724-1(d)(1)(i).

This standard is specifically adopted in the I.R.C. 4958 regulations for indicating an *organization*'s intent that a benefit was provided to a *disqualified person* as compensation in cases where an *organization* failed to report the benefit as otherwise required by the Code. Regs. 53.4958-4T(c)(3)(iii).

Under Regs. 301.6651-1(c) and other provisions that impose a reasonable cause standard, determining if reasonable cause was shown requires consideration of all the facts and circumstances.

e. Willful Neglect

I.R.C. 4962 does not define the term *willful neglect*. I.R.C. 6662(c) defines "negligence" for purposes of the negligence penalty as including any failure to make a reasonable attempt to comply with the provisions. In the generally accepted legal sense, negligence is the failure to do something a reasonable person, guided by those considerations that ordinarily regulate the conduct of human affairs, would do, or doing something a prudent and reasonable person would not do.

"Willful" is defined in several places; for example, Regs. 53.4941(a)-1(b)(4) defines "willful" as "voluntary, conscious, and intentional." Reg. 1.507-1(c)(5) provides that no motive to avoid the foundation restrictions is necessary to make an act or failure to act "willful," but that an act or failure to act is not "willful" if the foundation does not know it is an act to which the foundation rules apply.

Regs. 53.4958-1T(d)(5), relating to knowing participation by an *organization manager* in an *excess benefit transaction*, also defines "willful" as "voluntary, conscious, and intentional." This regulation also provides that no motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation "willful." However, *participation* by an *organization manager* is not "willful" if the *organization manager* does not know the transaction in which the *organization manager* is participating is an *excess benefit transaction*. So, the term *willful neglect* implies failure to exercise the care a reasonable person would observe under the circumstances to see that the standards were observed, despite knowledge of the standards or rules in question.

A finding that a violation was caused by *willful neglect* will preclude abatement of the 25% tax, but a mere finding of no *willful neglect* does not, in itself, justify abatement. Numerous cases that have considered similar standards under I.R.C. 6651, concerning additions for failure to file a tax return or pay tax, have held that the mere absence of *willful neglect* is insufficient, since there must also be *reasonable cause* for the violation. See, for example, Rembusch v. Commissioner, T.C.M. 1979-73; de Belaieff v. Commissioner, T.C.M. 1956-273; Rogers Hornsby v. Commissioner, 26 B.T.A. 591 (1932). Ignorance of the law is a clear example of the operation of this principle. The fact that a *disqualified person* did not know a transaction was an *excess benefit transaction* shows it was not due to *willful neglect*, but it does not meet the *reasonable cause* requirement.

ii. 200% Tax. I.R.C. 4961.

If the *disqualified person corrects* the *excess benefit transaction* in the *taxable period*, the Service will not impose the 200% tax. If the 200% tax has already been imposed, the Service will not assess the tax, or if the 200% tax has already been assessed, the tax and interest will be abated.

The *taxable period* (Regs. 53.4958-1T(c)(2)(ii)):

a. Begins when the *excess benefit transaction occurred*, and

b. Ends when a deficiency notice for the 25% tax is mailed to the *disqualified person*, or when the 25% tax is assessed on the *disqualified person*, whichever happens first.

i. Technical Advice

Area Offices are required to request technical advice from EO Technical when a *disqualified person* requests abatement of the 25% tax and the total 25% taxes involving all related parties and transactions within the period of limitations exceeds $200,000. Where several *disqualified persons* are *jointly and severally liable* for the 25% tax, the 25% tax is counted only once. Procedures regarding requesting technical advice are in Rev. Proc. 2001-5, 2001-1 I.R.B. 64. This revenue procedure is updated annually.

The Director, Exempt Organizations has the authority to abate the 25% tax. But where the total 25% tax involving all related *disqualified persons* and *excess benefit transactions* within the period of limitations is $200,000 or less, TE/GE Directors, Area Managers and Managers of TE/GE technical staffs have the authority to abate.

8. Period of Limitations. Regs. 53.4958-1T(e)(3).

The *period of limitations* for assessing I.R.C. 4958 excise taxes against *disqualified persons* and *organization managers* begins when the *organization* files its Form 990 for the period when the *excess benefit transaction occurred*, or when the Form 990 is due, whichever is later, and ends either three years or six years later.

i. 3 Years. If the *organization* filed Form 990 for the period when the *excess benefit transaction occurred* and adequately reported the *excess benefit transaction* on this return, the *period of limitations* would end three years later.

ii. 6 Years. If the *organization* filed Form 990 for the period when the *excess benefit transaction occurred* but did not *adequately report* the *excess benefit transaction* on this return, the *period of limitations* would end six years later.

An *excess benefit transaction* is *adequately reported* on Form 990 if it is disclosed in a manner sufficient to apprise the Service of the existence and nature of the *excess benefit transaction* with the *disqualified person* and, if applicable, the *participation* by the *organization manager*. The Service has the burden of proving that the disclosure of information on a return (or in a schedule or statement attached to the return) was insufficient to apprise the Service of the existence and nature of an *excess benefit transaction* with a *disqualified person* and *participation* by an *organization manager*.

iii. If the *organization* did not file Form 990 for the period when the *excess benefit transaction occurred*, the *period of limitations* would never end.

iv. Extending the Period of Limitations. Since the I.R.C. 4958 excise taxes are payable by the *disqualified person* or the *organization manager*, each *disqualified person* and each *organization manager* is considered a separate taxpayer. So, the Service and each *disqualified person* and *organization manager* may agree to extend the *period of limitations* for assessing I.R.C. 4958 taxes by each person executing a separate Form 872. Each 872 relates to each person's own tax year, not the tax year of the *organization*. If the spouse of a *disqualified person* or *organization manager* is also a *disqualified person* or *organization manager*, he/she should execute a separate Form 872; a "joint" Form 872 is not appropriate.

Because the *period of limitations* for assessing I.R.C. 4958 excise taxes against *disqualified persons* and *organization managers* begins when the *organization* files its Form 990, it is different from the *period of limitations* for assessing income taxes against a *disqualified person* or an *organization manager*.

9. Notice of Deficiency

When an Area Office sends a notice of deficiency for I.R.C. 4958 excise taxes, the Area Office should send each person who is liable for I.R.C. 4958 excise taxes a separate notice of deficiency. Also, each notice of deficiency should include:

i. All *excess benefit transactions occurring* in each of the tax years included in the notice, and

ii. Both the 25% tax and the 200% tax relating to each *excess benefit transaction* occurring in each year.

10. Penalties. Regs. 301.6684-1.

If a *disqualified person* or an *organization manager* is liable for I.R.C. 4958 excise taxes because of an act that is not due to *reasonable cause*, and the *disqualified person* or *organization manager* was either previously liable for I.R.C. 4958 excise taxes or the act is both *willful and flagrant*, the *disqualified person* or *organization manager* would be liable for a penalty of 100% of the applicable I.R.C. 4958 excise taxes.

D. Administrative Matters

1. Revocation. Regs. 53.4958-8T(a).

I.R.C. 4958 does not affect the standards for tax exemption under I.R.C. 501(c)(3) or I.R.C. 501(c)(4), such as the I.R.C. 501(c)(3) requirement that the *organization* be organized and operated exclusively for exempt purposes and the I.R.C. 501(c)(4) requirement that the *organization* be operated exclusively for the promotion of social welfare. Nor does I.R.C. 4958 affect the requirement under both I.R.C. 501(c)(3) of the Code and I.R.C. 501(c)(4) of the Code that no part of the *organization's* net earnings inure to the benefit of any private shareholder or individual. Whether a particular transaction is subject to I.R.C. 4958, the *organization* is still subject to the prohibition against impermissible private benefit.

In enacting I.R.C. 4958, Congress made it clear that the Service may impose intermediate sanctions for *excess benefit transactions* in lieu of, or in addition to, revocation of an *organization's* tax-exemption. But where the excess benefit does not rise to a level where it calls into question whether the *organization*, as a whole, functions as a tax-exempt organization, intermediate sanctions should be the sole sanction imposed. In practice, revocation of tax-exempt status would occur only when the *organization* no longer operates as a tax-exempt organization.

In determining whether to revoke the tax-exempt status of an *organization*, the Service will consider all the facts and circumstances, including these four factors:

i. Whether the *organization* has been involved in repeated *excess benefit transactions*.

ii. The size and scope of the *excess benefit transactions*.

iii. If, after concluding that the *organization* has been party to an *excess benefit transaction*, it has implemented safeguards to prevent future recurrences.

1. Whether there was compliance with other applicable laws.

The Service will publish additional guidance regarding the factors it will consider in determining when to revoke an *organization's* exemption as more experience is gained in administering this area. That guidance may specify additional factors or may revise the factors listed above.

2. Churches. Regs. 53.4958-8T(b).

In initiating and conducting any inquiry or examination into whether an *excess benefit transaction* has occurred between a church and a *disqualified person*, the procedures in I.R.C. 7611 should be used. The reasonable belief required to initiate a church tax inquiry is satisfied if there is a reasonable belief that an I.R.C. 4958 excise tax is due from a *disqualified person* for an *excess benefit transaction* involving a church. (See the appropriate section of the Exempt Organizations Examinations Guidelines Handbook relating to the restrictions on church tax inquiries and examinations under I.R.C. 7611.)

3. Technical Advice

Area Offices are required to request technical advice from EO Technical in cases where an I.R.C. 4958 excise tax is being proposed, in all I.R.C. 4958 cases being considered for resolution by a closing agreement, and in all cases where a *disqualified person* requests abatement of the 25% tax and the total 25% taxes involving all related parties and transactions within the period of limitations exceeds $200,000. Where several *disqualified persons* are jointly and severally liable for a 25% tax, the 25% tax is counted only once.) Procedures regarding requesting technical advice appear in Rev. Proc. 2001-5, 2001-1 I.R.B. 164. This revenue procedure is updated annually.

In appropriate circumstances, Area Offices should consider using the pre-submission conference procedures in Section 9 of Rev. Proc. 2001-5.

The Area Office should prepare a separate technical advice request for each *disqualified person* and for each *organization manager* who *knowingly participated* in an *excess benefit transaction*. When an Area Office submits a technical advice request under I.R.C. 4958, it should also submit a separate technical advice request for the *organization* relating to the issue of revocation of its exemption. In this request, the Area Office should explain its reasons for proposing or not proposing revocation of the *organization's* exemption, as the case may be. Similarly, if an Area Office submits a technical advice request proposing revocation of an *organization's* I.R.C. 501(c)(3) or I.R.C. 501(c)(4) exemption, it should also submit separate technical advice requests for any *disqualified persons* who entered into *excess benefit transactions* with the *organization* and for *organization managers* who *knowingly participated* in the *excess benefit transactions*, or it should explain its reasons for not submitting these requests.

In connection with any request for technical advice submitted to EO Technical, the Area Office should urge the *organization*, the *disqualified persons* and the *organization managers* to submit a written statement of the facts, issues and position.

Since an *excess benefit transaction* between a *disqualified person* and an *organization* may result in a *disqualified person* being liable for additional income tax, the Service Area Office may need to coordinate certain issues with the Wage and Investment Division or the Service operating division with jurisdiction over the *disqualified person*.

To permit EO Technical sufficient time to consider the request for technical advice, it may be necessary for the Area Office to request the *disqualified person* or the *organization manager* to consent to extending the period of limitations for assessing I.R.C. 4958 excise taxes. So, the Area Office should obtain from the appropriate persons executed Forms 872 (Consent to Extend the Time to Assess Tax). If the Area Office cannot obtain executed Form 872s from all appropriate persons to permit EO Technical sufficient time to consider the request for technical advice, the Area Office should contact EO Technical.

E. Fringe Benefits

The correct application of I.R.C. 4958 requires knowledge of the fringe benefit rules. A disqualified person may receive a variety of fringe benefits. The benefits need to be analyzed for two reasons.

1. To determine if compensation received by the disqualified person is reasonable.

2. To determine if the benefits received by the disqualified person are received in exchange for services rendered.

This portion of the article will explain how the temporary regulations treat fringe benefits. To make that discussion meaningful, some knowledge of fringe benefits is necessary. This section of the article consists of seven parts:

1. Fringe Benefit Taxation Generally.

2. Overview of I.R.C. 4958 and Fringe Benefits.

3. In-Depth Discussion of I.R.C. 132.

4. Fringe Benefits Subject to Other Statutory Exclusions.

5. Treatment of Fringe Benefits Not Excludable From Income.

6. Valuation of Fringe Benefits.

7. Employment Tax Treatment of Fringe Benefits.

Part 1 – Fringe Benefit Taxation Generally

The general rule is all fringe benefits are taxable. I.R.C. 61(a)(1) provides that gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. The regulations under I.R.C. 61 explain how it operates with Code sections that provide specific exclusions for certain fringe benefits.

Regs. 1.61-21(b) provides that to the extent a particular fringe benefit is specifically excluded from gross income under another section of subtitle A, that section will govern the treatment of that fringe benefit, not I.R.C. 61. So, if the requirements of the governing section are satisfied, the fringe benefit may be excluded from gross income.

I.R.C. 61 and the individual sections that provide deductibility or excludability are complex. Knowing I.R.C. 132 -- a "laundry list" of fringe benefits excluded from gross income -- is important to correctly apply I.R.C. 4958. I.R.C. 132 includes:

- No-additional-cost service
- Qualified employee discount
- Working condition fringe benefits
- *De minimis* fringe benefits
- Qualified transportation fringe benefits
- Qualified moving expense reimbursement

The working condition fringe benefit rule in I.R.C. 132(a)(3) is an example of the complexity in this area. That section is cross referenced to the ordinary and necessary business expense rules of I.R.C. 162 and the depreciation rules of I.R.C. 167.

I.R.C. 132(d) defines a "working condition fringe" as "property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under sections 162 or 167."

This reference to I.R.C. 162 does not complete the process. Congress added I.R.C. 274, effective January 1, 1963. I.R.C. 274 disallows in whole, or in part, certain expenditures for entertainment, gifts and travel that would otherwise be allowable under Chapter 1 of the Code (*i.e.*, I.R.C. 162 or 167). For example, a lavish or extravagant entertainment expense might be deductible under I.R.C. 162, but is disallowed as a deduction under I.R.C. 274.

The I.R.C. 274 requirements are in addition to the requirements for deductibility imposed by other Code provisions. If a deduction is claimed for any expenditure for entertainment, gifts, or travel, the taxpayer must first establish it is allowable as a deduction under Chapter 1 of the Code before the provisions of I.R.C. 274 become applicable. The regulations make it clear that I.R.C. 274 is a disallowance provision and does not make deductible any expense disallowed under any other Code provision.

I.R.C. 162(a) provides that a deduction will be allowed for all the ordinary and necessary expenses paid or incurred in the taxable year in carrying on any trade or business. I.R.C. 162(a)(1) permits a reasonable allowance for salaries or other compensation for personal services actually rendered. I.R.C. 162(a)(2) permits a deduction for travel expenses; including meals and lodging that are not lavish and extravagant. Thus I.R.C. 162(a)(2) ties in with I.R.C. 274.

I.R.C. 132 applies only to benefits provided directly by the employer to the employee; it does not deal with reimbursements by the employer to the employee for business expenses initially paid by the employee. For example, I.R.C. 132 treats as an excludable working condition fringe the value of an airplane ticket the employer gives to the employee to make a business trip. I.R.C. 132 does not cover reimbursement paid by the employer to the employee if the employee purchases the airline ticket for the business trip. Reimbursements are technically covered by Regs. 1.62-2. However, for administrative purposes, all TE/GE administrative personnel will treat reimbursements of a business expense the same as if the expense were paid directly by the employer, as long as the employee complies with the substantiation rules of I.R.C. 62 and 274. So qualifying reimbursements will be disregarded under I.R.C. 4958, to the same extent as direct payments by the employer are disregarded under I.R.C. 132.

Part 2 - Overview of I.R.C. 4958 and Fringe Benefits

Knowledge of fringe benefits is important to answer two questions for purposes of I.R.C. 4958.

1. Is the compensation received by the disqualified person reasonable?

This question is important to determine if the disqualified person has received an excess benefit. To determine if compensation received by the disqualified person that includes fringe benefits is reasonable, the regulations start with the definition of reasonable compensation. Regs. 53.4958-4T(b)(1)(ii)(A) contains the definition of reasonable compensation.

> In general. The value of services is the amount that would ordinarily be paid for like services by like enterprises under like circumstances (i.e., reasonable compensation). I.R.C. 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under paragraph (a)(4) of this section).

Regs. 53.4948-4T(a)(4) contains a list of economic benefits that are disregarded for purposes of I.R.C. 4958 and the calculation of reasonable compensation. On that list are benefits provided to volunteers, to members or donors, to charitable beneficiaries and to governmental units. For this discussion, the important provision is Regs. 53.4958-4T(a)(4)(i), which generally deals with fringe benefits provide to employees, partners, and contractors.

An economic benefit excluded from income under section 132 -- except any liability insurance premium, payment, or reimbursement that must be taken into account under Regs. 53.4958-4T(b)(1)(ii)(B)(2) -- is disregarded for purposes of 4958.

The first question is now answered. If a disqualified person receives a benefit from an employer, it must normally be tested under the reasonable compensation standard of Reg. Sec. 53.4958-4T(b)(1)(ii)(A). But if a disqualified person receives one or more of the benefits listed in I.R.C. 132 (including Regs. 1.62-2), the income received from those benefits will not be included in the calculation of reasonable compensation. This means all other fringe benefits need to be taken into consideration in calculating reasonable compensation. If a benefit is excluded by I.R.C. 132 but the disqualified person also received benefits used for personal purposes (*e.g.*, business use and personal use of employer-provided car), the value of the personal benefit will be included in the calculation of reasonable compensation even though the business use is disregarded.

2. Did the disqualified person receive the benefits in exchange for services rendered?

Regs. 53.4958-4T(a)(1) provides an excess benefit transaction means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit.

The key concept here is that an excess benefit is based on the value of the economic benefit exceeding the value of the consideration the disqualified person provides. The economic benefit must be received in exchange for consideration. The regulations make it very clear that it must be intended that the benefit be a part of compensation.

Regs. 53.4958-4T(c)(1) provides the general rule that an economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. Intent is shown only if the organization provides written substantiation that is contemporaneous with the transfer of the economic benefit.

The exception to the rule is for certain fringe benefits. If the fringe benefit is excluded from income by any provision of the Internal Revenue Code (*e.g.*, I.R.C. 132 or I.R.C. 119) substantiation is not required. The following is a road map for sorting through the benefits received by the disqualified person.

i. Identify the disqualified persons.

ii. Identify all the benefits, monetary and nonmonetary received by each disqualified person.

iii. Identify the benefits to be tested under the exclusion provisions of chapter 1 of Subtitle A.

   a. Test each provision.

   b. Isolate the benefits that qualify for exclusion under I.R.C. 132 (including Regs. 1.62-2). If the benefits received by the disqualified person fully qualify, they are completely disregarded under I.R.C. 4958. Any benefits described in I.R.C. 132 that do not qualify under I.R.C. 132 are included in the reasonable compensation calculation if substantiated as compensation. Any written evidence that the benefits were intended as excludable compensation is sufficient substantiation (for example: a contract; board minutes; or an employee handbook; or an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefits are excludable from income.) If there is substantiation, but upon examination, the Service determined that the benefits fail to qualify, then the failed benefits will be treated as having been substantiated as compensation and will be included in the reasonable compensation calculation. All unsubstantiated failed benefits are excess benefits under I.R.C. 4958.

c. Isolate the benefits that qualify for exclusion under any provision in the Code other than I.R.C. 132 (such as I.R.C. 119). Qualified benefits are not disregarded under I.R.C. 4958. They are included in the reasonable compensation calculation and need not be substantiated. Any benefits claimed to be excludable that do not qualify or that have a taxable component are included in the reasonable compensation calculation if substantiated, but are excess benefits under I.R.C. 4958 if not substantiated. Any written evidence that the benefits were intended as excludable compensation is sufficient substantiation (for example: a contract; board minutes; or an employee handbook; or an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefits are excludable from income.)

d. Any benefits not excluded from income under the Code are excess benefits under I.R.C. 4958 unless they are substantiated. If substantiated, they are included in the reasonable compensation calculation.

If a statutory exclusion is available for a particular fringe benefit, the requirements of that Code section must be met for the exclusion to apply. For example, if the statutory exclusion has a restriction against providing the benefit in cash, the fringe benefit is not excludable if cash or a cash equivalent such as a gift certificate is provided.

A "failed" fringe benefit is treated as any other form of compensation subject to the reasonable compensation requirements of I.R.C. 4958. As with all forms of consideration, only consideration contemporaneously substantiated can be included in the reasonable compensation calculation.

The applicable statutory exclusion for a fringe benefit may have a provision that limits the dollar amount of the benefit or requires a written plan. The provision must be satisfied for the fringe benefit to be excludable from taxation under that I.R.C. section.

Finally, it is important to remember that, even if a statutory exclusion applies, the result may be that the value of the fringe benefit is only partially excludable from the employee's gross income. For purposes of I.R.C. 4958, part of the benefit amount may be disregarded and it may be necessary to consider part of the benefit in the reasonable compensation analysis.

Note: The word "substantiation" has two uses for purposes of I.R.C. 4958. When used in the statutory exclusion provisions, such as I.R.C. 132, substantiation refers to keeping adequate books and records to support the exclusion. When used in I.R.C. 4958 it refers to evidence that fringe benefits were intended to be part of the compensation package. In an effort to be clear, the article will refer to the I.R.C. 4958 use as substantiation of compensation.

Part 3 – In-Depth Discussion of I.R.C. 132

A fringe benefit that satisfies the requirements for income exclusion under I.R.C. 132 is totally disregarded for I.R.C. 4958 purposes. I.R.C. 132 was added to the Code in 1984 to explicitly exclude four commonly provided fringe benefits. Two other exclusions have since been added. There are now specific statutory exclusions for working condition fringes, *de minimis* fringes, qualified employee discounts, no-additional-cost services, qualified transportation fringes, and qualified moving expense reimbursements.

A. Working Condition Fringe Benefits

I.R.C. 132(d) and I.R.C. 1.132-5 of the regulations defines a working condition fringe as any property or services provided to an employee to the extent that, if the employee paid for the property or services, the payment would be allowable as a deduction under I.R.C. 162 or 167. I.R.C. 132(d) excludes from the gross income of an employee the value of work related items provided by the employer so the employee can perform his or her job.

Common working condition fringes are desks, computers and office space. This exclusion applies only if (1) the employee's use of the property relates to the employer's business, and (2) the business use is substantiated by adequate records or sufficient evidence corroborating the employee's own statement. Regs. 1.132-5(c).

On audit, the most common working condition fringe is likely to be the use of an automobile for business purposes. Other commonly seen working condition fringes will be use of entertainment facilities, business travel and entertainment, and spousal or dependent travel for business purposes.

In general, the test for whether a fringe benefit will be excluded under I.R.C. 132(a)(3) (including Regs. 1.62-2) and disregarded under I.R.C. 4958 is determined by I.R.C. 162, 167 and (in appropriate cases) I.R.C. 267. The following three steps should be followed:

- Analyze the payment as if the employee had used the money to purchase the goods or services directly.

- Determine if the cost of the benefit would have been deductible by the employee under I.R.C. 162 as an ordinary and necessary business expense or depreciated under I.R.C. 167.

- If the expenditure is for travel, entertainment, or business gifts, determine if the expenditure must be disallowed as a business expense under I.R.C. 274.

For purposes of this test, limitations on employee deductions, such as the two-percent adjusted gross income threshold are ignored. However, I.R.C. 132 has many special rules for exclusion from income taxes, and these apply in determining if the benefit is disregarded for purposes of I.R.C. 4958.

Unlike other exclusions that apply only to employees, the working condition fringe exclusion is generally available to independent contractors, partners, and directors. Regs. 1.132-1(b)(2). There are no nondiscrimination rules for working condition fringes. Regs. 1.132-5(q). So, the benefits may be provided to some employees and not to others.

Additional requirements apply to certain types of working condition fringe benefits, such as the use of an automobile for security purposes. *See, e.g.*, Regs. 1.132-5(m), as amended by T. D. 8457, 1992-2 C.B. 12.

1. Use of Employer-Provided Automobiles

An employee's use of a vehicle for the employer's business purposes will be excluded from the employee's income as a working condition fringe benefit if the use is properly substantiated. In such circumstances, the benefit is disregarded under I.R.C. 4958 and no valuation is necessary and the business related use of the vehicle is excluded under I.R.C. 132 and disregarded for purposes of I.R.C. 4958.

Any personal use of the vehicle (including use of chauffeur services) must be valued and included both in income and the calculation of reasonable compensation for I.R.C. 4958 purposes. Whatever valuation rule is used, if the rule results in the employee or contractor realizing additional income, that income is a benefit that must be considered in determining excess benefits for I.R.C. 4958.

The general rule of valuation is fair market value. But an employer may use special valuation rules to value an employee's automobile use. If a special valuation rule is not properly applied or if it is used to value a fringe benefit by a taxpayer not entitled to use the rule, the taxpayer must determine FMV under the general valuation rules. Regs. 1.61-21(c)(5).

There are three valuation methods: the annual lease valuation rule (ALV), the cents-per-mile valuation rule, and the commuting valuation rule. Chauffeur services are valued differently. The four rules are discussed below. For I.R.C. 4958 purposes in the absence of substantiation, the agent should determine the value of the vehicle using the following method.

Value should be determined by the amount an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the geographic area where the vehicle is available for use. Regs. 1.61-21(b)(4).

For example, if a DP's salary is excessive by $100,000 and his personal use of an organization's automobile is valued at $6,000, then the total excess benefit taxed under I.R.C. 4958 will be $106,000.

a. Employer Provided Automobile: Annual Lease Valuation Rule

An employer may value an employee's personal use of an automobile by reference to the Annual Lease Value (ALV) of the automobile. A table provided in Regs. 1.61-21(d) determines the ALV. by the fair market value of the automobile (plus sales tax and title fees) on the first date it is available for employee use.

Safe harbor rules for determining FMV for purposes of the ALV are provided in Regs. 1.61-21(d)(5), as supplemented by Notice 89-110. For example, the ALV for an automobile with a fair market value of $25,000 is $6,850.

The amount taxed to the employee is determined first by multiplying the ALV by the employee's business use percentage. The business use percentage is the number of miles driven for the employer's business as a percentage of the employee's total annual mileage. The amount taxed to the employee is the difference between the ALV after performing the calculation: Amount Taxed = ALV (business mileage/total annual mileage)

For example, if the ALV is $5,000 and the employee's business use percentage is 70%, the employee would exclude from income $3,500 (70% of $5,000) and be taxed on $1,500 ($5,000 less $3,500).

The ALV includes insurance and maintenance, but does not include fuel provided by the employer. Regs. 1.61-21(d)(3). Fuel provided in kind may be valued at 5.5 cents per mile for each mile the vehicle is driven in the United States. Where the cost of fuel is reimbursed by or charged to the employer, the value is based generally on the amount of the actual reimbursement.

The ALV of an automobile is recalculated every four years. In general and except for any year when the commuting valuation rule is used, the ALV rule must be used the first day the automobile is provided to the employee for personal use and must be used for all subsequent years. Regs. 1.61-21(d)(7).

The employer has the option of including the total ALV in the employee's gross income, instead of excluding any portion that qualifies as a working condition fringe. This option is available only if the employer is using the ALV rule. Regs. 1.132-5(b)(1)(iv).

b. Employer-Provided Automobile: Cents-Per-Mile Valuation Rule

Under this valuation rule, an employer uses the standard mileage rate (*e.g.*, 32.5 cents per mile per mile in 2000, and 34.5 cents per mile in 2001) to value the number of miles driven by the employee for personal purposes. Regs. 1.61-21(e). This rule is available if:

- The employer reasonably expects the vehicle will be "regularly used" in the employer's business throughout the calendar year; or the vehicle is driven primarily by employees for at least 10,000 miles in a calendar year; and

- The fair market value of the vehicle does not exceed $12,800, as indexed ($15,400 in 2001). The figures are updated annually in a revenue procedure issued early in the calendar year. (Rev. Proc. 2001-19, 2001-9 I.R.B. 732.)

Whether a vehicle is considered regularly used in the employer's trade or business depends on the particular facts and circumstances. Under safe harbor rules, the regular use requirement is met if at least 50% of the vehicle's total annual mileage is for the employer's business, or the vehicle is generally used each workday to transport at least three employees to and from work in an employer-sponsored commuting vehicle pool.

The cents-per-mile value includes the cost of maintenance, insurance and fuel provided by the employer. Regs. 1.61-21(e)(3).

The cents-per-mile rule must be used the first day the automobile is provided to the employee for personal use and must be used for all subsequent years in which the vehicle qualifies for use of the rule. Regs. 1.61-21(e)(5).

c. Employer-Provided Automobile: Commuting Valuation Rule

The commuting use of an employer-provided vehicle is valued at $1.50 per one-way commute if all the following conditions are met. Regs. 1.61-21(f).

- The vehicle is owned/leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;

- The employer, for *bona fide* noncompensatory business reasons, requires the employee to commute to and from work in the vehicle;

- The employer has established a written policy under which the employee may not use the vehicle for personal purposes other than for commuting or *de minimis* personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home);

- The employee, except for *de minimis* personal use, does not use the vehicle for any personal purpose other than commuting; and

- The employee required to use the vehicle for commuting is not a "control employee" (see definition below) of the employer.

The $1.50 per one-way commute amount is includable in the income of each employee riding in a car or vanpool. Regs. 1.61-21(f)(3). The $1.50 commuting value includes the value of insurance, maintenance, and fuel.

An employer-provided vehicle that is generally used each workday to transport at least three employees to and from work in an employer-sponsored vanpool is deemed to meet the first and second requirements of the commuting valuation rules. Regs. 1.61-21(f)(1).

The rule may not be used to value the commuting use of a chauffeur-driven vehicle. Regs. 1.61-21(f)(2)(i).

Under Regs. 1.61-21(f)(5) and Regs. 1.61-21(f)(7), a "control employee" of a non-governmental employer is an employee who meets one of the following criteria:

- Is a board-appointed, shareholder-appointed, confirmed, or elected officer of the employer whose compensation equals or exceeds $50,000 as indexed ($75,000 for 2000 and 2001). Notice 2006-6, 2000-2 C.B. 600.

- Is a director of the employer;

- Owns a 1% or greater equity, capital or profit interest in the employer; or

- Receives \$100,000 or more in annual compensation as indexed (\$150,000 in 2000 and 155,000 in 2001.) *Id.*

Under Regs. 1.61-21(f)(6) and Regs. 1.61-21(f)(7), a "control employee" of a government employer is <u>either</u>:

- An elected official; or

- An employee whose annual compensation is at least as great as a federal government employee at Executive Level V (\$108,200 for 1995 through 1997; \$110,700 for 1998 through 2000, \$125,700 for 2001.).

d. Employer-Provided Automobile: <u>Chauffeur Services</u>

There are no special valuation rules available for valuing the personal use of chauffeur services, such as for commuting. So, the value of chauffeur services for personal use may be valued either by reference to:

- The FMV of the services as determined in an arm's length transaction, or

- The compensation of the chauffeur.

The amount of time a chauffeur is "on call" to perform driving services is included in the value of the services under either method. Regs. 1.61-21(b)(5).

If a chauffeur drives an employee for both business and personal purposes, the value of the services includable in the employee's income is based on the amount of time the chauffeur spends driving (or is on call to drive) the employee for personal reasons. The value of the personal use portion is included in the employee's gross income. If the substantiation as compensation rules are met, the amount is included in the reasonable compensation analysis. If the substantiation rules are not met, the amount is not part of compensation and is considered an excess benefit.

2. Employee Use of Organization Airplane

The regulations under I.R.C. 132 do not contain any special rules for distinguishing business and personal use of an organization's airplane. Instead, the regulations contain a cross-reference to the "Non-commercial flight valuation rules" in Regs. Sec. 1.61-21(g). As with all other I.R.C. 132 benefits, business use is disregarded for I.R.C. 4958 purposes and the personal use of the airplane is taxable and includable in the excess benefits computation if substantiated as compensation.

A detailed explanation of these regulations is beyond the scope of this article. However, note that some automobile valuation rules allow incidental personal use without tax or inclusion in the I.R.C. 4958 excess benefits computation. Regs. 1.61-21(g) does not provide any incidental use exceptions for personal use of an airplane.

3. Reimbursement for Business Travel and Entertainment Expenses

All payments or reimbursements by an organization to an employee (including reimbursements for business travel or entertainment expenses) will be treated as a working condition fringe excludable from income and disregarded under I.R.C. 4958 if the requirements of Regs. 1.62-2(c) are satisfied. The following is a brief summary of those requirements.

Reimbursement plans are generally divided into accountable and nonaccountable plans:

- *Accountable Plans*

If the employer maintains an accountable plan, all reimbursements to the employee for business expenses are excluded from the employee's income and are disregarded under I.R.C. 4958. To be an accountable plan, the employer's reimbursement or allowance arrangement must include all three of the following:

(1) The employee's expenses must have a business connection—that is, the employee must have paid or incurred deductible expenses while performing services as an employee of the employer.

(2) The employee must adequately account to the employer for these expenses within a reasonable period.

(3) The employee must return any excess reimbursement or allowance within a reasonable period.

Any expenses that fail to meet all three of the above rules are treated as having been reimbursed under a nonaccountable plan (discussed below). If the employee is reimbursed for expenses that are not deductible business expenses—for example, travel that is not away from home—those reimbursements are also treated as paid under a nonaccountable plan.

As noted in paragraph (2) above, under an accountable plan the employee must adequately account to the employer for the employee's expenses. The employee adequately accounts by giving the employer a statement of expense, an account book, a diary, or a similar record in which the employee has entered each expense at or near the time it was incurred, along with documentary evidence (such as receipts) of the travel, mileage, and other employee business expenses.

The employee must also account for all amounts he or she received in the year as advances, reimbursement, or allowances. This includes amounts the employee charged to the employer by credit card or other method. The employee must provide to the employer the same type of records and supporting information the employee would have to give to the IRS if the IRS questioned a deduction on the employee's return. The employee must pay back the amount of any reimbursement or other expense allowance for which the employee did not adequately account or that is more than the amount for which the employee accounted.

If the employee reimburses the employee for expenses under a per diem or car allowance, the employee can generally use the allowance as proof for the expenses. A per diem or car allowance satisfies the adequate accounting requirement for the employee's expenses only if all four of the following conditions apply:

(1) The employer reasonably limits payments of the travel expense to those that are ordinary and necessary in the conduct of the trade or business.

(2) The employee proves the time (dates), place, and business purpose of the employee's expense to the employer within a reasonable period.

(3) The employee is not related to the employer. If the employee is related to the employer, the employee must be able to prove the expenses to the IRS even if the employee has already adequately accounted to the employer and returned any excess reimbursement.

(4) The allowance is similar in form to and not more than the federal rate.

The federal rate can be figured using any of the following methods.

(1) The regular federal per diem rate.

(2) The standard meal allowance.

(3) The high-low rate.

(4) For car expense, either the standard mileage rate or a fixed and variable rate (FAVR).

The "regular per diem rate" is the highest amount the federal government will pay to its employees for lodging, meal and incidental expenses (or meal and incidental expense only) while they are traveling away from home in a particular are. The rates are different for different locations. Publication 1542 gives the rates in the continental United States (CONUS) for the current year. The State Department Internet site gives the rates for foreign areas ("OCONUS").

The "standard meal allowance" is the federal rate for meal and incidental expenses (M&IE). The rate for most small localities in the United States is \$30. Most major cities and many other localities qualify for higher rates. See Publication 1542 for CONUS and the State Department Internet site for OCONUS.

The employee receives an allowance only for meals and incidental expenses when the employer does one of the following:

(1) Provides the employee with lodging in kind.

(2) Reimburses the employee, based on receipts, for the actual cost of the employee's lodging.

(3) Pays the hotel, motel, etc. directly for the lodging.

(4) Does not have a reasonable belief that the employee had lodging expenses, such as when the employee stays with friends or relatives.

(5) Computes the allowance on a basis similar to that used to compute the employee's compensation, such as hours worked or miles traveled.

The "high-low rate" mentioned above is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate for each city. Under the high low method, the per diem amount for travel in 2000 is \$201 (including \$42 for M&IE) for certain high cost locations. All other areas have a per diem amount of \$124 (including \$34 for M&IE). *See* Publication 1542.

The "standard mileage rate," mentioned above, is a set rate per mile that the employee can use to compute deductible car expenses. For 2000, the standard mileage rate was 32.5 cents per mile; for 2001, the rate is 34.5 cents per mile.

The "fixed and variable rate" (FAVR) mentioned above is an allowance the employer may use to reimburse the employee's car expenses. Under this method, the employer pays an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover the employee's variable operating costs (such as gas, oil, etc.) plus a flat amount to cover the employee's fixed costs (such as depreciation, lease payments, insurance, etc.

The employee's reporting of reimbursements under an accountable plan will depend on whether the expenses were more or less than the federal rate. If the reimbursements were less than or equal to the federal rate, the reimbursements will not be included on the employee's Form W-2. The employee need not report the expenses or the reimbursements on the employee's Form 1040. The reimbursements may be disregarded under I.R.C. 4958.

If the actual business expenses are more than the reimbursements, the employee may complete Form 2106 and deduct the excess amount on Form 1040, Schedule A. Properly deducted amounts may be disregarded under I.R.C. 4958.

If the reimbursements were more than the federal rate, the employer must include the reimbursement amount in excess of the federal rate in Box 1 of the employee's Form W-2. The employee must report this amount as income from wages. The excess reimbursements must be tested for reasonableness and substantiated as compensation under I.R.C. 4958. If the excess reimbursements are not substantiated, they are automatically excess benefits under I.R.C. 4958.

- *Nonaccountable Plans*

A nonaccountable plan is a reimbursement or expense allowance arrangement that does not meet the rules for accountable plans discussed above. If there is a nonaccountable plan, the employer should combine the amount of any reimbursement or other expense allowance paid to the employee under a nonaccountable plan with wages, salary or other pay in box 1 of the Form W-2.

If the employer uses a nonaccountable plan, the employee may be able to deduct some or all the business expenses on Form 2106 and file it with the Form 1040. See Publication 17 and the instructions to Form 2106 for detailed rules. To the extent an employee on a nonaccountable plan fails to satisfy the deduction and reporting rules as embodied in Form 2106, the reimbursements are not covered by Regs. 1.62-2(c) or I.R.C. 132, and the reimbursements may not be disregarded. The reimbursements must instead be tested for reasonableness and substantiation as compensation like any other payment by the exempt organization to a disqualified person.

For example, assume an organization sends an employee on a trip to Paris to attend a convention. The employee spends seven days on business, and seven extra days in Paris engaging in personal activities. The organization mistakenly pays all the expenses of the trip, including the seven extra days. The employer is on an accountable plan and the employee satisfies all the requirements for accountable plan substantiation for the first seven days of the trip, but does not return the reimbursement for the seven nonbusiness days. The reimbursement for the seven business days may be disregarded for purposes of I.R.C. 4958. The expenses of the seven extra days would not satisfy the requirements for an accountable plan, and the employee could not deduct the expenses on the employee's Form 1040. So, any reimbursements for those expenses would be includable in the employee's income and wages and would be added to the I.R.C. 4958 reasonable compensation analysis.

4. Social Club Dues Paid by Organization

Regs. 1.132-5(s) provides two alternative tax treatments for dues paid by the employer for the benefit of an employee.

Assume that a club whose dues are paid by an organization is used 40 percent for business and 60 percent for personal purposes by a disqualified person.

Under the first alternative, the organization could choose to treat the entire amount as compensation to the DP. In that event, the entire amount of the dues would be taxable to the disqualified person and would be added in an I.R.C. 4958 reasonable compensation computation.

Alternatively, and more likely, the organization could treat the 40 percent business use as a working condition fringe. The organization would then report the 60 percent of the dues, representing the nonbusiness use, as compensation to the disqualified person, and such amount would be taxable and added to the reasonable compensation computation. *See* Regs. 1.132-5(s), Examples (1) and (2).

5. Spouse and Dependent Travel

Organizations often pay the travel expenses of the spouse or dependents of employees when the employee is traveling on organization business. Regs. 1.132.5(t) allows two alternative methods of handling such expenditures for tax purposes.

First, the organization may add the cost of such travel to the employee's compensation. In that event, the entire amount of the additional compensation would be taxable to the disqualified person and be includable in the excess benefits computation under I.R.C. 4958.

Alternatively, the organization may seek to have all or part of the expenditures treated as a working condition fringe benefit. If the requirements of I.R.C. 132 are met the benefit will be disregarded for purposes of I.R.C. 4958. The benefit will qualify under I.R.C. 132 if it can be adequately demonstrated that the spouse's, dependent's, or other accompanying individual's presence on the employee's business trip has a bona fide business purpose, and if the employee substantiates the travel expenses under Code Secs. 162 and 274.

Normally, it is very difficult for an organization to prove it had a bona fide business purpose for paying or reimbursing the costs incurred by spouses accompanying disqualified persons on business trips. The courts have used a two-step analysis.

(1) The dominant purpose must serve the employer's business.

(2) The spouse must actually spend a substantial amount of time assisting the accomplishment of the employer's purpose. Danville Plywood Corp. v. United States, 899 F.3d 3 (Fed. Cir. 1990), quoting United States v. Disney, 413 F.2d 783, 788 (9th Cir. 1969).

"The spouse's performance of an incidental service does not meet the requirement." Danville, supra, at 14. For example, performance of social functions (such as socializing with the spouses of business associates) does not satisfy the bona fide business purpose test. The same principles would apply for excluding the travel expenses of dependents of the disqualified person.

If the bona fide business purpose test is not satisfied respecting a spouse or dependent, the entire amount of the expense attributable to those persons would be taxable and includable in the excess benefits computation of the disqualified person. The spouse and dependents may be jointly and severally liable for the I.R.C. 4958 taxes to the extent of the excess benefits each received. However, automobile, hotel room, and other fixed costs do not have to be shared evenly between the disqualified person and the spouse and dependents.

For example, if the disqualified person normally travels to the business site in an automobile, and rents a hotel room, then the costs of the automobile travel and the hotel room need not be allocated between the disqualified person and the accompanying spouse or dependents. If the hotel charges a fee for additional persons in the room, only that additional fee would be includable in the excess benefits computation.

6. Personal Use of Office Credit Card

Any use of the office credit card for personal purposes is taxable as income to the employee. The value of such personal use is an automatic excess benefit unless it is substantiated as compensation.

7. Other Working Condition Fringe Benefits

Personal use of the employer's resources does not qualify as I.R.C. 132 working condition fringe benefits. Some examples are, non-*de minimis* personal use of cell phones, substantial use of office copying machines for personal use, and personal use of organization employees to perform substantial personal work (*e.g.*, use of office cleaning personnel to clean a disqualified person's residence).

The value of these benefits constitutes automatic taxable excess benefits unless there is substantiation as compensation.

B. *De Minimis* Fringe Benefits

1. General Rules

A *de minimis* fringe benefit is any property or service of a value so small (after taking into account the frequency that similar fringes are provided by the employer to the employer's employees) to make accounting for it unreasonable or administratively impracticable. I.R.C. 132(e).

The *de minimis* fringe exclusion applies to any recipient of the fringe benefit, and not just employees. Regs. 1.132-1(b)(4). Generally, frequency is determined on an individual recipient basis. Benefits that qualify as *de minimis* fringes are disregarded for purposes of I.R.C. 4958.

Regs. 1.132-6(e)(1) provides the following examples of *de minimis* fringe benefits:

- Occasional sporting event tickets
- Local telephone calls
- Coffee, doughnuts and soft drinks
- Traditional birthday or holiday gifts
- Occasional cocktail parties, group meals or picnics for employees and their guests
- Flowers, fruit, books, or similar property provided under special circumstances (e.g., because of illness, outstanding performance, or family crisis).

The Service has not established a bright line test for determining if an item is *de minimis*. In other words, there is no threshold amount below, which everything is *de minimis* and above which nothing is *de minimis*.

However, group-term life insurance on the life of an employee's dependent is excludable from income as a *de minimis* fringe if the face amount of the insurance does not exceed $2,000. Insurance provided in excess of this amount may or may not be excluded from income, depending on the cost of the insurance over the amount paid by the employee (on an after tax basis). *See* Notice 89-110, 1989-2 C.B. 447.

Regs. 1.132-6(e)(2) provides the following examples of benefits that do not qualify for exclusion as *de minimis* fringes:

- Cash (except for occasional meal money and local transportation fare provided because overtime work necessarily extended the employee's work schedule)
- Cash equivalents, such as gift certificates or a savings bond
- Season tickets to sporting or theatrical events
- Commuting use of an employer's car for more than one day per month
- Memberships in private athletic or country clubs, regardless how frequently the employee uses the facility
- Use of an employer's apartment, hunting lodge, boat, etc. for a weekend

Caution: Items chosen by employees under a catalog award program are generally not *de minimis* fringe benefits because the catalog award is viewed as a cash equivalent due to its similarity to a gift certificate. So, whether the value of the items available in the catalog would otherwise be considered nominal is irrelevant.

If an employer provides a benefit that exceeds the value or frequency limits applicable for the *de minimis* fringe exclusion to apply, the entire benefit is taxed to the employee, not just the portion that exceeds the *de minimis* limits. Regs. 1.132-6(d)(4). The value of the benefit is automatically an excess benefit unless substantiated as compensation.

There are no nondiscrimination requirements that apply to *de minimis* fringe benefits. Regs. 1.132-6(f). So, an employer may provide the benefits to some employees and not to others.

2. Eating Facilities

Many employers often offer discounts on the cost of meals for employees. The value of meals provided at a discount to employees at an employer-operated eating facility is excludable from an employee's income if certain conditions are met. *See* I.R.C. 132(e); Regs 1.132-7(a).

(1) On an annual basis, the revenue from the facility must equal or exceed its direct operating costs;
(2) The facility must be owned or leased by the employer and operated by the employer (or a third party contractor);
(3) The facility must be located on or near the employer's business premises; and
(4) The meals must be provided during, or immediately before or after the employee's workday.

The direct operating costs of a facility are the cost of food and beverages and the cost of labor for personnel performing services at the facility. This test may be applied separately for each of an employer's eating facilities or the costs may be aggregated. Regs. 1.132-7(b).

If an employer can reasonably determine the number of meals received by volunteers who receive food and beverages at a hospital, free or at a discount, the employer may, in determining if the revenue from the facility equals or exceeds the direct operating costs of the facility, disregard all costs and revenues attributable to such meals. The same rule applies to meals that are excludable from income by the recipient employees under I.R.C. 119.

If an employer charges non-employees a greater amount than employees, the employer must disregard all costs and revenues attributable to the meals provided to the non-employees.

If the meal exclusion does not apply, then the employee is taxed on the difference between the fair market value of the meal and the amount the employee paid for the meal. Regs. 1.132-7(c). In the alternative, the employer can use the special valuation rule under Regs. 1.61-21(j).

The exclusion is available to highly compensated employees only if the conditions listed above are satisfied and the facility is available to all employees on substantially the same terms. Regs. 1.132-7(a)(1)(ii).

For years beginning after December 31, 1996, a highly compensated employee is an employee who:

(1) Was a 5 percent owner at any time in the year or the preceding year, or

(2) For the preceding year (a) had compensation from the employer in excess of \$80,000, as indexed (\$85,000 for 2001), and (b) if the employer so elects, was in the top-paid group of employees for the preceding year. I.R.C. 1431 of the Small Business Job Protection Act, Pub. L. No. 104-188, amending I.R.C. 414(q).

The employer must include leased employees in determining if an eating facility is discriminatory.

Issue to Consider: An organization may have several different eating facilities, some of which may not be available to employees on substantially the same terms. If access to an eating facility is limited to the employee doctors, for example, the hospital should check to see if the nondiscrimination rule is satisfied. The regulations provide that each dining room or cafeteria must be treated as a separate facility for purposes of the nondiscrimination test, even if it does not have its own kitchen.

A substantial amount could be added to the excess benefits computation of a highly compensated employee if the employer eating facility did not satisfy the nondiscrimination test. If the benefit is not substantiated as compensation, the value is an automatic excess benefit.

C. Qualified Transportation Fringe Benefits

1. Basic Rules

I.R.C. 132(f) provides very specific requirements for excluding the value of certain employer-provided transportation fringe benefits from an employee's gross income. These rules are further discussed in Notice 94-3, 1994-1 C.B. 327, and IRS Publication 15-B. To be excludable, the benefit must be one of the following "qualified transportation fringes:"

(1) Transportation in a commuter highway vehicle;

(2) Transit passes; and

(3) Qualified parking.

If a transportation fringe does not satisfy these requirements, the value of the fringe must be added to the disqualified person's income and will be taken into consideration for purposes of determining excess benefits under I.R.C. 4952. If not substantiated as compensation, the benefit will be an automatic excess benefit.

2. Qualified Transportation Fringes: Parking

Under I.R.C. 132(f)(2), for tax years beginning 2001, up to $180 per month is excludable from the gross income of an employee for qualified parking provided by the employer. For tax years beginning in 1997, the limit was $170 per month.

The general valuation rules of Regs. 1.61-21(b) are used to determine if the amount of a qualified transportation fringe exceeds the excludable amount and to determine the amount includable in income. There are two basic valuation methods.

The value of parking provided by an employer to an employee is based on:

- The cost (including taxes or other added fees) an individual would incur in an arm's-length transaction to obtain parking at the same site.

- If that cost is not ascertainable, then the value of parking is based on the cost an individual would incur in an arm's-length transaction for a space in the same lot or a comparable lot in the same general location under the same or similar circumstances.

NOTE:

(1) A monthly rate may be used to determine a monthly value rather than the daily rate multiplied by the number of days in the month.

(2) If an annual rate is available, the monthly rate may be determined by dividing the annual rate by twelve.

(3) If a space is available for less than a month, the space may be valued according to the daily rate multiplied by the number of days the employee has access to the space.

(4) In no case is it necessary, however, for the monthly value to exceed the monthly rate. These rates may only be used if they are available to the public.

i. Access Rather Than Use

The value of the parking subject to tax under I.R.C. 61 (the amount above the I.R.C. 132 permitted amount) is the right of access on any given day to employer-provided parking, and not the actual use of the parking by the employee.

Example: Greg has unlimited access to qualified parking provided by his employer at no charge to Greg. The fair market value of the parking is $200 per month. The benefit satisfies the requirements of I.R.C. 132(f) so Greg can exclude up to $180 per month from income. In one particular month, Greg used the parking space for only 5 days, because he was away on business travel for 1 week and on a personal vacation for 2 weeks. Because Greg had access to the parking space for the entire month, the amount includable in his gross income and in his excess benefits computation is the amount full monthly fair market value exceeds the statutory limit--$20. If Greg does not substantiate the $20 as compensation, it is an automatic excess benefit.

ii. Definition of "Qualified Parking"

"Qualified parking" is access to parking provided to an employee on or near the employer's business premises or on or near a location from which the employee commutes to work by car pool, commuter highway vehicle, mass transit facilities, transportation provided by any person in the business of transporting persons for compensation or hire, or by any other means. A car pool means two or more individuals who commute together in a motor vehicle on a regular basis.

The exclusion for qualified parking is not available for parking on or near property used by the employee for residential purposes.

iii. Parking Available Primarily to Customers

Employer-provided parking that is available primarily to customers of the employer, free of charge, will be deemed to have a fair market value of $0. This rule does not apply, however, if an employer maintains "preferential" reserved spaces for employees. A reserved space is "preferential" if it is more favorably located than the spaces available to the employer's customers.

> Example: Newco's place of business is situated in a shopping mall. Ample free parking is available primarily to customers in the mall parking lot. Spaces reserved for employees are no closer to the mall than the spaces available to customers. The spaces reserved for employees have a fair market value of $0 because the spaces are not "preferential" reserved spaces.

3. Qualified Transportation Fringes: Commuting in an Employer-Provided Commuter Highway Vehicle

i. In General

Employees may exclude the value of commuting in an employer-provided commuter highway vehicle if certain requirements are satisfied. If these requirements are met, the value of the benefit will also be disregarded for purposes of I.R.C. 4958.

ii. Definition of commuter vehicle

A "commuter highway vehicle" is any highway vehicle that:

(1) Has a seating capacity of at least six adults (excluding the driver); and

(2) At least 80% of the vehicle's mileage use must be reasonably expected to be—

For transporting employees in connection with travel between their residences and their place of employment; and

On trips when the number of employees transported for commuting is, on average, at least one-half of the adult seating capacity of the vehicle (excluding the driver).

Commuter highway vehicles (or "vanpools") can be operated by the employer, by a third party for the employer, or by the employees.

The maximum value of an employee's excludable transportation was $65 per month in 1997 through 2001; it rises to $100 in 2002; and will increase with inflation each year thereafter. Notice 94-3, 1994-1 C.B. 327, 330, instructs that any of four valuation methods may be used. They are Regs 1.61-2(b), 1.61-2(d), 1.61-2(e), and 1.61-2(f). The monthly maximum is a combined total for commuter vans and transit passes.

4. Qualified Transportation Fringes: Transit Passes

The value of transit passes provided by an employer to employee is also excluded from income and disregarded from I.R.C. 4958 if certain conditions are met. A "transit pass" is any pass, token, farecard, voucher, or similar item entitling a person to transportation (or transportation at a reduced price):

(1) On mass transit facilities (whether or not publicly owned); or

(2) Provided by any person in the business of transporting persons for compensation or hire in a commuter highway vehicle.

As noted above, the maximum excludable value of the pass is the combined value of employer provided commuter vehicle travel and the value of the transit pass.

5. Definition of Employee

Employers can provide qualified transportation fringes only to "employees" within the meaning of Regs 1.132-1(b)(2)(i). This definition includes common law employees and other statutory employees, such as officers of corporations.

Self-employed individuals, who are employees within the meaning of I.R.C. 401(c)(1), are not employees for purposes of I.R.C. 132(f). Therefore, partners, 2-percent shareholders of S corporations, sole proprietors, and other independent contractors are not employees for purposes of I.R.C. 132(f). An individual who is both a 2-percent shareholder of an S corporation and an officer of that S corporation is not considered an employee for purposes of I.R.C. 132(f).

However, an independent contractor may exclude as a *de minimis* fringe benefit a public transit pass provided to the independent contractor if the value of the pass does not exceed $21 in any month. If the value does exceed $21, the entire value is includable in income, and is an excess benefit for a disqualified person if compensation is unreasonable or if there was no contemporaneous substantiation. An independent contractor may only exclude the value of parking if the parking qualifies as a *de minimis* fringe benefit; the parking cannot be excluded as a working condition fringe benefit. Regs. 1.132-1(b)(2).

6. Cash Reimbursements

Cash reimbursements (but not cash advances) by an employer to an employee for qualified parking, transit passes, and transportation in a commuter highway vehicle are also excludable from income and disregarded under I.R.C. 4958. This treatment is only available if the employer establishes a bona fide reimbursement arrangement to ensure employees have incurred the expenses.

However, cash reimbursements for transit passes are only excludable if a voucher or similar item that may be exchanged for a transit pass is not readily available to the employer.

For example, if the employer cannot obtain a voucher on terms no less favorable than those to individual employees and without incurring a significant administrative cost).

D. Qualified Employee Discounts

An employee who purchases, at a discount, the qualified goods or services of the employer may exclude the discount from income if certain conditions are met. I.R.C. 132(c); Regs. 1.132-3. If they are not satisfied, the discount's value is included in the employee's compensation for purposes of I.R.C. 4958. I.R.C. 132(c) requires:

(1) The employee must perform substantial services in the same line of business in which the discounted property or services are sold.

(2) The property discounted must be offered for sale to customers in the ordinary course of the employer's line of business.

The line of business limitation is not satisfied if the employer's property or services are sold primarily to employees, rather than to customers.

Qualified property does not include (a) real property and (b) personal property (whether tangible or intangible) of a kind commonly held for investment.

(3) The discount is limited.

For <u>services</u> sold to an employee at a discount, the maximum discount permitted is 20% of the price the services are being offered by the employer to customers.

> For property sold to an employee at a discount, the maximum permitted is the employer's "gross profit percentage" multiplied by the sales price of the property to customers.

The gross profit percentage is the excess of the aggregate sales price of the property sold by the employer to customers and employees over the employer's aggregate cost of the property, then divided by the aggregate sales price. The aggregate values have to be used because goods and services are often sold at a variety of prices. The following example is from the regulations.

If the aggregate sales price of property in an employer's line of business for the prior taxable year was $800,000 and the aggregate cost of the property for the year was $600,000, the gross profit percentage would be 25 percent ($800,000 minus $600,000, then divided by $800,000).

The gross profit percentage is then applied to the price the property is being offered for sale to customers to determine the exact dollar amount of the qualified employee discount. The gross profit percentage must be calculated separately for each line of business. The regulations provide special rules for determining the sales price to customers.

The qualified employee discount exclusion applies only to current employees, retired employees, their spouses and certain others. Independent contractors are not eligible for the exclusion. Regs. 1.132-1(b)(1).

Under special nondiscrimination rules, the qualified employee discount exclusion applies to highly compensated employees only if the benefit is nondiscriminatory. If the nondiscrimination rules are not met, the exclusion is nevertheless available to non-highly compensated employees. Regs 1.132-8.

E. Qualified Moving Expense Reimbursements

I.R.C. 132(g) provides "qualified moving expense reimbursements" provided by employers after December 31, 1993, will be excludable from an employee's income if certain conditions are satisfied. *See* Section 13213(d) of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66. *See also* IRS Publication 521 (Moving Expenses) for more detailed rules. To the extent the requirements are met, the reimbursements are disregarded for I.R.C. 4958 purposes. Organizations sometimes provide substantial moving benefits to disqualified persons.

1. Basic Rule

A "qualified moving expense reimbursement" is any amount received (directly or indirectly) by an individual from an employer as payment for (or a reimbursement of) expenses that would be deductible as moving expenses under I.R.C. 217 if directly paid or incurred by the individual.

2. Changes to I.R.C. 217

After December 31, 1993, deductible moving expenses are limited to the reasonable costs of (1) moving household goods and personal effects from the former residence to the new residence and (2) traveling (including lodging in the period of travel) from the former residence to the new place of residence. Deductions are not permitted for meals, real estate expenses, premoving house-hunting expenses, and temporary living expenses. Also, the mileage limit to qualify for the deduction was raised from 35 to 50 miles.

If the employer advances or reimburses an employee for expenses made in connection with the employee's move and the advance or reimbursement exceeds the "qualified moving expense reimbursement" permitted by I.R.C. 132(g), the excess must be included in the employee's gross income. It will also be considered wages for employment tax purposes and must be included in the excess benefit computation subject to the substantiation of compensation rules.

3. Use of Relocation Companies

Employers often use third party relocation companies to handle the sales of employees' homes. The payment of a real estate commission by a relocation company has recently been considered. Since commissions are no longer deductible under I.R.C. 217, any payment of the commission by the employer (or by the relocation company on the employer's behalf) would be income to the employee <u>if</u> the employee was legally obligated to pay the commission.

Conversely, if the employee was <u>not</u> legally obligated to pay the real estate commission, due to complicated use of exclusionary clauses in listing agreements and "separate" sales (i.e., one from the employee to the relocation company and another from the company to the independent buyer), the Service has taken the position that there is no income or wages to the employee.

This complicated issue requires careful analysis of the facts and circumstances, including whether the exclusionary clause effectively insulates the employee from any legal obligation to pay the commission. If you have any questions please contact one of the authors of this article.

F. Special Rule for Athletic Facilities

An employee is not taxed on the value of the use of an athletic facility operated by the employer and located on the employer's premises, provided substantially all the use of the facility is by employees, their spouses and their dependent children. I.R.C. 132(j)(4); Regs. 1.132-1(b)(3).

This exclusion applies to the use of a gym, pool, golf course, tennis course or other athletic facility. It does not apply to any facility if access to the facility is made available to the public through the sale of memberships, the rental of the facility, or a similar arrangement. The exclusion does not apply to any athletic facility for residential use, such as a resort with accompanying athletic facilities.

No nondiscrimination rules must be met for the exclusion to apply. Regs. 1.132-1(e)(5).

Issues to consider: The substantial use restriction may prevent the athletic facility exclusion from applying to employees of hospitals, particularly university hospitals. For example, if substantially all athletic facility use is by students, the exclusion may not apply to faculty and other employees.

Part 4 – Fringe Benefits Subject to Other Statutory Exclusions

Only I.R.C. 132 fringe benefits are excluded from income for income tax purposes and disregarded for purposes of I.R.C. 4958. There are fringe benefits excluded from income under sections of the Code other than I.R.C. 132. These fringe benefits are taken into consideration for purposes of I.R.C. 4958. An I.R.C. 4958 analysis requires they be included in the recipient's compensation for purposes of determining if these and other benefits are excessive.

However, these fringe benefits are not subject to I.R.C. 4958(c)(1) and I.R.C. 53.4958-4T(c) of the regulations. So the organization providing the benefits does not have to contemporaneously substantiate its intent to treat the amount as compensation. Contemporaneous substantiation is more fully discussed in Section B relating to the rebuttable presumption.

Regs. 53.4958-4T(c)(2) provides an organization is not required to indicate its intent to provide an economic benefit as compensation for services if the economic benefit is excluded from the disqualified person's gross income for income tax purposes by the provisions of chapter 1 of Subtitle A.

Examples of these benefits include, but are not limited to employer-provided health benefits and contributions to a qualified pension, profit-sharing or stock bonus plan under

I.R.C. 401(a), and any benefits described in I.R.C. 127 and I.R.C. 137. Except for disregarded economic benefits (I.R.C. 132 benefits), all compensatory benefits an organization provided in exchange for performance of services are taken into account in determining the reasonableness of a person's compensation for purposes of I.R.C. 4958.

We will discuss below several statutory exclusions most likely to apply to the disqualified persons of exempt organizations.

A. Employer-Provided Meals Under I.R.C. 119

For employer-provided meals to be excludable from an employee's gross income under I.R.C. 119, three conditions must be satisfied:

- The meals must be provided in kind; if an employee has an option to receive additional compensation in lieu of the meals, the value of the meals is not excludable;
- The meals must be provided for the convenience of the employer; and
- The meals must be provided on the employer's business premises. (Because of the more favorable I.R.C. 119 treatment for employer-provided meals, the agent may consider treating the Regs. 1.132-7 employer-provided meals as I.R.C. 119 meals, in the absence of evidence to the contrary.)

B. Employer-Provided Lodging Under I.R.C. 119

For employer-provided lodging to be excludable from an employee's gross income under I.R.C. 119, four conditions must be satisfied:

- The lodging must be provided in kind; if an employee has an option to receive additional compensation in lieu of actual lodging, the value of the lodging is not excludable;
- The lodging must be provided for the convenience of the employer;
- The lodging must be on the employer's business premises; and
- The lodging must be a condition of the employee's employment (i.e., the employee must be compelled or required to accept the lodging to be able to properly perform the duties of the job).

C. Special Rules for Educational Institutions — I.R.C. 119(d)

For lodging not meeting the rule of I.R.C. 119(a), which excludes the full value of the lodging from an employee's gross income, the special rule of I.R.C. 119(d) may apply.

The value of qualified campus lodging furnished to an employee of an educational institution is not included in the employee's gross income except to the extent the employee has not paid rent equal to or in excess of the safe harbor valuation rule of I.R.C. 119(d)(2).

Qualified campus lodging must be located on, or in the proximity of, the educational institution's campus. It may be provided to any employee of the educational institution, including non-faculty employees. The benefit extends to the employee's spouse and dependents.

The rent an employee pays must at least equal the *lesser* of (i) 5% of the appraised value of the lodging, or (ii) the average of rentals paid (other than by employees or students) to the educational institution for comparable housing during the calendar year. A qualified independent appraiser must determine fair market value on an annualized basis. Although a new appraisal is not required every year, the appraisal must be reviewed annually.

The use of the above formula in connection with I.R.C. 4958 may be illustrated by the following example:

Mr. Wisdom, a professor at Paradise University, rents a home from the University that is qualified campus lodging. The residence is appraised at $200,000. Five percent of $200,000 is $10,000 per year. The average rent paid by persons other than employees or students is $15,000 and $15,000 is the fair rental value of Professor Wisdom's house. If Professor Wisdom pays $11,000 rent, the rental value of the house is excludable from income, but the $4,000 below market rental benefit is included in his I.R.C. 4958 excess benefit computation.

If Professor Wisdom paid only $8,000 rent, then $2,000 ($10,000 less $8,000) would be includable in his income. Under I.R.C. 4958, the full amount of the below-market rental benefit must be taken into account. $15,000 fair rental value less the $10,000 (5% of appraised value) is still excluded from income under I.R.C. 119(d), and that amount is included in the reasonable compensation calculation even if it is not substantiated as compensation. The $2,000 that is included in income is included in the excess benefit computation if substantiated as compensation; if not so substantiated, the $2,000 is an automatic excess benefit.

D. Tuition Reduction Plan Under I.R.C. 117(d)

If a tuition reduction plan is not a "qualified tuition reduction" within the meaning of 117(d), then the benefit is taxable. For example, it may be determined that a program discriminates in favor of highly compensated employees within the meaning of I.R.C. 117(d)(3) and 414(q).

Nonetheless, a qualified tuition reduction provided to employees who are not highly compensated employees within the meaning of I.R.C. 414(q) is excluded from income notwithstanding that the plan under which the benefits are offered is discriminatory within the meaning of I.R.C. 117(d)(3).

Highly compensated employees will be taxed on the value of the benefit unless the plan is nondiscriminatory.

Except as provided in I.R.C. 117(d)(5) for teaching and research assistants, the term "qualified tuition reduction" applies only to education below the graduate level. A plan that provides graduate tuition benefits to faculty, staff, and their families is not a qualified tuition reduction plan.

All tuition reductions are added to the calculation of reasonable benefits under I.R.C. 4958.

E. Examples of other I.R.C. provisions excluding specific fringe benefits are:

I.R.C. 104(a)(1)	Amounts received under worker's compensation statutes
I.R.C. 105	Amounts received under accident and health plans
I.R.C. 106	Contributions by employer to accident and health plans
I.R.C. 125	Cafeteria plans

Part 5 – Treatment of Fringe Benefits Not Excludable from Income

I.R.C. 4958 treats fringe benefits in three different ways.

(1) Benefits excluded from income under I.R.C. 132 are disregarded.

(2) Benefits excluded from income under other Code sections are included in the calculation of reasonable compensation whether or not they are substantiated as compensation. If compensation is found not to be reasonable, there will be taxable excess benefit.

(3) Benefits included in income. If substantiated as compensation the benefit will be included in the calculation of reasonable compensation. If compensation is

found not to be reasonable, there will be taxable excess benefit. If not substantiated, the benefit is an excess benefit and is taxable.

Examples of fringe benefits not covered by any statutory exclusion, include:

(1) Employer-provided accounting and financial counseling
(2) Interest free loans
(3) Housing assistance payments
(4) Expense paid vacations or free use of employer-provided vacation homes
(5) Employer provided vacation travel
(6) Clothing allowances for personal clothing
(7) Employer provided pleasure boats
(8) Employer payments of mortgages on employee's residence
(9) Employer provided interest free or below-market-rate loans.

The key to compliance with I.R.C. 4958 is to follow the substantiation rules. An exempt organization substantiates a fringe benefit by clearly indicating its intent to treat the benefit as compensation when the benefit is paid. This is done by providing written substantiation that is contemporaneous with the transfer of the fringe benefits under consideration. This substantiation may take one of several forms:

(1) A signed written employment contract; or

(2) The organization reports the benefit as compensation on an original Form W-2, Form 1099, or Form 990, or on an amended form filed before the start of an IRS examination; or

(3) The disqualified person reports the benefit as income on the person's original Form 1040 or on an amended form filed before the start of an IRS examination.

(4) In the case of fringe benefits that are claimed to be excludable from income, contemporaneous substantiation includes any written evidence that the benefits were intended as excludable compensation (for example: a contract; board minutes; or an employee handbook; or an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefits are excludable from income.)

There are three ways these substantiation rules can become necessary.

First, if the fringe benefit is a type not described in an exclusion statute.

Second, if all or part of the value of a statutory fringe benefits (either under I.R.C. 132 or other income exclusion provisions) fails to comply with the requirements of the Code. For example, the extent an employer-provided automobile exceeds the I.R.C. 132 exclusion limitations, or the extent an I.R.C. 127 dependent care allowance exceeds the statutory maximum.

Third, if the benefit completely fails to comply with the requirements of I.R.C. 132 or the other exclusion provisions. For example, if a benefit failed a nondiscrimination requirement of one of these provisions, or if a benefit was not covered at all by one of these provisions. In such situations, the entire value of the benefit automatically becomes subject to the I.R.C. 4958 tax if the benefit is not substantiated.

Part 6 – Valuation of Fringe Benefits

If a fringe benefit is not excluded from gross income or only partially excluded, it must be valued. The employee is taxed on the amount the fair market value (FMV) of the fringe benefit exceeds the sum of:

(1) The amount paid for the benefit by or for the employee, and

(2) The amount, if any, specifically excluded from gross income by another section of the I.R.C. Regs 1.61-21(b)(1).

This remaining amount is included in compensation for I.R.C. 4958 purposes and is subject to the reasonable compensation analysis.

A. General Rule — Fair Market Value

The general rule of valuation is to use fair market value (FMV), the amount an individual would have to pay for the particular fringe benefit in an arm's-length transaction to buy or lease the benefit. The effect of any special relationship that may exist between the employer and the employee must be disregarded in determining FMV. Further, the employee's subjective perception of the value of a fringe benefit and the cost incurred by the employer are not relevant to the determination.

The regulations, however, provide special valuation rules for some commonly-provided fringe benefits, such as the use of employer-provided vehicles and airplanes. If an employer uses a special valuation rule, the special value is treated as the FMV of the benefit for income tax, employment tax and other reporting purposes. Regs 1.61-21(c)(2).

B. Rules for Valuing Use of Employer-Provided Automobiles

There are special valuation rules an employer may use to value an employee's use of an employer-provided automobile. (These valuation rules are discussed in Part 3A - Working Condition Fringe Benefits.) Generally, an employee's use of an employer-provided vehicle for the employer's business purposes will be excluded from the employee's income as a working condition fringe benefit if the use is properly documented.

Personal use, such as commuting, is taxable to the employee. If a special valuation rule is not properly applied or if it is used to value a fringe benefit by a person not entitled to use the rule, FMV must be determined under the general valuation rules. Regs 1.61-21(c)(5).

Part 7 – Employment Tax Treatment of Fringe Benefits

A. General Rule

The rules concerning the employment tax implications of fringe benefits have no application to the I.R.C. 4958 analysis. The rules are provided here only to provide a more complete understanding of the taxation of fringe benefits. For a more complete discussion, see IRS Publication 15, Circular E (Employers' Tax Guide).

If a fringe benefit is excludable from the employee's gross income, then its value is not added to the employee's wages and there are no employment tax consequences. On the other hand, if the benefit is not excludable (or is only partially excludable), its value must be reported as wages in Box 1 of the employee's Form W-2 and the employer generally must withhold income taxes and the employee's share of FICA, besides paying its share of FICA and FUTA.

The employment tax provisions exclude a benefit from wages if at the time the benefit was provided it was reasonable to believe the employee was able to exclude the benefit from income under I.R.C. 132.

The employer, at a minimum, must have ascertained the applicable law and applied it to the particular facts. In other words, the reasonable belief asserted must be based on a reasoned judgment made at or before the time the benefit was provided. The fact an employer's competitors treat certain benefits as excludable is insufficient to support the employer's assertion of a reasonable belief.

Employers are subject to penalties for failing to report correctly employee compensation, including fringe benefits. These penalties include a 100% penalty for the employer's failure to collect and pay the employee's share of FICA taxes attributable to taxable fringe benefits.

B. Special Rule for Non-Cash Fringe Benefits

Special reporting and withholding rules apply to an employer's provision of non-cash fringe benefits, such as vehicles:

- An employer may elect to treat the benefits as paid on a pay period, semiannual or annual basis, as long as the benefits are treated as paid no less frequently than annually.

- An employer may withhold income taxes at the flat 28% supplemental wage-withholding rate.

- An employer may treat benefits provided in the last two months of the employer's tax year (e.g., November and December) as paid in the following tax year.

- An employer may elect not to withhold income taxes on the value of the personal use of a vehicle, as long as the employer so notifies the employee and includes the taxable amount on the employee's Form W-2.

IRS Announcement 85-113, 1985-31 I.R.B. 31.

F. Conclusion

I.R.C. 4958 imposes excise taxes on top officials of I.R.C. 501(c)(3) and I.R.C. 501(c)(4) organizations who receive excessive economic benefits from their organizations. Also, I.R.C. 4958 imposes excise taxes on managers who knowingly participate in the transfer of these excessive economic benefits. However, top officials of these organizations who would be liable for these taxes may avoid them by making proper and timely restitution to the organization. Recently, the Treasury Department issued temporary regulations implementing I.R.C. 4958. A thorough understanding of these regulations is key to the ability of the Service to fairly and accurately apply I.R.C. 4958.

Appendices

Appendix 1 – I.R.C. 4958 in Steps
Appendix 2 – Rebuttable Presumption Checklist – Compensation
Appendix 3 – Rebuttable Presumption Checklist – Property

APPENDIX 1

I.R.C. 4958 IN STEPS

Step 1 – Determine if the organization is an *applicable tax-exempt organization* (*ATEO*).

- Include organizations that were *ATEOs* at any time in 5-year Lookback Period.
- Eliminate private foundations.
- Eliminate governmental entities. Regs. 53.4958-2T(a)(1).
- Eliminate organizations whose exemption has been revoked for reasons other than inurement or private benefit. Regs. 53.4958-2T(a)(4).

If organization is not an ATEO, IRC 4958 does not apply.

Step 2 – Determine if *ATEO* is a church.

- For churches, follow the procedures of IRC 7611. Regs. 53.4958-8T(b).

Step 3 – Identify the *disqualified persons* (*DPs*).

- Identify persons who are:

1) Automatically not *DPs*. Regs. 53.4958-3T(d).

If there are no DPs, IRC 4958 does not apply.

2) Automatically *DPs*. Regs. 53.4958-3T(c).

3) Family members of a *DP*. Regs. 53.4958-3T(b)(1).

4) Entities controlled by a *DP*. Regs. 53.4958-3T(b)(2).

5) Determine if there are facts and circumstances tending to show that the person:

Has substantial influence over the affairs of the *ATEO*. Regs. 53.4958-3T(e)(2).

If there are no DPs, IRC 4958 does not apply.

Step 4 – Determine if DPs have engaged in *excess benefit transactions*.

- Review all significant transactions between *DPs* and *ATEO*.
- Determine when each transaction *occurred*. Regs. 53.4958-1T(e).
- Determine whether each transaction *occurred* on or after September 14, 1995. Regs. 53.4958-1T(f).

  Eliminate transactions that *occurred* under a written contract that was binding on September 13, 1995 and at all times thereafter before the transaction *occurred*.

  Do not eliminate transactions that *occurred* under a binding written contract if the contract was *materially changed* after September 13, 1995.

- Determine when the *period of limitations* ends for each *excess benefit transaction*. Regs. 53.4958-1T(e)(3).

  Eliminate transactions that *occurred* after the period of limitations ended.

- ***Eliminate*** portions of transactions that involve:

  Fixed payments made under an *initial contract*. Regs. 58.4958-4T(a)(3).

  Nontaxable fringe benefits excludable under IRC 132. Regs. 53.4958-4T(a)(4)(i).

  Other disregarded benefits. Regs. 53.4958-4T(a)(4)(ii) to (v).

  Expense reimbursements paid under an "accountable plan" under Regs. 1.62-2(c)(2).

- Test the remaining transactions to determine if the *ATEO* clearly indicated its intent to treat the benefits as compensation for services. Regs. 53.4958-4T(c).

  If not, the benefits are treated as excess benefits.

- Determine the value of benefits ATEO provided to DP and the value of the consideration received from the DP. Regs. 53.4958-4T(b)(1).

  If the value of economic benefits ATEO provided to DP exceeds value of consideration received from DP, DP has received an excess benefit.

  If there is no excess benefit, IRC 4958 does not apply.

Step 5 – You have now identified the excess benefit transactions. Has the Rebuttable Presumption been established by the ATEO?

- If the Rebuttable Presumption has been established:

  Has the Service developed sufficient contrary evidence to rebut the comparability data? Regs. 53.4958-6T(b)

  If the Service cannot rebut the presumption, the transaction is not an excess benefit transaction.

- If the Rebuttable Presumption has not been established:

  Since the Rebuttable Presumption is not a requirement, analyze the transaction to determine if the DP received an excess benefit.

Step 6 – Contact EO Technical to determine if a request for technical advice should be submitted.

You can call either:

Larry Brauer	202-283-9457
Toussaint Tyson	202-283-8977
Len Henzke	202-283-8865
Debra Kawecki	202-283-9486
Chuck Barrett	202-283-8944

APPENDIX 2

REBUTTABLE PRESUMPTION CHECKLIST COMPENSATION

(See text for definitions of terms in *italics*.)

1. *Applicable tax-exempt organization*: ____________________

2. *Disqualified person*:

   Name: ____________________

   Title / Position Description: ____________________

3. Terms of compensation arrangement:

   Salary: __________

   Bonus: __________

   Deferred compensation: ____________________

   Fringe benefits (excluding IRC 132 fringes and expense reimbursements under an accountable plan):
   ____
   ____

   Liability insurance premiums: ____________________

   Foregone interest on loans: ____________________

   Other: ____________________

4. Name of *authorized body*: ____________________

5. Date *authorized body* approved compensation arrangement: __________

6. Members of a*uthorized body* on date of approval:
   A. ____________________
   B. ____________________
   C. ____________________
   D. ____________________
   E. ____________________

7. Titles / Positions in *applicable tax-exempt organization*:
   A. __________
   B. __________
   C. __________
   D. __________
   E. __________

8. Background (education, experience, etc.):
   A. __________
   B. __________
   C. __________
   D. __________
   E. __________

9. *Conflict of interest* as to compensation arrangement:
   A. __________
   B. __________
   C. __________
   D. __________
   E. __________

10. Comparable Data

   - Compensation paid by similar organizations for functionally comparable positions: __________

   - Availability of similar services in geographic area of *applicable tax-exempt organization*: __________

   - Current compensation surveys compiled by independent firms: __________

   - Actual written offers from similar institutions: __________

   - If *applicable tax-exempt organization* is a *small organization*, compensation data paid by 3 comparable organizations in similar communities for similar services:
     1. __________
     2. __________
     3. __________

11. Documentation

Description of records: ______________________________

Date records were prepared: ______________________________

Date records were approved by *authorized body*: ______________________________

Per records:

- Terms of transaction approved: ______________________________
____
- Date reviewed and approved by *authorized body* as reasonable, accurate and complete: ______________________________
- Members of *authorized body* present during debate:
  A. ______________________________
  B. ______________________________
  C. ______________________________
  D. ______________________________
  E. ______________________________
- Members of *authorized body* who voted on transaction:
  A. ______________________________
  B. ______________________________
  C. ______________________________
  D. ______________________________
  E. ______________________________
- Description of comparability data obtained and relied on by *authorized body*:
____
____
- Description of how comparability data was obtained:
____
- Description of any actions taken as to consideration of transaction by member of *authorized body* who had a *conflict of interest*: ______________________________
____
- If value determined differs from comparability data, basis for determination:
____
____

12. For a non-fixed payment subject to a cap:

- Date authorized body obtained comparability data that a fixed payment would be reasonable compensation: ______________________________

- Amount of such fixed payment: ______________________________

- Maximum amount payable under contract (both fixed and non-fixed payments): ______________________________

APPENDIX 3

REBUTTABLE PRESUMPTION CHECKLIST PROPERTY

(See text for definitions of terms in *italics*.)

1. *Applicable tax-exempt organization*: ______________________

2. *Disqualified person*:

   Name: ______________________

   Title / Position Description: ______________________

3. Property to be transferred or used:

   Description: ______________________

   Location: ______________________

4. Name of *authorized body:* ______________________

5. Date *authorized body* approved property transfer:

   ____

   Members of a*uthorized body* on date of approval:
   A. ______________________
   B. ______________________
   C. ______________________
   D. ______________________
   E. ______________________

7. Titles / Positions in *applicable tax-exempt organization*:
   A. ______________________
   B. ______________________
   C. ______________________
   D. ______________________
   E. ______________________

8. Background (education, experience, etc.):
   A. ______________________
   B. ______________________
   C. ______________________
   D. ______________________
   E. ______________________

9. *Conflict of interest* as to property transfer:
   A. ______
   B. ______
   C. ______
   D. ______
   E. ______

10. Comparable Data – Appraisals

    - Appraiser(s) name and address:

      ______
      ______

    - Appraiser(s) qualifications:

      ______
      ______

    - Date(s) of appraisal(s):

      ______
      ______

    - Fair market value per appraisal(s):

      ______
      ______

    - Appraisal method(s) used (e.g., sales comparison, income analysis, replacement cost, etc.):

      ______
      ______

11. Comparable Data – Offers received from open and competitive bidding:

    ______
    ______

12. Documentation

    Description of records: ______

    Date records were prepared: ______

    Date records were approved by *authorized body*: ______

Per records:

- Terms of transaction approved: ____________________________________
  ____
- Date reviewed and approved by *authorized body* as reasonable, accurate and complete: ____________________________________
- Members of *authorized body* present during debate:
  A. ____________________________________
  B. ____________________________________
  C. ____________________________________
  D. ____________________________________
  E. ____________________________________
- Members of *authorized body* who voted on transaction:
  A. ____________________________________
  B. ____________________________________
  C. ____________________________________
  D. ____________________________________
  E. ____________________________________
- Description of comparability data obtained and relied on by *authorized body*:
  ____
  ____
- Description of how comparability data was obtained: ____________________
  ____
- Description of any actions taken as to consideration of transaction by member of *authorized body* who had a *conflict of interest*: ____________________
  ____
- If value determined differs from comparability data, basis for determination:
  ____
  ____

Michael T. CARACCI and Cindy v. Commissioner of Internal Revenue. (2014).

118 T.C. 379
United States Tax Court.

Michael T. CARACCI and Cindy W. Caracci, et al.,[1] Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Nos. 12481–99, 12483–99, 17333–99, 17335–99, 17337–99, 17339–99X, 17341–99, 12482–99, 14711–99X, 17334–99, 17336–99X, 17338–99, 17340–99, 17342–99. | May 22, 2002.

West Headnotes (21)

[1] **Internal Revenue**
Excise
Taxes on Foundations and Trusts
"Fair market value," for purpose of determining liability for excise taxes on excess benefit transaction by tax-exempt organization, is the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of all relevant facts and neither person being under any compulsion to buy or to sell. 26 U.S.C.A. §4958(a)(1).

1 Cases that cite this headnote

[2] **Internal Revenue**
Excise
Taxes on Foundations and Trusts
When determining fair market value, for purpose of determining liability for excise taxes on excess benefit transaction by tax-exempt organization, the willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and characteristics of these hypothetical persons are not necessarily the same as personal characteristics of the actual seller or a particular buyer. 26 U.S.C.A. §4958(a)(1).

1 Cases that cite this headnote

[3] **Internal Revenue**
Excise
Taxes on Foundations and Trusts
Fair market value, for purpose of determining liability for excise taxes on excess benefit transaction by tax-exempt organization, reflects the highest and best use of the relevant property on valuation date and takes into account special uses that are realistically available because of the property's adaptability to a particular business. 26 U.S.C.A. §4958(a)(1).

1 Cases that cite this headnote

[4] **Internal Revenue**
Excise
Taxes on Foundations and Trusts
For purpose of determining liability for excise taxes on excess benefit transaction by tax-exempt organization, fair market value is not affected by whether the owner has actually put the property to its highest and best use, rather, reasonable and objective possible uses for the property control its valuation. 26 U.S.C.A. §4958(a)(1).

Cases that cite this headnote

[5] **Internal Revenue**
Excise
Taxes on Foundations and Trusts
For purpose of determining liability for excise taxes on excess benefit transaction by tax-exempt organization, the hypothetical willing buyer and seller in the fair market value determination are presumed to be dedicated to achieving the maximum economic advantage, and the hypothetical sale should not be construed

in a vacuum isolated from actual facts. 26 U.S.C.A. §4958(a)(1).

1 Cases that cite this headnote

[6] **Internal Revenue**

Excise

Taxes on Foundations and Trusts

In determining whether excess benefits were received by operators of the tax-exempt home health care providers in transfer of assets to for-profit entities, as would subject operators to liability for excise taxes, value was properly attributed to the "cost-shifting" mechanism, arising for an agency that sought less than the maximum reimbursement allowed by Medicare and from Medicare reimbursing additional costs to such agencies not permitted for hospitals and nursing homes; including the cost-shifting value considered hypothetical buyers who were positioned to use the purchased assets more profitably than other entities. 26 U.S.C.A. §4958(a)(1).

1 Cases that cite this headnote

[7] **Internal Revenue**

Admissibility

Trial court judge bears a special gatekeeping obligation to ensure that any and all expert testimony is relevant and reliable.

2 Cases that cite this headnote

[8] **Internal Revenue**

Weight

and Sufficiency

Tax Court has broad discretion to evaluate the helpfulness and persuasiveness of an expert's testimony in light of expert's qualifications and with due regard to all other credible evidence in the record.

Cases that cite this headnote

[9] **Internal Revenue**

Weight

and Sufficiency

Tax Court may embrace or reject an expert's opinion in toto, or it may pick and choose portions of the opinion to adopt.

1 Cases that cite this headnote

[10] **Internal Revenue**

Excise

Taxes on Foundations and Trusts

In determining whether excess benefits, subject to excise tax, were received by operators of tax-exempt home health care providers in sale of assets to for-profit entities, value of tax-exempt entities was determined by using the comparable value method and using the market value of invested capital (MVIC) approach to compare the privately held tax-exempt entities to similar publicly traded businesses, which harmonized the differences between debt and equity usage by publicly traded companies and privately held entities, and considered the total investment in entities. 26 U.S.C.A. §4958(a)(1).

Cases that cite this headnote

[11] **Internal Revenue**

Excise

Taxes on Foundations and Trusts

In determining whether excess benefits, subject to excise tax, were received by operators of tax-exempt home health care providers in sale of assets to for-profit entities, the accurate price-to-revenue multiple for market value of invested capital (MVIC) approach for valuing privately held tax-exempt entities should have been no higher than .25, which expert applied to merged and acquired comparable companies. 26 U.S.C.A. §4958(a)(1).

Cases that cite this headnote

[12] **Internal Revenue**

Excise Taxes on Foundations and Trusts

Valuation of home health agencies, for determining whether excess benefits, subject to excise tax, were received by operators of tax-exempt organization, should have included amounts of payroll that were withheld for longer than two weeks, not as current liabilities, but rather as part of the invested capital, where agencies paid their employees six weeks in arrears; employees effectively made loans of four weeks wages to company, which would not be repaid until employees left the agency. 26 U.S.C.A. §4958(a)(1).

Cases that cite this headnote

[13] **Internal Revenue**

Excise Taxes on Foundations and Trusts

For valuation of home health agencies, to determine whether excess benefits, subject to excise tax, were received by operators of tax-exempt organization, current liabilities were increased by amount reflecting a reserve for disallowed claims on its Medicare cost reports. 26 U.S.C.A. §4958(a)(1).

Cases that cite this headnote

[14] **Internal Revenue**

Persons Liable

Disqualified persons, who were jointly and severally liable for excise taxes imposed on excess benefits received when assets of tax-exempt organizations were transferred to for-profit corporations, included directors and officers of the tax-exempt entities, relatives of officers and directors, and the for-profit corporations, which were entities that were at least 35–percent controlled by disqualified persons. 26 U.S.C.A. §4958(a)(1), (f)(1).

Cases that cite this headnote

[15] **Internal Revenue**

Purposes and Activities of Organization

For tax-exempt organization, the presence of a single substantial nonexempt purpose can destroy the exemption, regardless of the number or importance of exempt purposes. 26 U.S.C.A. §501(c)(3).

Cases that cite this headnote

[16] **Internal Revenue**

Revocation of Exemptions

Where intermediate sanctions had been assessed against owners of tax-exempt home health providers for transferring their assets to for-profit corporations for less than fair market value, it was not appropriate to remove providers' tax-exempt status, since providers were dormant, they had not operated contrary to their exempt purpose after the transfer, and maintaining their exempt status made it possible for transferors to use correction provisions of the Internal Revenue Code. 26 U.S.C.A. §§4961 - 4963.

Cases that cite this headnote

[17] **Internal Revenue**

Extra Compensation or Gift

When property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift. 26 U.S.C.A. §2512(b).

Cases that cite this headnote

[18] **Internal Revenue**

Extra

Compensation or Gift

In the corporate setting, a transfer for less than adequate and full consideration may be a gift by the transferor to the individual shareholders of the corporation to the extent of their proportionate interests in the corporation. 26 U.S.C.A. §2512(b).

Cases that cite this headnote

[19] **Internal Revenue**

Extra

Compensation or Gift

When the shareholders of a corporation in receipt of transfer for less than full consideration are members of the transferor's family, that fact is strongly indicative of a gift, as opposed to compensation subject to income tax. 26 U.S.C.A. §2512(b).

Cases that cite this headnote

[20] **Internal Revenue**

Extra

Compensation or Gift

Transfers of stock to children of insiders who transferred assets of tax-exempt entities to for-profit corporations were gifts, rather than compensation subject to income tax, where children paid nothing for the stock, and did not contribute property for it. 26 U.S.C.A. §2512(b).

Cases that cite this headnote

[21] **Internal Revenue**

Extra

Compensation or Gift

Transfer of property to an employee who is a member of the employer's family is more properly considered a gift, rather than compensation subject to income tax, when the transfer is not made in recognition of the employee's work, but is made in connection with the family relationship. 26 U.S.C.A. §2512(b).

Cases that cite this headnote

Attorneys and Law Firms

***380** David D. Aughtry and Vivian D. Hoard, for petitioners.

Robin W. Denick and Mark A. Ericson, for respondent.

Extra **Opinion**

LARO, J.

***379** Members of the C family wholly own three home health care organizations (P1, P2, and P3) exempt from Federal income taxes under sec. 501(c)(3), I.R.C. In 1995, the C family created three S corporations (S1, S2, and S3) and collectively received all of the resulting stock. P1, P2, and P3 then transferred all of their assets to S1, S2, and S3, respectively, in exchange for each transferee's assumption of the transferor's liabilities. R determined that the fair market value of the transferred assets substantially exceeded the consideration received in exchange. Accordingly, R determined S1, S2, S3, and members of the C family were liable for excise taxes under sec. 4958, I.R.C., and members of the C family who received stock in S1, S2, or S3 but did not have an ownership interest in P1, P2, and P3 were liable for income taxes on the value of the stock received. R also revoked the tax exemptions of P1, P2, and P3. *Held:* The transferred assets' value at the time of transfer decided. *Held, further,* the value of the transferred assets exceeded the value of the consideration received; thus, S1, S2, S3, and members of the C family are "disqualified persons" subject to excise taxes under sec. 4958, I.R.C., as beneficiaries of "excess benefit transactions". *Held, further,* although P1, P2, and P3 engaged in "excess benefit transactions", a revocation of their tax-exempt status is inappropriate given the "intermediate sanctions" under sec. 4958, I.R.C. *Held, further,* the three members of the C family are not liable for the income taxes determined by R.

These cases are before the Court consolidated. Petitioners seek review of respondent's determinations for 1995 of income tax deficiencies, excise tax deficiencies under section 4958, accuracy-related penalties under section 6662(a), and revocations of exempt status under section 501(c)(3). [2] Respondent determined the following income tax deficiencies and accuracy-related penalties:

Petitioner	Deficiency	Accuracy-related penalty sec. 6662(a)
Michael T. and Cindy W. Caracci	$2,192,643	$438,528.60
Vincent E. and Denise A. Caracci	1,272,216	254,443.20
Christina C. and David C.		
McQuillen	1,272,307	254,461.40

***381** Respondent determined the following excise tax deficiencies:

	Deficiency		
Petitioner	Sec. 4958(a)(1)	Sec. 4958(a)(2)	Sec. 4958(b)
Sta–Home Health Agency	$1,948,559	–0–	$15,588,474
of Carthage, Inc.			
Sta–Home Health Agency	1,384,944	–0–	11,079,522
of Greenwood, Inc.			
Sta–Home Health Agency	1,302,420	–0–	10,419,362
of Jackson, Inc.			
Joyce P. Caracci	4,635,923	$30,000	37,087,388
Michael Caracci	4,635,923	30,000	37,087,388
Victor Caracci	4,635,923	–0–	37,087,388
Vincent E. Caracci	4,635,923	–0–	37,087,388
Christina C. McQuillen	4,635,923	30,000	37,087,388

Respondent determined that the three Sta–Home tax-exempt entities failed to qualify for tax-exempt status under section 501(c)(3). [3]

Following respondent's concession that none of petitioners are liable for section 4952(a)(2) excise taxes or section 6662(a) accuracy-related penalties, we are left to decide: (1) Whether Joyce Caracci, Michael Caracci, Victor Caracci, Vincent Caracci, Christina McQuillen, and the Sta–Home for-profit entities are liable for excise taxes under section 4958 because of the transfers of assets from the Sta–Home tax-exempt entities to the Sta–Home for-profit entities in exchange for the transferees' assumption of the transferors' liabilities (the asset transfer); (2) whether Michael Caracci, Vincent Caracci, and Christina McQuillen, as shareholders of the Sta–Home for-profit entities but not of the Sta–Home tax-exempt entities, are liable for income taxes in connection with the asset transfer; and (3) whether the asset transfer resulted in a revocation of the Sta–Home tax-exempt entities' tax-exempt status on account of a violation of section 501(c)(3); i.e., the transfer resulted in the Sta–Home tax-exempt entities' being operated for a substantial nonexempt ***382** purpose, constituted prohibited inurement, and impermissibly benefited private interests. [4]

FINDINGS OF FACT

Some facts have been stipulated. We incorporate herein by this reference the parties' stipulation of facts and the exhibits submitted therewith. We find the stipulated facts accordingly. The couples, Michael and Cindy **Caracci**, Victor and Joyce **Caracci**, Vincent and Denise **Caracci**, and Christina and David McQuillen, are husband and wife, each of whom resided in Mississippi when the petitions were filed. Christina McQuillen is the sister of Michael and Vincent **Caracci**, and the three of them are the children of Victor and Joyce **Caracci** (the father, mother, and three children are referred to collectively as the **Caracci** family). The principal place of business of the various Sta–Home entities also was in Mississippi at that time.

From 1973 to 1976, Joyce **Caracci** served as a consulting nurse for the State of Mississippi Board of Health, surveying healthcare facilities for participation in the Medicare/Medicaid programs. On May 3, 1976, Joyce **Caracci**, Victor **Caracci**, and a third individual not relevant herein started Sta–Home Home Health Agency, Inc. Approximately 1 year later, Joyce **Caracci**, Victor **Caracci**, and a third individual not relevant herein formed the other two Sta–Home tax-exempt entities. Each of the Sta–Home tax-exempt entities was formed as a nonstock corporation under Mississippi law, with Victor and Joyce **Caracci** as the owners during all relevant times. In the early years of their business, Victor and Joyce **Caracci** borrowed money collateralized by their residence to fund the Sta–Home tax-exempt entities' operations, and they (the individuals) guaranteed the extension of credit to the entities. Throughout the years, the managers of the three separate entities generally operated the entities as one integrated unit. (Because the parties also generally treat the three separate entities as one integrated unit, so do we.) During the subject year, Joyce **Caracci**, Michael **Caracci**, and Christina McQuillen were the Sta–Home tax-exempt entities' only ***383** directors and officers. Those entities employed or retained the following **Caracci** family members or spouses in the corresponding position:

Individual	Position
Victor **Caracci**	Consultant
Joyce **Caracci**	Chief operating officer/administrator
Michael **Caracci**	Chief executive officer
Christina McQuillen	Director of personnel
Vincent **Caracci**	General counsel

Denise Caracci	Nurse (from August 1991 to May 1995)
David McQuillen	Maintenance man

The Sta–Home tax-exempt entities participated in the Medicare program. Medicare was established in title XVIII of the Social Security Act, Pub.L. 89–97, 79 Stat. 291 (1965), and is the principal healthcare insurance for individuals who are either disabled or aged 65 or older. It is administered by the Healthcare Financing Administration (HCFA), a division of the U.S. Department of Health and Human Services, with whom private insurance companies in different regions of the country have contracted to serve as fiscal intermediaries.

In 1995, Medicare reimbursed home healthcare providers at an amount that equaled the lesser of the actual reasonable cost or customary charges, up to the maximum "cost cap"; i.e., the aggregate per-visit costs limitation under the law applicable to Medicare. During 1995, Medicare paid home health care agencies for the necessary services they provided to covered beneficiaries on a retrospective cost system under which Medicare sent a "periodic interim payment" (PIP) every 2 weeks to home health care agencies to cover claims activity. The Sta–Home tax-exempt entities used the PIP payments to fund their payroll, which was paid biweekly. Home health care agencies also submitted quarterly reports and filed annual cost reports with the fiscal intermediary. If PIP payments differed from the payments allowable as ascertained from the cost report, the fiscal intermediary made the appropriate adjustment by reimbursing the home health care agency for an underpayment or requiring the agency to remit an overpayment. The Aetna Insurance Co ., which was the ***384** fiscal intermediary for the Sta–Home tax-exempt entities, disallowed the Sta–Home tax-exempt entities' claimed costs on various items such as advertisements, pencils, cell phones, pagers, desks, and nurse recruiting. The average amount of disallowed costs annually was .7 percent.

Under Mississippi law, a certificate of need (CON) is required to operate a licensed home health agency. Since 1983, Mississippi has had a moratorium on issuing new home health care licenses. In 1995, the only method of establishing a new home health care agency business in Mississippi was to purchase the license of an existing licensed home health care agency. Although several bills have been introduced in the Mississippi legislature to lift the moratorium, none has ever been enacted. Michael Vincent, the chief executive officer of the Sta–Home corporations, had personally contacted members of the Mississippi legislature to urge them not to lift the moratorium. He also had urged others to ask the Mississippi legislators not to lift the moratorium. From 1986 to 1993, the home health care business in Mississippi increased 340 percent (as compared to doubling nationally), but no new home health care agencies had entered that State.

In 1995, the Sta–Home tax-exempt entities ranked first or second in market share in 14 of the 19 counties in their service area. "Sta–Home" was a recognized name in home health care in Mississippi, and it had a generally good reputation among Mississippi's elderly population. In 1993, the Sta–Home tax-exempt entities were the first freestanding agencies in Mississippi to become accredited by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). JCAHO accreditation required achieving or exceeding certain regulatory standards, including conditions as to the quality of patient care. During 1995, the Sta–Home tax-exempt entities provided 834,596 home health care visits, and over 95 percent of the entities' services were to Medicare beneficiaries. The Sta–Home tax-exempt entities also had several manuals that they had developed in-house regarding policies and procedures, including personnel, nursing, home health aid, physical therapy, and social work manuals.

It was generally recognized that under the Medicare reimbursement system in place in 1995, there was no ability for home health agencies to realize profits beyond costs and ***385** that the reimbursement system provided little incentive for providing services efficiently. This situation prevailed because Medicare reimbursed a home health agency only for "allowable" costs at its discretion. Therefore, any denied claim for reimbursement produced a cash outflow to the business. The Sta–Home tax-exempt entities generated gradually increasing revenue, but also commensurate losses, in the 3 years preceding October 1, 1995.

The Sta–Home tax-exempt entities' accounting firm prepared unaudited combined financial statements. The results from operations reported by the combined Sta–Home tax-exempt entities on their returns for fiscal years ended September 30, 1991 through 1995, were:

Year	Revenue	Expenses	Net Income (Loss)
1991	$11,736,061	$11,799,721	($63,660)
1992	18,442,072	18,414,315	27,757
1993	25,162,701	25,208,255	(45,554)
1994	36,882,957	37,141,686	(258,729)
1995	44,101,849	44,535,239	(433,390)

According to those combined financial statements, the total assets and liabilities of the Sta–Home tax-exempt entities for those years were:

Year	Assets	Liabilities	Deficit
1991	$3,203,759	$3,787,285	($583,526)
1992	5,404,925	5,960,696	(555,771)
1993	6,910,710	7,639,855	(729,145)
1994	7,515,492	8,417,027	(901,535)
1995	10,736,407	12,144,655	(1,408,248)

To ease their financial statuses, the Sta–Home entities required their employees—including the **Caracci** family members themselves—to forgo payment for the first 6 weeks of employment. After that initial period, the employees were entitled to collect a paycheck for 2 weeks' work. The 4 weeks' initial earnings were withheld until the employees left the companies.

The Sta–Home tax-exempt entities had a policy of giving its employees discretionary bonuses. For the pay period ended December 12, 1994, the entities paid bonuses totaling $966,204 to all personnel with the exception of new hires. On ***386** April 10, 1995, the entities also approved for the directors bonuses of 15 percent. For the pay period ended June 23, 1995, the entities approved additional bonuses totaling $664,116. On September 29, 1995, the entities approved further bonuses totaling $2,314,086; this bonus created a $2,314,086 liability that was assumed by the Sta–Home for-profit entities incident to the asset transfer.

Mississippi historically reports the lowest per capita income of any State with corresponding high unemployment and low education levels. An official Mississippi State Health Plan, prepared in 1995, indicated that poorly educated, low-income, and ill-housed people often had greater healthcare needs than other members of society. The socioeconomic characteristics of the Sta–Home tax-exempt entities' service territory produced a higher use of home health care services in comparison to other areas of the country. In 1992, Medicare paid an average of $13,432 per Mississippi patient, ranking the State highest in Federal payments per recipient among all States. During 1994 and 1995, 95 percent of all visits made by home health agencies operating in Mississippi were paid for by Medicare.

During 1994 and 1995, the prospect arose of Medicare's shifting from a PIP cost reimbursement system to a prospective payment system (PPS). Several groups discussed the proposal in theory, but no one knew exactly what form PPS might take. The Sta–Home tax-exempt entities, through Vincent **Caracci**, an attorney whose job included keeping abreast of current events, learned of these proposed changes. Petitioners came to understand that the Sta–Home tax-exempt entities would not under a PPS receive a check every 2 weeks but would have to file a claim for every service rendered and wait for the claim to be processed and paid. Petitioners became concerned about the lack of cashflow under a PPS. They also believed that a PPS would reduce the Sta–Home tax-exempt entities' income.

Late in December 1994, the **Caracci** family consulted an attorney named Thomas Kirkland (Kirkland) about converting the Sta–Home tax-exempt entities into for-profit corporations. Kirkland's firm represented many home health care agencies, and he had recommended that all of those agencies make such a conversion. Kirkland's recommendation was based, in part, on his discussions with bankers who were ***387** reluctant to lend money to nonprofit home healthcare agencies. By 1991, petitioners' regular accountant, Danny Hart (Hart), also recommended that the Sta–Home tax-exempt entities convert to nontax-exempt status.

Kirkland retained a tax attorney named James Pettis (Pettis) to help Kirkland convert the Sta–Home tax-exempt entities into for-profit entities. Subsequently, Pettis learned that Kirkland's firm had not obtained an appraisal for any of its previous conversions. Pettis informed Kirkland that Pettis "strongly [disagreed]" with that approach. By letter dated July 7, 1995, Kirkland's firm retained Hart's accounting firm to appraise the Sta–Home tax-exempt entities' net assets as of a proposed transaction date of October 1, 1995.

The appraisal was slow in coming. Pettis, the tax adviser, insisted on seeing the appraisal before proceeding with any transaction that would effect a conversion. After reading the appraisal, Pettis was concerned that it failed to deal with issues concerning intangible assets. He believed that the mere fact that an entity had lost money or had a negative cashflow did not mean that the entity was worthless. He also was concerned that the appraisal failed to address Rev. Rul. 59–60, 1959–1 C.B. 237, where the Commissioner has set forth standards on valuation for Federal income tax purposes. Upon Pettis's request, he received a second appraisal. Because some of his concerns as to intangible assets remained after reading the second appraisal, he sought and received assurance that the Sta–Home tax-exempt entities' liabilities far exceeded the value of their assets and that the value of the intangibles would not give the entities a positive fair market value.

On July 11, 1995, the Sta–Home tax-exempt entities' boards of directors authorized the conversion of those entities into S corporations. The S status was chosen so that the shareholders could deduct the new entities' future losses. On August 22, 1995, in anticipation of a transfer of the Sta–Home tax-exempt entities' assets, Kirkland's firm, with petitioners' approval, formed the Sta–Home for-profit entities under Mississippi law. Each of those corporations subsequently elected to be taxed as an S corporation for Federal income tax purposes. Since their formation, the only shareholders of each of the Sta–Home for-profit entities have been Joyce **Caracci** (17.5 percent), Victor **Caracci** (17.5 percent), ***388** Michael **Caracci** (30 percent), Christina McQuillen (17.5 percent) and Vincent **Caracci** (17.5 percent). The only directors and officers have been members of the **Caracci** family.

On August 28, 1995, Hart's accounting firm tendered an appraisal stating that the value of the Sta–Home tax-exempt entities' assets was less than their liabilities. Kirkland had assumed that this would be the case. On September 1, 1995, Kirkland executed and filed on behalf of each of the Sta–Home tax-exempt entities "Notices of Intent to Change Ownership" with the State of Mississippi Department of Health.

Effective October 1, 1995, Sta–Home Home Health Agency, Inc., transferred all of its tangible and intangible assets to Sta–Home Health Agency of Jackson, Inc., Sta–Home Home Health Agency, Inc., of Forest, Mississippi, transferred all of its tangible and intangible assets to Sta–Home Health Agency of Carthage, Inc., and Sta–Home Home Health Agency, Inc., of Grenada, Mississippi, transferred all of its assets to Sta–Home Health Agency of Greenwood, Inc. The consideration paid by each transferee was the assumption of the related transferor's liabilities. Since the transfers, the transferors have not engaged in any activities, charitable or otherwise; nor have they been dissolved under Mississippi law.

On October 19, 1995, Robert Crowell, Hart's accounting partner, sent a letter to Kirkland setting forth several reasons that Sta–Home should convert to a profit corporation from a nonprofit. These included the need to raise capital and/or enter into profit-making ventures, in view of the past losses and accumulated deficit; the ability to participate in major changes taking place in the healthcare industry, including mergers and acquisitions; the provision of ownership interests for succession plans to keep key management in place; and the ability to deal with changes in the reimbursement system within the near future. Four days later, the documents were executed that constitute the contract under which all of the transferors' assets were transferred to the transferees.

Other than State and Federal filing requirements and the slight changes in the names of the entities, the Sta–Home operations remained the same after the transfer as they were before. The Sta–Home for-profit entities continued to use a ***389** fiscal year ending on September 30 for financial accounting and Medicare reporting purposes, although not for tax purposes. As part of the transfers, the Sta–Home for-profit entities accepted assignment of the Sta–Home tax-exempt entities' Medicare provider agreements and continued to use the provider numbers of the Sta–Home tax-exempt entities. The Sta–Home for-profit entities continued to receive PIP payments and lump-sum settlements from the Medicare program, including quarterly payments based on quarterly PIP reports. The Sta–Home for-profit entities received a net preacquisition payment relating to settlement of the Sta–Home tax-exempt entities' 1987 fiscal year. Substantially, the same employees continued to do the same work, and the same assets were used in the same three locations. The **Caracci** family members continued to be employed by the Sta–Home for-profit entities in the same positions in which they were employed by the Sta–Home tax-exempt entities, and each member's compensation and employment benefits remained subject to review by HCFA through the cost reporting process. The 1995 and 1996 combined salaries paid to Joyce **Caracci**, Michael **Caracci**, Vincent **Caracci**, and Christina McQuillen [5] by the Sta–Home entities were as follows:

Individual	1995	1996
Joyce **Caracci**	$140,472	$141,685
Michael **Caracci**	226,483	232,686
Vincent **Caracci**	70,180	65,434
Christina McQuillen	64,514	55,952

The mid–1990's showed significant growth in the home health care industry. Natl. expenditures for home nursing care grew from $3.8 billion in 1990 to $20.5 billion in 1997. There was also substantial activity in home health care agency acquisitions. There were 42 such acquisitions in 1994, 60 in 1995, 112 in 1996, and 139 in 1997.

During 1995, the primary buyers of home health agencies were hospitals, nursing homes, and other home health agencies. They were able to take advantage of a mechanism known as "cost-shifting". This attribute enabled a buyer such as a hospital (which generally received reimbursement under the PPS) to shift some of its costs to a cost reimbursement ***390** system for payment by the Medicare program. Cost shifting was possible because: (1) The purchased home health care agencies had room under their cost cap because they had sought less than the maximum reimbursement allowed by Medicare and (2) Medicare reimbursed home health care providers for costs, such as overhead, that were not directly related to home visits. Hospitals and nursing homes could benefit by acquiring a home health care agency and shifting some of their overhead costs to that agency to the extent that there was room under its cost cap.

During 1994 and 1995, a number of home health agencies in Mississippi were sold. The State Board of Health identified 11 such acquisitions. Seven were by hospitals; two were by home health care agencies; one was by an individual from a bankruptcy trustee, and one was a corporate reorganization. All of the acquisitions by hospitals involved home health agencies in or near Mississippi, although on occasion the corporate headquarters of the acquiring corporations were located outside Mississippi. In 1995, the Deaconess Hospital Corp. of Cincinnati, Ohio, acquired the stock of Southern Mississippi Home Health, Inc., a Mississippi corporation.

Home health agencies remained under a cost reimbursement system until September 30, 1999, when legislation passed by Congress in 1997 providing a PPS for home health agencies took full effect. HCFA encountered problems implementing the system, and it was not finally implemented until October 1, 2000.

OPINION

I. ***Introduction***

Respondent has determined that petitioners' participation in the asset transfer made them liable for deficiencies totaling $256,114,435. [6] Respondent's determination rests on his expert's determination that the fair market value of the transferred assets exceeded the assumed liabilities by approximately $20 million. Petitioners argue that the ***391** assumed liabilities exceeded the fair market value of the transferred assets. Petitioners rely on their expert, who concluded similarly. It is with this backdrop that we proceed to decide the assets' value at the time of the transfer. We bear in mind the wide difference in values ascertained by the experts.

II. ***Fair Market Value***

A. *Overview*

[1] [2] A determination of fair market value is factual, and a trier of fact must weigh all relevant evidence of value and draw appropriate inferences. *Commissioner v. Scottish Am. Inv. Co.*, 323 U.S. 119, 123–125, 65 S.Ct. 169, 89 L.Ed. 113 (1944); *Helvering v. Natl. Grocery Co.*, 304 U.S. 282, 294, 58 S.Ct. 932, 82 L.Ed. 1346 (1938); *Zmuda v. Commissioner*, 79 T.C. 714, 726, 1982 WL 11177 (1982), affd. 731 F.2d 1417 (9th Cir.1984); *Mandelbaum v. Commissioner*, T.C. Memo.1995–255, affd. without published opinion 91 F.3d 124 (3d Cir.1996). Fair market value is the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of all relevant facts and neither person being under any compulsion to buy or to sell. *United States v. Cartwright*, 411 U.S. 546, 551, 93 S.Ct. 1713, 36 L.Ed.2d 528 (1973); *Kolom v. Commissioner*, 644 F.2d 1282, 1288 (9th Cir.1981), affg. 71 T.C. 235, 1978 WL 3305 (1978); *Estate of Hall v. Commissioner*, 92 T.C. 312, 335, 1989 WL 10688 (1989). See generally Rev. Rul. 59–60, 1959–1 C.B. 237. The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the characteristics of these hypothetical persons are not necessarily the same as the personal characteristics of the actual seller or a particular buyer. *Propstra v. United States*, 680 F.2d 1248, 1251–1252 (9th Cir.1982); *Estate of Bright v. United States*, 658 F.2d 999, 1005–1006 (5th Cir.1981); *Estate of Jung v. Commissioner*, 101 T.C. 412, 437–438, 1993 WL 460544 (1993); *Mandelbaum v. Commissioner, supra.*

[3] [4] [5] Fair market value reflects the highest and best use of the relevant property on the valuation date and takes into account special uses that are realistically available because of the property's adaptability to a particular business. *Mitchell v. United States*, 267 U.S. 341, 344–345, 45 S.Ct. 293, 69 L.Ed. 644 (1925); *Symington v. Commissioner*, 87 T.C. 892, 896, 1986 WL 22044 (1986); *Stanley Works v. Commissioner*, 87 T.C. 389, 400, 1986 WL 22172 (1986); *Estate of Proios v.* ***392** *Commissioner*, T.C. Memo.1994–442. Fair market value is not affected by whether the owner has actually put the property to its highest and best use. The reasonable and objective possible uses for the property control the valuation thereof. *United States v. Meadow Brook Club*, 259 F.2d 41, 45 (2d Cir.1958); *Stanley Works v. Commissioner, supra* at 400. The hypothetical willing

buyer and seller are presumed to be dedicated to achieving the maximum economic advantage, *Estate of True v. Commissioner*, T.C. Memo.2001–167, and the " hypothetical sale should not be construed in a vacuum isolated from the actual facts", *Estate of Andrews v. Commissioner*, 79 T.C. 938, 956, 1982 WL 11197 (1982).

[6] Here, the parties dispute whether any value should be given to the Sta–Home tax-exempt entities' cost-shifting attribute. Cost-shifting could attract prospective purchasers, such as hospitals, that desired to acquire a home health care agency and use its cost-shifting capacity. At our request, the parties have discussed whether attributing value to this mechanism is consistent with the requirement that fair market value be determined using a "hypothetical" buyer. We conclude that it is. A hypothetical buyer may be one of a class of buyers who is positioned to use the purchased assets more profitably than other entities. Accordingly, we have held that fair market value takes into account special uses that are realistically available because of a property's adaptability to a particular business. *Stanley Works v. Commissioner, supra* at 400. Acknowledging the existence of such businesses in the universe of hypothetical buyers also is consistent with the standard that assets are not valued in a vacuum but, instead, are valued at their highest and best use.

The cases petitioners cite do not require a different conclusion. The cases of *Morrissey v. Commissioner*, 243 F.3d 1145 (9th Cir.2001), revg. and remanding *Estate of Kaufman v. Commissioner*, T.C. Memo.1999–119, *Estate of Andrews v. Commissioner, supra,* and *Estate of Magnin v. Commissioner*, T.C. Memo.2001–31, stand for the proposition, which we accept, that the attributes of a hypothetical willing buyer cannot be limited to those of a particular buyer. That proposition is inapplicable where, as here, we do not confine the hypothetical buyer to a specific and identifiable buyer but include the entire class of buyers for whom the Sta–Home ***393** tax-exempt entities' cost-shifting attributes could be especially adaptable. *Stanley Works v. Commissioner, supra.*

Nor are petitioners assisted by citing *Estate of Davis v. Commissioner*, 110 T.C. 530, 1998 WL 345523 (1998). There, we rejected the Commissioner's attempt to narrow the field of hypothetical willing buyers. The Commissioner had done so by advancing the unwarranted assumption that a hypothetical buyer would cause the acquired corporation to escape its potential tax liabilities by having it elect S corporation status and by not permitting it to sell any of its assets for 10 years thereafter. Unlike the assumption there, the assumption here that the cost-shifting attribute is a valuable asset is fully warranted. In fact, as explained below, both experts have ascribed value to the Sta–Home tax-exempt entities' cost-shifting mechanism. In addition, petitioners' expert, Alfred D. Hahn (Hahn), has elsewhere written that "transaction prices reflect the value to a buyer to shift overhead costs". Hahn et al., "Home Health Agency Valuation: Opportunity Amid Chaos", Intrinsic Value (Spring 1998).

B. ***Role of the Expert***

[7] As typically occurs in a case of valuation, each party relies primarily upon an expert's testimony and report to support the respective positions on valuation. A trial judge bears a special gatekeeping obligation to ensure that any and all expert testimony is relevant and reliable. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 147, 119 S.Ct. 1167, 143 L.Ed.2d 238 (1999); *Daubert v. Merrill Dow Pharm., Inc.*, 509 U.S. 579, 589, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993).

[8] [9] The Court has broad discretion to evaluate the cogency of an expert's analysis. *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43, 85, 2000 WL 1048512 (2000). Sometimes, an expert will help us decide a case. E.g., *Booth v. Commissioner*, 108 T.C. 524, 573, 1997 WL 328581 (1997); *Trans City Life Ins. Co. v. Commissioner*, 106 T.C. 274, 302, 1996 WL 208816 (1996); see also *M.I.C., Ltd. v. Commissioner*, T.C. Memo.1997–96; *Estate of Proios v. Commissioner, supra.* Other times, he or she will not. E. g., *Estate of Scanlan v. Commissioner*, T.C. Memo.1996–331, affd. without published opinion 116 F.3d 1476 (5th Cir.1997); *Mandelbaum v. Commissioner*, T.C. Memo 1995–255 Aided by our common sense, we weigh the helpfulness and persuasiveness of an expert's testimony in light of his or her qualifications and ***394** with due regard to all other credible evidence in the record. *Neonatology Associates, P.A. v. Commissioner, supra* at 85. We may embrace or reject an expert's opinion in toto, or we may pick and choose the portions of the opinion

to adopt. *Helvering v. Natl. Grocery Co.*, 304 U.S. at 294–295; *Silverman v. Commissioner*, 538 F.2d 927, 933 (2d Cir.1976), affg. T.C. Memo.1974–285; *IT & S of Iowa, Inc. v. Commissioner*, 97 T.C. 496, 508, 1991 WL 231132 (1991); see also *Pabst Brewing Co. v. Commissioner*, T.C. Memo.1996–506. We are not bound by an expert's opinion and will reject an expert's opinion to the extent that it is contrary to the judgment we form on the basis of our understanding of the record as a whole. *Orth v. Commissioner*, 813 F.2d 837, 842 (7th Cir. 1987), affg. *Lio v. Commissioner*, 85 T.C. 56, 1985 WL 15372 (1985); *Silverman v. Commissioner, supra* at 933; *IT & S of Iowa, Inc. v. Commissioner, supra* at 508; *Chiu v. Commissioner*, 84 T.C. 722, 734, 1985 WL 15340 (1985).

Here, the experts began by observing that the methodology traditionally used in business appraisals includes an income approach, a cost approach, and a market approach. In an income approach, value depends upon the present future economic benefits to be derived from ownership. An enterprise's price-per-share value is then estimated by discounting the net cashflow available for distribution back to their present value, at market-based rates of return. The cost approach uses estimates of current costs to replace the enterprise's fixed assets and certain intangible assets. The market approach establishes the value of a privately held corporation through analyses of sales or transfers of guideline companies. The information derived from this analysis is then used to form an opinion of market value for a subject company.

C. ***Expert Testimony for Petitioners***

To support their contention that the value of the Sta–Home tax-exempt entities' assets was less than the liabilities assumed, petitioners rely upon the report and testimony of Hahn. Hahn, a director in PricewatershouseCoopers Northeast Region Corporation Valuation Consulting Group, has written extensively on the valuation of home healthcare agencies and has frequently appeared as an expert witness.

***395** Hahn started by noting that because of the predominance of Medicare in the payor mix of most home health agencies, a conventional cashflow or earnings approach to valuation would produce "a very different result from other, more appropriate approaches." This is so because home health agencies, with a preponderance of Medicare-eligible patients, earn little if any profit. [7]

Hahn instead relied principally upon an "Adjusted Balance Sheet" methodology, a form of the cost approach. That methodology restates a company's accounting balance sheet to its fair market value equivalent. Hahn explained that this approach involves the identification and valuation of tangible and intangible assets and liabilities, whether or not they appear on the subject company's accounting balance sheet.

Hahn started with the unaudited balance sheets prepared by petitioners' accounting firm in 1995. He concluded that several of the Sta–Home tax-exempt entities' asset accounts required revaluation. He noted that there were several "unrecorded material assets and liabilities" in addition to the assets and liabilities on the balance sheets. In terms of the assets, he indicated that economic intangible assets should be adjusted to fair market value. He also included some liabilities that were not recorded on the unaudited balance sheet, such as a balance due to Medicare from the Jackson and Grenada facilities for the fiscal year 1993. He further made allowance for pending events which, he opined, suggested the possibility of future claims against the companies, such as a reserve for future downward reimbursement adjustments by Medicare.

Hahn observed that the passage of time had obscured the then-current value of the companies because the analysis was prepared 5 years after the actual transaction. Accordingly, Hahn prepared both a "base case" and a "best case" scenario to develop a range of fair market values. He concluded that the fair market value of the Sta–Home tax-exempt entities' total tangible and intangible assets was between $10.5 million and $11.5 million. He noted that the entities' total recorded and contingent liabilities were ***396** between $12 million and $12.5 million. His result indicates that the combined liabilities of the Sta–Home tax-exempt entities exceeded the value of their assets by $.5 million to $2 million.

The following tables set forth Hahn's "base case" and "best case" adjusted balance sheets. The first figure column lists the unaudited balance sheets for the fiscal year ended September 30, 1995. The next column (PwC Valuation Adjustments) shows changes made by Hahn. The last column shows Hahn's estimate of the fair market value of each category after making his changes.

Valuation of Sta–Home Agency, Inc.—Combined

Adjusted Balance Sheet Approach

Valuation Performed as of 9/30/95

Best Case Scenario

	Compiled FYE 9/30/95	PwC Valuation Adjustments	Fair Market Value FYE 9/30/95
Cash	$1,271,031	—	$1,271,031
Accounts receivable	9,115,026	($857,786)	8,257,240
Allowance for contractual adjustments	(4,205,058)	274,701	(3,930,357)
Allowance for bad debts	—	(264,444)	(264,444)
Est. third-party payor settlements —Medicare	2,269,063	(295,473)	1,973,590
Allowance for unsuccessful claims	—	(543,803)	(543,803)
Accounts receivable— employ ees	51,518	—	51,518
Accounts receivable—other	96,820	—	96,820
Prepaid expenses	656,465	—	656,465
Total current assets	9,254,865	—	7,568,060
Property, plant & equipment	2,850,538	—	2,850,538
Accumulated depreciation	(1,456,464)	—	(1,456,464)

Total PP & E	1,394,074	—	1,394,074
Deposits	9,033	—	9,033
Long-term accounts receivable—other	78,435	(59,610)	18,825
Total other assets	87,468	—	27,858
Workforce-in-place	—	2,100,000	2,100,000
Cost-shifting capacity	—	667,467	667,467
Total intangible assets	—	—	2,767,467
		—	
Total assets	10,736,407		11,757,459
Current portion of long-term debt	369,967	—	369,967
Accounts payable	750,199	—	750,199
Accounts payable —other	165,808	—	165,808
Accrued payroll	5,009,968	—	5,009,968
Accrued payroll taxes	1,141,431	—	1,141,431
Other accrued expenses	4,206,978	—	4,206,978
Due to Medicare	—	201,000	201,000
Total current liabilities	11,644,351	—	11,845,351
Notes payable, long-term portion	500,304	—	500,304
Total liabilities	12, 144,655	—	12,345,655
Liabilities in excess of assets	(1,408,248)	—	(588,196)

Valuation of Sta–Home Agency, Inc.—Combined APPENDIX C

Adjusted Balance Sheet Approach

Valuation Performed as of 9/30/95

Best Case Scenario

	Compiled FYE 9/30/95	PwC Valuation Adjustments	Fair Market Value FYE 9/30/95
Cash	$1,271,031	—	$1,271,031
Accounts receivable	9,115,026	($1,072,232)	8,042,794
Allowance for contractual adjustments	(4,205,058)	274,701	(3,861,682)
Allowance for bad debts		(142,885)	(142,885)
Est. third-party payor sett lements —Medicare	2,269,063	(295,473)	1,973,590
Allowance for unsuccessful claims		(1,087,606)	(1,087,606)
Accounts receivable—employ ees	51,518	—	51,518
Accounts receivable—other	96,820	—	96,820
Prepaid expenses	656,465	—	656,465
Total current assets	9,254,865	—	7,000,045
Property, plant & equipment	2,850,538	—	2,850,538
Accumulated depreciation	(1,456,464)	—	(1,456,464)
Total PP & E	1,394,074	—	1,394,074
Deposits	9,033	—	9,033

Long-term accounts receivable—other	78,435	(59,610)	18,825
Total other assets	87,468	—	27,858
Workforce-in-place	—	2,100,000	2,100,000
Total intangible assets	—	—	2,100,000
Total assets	10,736,407		10,521,977
Current portion of long-term debt	369,967	—	369,967
Accounts payable	750,199	—	750,199
Accounts payable—other	165,808	—	165,808
Accrued payroll	5,009,968	—	5,009,968
Accrued payroll taxes	1,141,431	—	1,141,431
Other accrued expenses	4,206,978	—	4,206,978
Due to Medicare	—	201,000	201,000
Total current liabilities	11,644,351	—	11,845,351
Notes payable, long-term portion	500,304	—	500,304
Unaudited cost reports	—	(517,909)	517,909
Total liabilities	12,144,655	(718,909)	12,863,564
Liabilities in excess of assets	(1,408,249)	(933,338)	(2,341,587)

***398** To corroborate his findings of net asset value, Hahn used a market-transaction approach. This approach involved valuing the Sta–Home tax-exempt entities on the basis of market values of comparable companies that had been sold. To Hahn, the comparable approach was only a secondary indication of value, because sales of other individual home health care agencies appeared to be too "idiosyncratic" to provide a principled basis for valuation. In any event, Hahn noted that approximately 50 applications to change ownership had been filed by home health care agencies in Mississippi during the 11–year period ended in 1995. Little information was available as to these ownership changes, and Hahn found only two guideline transfers.

Hahn further noted that the Sta–Home tax-exempt entities were focused almost entirely upon traditional home health care and depended almost entirely upon Medicare payments. Publicly traded companies, by contrast, usually utilized traditional home health care agencies as part of a broader mix of health care business. Hahn concluded, therefore, that a comparison to publicly traded companies would not be appropriate to value the Sta–Home tax-exempt entities, and he instead utilized "readily available" information on 13 comparable sales derived from privately held transactions engaged in by those publicly traded companies. From these privately held transactions, Hahn excluded sales of privately held home health agencies that provided sophisticated "infusion or respiratory therapy" because those could attract reimbursement at a higher rate than those available to the more traditional home health care agencies such as Sta–Home.

Principally upon the basis of his adjusted balance sheet and comparable market computations, Hahn reached an ultimate conclusion that the Sta–Home tax-exempt entities' liabilities exceeded their total tangible and intangible assets by $600,000 to $2,350,000.

Finally, Hahn turned his attention to making adjustments to the Sta–Home for-profit entities' stock for "control premiums" and lack of marketability. He hypothecated that no additional premium for control of the Sta–Home tax-exempt entities was appropriate because the sale of 100 percent of the Sta–Home tax-exempt entities was contemplated (therefore, all of the value of the companies would be included in ***399** the transaction price). He also concluded that any adjustment to reflect the fact that Mississippi presented an unattractive market for the sale of the Sta–Home tax-exempt entities had been incorporated into his adjusted balance sheet valuation.

With respect to the value of the stock held by the individual shareholders, Hahn noted that no one individual could control the Sta–Home tax-exempt entities. While he believed that this usually would require that a minority discount be reflected in the value of the shares held by the noncontrolling shareholders, he concluded that a minority discount was not appropriate here because the shares represented equity interests in a loss corporation. He noted, however, that at the time of the asset transfer the appropriate control premium and market discount in the home health care industry were approximately 36 percent and 26 percent, respectively.

D. ***Expert Testimony for Respondent***

Charles A. Wilhoite (Wilhoite) presented expert testimony on behalf of respondent. Wilhoite, a certified public accountant, is a principal of Willamette Management Associates and codirector of that firm's office in Portland, Oregon. He has performed a number of assignments involving the analysis and appraisal of professional practices, with a heavy concentration in the health care field. He has been involved with assignments requiring the valuation of intangible assets, including CONs, customer relationships, goodwill, and workforces.

Petitioners argue that Wilhoite's testimony should be stricken because, they claim, his qualifications as an expert and his methodology are insufficient to meet the standards set forth in *Daubert v. Merrill Dow Pharm., Inc.,* 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993). These contentions are nonsensical and border on the frivolous. *Gross v. Commissioner,* T.C. Memo.1999–254, affd. 272 F.3d 333 (6th Cir.2001). We have no reason to question our recognition of Wilhoite as an expert on the fair market valuation of health industry and related businesses; i.e., the business of the Sta–Home tax-exempt entities. Nor are we unsatisfied as to the reliability of his methodology, including ascertaining the fair market values of invested capital ***400** for comparable entities. *BTR Dunlop Holding, Inc. v. Commissioner,* T.C. Memo.1999–377.

Turning to Wilhoite's testimony, Wilhoite, like Hahn, considered the three principal means of valuing a company's assets; i.e., the income, cost, and market approaches. Wilhoite rejected the cost approach as a means of valuing the Sta–Home tax-exempt entities. He noted that the value of the Sta–Home tax-exempt entities' intangible assets was especially important because the entities were service-based business with a relatively low investment in tangible assets. He noted that the Sta–Home tax-exempt entities' intangible assets included operating licenses, Medicare certifications, patient lists, referral relationships, a trained and assembled workforce, proprietary policies and procedures and trade name, and a going concern value. He noted that the CONs had been subject to a moratorium for the 12 years prior to the valuation date. He noted that "health issues" prevented him from learning details about the Sta–Home tax-exempt entities' intangible assets from the Sta–Home tax-exempt entities' management and that much of that information was simply not available.

He explained that several of the home health care agencies acquired in recent transactions had incurred losses immediately before their sale. He observed, however, that the purchasers of those agencies still had paid considerable amounts to acquire them. To Wilhoite, this factor indicated that the intangible assets even of companies that showed losses were worth considerable sums to potential acquirers. Moreover, it indicated to Wilhoite that an examination of similar acquisitions would result in an indication of a value which included the value of intangible assets.

Wilhoite decided that a better valuation would come from employing the market approach; i.e., examining transfers of ownership of comparable home health care agencies. His market approach utilized two types of transfers. One involved the valuation of comparable publicly traded home health care agencies. The other valued the consideration paid for merged or acquired companies. In addition to the two-pronged market approach, Wilhoite also utilized an income method, wherein he calculated the value of the Sta–Home tax-exempt entities' cost-savings attribute to a potential buyer.

***401** As a basis for his valuations under both the market and income approaches, Wilhoite ascertained the market value of invested capital (MVIC) for the Sta–Home tax-exempt entities. The MVIC represents the market value of a company's capital structure—all of its ownership equity and all of its interest-bearing debt. The MVIC method is commonly used in the valuation of closely held companies. Its use operates to minimize differences in capital structure between a closely held company and publicly traded companies which are used as comparables. See Pratt et al., Valuing Small Business and Professional Practices 548 (3d ed.1998).

Wilhoite turned first to the market approach, examining the value of publicly traded companies that operated home health care agencies. For each of these, he ascertained a "revenue pricing multiple"; i .e., a percentage that when multiplied by the annual revenues of a home health care agency would reflect the MVIC of that agency. The MVIC of the comparable companies reflected a median revenue multiple of .61. Because Sta–Home tax-exempt entities were nonprofit companies, however, their returns on invested capital were considerably lower. Wilhoite selected a multiple of .3, noting that this multiple represented a discount of 50 percent from the median guideline company multiple. He then multiplied .3 times the Sta–Home tax-exempt entities' 1995 revenues of $45,209,000 to arrive at an MVIC for the Sta–Home tax-exempt entities of $13,563,000.

Wilhoite next turned his attention to the guideline merged and acquired company method. He examined figures available from publications such as the "Home Health Care M & A Report" published by Irving Levin Associates, Inc. He pointed out that two of the comparable merged or acquired companies were very close in revenues to the Sta–Home tax-exempt entities; of those two, the MVIC of Patient–Care, Inc., represented a revenue multiple of .40, and the MVIC of Magellan Health Services, Inc., reflected a revenue multiple of 1.08. With respect to a comparable company that operated at a loss, namely, Nurse–Care, Inc., Wilhoite noted that when acquired, it had reported revenues of $15.3 million but overall losses of 1.9 percent. Nurse–Care, Inc., sold for an MVIC revenue multiple of .21. Taking these factors into consideration, Wilhoite selected a revenue multiple of .25 times the last year's revenue. This amount was approximately 20 percent ***402** higher than that of Nurse–Care, Inc., but 50 percent lower than the guideline for the median merged or acquired companies. Having applied the .25 multiple to the Sta–Home tax-exempt entities' last 12–month revenue of $45,209,000, Wilhoite arrived at an MVIC of $11,302,000.

Wilhoite then turned to the income approach. He ascertained that the Sta–Home tax-exempt entities could generate meaningful income for a purchaser that was positioned to use the cost-shifting strategy. An officer of Sta–Home tax-exempt entities had indicated to Wilhoite that the entities had historically received reimbursed costs in an amount that was 5 percent below the limit they were allowed. Wilhoite ascertained that the annual value of such a saving in 1995 was $1,408,168. To ascertain the present value of a stream of such payments, Wilhoite ascertained an appropriate multiplier by examining the weighted average cost of capital for Sta–Home tax-exempt entities, less the anticipated increases generated by long-term growth. Wilhoite arrived at a capitalization rate of 12.8 percent. This capitalization rate yielded a value for the Sta–Home tax-exempt entities, on the basis of use of the cost gap, of $11,001,000.

To conclude his study, Wilhoite assigned a weighted percentage to each of the three values he had derived under the two market approaches and the single income approach. He gave the most weight to the income approach, somewhat less weight to the publicly traded comparable approach, and the least weight to the merged or acquired comparable approach. His weighted average was $11,604,000 for the MVIC. Wilhoite then took into account the fact that, although they were ongoing businesses, the Sta–Home tax-exempt entities had nevertheless generated a net working capital deficit; i.e., the current liabilities exceeded the current assets by more than $2 million. While sufficient current assets would usually be present in an ordinary operating business to pay for current liabilities, this was not the case for the Sta–Home tax-exempt entities. A purchaser would quickly have to come up with additional moneys to pay the bills. Wilhoite viewed the necessity for such a "working capital infusion" as a factor that would lower the value of the calculated MVIC. Thus, from the $11,604,000 value for the MVIC, he subtracted the $2,020,000 deficit that a buyer of the Sta–Home tax-exempt ***403** entities would have to provide following an acquisition of the companies.

To the resulting figure for the now-discounted MVIC, Wilhoite added the companies' current liabilities. He did so because accounting rules require the asset side and the liability side of a company's balance sheet to be equal. His calculated MVIC, which comprised long-term liabilities and owners' equity, did not include current liabilities. Wilhoite reasoned that, by adding the known current liabilities to the MVIC, he would complete the liability side of the balance sheet. The asset sheet would thus be an amount that equaled the liabilities so computed. He compared the inclusion of current liabilities as a means of ascertaining value by showing that petitioners had done essentially the same operation. Their position was that the companies' value was equal to the total liabilities, both long-term and short-term debt. The difference between Wilhoite's view and that of petitioners is that Wilhoite concluded, on the basis of his MVIC analysis, that the companies had some value, which was expressed on the liabilities side as owners' equity. Petitioners, however, maintained that there was no owners' equity and, hence, they did not include it in the balance sheet. His explanation stated:

> Basic accounting requires that the total asset value of an entity (i.e., the "left-hand side" of the balance sheet) is equal to the sum of the total liabilities and equity, or net asset value, of an entity (i.e., the "right-hand side" of the balance sheet). * * * [The Sta–Home for-profit entities] and the **Caraccis** reported acquired all of the assets of the tax-exempt agencies by assuming all of the liabilities of the tax-exempt agencies. Because the **Caraccis** assumed no equity value existed, and because basic accounting requires that the "left-hand side" of the balance sheet equal the "right-hand side", our independently determined estimate of the fair market value of Sta–Home's invested capital (i.e., interest-bearing debt and equity, reduced by the estimated working capital infusion) combined with reported current liabilities,

provides the total "right-hand side" of the balance sheet.

The result is as follows:

Indicated MVIC	$11,604,000
Less working capital infusion	2,020,000
Plus current liabilities	11,274,000
Indicated asset value	20,858,000

404** E. ***Our Valuation of the Sta–Home Tax–Exempt Entities

The traditional determinants of fair market value persist even when valuing a nonprofit, tax-exempt company. There are differences, however, in the amount of weight usually given to the earnings and profits of regular business organizations and those of tax-exempt entities. Earnings and profits are obviously less meaningful in the case of nonprofit organizations. Here, Medicare funded 95 percent of the Sta–Home tax-exempt entities' operations. As applicable herein, the Medicare program was not designed to produce corporate profits nor to contribute to the capital growth of healthcare organizations. It was designed to reimburse providers of home health care services for their costs, including administrative salaries and overhead. The system nevertheless permitted the operators of such agencies to generate executive-level salaries and benefits for themselves. It also permitted them to accumulate substantial assets in their businesses without paying income taxes on any of their earnings.

Petitioners urge that "common sense" requires a decision in their favor. They argue that they incurred losses, not gains, on the transactions leading to formation of the Sta–Home for-profit entities. They point to balance sheets which show that the liabilities they assumed exceeded the value of the assets they acquired.

We disagree with petitioners' so-called common sense rationale. To the contrary, we think it obvious that a company's negative book value does not require a finding that the company had a fair market value of less than zero. Nor does the fact that a company operates at a loss mean that its intangible assets have no value. Those assets are still capable of generating revenue, thus proving they have value. Even petitioners' tax adviser, Pettis, testified to that effect.

Moreover, the Sta–Home tax-exempt entities' assets generated revenues of approximately $45 million in the year they were transferred to the Sta–Home for-profit entities. The Sta–Home tax-exempt entities reported a modest income from operations, but, after deducting interest and depreciation (mostly for their fleet of automobiles), they reported a loss of $506,713. Although in 1995 they also reported an increase for the third consecutive year in the negative net asset value to a new total of $1,408,248, the evidence shows that their ***405** fourth employee bonus in that year amounted to some $2,314,086. Had they not declared that bonus, they would have reported nontaxable income of approximately $1,785,000, or, in other words, more than enough to eliminate the accumulated deficit in net asset value.

The Sta–Home tax-exempt entities' expert also reported that their total payroll for 1995 was $34,600,000, or about 80.5 percent of operating expenses, and that this amount of employee compensation was "generous". A common range of compensation for other home health care agencies was between 70 and 75 percent. Had petitioners not declared the last bonus, their compensation expense would have been $34,085,914, or 75.4 percent of operating expenses. This amount would have exceeded the industry average and still enabled the companies to eliminate their accumulated deficit and show a modest profit. Thus, even though the Sta–Home tax-exempt entities reported a history of losses, they at least had the potential to generate income and thus demonstrate a substantial fair market value.

[10] [11] We believe that the best evidence of the value of the Sta–Home tax-exempt entities arises from the use of the comparable value method employed

by both experts. We also are persuaded that the fair market value is best determined by relying upon the rationale of Wilhoite. His use of the MVIC approach to compare the privately held Sta–Home tax-exempt entities to similar publicly traded businesses is especially appropriate here. That approach harmonizes the differences between debt and equity usage by publicly traded companies and privately held entities. It also considers the total investment, which, as discussed *infra,* is especially important for the Sta–Home tax-exempt entities.

We do not agree, however, that Wilhoite ascertained an accurate price-to-revenue multiple for ascertaining the Sta–Home tax-exempt entities' MVIC. His .3 multiplier was approximately half that applicable to the median of the publicly traded comparables. His discount reflects petitioners' demonstration that many of these publicly traded companies functioned in areas where combinations of businesses, including managed care operations, produced more favorable prospects than were generally available in Mississippi. Wilhoite's discount does not, however, sufficiently take into account the absence from the Sta–Home services of some of the more ***406** sophisticated, and remunerative, home health care techniques, such as infusion and respiratory therapies. These techniques were utilized by many of the comparison companies. We therefore believe that the price-to-revenue multiple for publicly traded companies should be no higher than the .25 that he applied to the merged and acquired comparable companies.

We also fail to find Wilhoite's valuation particularly meaningful solely on the basis of the capitalization of Sta–Home tax-exempt entities' intangible known as the "cost gap". Wilhoite has correctly noted that the cost gap has substantial potential value to a hospital purchaser, and, in fact, Hahn has written extensively about the value of this cost-shifting attribute. We feel, however, that Wilhoite has included too many imponderables in his calculation. For example, we do not believe that the entire value of the Sta–Home tax-exempt entities is appropriately bound up in the marketability of a single intangible asset—the cost gap. Nor do we believe that it is justified to conclude that the cost gap would produce economic benefits indefinitely, especially in view of the official scrutiny it had received before, and during, 1995. Finally, we observe that Wilhoite has assumed that the cost gap would equal 95 percent of the allowable cost ceiling (i.e., be 5 percent less than the ceiling). This percentage appears to have been accurate for earlier years, but the most recent cost gap was only 2.86 percent below the cost ceiling. The way for a potential buyer to increase the cost-gap percentage would be to reduce costs further. We do not think, however, that a buyer of the Sta–Home tax-exempt entities would necessarily decrease expenses to move the cost gap asset from its most recent 2.86–percent level back to historic 5–percent level and then continue this cost gap indefinitely. On balance, we believe that the most weight is properly given to Wilhoite's estimate of the MVIC for the Sta–Home tax-exempt entities, using a price-to-revenue multiple of .25. This results in an MVIC of $11.3 million.

Petitioners have raised a number of issues concerning the Sta–Home tax-exempt entities' MVIC, and we believe that one of their points has merit. Their principal contention arises from their concession that the Sta–Home tax-exempt entities' capital structure was "different". They explained that the entities' practice of requiring employees to forgo paychecks ***407** for the first 6 weeks created a pool of approximately $6.1 million. Although they identified this amount as a current liability in the form of accrued payroll and accrued payroll taxes, this permanent pool actually functioned as a source of permanent capital. To prove their point, they show that their reported current liabilities for 1995 were 108 percent of invested capital, an amount several times greater than that of comparable companies. In effect, they argue, their employees had made a collective long-term loan to the company. We agree. In operation, much of the $6.1 million which had been held back from the employees' payroll and payroll taxes functioned as a source of long-term financing.

[12] [13] Not all of the withheld payroll, however, is properly considered long-term financing. Petitioners' accountant, Hart, testified that the Sta–Home tax-exempt entities originally had a "two-week payroll" which was extended to 4 weeks, and then to 6 weeks, as a source of working capital. Hahn's report states that Medicare pays home health care agencies no less frequently than every 2 weeks based on estimated costs. To aid their cashflow situation, the Sta–Home

entities paid their employees 6 weeks in arrears. Thus, an employee was required to wait 6 weeks before getting his or her first paycheck, for 2 weeks' work. In the meantime, however, Medicare reimbursed the companies for the amount of accrued wages every 2 weeks. The entities thus received 6 weeks' worth of wages per employee before being required to pay out 2 weeks' worth. The deferral of actual payment meant, in effect, that each employee made a loan of 4 weeks' wages to the company, and the "loan" would not be repaid until the employee left his or her employment. When one employee left, another was presumably hired, and the new employee would be required to forgo 4 weeks' salary, thus keeping the total amount of deferrals relatively stable. By 1995, this practice had generated a "float" of approximately $4.1 million that the entities possessed and were not required to repay until some unspecified time in the future. It appears that 2 weeks' worth of payroll and payroll taxes is properly characterized as short-term liabilities. We conclude that the amounts of payroll that were withheld for longer than 2 weeks were not, in this case, properly characterized as current liabilities. For purposes of this valuation, they should be considered part of the invested capital. Accordingly, of the ***408** $6,150,000 withheld, two-thirds (or 4 weeks' worth) should be excluded from the current liabilities that Wilhoite added to the MVIC. Wilhoite based his calculation of MVIC upon an informed estimate of the value of invested capital (i.e., long-term debt plus owner's equity) that would produce the known revenues. For 1995, his calculations showed that invested capital of $11.3 million would produce the reported $45,209,000 in revenue that the Sta–Home tax-exempt entities generated. Some part of this MVIC is readily discernible; it includes $500,000 of long-term debt. Additionally, as we have explained, it also includes the $4.1 million of deferred wages that functioned as long-term debt for the companies. As earlier observed, however, a buyer would have to include as part of the purchase price not only the value of the invested capital, the MVIC, but also the current liabilities that the purchased company would have to pay. Wilhoite accordingly added current liabilities of $11,475,000 from the Sta–Home tax-exempt entities' balance sheets to his calculated MVIC of $11.3 million. That amount of current liabilities, however, includes $4.1 million of withheld wages that operate as long-term debt and thus form part of the MVIC. To avoid duplicating this $4.1 million figure in arriving at a fair market value for the companies, we believe that it should be excluded from current liabilities. (Removing $4.1 million from current liabilities, however, also restores the $2,020,000 working capital shortfall resulting from the failure of current assets to match current liabilities. Accordingly, there is no longer a need to reduce the asset value by the amount of the capital infusion.) Finally, we also believe that current liabilities should be increased by $201,000, as suggested by Hahn, to reflect a reserve for disallowed claims on its Medicare cost reports. This increases the current liabilities to $11,475,000, before deducting the amount of withheld payroll that is to be considered part of the MVIC.

When we take these modifications into account, we arrive at a fair market value of $18,675,000:

Indicated MVIC	$11,300,000
Plus current liabilities	11,475,000
Less withheld payroll	(4,100,000)
Indicated asset value	18,675,000

***409** We are unimpressed and unpersuaded by Hahn's conclusions as to the fair market value of the Sta–Home tax-exempt entities, and we have decided not to accept them. His reasoning that the Sta–Home tax-exempt entities had a fair market value of less than zero is unconvincing, and, in fact, appears to be more an advocacy of petitioners' litigating position than a candid fair market appraisal. We think a willing buyer would be puzzled and confused by his conclusions. Neither Hahn's "adjusted balance sheet" approach nor his backup market approach justify the finding of a negative net worth.

First, in one substantial respect, even Hahn's "best case" adjusted balance sheet is seriously deficient. Hahn's report states: "Most buyers concentrate on the intangible assets of a home health agency." His conclusions, however, fail to account for much of the substantial value of the Sta–Home tax-exempt entities' intangible assets. Hahn ascertained a value for two intangible assets. He first developed a value for the Sta–Home tax-exempt entities' workforce in place of $2.1 million to $3.4 million. He used the $2.1 million value in both the "base case" and "best case" scenarios. He fails to justify using the lower value in the "best case" scenario. Petitioners have assembled a workforce of approximately 1,000. A very substantial proportion of them are highly trained professionals, including registered nurses and other trained medical personnel. The Sta–Home tax-exempt entities employed 25 percent of the full-time and 17 percent of the part-time home health care staff in the State of Mississippi. If Hahn has developed an approximate value of $3.4 million, we see no reason not to employ this estimate in the "best case" scenario. Indeed, we suspect that the value of the workforce is higher, but on this record, we cannot reasonably estimate how much.

With respect to another intangible asset, Hahn's "best case" scenario ascribed a value of $667,000 to the "cost gap" attribute that the Sta–Home tax-exempt entities presented for a qualifying buyer. His valuation is based on the assumption that the value of this attribute would end after 1 year. This value is too low. The cost gaps were available under the then-current reimbursement program. They would cease to exist under a PPS. Although there had been discussions of a PPS for several years, Congress had passed no such legislation at the time of the transfer, and there is no evidence that ***410** the prospect of such legislation had a negative effect upon the value of home health care agencies. In fact, one of Hahn's articles, published in the Spring of 1998, demonstrates a "furious pace of home health transfers" from 1994 through 1997. The article contains a chart showing that the number of home health agency transfers did not begin to decrease until the second quarter of 1997. A "best case" scenario would, we think, indicate at least a 2–year value for the cost gap asset. By using a 2–year figure in Hahn's computations, we arrive at a value of more than $1 million for the cost-shifting attribute.

Hahn's valuation of the intangible assets also fails to address the value of the CONs held by the Sta–Home tax-exempt entities. These certificates effectively closed the home health care market to competition during a period of high growth for the industry. Michael **Caracci** acknowledged his efforts to lobby the Mississippi legislature in the interests of keeping the CON moratorium in place, thus preserving the monopoly of the Sta–Home tax-exempt entities and others who had received CONs before the moratorium. His efforts indicate that the CONs possessed by the Sta–Home tax-exempt entities would be worth considerable amounts to a willing buyer, but Hahn did not ascribe any value to them.

We conclude that the absence of a candid valuation for the Sta–Home tax-exempt entities' intangible assets explains the considerable gap between the adjusted balance sheet value ascertained by Hahn and the $18,675,000 value we have decided today. [8]

We also reject Hahn's assertion that his alternate "market" approach to valuation guideline supports his adjusted balance sheet approach. Initially, we find that his selection of guideline companies is at least adequate. Most of them value "traditional" visiting nurse companies, such as petitioners, and thus Hahn avoids the problem of including home health care agencies that offer more technical home health care services. He has also included both publicly traded and privately held companies in his survey, and he has included ***411** both companies that have positive income and companies that reported losses. His guideline companies also include those with a positive net worth and companies that indicate a negative equity capital.

We are unable, however, to accept Hahn's conclusions of fair market value on the basis of his market approach. Hahn has derived two "Implied Valuation Multiples". The first is a ranking based upon the ratio of selected comparable companies' sale prices to their most current revenues. The second is a ranking of the companies' sale prices to their total book assets. [9] The median sale prices were .68 times annual revenues and 1.9 times total book assets. Here, however, in his "best case" scenario, he has ascertained that the Sta–Home tax-exempt entities would sell at a price only .22 times annual revenues and, further, that they would sell at a price only 1.1 times their total book assets. Hahn's "best case" scenario ranks the Sta–Home tax-exempt entities next to last in both categories. In contrast, none of the comparable companies ranks as low in *both* categories. Clausen Health Services, for example, sold at a multiple of .22 times revenues, a ratio close to that ascribed to the Sta–Home tax-exempt entities. Clausen's sale price, however, also represented a price-to-asset ratio of 1.64, ranking seventh among the comparables. If the Sta–Home tax-exempt entities sold at this multiple, the indicated fair market value would be $17,670,040. [10] Another example shows that House Call, Inc., sold at a price 1.08 times its total assets, a ratio close to the 1.10 that Hahn has ascribed to the Sta–Home tax-exempt entities. House Call, Inc.'s sale price, however, also indicates that it sold at a multiple of .74 times revenues, ranking second of the 13 comparables. If the Sta–Home tax-exempt entities were sold at this ratio, the indicated sales price would be approximately $33 million. Moreover, in an article published in the spring of 1997, Hahn indicated that for the prior 2 years, a standard market benchmark for valuing traditional visiting nursing agencies, such as the Sta–Home ***412** tax-exempt entities, was a price-to-revenue multiple of .55. Hahn & Spieler, "Valuation of Home Health Care Companies," Intrinsic Value (Spring 1997). We fail to understand why the Sta–Home tax-exempt entities had a much lower multiple of .26. We recognize that the Sta–Home tax-exempt entities operated at a loss for the prior year, but so did 8 of the 13 comparable companies. We further recognize that the Sta–Home tax-exempt entities' equity capital was a negative amount, but so was that of 7 of the 13 comparable companies. These characteristics reflect the accepted conclusion that exempt entities operating under the Medicare reimbursement system stood little chance of turning a profit. In fact, Hahn's 1997 article states that "Analysis of recent VNA [i.e. traditional visiting nursing agency] transactions indicates that companies with operating losses have transacted at multiples of revenue similar to agencies with operating profits." *Id.* at 3.

Accordingly, we conclude that the sale price we have decided more accurately reflects the fair market value of the Sta–Home tax-exempt entities than does that of Hahn. We note that our valuation of $18,675,000 indicates that the Sta–Home tax-exempt entities would sell at a price-to-revenue multiple of .42, lower than the .68 median applicable to Hahn's comparable home health care agencies. Our finding also indicates that the ratio of price to book value would be 1.75, which again is less than the 1.90 median for the same comparable companies.

In reaching this value, we have also considered, but rejected, petitioners' arguments that conditions in Mississippi require a finding that the assets of the Sta–Home tax-exempt entities were worth less than the liabilities assumed. Petitioners argue strenuously that the Sta–Home tax-exempt entities' operation in Mississippi, a relatively poor and rural State, dramatically reduces their fair market value. Petitioners do not mention, however, that the Federal per-patient Medicare payment was higher for Mississippi than for any other State. We think that this factor substantially offsets the demographic challenges of operating home health care agencies in Mississippi.

Petitioners also maintain that there was no market in Mississippi for acquisition of the Sta–Home tax-exempt entities. The record in this case, however, indicates that there were ***413** many such sales, including the purchase of Mississippi home health care agencies by out-of-State hospitals. We are not convinced that reasonable exploration by a willing seller would have failed to turn up a willing buyer, whether in Mississippi or elsewhere.

F. *Excess Value*

Having found the fair market value of the Sta–Home tax-exempt entities, we turn to decide the value in excess of the assumed liabilities. We are satisfied that the Sta–Home for-profit entities intended to, and did, assume all of the liabilities of the predecessor businesses. The evidence includes an audited balance sheet, prepared for purposes of this case, which indicates that the total liabilities as of September 30, 1995, were $13,310,860. To this amount we think there is properly added $201,000, as ascertained by Hahn, representing a reserve account for cost claims disallowed by Medicare. Total liabilities assumed were therefore $13,511,000. Subtracting the total liabilities from the fair market value we have decided, results in an excess of $5,164,000:

Fair market value	$18,675,000

Assumed liabilities	*(13,511,000)*
Excess	5,164,000

III. ***Excise Taxes Under Section 4958***

Section 4958, the provisions of which are set forth in the appendix to this report, was added to the Internal Revenue Code by the Taxpayer Bill of Rights 2, Pub.L. 104–168, sec. 1311(a), 110 Stat. 1452, 1475 (1996).[11] Section 4958 is patterned after section 4941, which applies to acts of self-dealing between private foundations and disqualified persons. Section 4958 applies to public charities and social welfare organizations which are exempt from Federal income taxes.[12]

***414** Section 4958 was enacted to impose penalty excise taxes as "intermediate" sanctions in cases where organizations exempt from tax under section 503(c) engage in "excess benefit transactions." H. Rept. 104–506, at 56 (1996), 1996–3 C.B. 49, 104. An excess benefit transaction is one in which a tax-exempt organization provides an economic benefit to one or more of the organization's insiders, called "disqualified persons", if the fair market value of the benefit exceeds the value of what the organization receives in return. Sec. 4958(c)(1)(A); H. Rept. 104–506, *supra* at 56, 1996–3 C.B. at 104. Disqualified persons include not only those who are able to exercise substantial influence over the tax-exempt organization, but also their family members and entities in which those individuals have 35 percent of the voting power. Disqualified persons are subject to the excise penalties, whether the excess benefit transactions are accomplished "directly or indirectly". Sec. 4958(c).

Before the enactment of section 4958, if an organization within its purview did not comply with the rules regarding tax exemption, the Commissioner's only recourse was to revoke the organization's exemption. The Treasury Department realized that such a response might be inappropriate when the exempt organization did not conform to all the applicable rules but was nevertheless capable of functioning for a charitable purpose. See U.S. Department of the Treasury's Proposals to Improve Compliance by Tax–Exempt Organizations: Hearing Before the Subcommittee on Oversight of the House Comm. On Ways and Means, 103d Cong., 2d Sess. 17 (1994). At the urging of the Treasury Department, Congress enacted section 4958. See H. Rept. 104–506, *supra* at 56, 1996–3 C.B. at 104.

A disqualified person who receives an excess benefit from an excess benefit transaction is liable for an initial excise tax equal to 25 percent of the excess benefit. Sec. 4958(a)(1). If the initial tax is imposed and the transaction is not corrected within the taxable period, then the disqualified person is liable for an additional tax of 200 percent of the excess benefit. Sec. 4958(b).

[14] ***415** Here, the fair market value of the Sta–Home tax-exempt entities' transferred assets far exceeded the consideration paid by the Sta–Home for-profit entities. Thus, the asset transfers were excess benefit transactions which directly benefited the transferees (i.e., the Sta–Home for-profit entities) and indirectly benefited the Sta–Home for-profit entities' shareholders (i.e., the **Caracci** family members). Petitioners do not seriously dispute that they are disqualified persons with respect to the Sta–Home tax-exempt entities. Joyce P. **Caracci**, Michael **Caracci**, and Christina C. McQuillen, as directors and officers of each of the three Sta–Home tax-exempt entities, are disqualified persons because they were in positions to exercise substantial influence over the entities' affairs. Sec. 4958(f)(1)(A). Victor **Caracci** and Vincent **Caracci** are disqualified persons because of their familial relationships to Joyce P. **Caracci**, Michael **Caracci**, and Christina C. McQuillen. Sec. 4958(f)(1)(B). Sta–Home Health Agency of Carthage, Inc., Sta–Home Health Agency of Greenwood, Inc., and Sta–Home Health Agency of Jackson, Inc., are disqualified persons because they are entities that are 35–percent controlled by disqualified persons; in fact, members of the **Caracci** family own 100 percent of the Sta–Home for-profit entities' voting stock. Sec. 4958(f)(1)(C). Accordingly, petitioners are subject to excess benefit taxes under section 4958.

Because we have decided the value of the Sta–Home tax-exempt entities' assets on the basis of a revenue multiple, it is appropriate to ascribe the excess benefit to each of the Sta–Home for-profit entities in proportion to the amounts the 1995 revenues of their respective predecessors bore to the total revenue. This produces the following results:

Entity	Percentage	Benefit
Sta–Home Health Agency of Carthage, Inc.	42.1	$2,173,682
Sta–Home Health Agency of Greenwood, Inc.	30.1	1,554,105
Sta–Home Health Agency of Jackson, Inc.	27.8	1,435,353

Because each of the three entities acquired or assumed its predecessor's assets and liabilities, as opposed to acquiring its predecessor's stock, we see no basis to apply a minority discount to the value of the excess benefits each has received. ***416** Nor for that reason is an application of a minority discount appropriate as to the excise taxes imposed upon the individual shareholders of the Sta–Home for-profit entities.

We conclude that each of the disqualified person/ petitioners is jointly and severally liable for the initial and additional taxes under section 4958(a)(1) and (b) as to the excess benefits. The effect of our holding is that the individual petitioners are jointly and severally liable for the total excess benefit of $5,164,000 from the three Sta–Home entities, while the Sta–Home for profit entities are liable for taxes as specified in the above table. In so concluding, we decline at this time petitioners' invitation to abate the initial and additional excise taxes pursuant to section 4961 (second-tier tax abatement) and section 4962(a) (first-tier tax abatement). Because the excess benefit transactions have never been corrected for purposes of section 4958(f)(6), petitioners' invitation is, at best, premature. Petitioners have not as of yet met the prerequisite for the requested abatement; i.e., a timely correction. In this regard, however, we note that sections 4961(a) and 4963(e)(1) generally allow for the abatement of a section 4958 excise tax if the excess benefit transaction giving rise thereto is corrected within 90 days after our decision sustaining the tax becomes final. Cf. *Morrissey v. Commissioner,* T.C. Memo.1998–443. Because the issue of whether petitioners will or would qualify for an abatement is not yet ripe for decision, we express no opinion on this issue.

IV. ***Revocation of Tax–Exempt Status***

Section 501(c)(3) requires, among other things, that an organization be operated exclusively for one or more specified exempt purposes. An organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest and its net earnings do not inure to the benefit of any shareholder or individual. Sec. 1.501(c)(3)–1, Income Tax Regs.

[15] The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. *Better Bus. Bureau v. United States,* 326 U.S. 279, 283, 66 S.Ct. 112, 90 L.Ed. 67 (1945); *Am. Campaign Acad. v. Commissioner,* 92 T.C. 1053, 1065, 1989 WL 49678 (1989). When an organization operates for the benefit of private interests, such as designated ***417** individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. Prohibited benefits may include an advantage, profit, fruit, privilege, gain, or interest. *Am. Campaign Acad. v. Commissioner, supra* at 1065–1066. We have held that when a section 501(c)(3) tax-exempt entity sells its assets for less than fair market value to a for-profit corporation whose shareholders are directors of the tax-exempt entity, the sale constitutes inurement and

revocation may be appropriate. *Anclote Psychiatric Ctr., Inc. v. Commissioner,* T.C. Memo.1998–273.

With the enactment of section 4958, however, the issue whether the tax-exempt status of the Sta–Home tax-exempt entities should be revoked must now be considered in the context of the "intermediate sanction" provisions. As noted above, the intermediate sanction regime was enacted in order to provide a less drastic deterrent to the misuse of a charity than revocation of that charity's exempt status. The legislative history explains that "the intermediate sanctions for 'excess benefit transactions' may be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status." H. Rept. 104–506, *supra* at 59, 1996–3 C.B. at 107. A footnote to this statement explains: "In general, the intermediate sanctions are the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization". *Id.* n. 15, 1996–3 C.B. at 107. Although the imposition of section 4958 excise taxes as a result of an excess benefit transaction does not preclude revocation of the organization's tax-exempt status, the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case.

[16] We do not believe that this is such an unusual case. The dormant state of the Sta–Home tax-exempt entities precludes calling into question whether, on the whole, they are functioning tax-exempt entities. Moreover, we perceive three reasons why it is not appropriate to remove their tax-exempt status at this time. First, the excess benefit represented the fair market value of the Sta–Home tax-exempt entities' assets less the liabilities assumed by the Sta–Home for-profit entities. ***418** Given that we have already sustained the imposition of intermediate sanctions as to this excess value, we do not believe it appropriate under the facts herein to conclude that the single transaction (as to each entity) underlying the excess value also requires our revocation of each entity's tax-exempt status. Second, the Sta–Home tax-exempt entities have not since the transfers been operated contrary to their tax-exempt purpose. Third, we find some credence in petitioners' suggestion that maintenance of the tax exemption may enable them to utilize the correction provisions made available in sections 4961 through 4963. While the issue is not ripe for us to decide at this time, we note that a permissible correction may require that the Sta–Home for-profit entities transfer the assets back to the Sta–Home tax-exempt entities. If we were to remove the Sta–Home tax-exempt entities' tax-exempt status at this stage, however, those entities would no longer be tax-exempt entities available to receive the assets.

The legislative history quoted above indicates that "the term 'correction' means undoing the excess benefit to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards." H. Rept. 104–506, *supra* at 59, 1996–3 C.B. at 107. Petitioners suggest that preserving the tax-exempt status of the now-dormant tax-exempt Sta–Home entities may leave petitioners with a means of correction by placing the entities back into a "financial position not worse than it would be" if the disqualified persons had observed the proper standards. While, as noted above, we do not address the issue of timely corrections, we believe that leaving the exemptions intact is consistent with both the legislative history underlying section 4958 and the provisions for abatement in sections 4961 through 4963.

V. *Income Taxes*

Michael **Caracci**, Vincent **Caracci**, and Christina McQuillen (collectively, the **Caracci** children) had no ownership interest in the Sta–Home tax-exempt entities. The **Caracci** children also did not contribute any property to the Sta–Home for-profit ***419** entities in exchange for the stock that they received in those entities upon their formation. Respondent determined that the **Caracci** children realized gross income by virtue of the fact that the Sta–Home for-profit entities, in connection with their organization, received the assets of the Sta–Home tax-exempt entities. Respondent argues in brief that the assets of the Sta–Home tax-exempt entities were constructively transferred to the **Caracci** children who, in turn, contributed those assets to the Sta–Home for-profit entities. Respondent argues in brief that the constructive transfer is an accession to wealth that is includable in the **Caracci** children's gross income under section 61.

[17] [18] [19] We disagree with respondent that the asset transfer resulted in gross income to the **Caracci** children. Although section 61 provides broadly that gross income includes all income "from whatever source derived", section 102(a) generally exempts from that provision the value of any property received by gift. When property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift. Sec. 2512(b); *Commissioner v. Wemyss,* 324 U.S. 303, 65 S.Ct. 652, 89 L.Ed. 958 (1945); *Georgia Ketterman Trust v. Commissioner,* 86 T.C. 91, 96, 1986 WL 22078 (1986); *Estate of Higgins v. Commissioner,* T.C. Memo.1991–47. In the corporate setting, such a transfer may be a gift by the donor to the individual shareholders of the corporation to the extent of their proportionate interests in the corporation. *Kincaid v. United States,* 682 F.2d 1220, 1224 (5th Cir.1982); *Chanin v. United States,* 183 Ct.Cl. 840, 393 F.2d 972 (1968); *Estate of Hitchon v. Commissioner,* 45 T.C. 96, 103–104, 1965 WL 1253 (1965); *Tilton v. Commissioner,* 88 T.C. 590, 597, 1987 WL 39956 (1987); *Estate of Trenchard v. Commissioner,* T.C. Memo.1995–121; sec. 25.2511–1(h)(1), Gift Tax Regs. When the shareholders of a recipient corporation are members of the donor's family, that fact is strongly indicative of a gift. See *Kincaid v. United States, supra; Tilton v. Commissioner, supra; Estate of Hitchon v. Commissioner, supra; Estate of Trenchard v. Commissioner, supra; Estate of Higgins v. Commissioner, supra.*

[20] Here, Victor and Joyce **Caracci** set up transactions pursuant to which their three children each received stock in the Sta–Home for-profit entities that, in connection therewith, ***420** had a total net asset value of more than $5 million. The **Caracci** children, the natural heirs of Victor and Joyce **Caracci**, paid nothing for that stock, nor did they contribute property for it. The transfers were effectively gifts to the **Caracci** children.

[21] The fact that the children were also employees of the new corporations does not transform their receipt of 65 percent of the corporate stock into compensation subject to income tax. We are aware that section 102(c) provides that the transfer of property to an employee is generally deemed to be compensation, rather than a gift. We believe, however, that a transfer of property to an employee who is a member of the employer's family is more properly considered a gift when the transfer is not made in recognition of the employee's work but is made in connection with the family relationship.

The transfer of most of the assets involved in this case is clearly attributable to the familial relationship between the **Caracci** parents and their children. It contrasts strongly to situations cited by respondent involving compensation, such as *Strandquist v. Commissioner,* T.C. Memo.1970–84 (president of car sales company taxable on value of new cars he received in excess of value of used cars he turned in). Nor is this a situation involving disguised rentals paid to a lessor-shareholder, as in *Haag v. Commissioner,* 334 F.2d 351, 355 (8th Cir.1964), affg. 40 T.C. 488, 1963 WL 1570 (1963). Nor is it, in substance, a distribution with respect to the stock of a controlling shareholder for his personal benefit, as in *Kenner v. Commissioner,* T.C. Memo.1974–273 (doctor who owned tax-exempt hospital corporation taxed on relatively small amounts it transferred to corporation that operated his ranch in Arizona). Here, during the year in issue, none of the home health care assets was distributed to any of the children, and none of the children sold the stock or otherwise benefited personally from the transfer of the home health care assets to the for-profit entities.

On the evidence before us, we conclude that the transfers of the home health care assets to the for-profit entities constituted gifts to the **Caracci** children, and not the realization of taxable income by them. They are not subject to income taxes on those transfers.

***421** In view of the foregoing,

Decisions will be entered for petitioners in docket Nos. 14711–99X, 17336–99X, and 17339–99X, and will be entered under Rule 155 in the remaining dockets.

APPENDIX

SEC. 4958. TAXES ON EXCESS BENEFIT TRANSACTIONS

(a) Initial Taxes.—

(1) On the disqualified person.—There is hereby imposed on each excess benefit transaction a tax equal to 25 percent of the excess benefit. The tax imposed by this paragraph shall be paid by any disqualified person referred to in subsection (f)(1) with respect to such transaction.

(2) On the management.—In any case in which a tax is imposed by paragraph (1), there is hereby imposed on the participation of any organization manager in the excess benefit transaction, knowing that it is such a transaction, a tax equal to 10 percent of the excess benefit, unless such participation is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any organization manager who participated in the excess benefit transaction.

(b) Additional Tax on the Disqualified Person.—In any case in which an initial tax is imposed by subsection (a)(1) on an excess benefit transaction and the excess benefit involved in such transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 200 percent of the excess benefit involved. The tax imposed by this subsection shall be paid by any disqualified person referred to in subsection (f)(1) with respect to such transaction.

(c) Excess Benefit Transaction; Excess Benefit.—For purposes of this section—

(1) Excess benefit transaction.—

(A) In general.—The term "excess benefit transaction" means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any 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. For purposes of the preceding sentence, an economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit.

(B) Excess benefit.—The term "excess benefit" means the excess referred to in subparagraph (A).

(2) Authority to include certain other private inurement.—To the extent provided in regulations prescribed by the Secretary, the term "excess benefit transaction" includes any transaction in which the amount of any economic benefit provided to or for the use of a disqualified ***422** person is determined in whole or in part by the revenues of 1 or more activities of the organization but only if such transaction results in inurement not permitted under paragraph (3) or (4) of section 501(c), as the case may be. In the case of any such transaction, the excess benefit shall be the amount of the inurement not so permitted.

(d) Special Rules.—For purposes of this section—

(1) Joint and several liability.—If more than 1 person is liable for any tax imposed by subsection (a) or subsection (b), all such persons shall be jointly and severally liable for such tax.

(2) Limit for management.—With respect to any 1 excess benefit transaction, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed $10,000.

(e) Applicable Tax–Exempt Organization.—For purposes of this subchapter, the term "applicable tax-exempt organization" means—

(1) any organization which (without regard to any excess benefit) would be described in paragraph (3) or (4) of section 501(c) and exempt from tax under section 501(a), and

(2) any organization which was described in paragraph (1) at any time during the 5–year period ending on the date of the transaction.

Such term shall not include a private foundation (as defined in section 509(a)).

(f) Other Definitions.—For purposes of this section —

(1) Disqualified person.—The term "disqualified person" means, with respect to any transaction—

(A) any person who was, at any time during the 5–year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization,

(B) a member of the family of an individual described in subparagraph (A), and

(C) a 35–percent controlled entity.

(2) Organization manager.—The term "organization manager" means, with respect to any applicable tax-exempt organization, any officer, director, or trustee of such organization (or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization).

(3) 35–percent controlled entity.—

(A) In general.—The term "35–percent controlled entity" means—

(i) a corporation in which persons described in subparagraph (A) or (B) of paragraph (1) own more than 35 percent of the total combined voting power,

(ii) a partnership in which such persons own more than 35 percent of the profits interest, and

(iii) a trust or estate in which such persons own more than 35 percent of the beneficial interest.

(B) Constructive ownership rules.—Rules similar to the rules of paragraphs (3) and (4) of section 4946(a) shall apply for purposes of this paragraph.

(4) Family members.—The members of an individual's family shall be determined under section 4946(d); except that such members also shall ***423** include the brothers and sisters (whether by the whole or half blood) of the individual and their spouses.

(5) Taxable period.—The term "taxable period" means, with respect to any excess benefit transaction, the period beginning with the date on which the transaction occurs and ending on the earliest of—

(A) the date of mailing a notice of deficiency under section 6212 with respect to the tax imposed by subsection (a)(1), or

(B) the date on which the tax imposed by subsection (a)(1) is assessed.

(6) Correction.—The terms "correction" and "correct" mean, with respect to any excess benefit transaction, undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

Parallel Citations

118 T.C. 379, Tax Ct. Rep. (CCH) 54,747, Tax Ct. Rep. Dec. (RIA) 118.25

Footnotes

1 Cases of the following petitioners are consolidated herewith: Vincent E. and Denise A. **Caracci**, docket No. 12482–99; Christina C. and David C. McQuillen, docket No. 12483–99; Sta–Home Home Health Agency, Inc., of Grenada, Mississippi, docket No. 14711–99X; Sta–Home Health Agency of Carthage, Inc., docket No. 17333–99; Sta–Home Health Agency of Greenwood, Inc., docket No. 17334–99; Michael **Caracci**, docket No. 17335–99; Sta–Home Home Health Agency, Inc., of Forest, Mississippi, docket No. 17336–99X; Victor **Caracci**, docket No. 17337–99; Christina C. McQuillen, docket No. 17338–99; Sta–Home Home Health Agency, Inc., docket No. 17339–99X; Joyce P. **Caracci**, docket No. 17340–99; Vincent E. **Caracci**, docket No. 17341–99; and Sta–Home Health Agency of Jackson, Inc., docket No. 17342–99.

2 Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the year in issue, and Rule references are to the Tax Court Rules of Practice and Procedure.

3 The three Sta–Home tax-exempt entities are Sta–Home Home Health Agency, Inc., Sta–Home Home Health Agency, Inc., of Forest, Mississippi, and Sta–Home Home Health Agency, Inc., of Grenada, Mississippi. The three entities against which respondent determined excise tax deficiencies are the Sta–Home for-profit entities.

4 The parties also dispute who bears the burden of proof as to the central issue in this case; namely, the value of the transferred assets. We do not decide that dispute. Our findings of value are based on our examination of the evidence in the well-developed record, which, in relevant part, includes stipulated facts, expert reports, other exhibits, and witness testimony.

5 Victor **Caracci** was paid on a consulting basis that varied significantly from year to year.

6 Of course, were the respondent to prevail in full, he would be entitled to only $46,460,477 of approximately $256,114,435. The lion's share of the $256,114,435 is attributable to excise taxes under sec. 4958(a)(1) and (2) and (b) totaling $41,753,311 ($4,635,923 + $30,000 + $37,087,388), for all or part of which respondent has determined that eight petitioners are jointly and severally liable.

7 The evidence includes an article written by Hahn wherein he reports that his firm's database reflects that "more than 75 percent of home health agency acquisitions involved agencies that recorded losses." Hahn, "Payment Reform Will Shift Home Health Agency Valuation Parameters", Healthcare Financial Management (Dec.1998).

8 Hahn's "best case" scenario indicates that the value of the intangible assets represents 17.68 percent of the total assets. In one of his recent articles, he presents a chart showing the goodwill value of seven publicly traded home healthcare companies. The lowest of these indicates a goodwill value to total asset ratio of 22 percent, and the others indicate values at 31 percent, 39 percent, 47 percent, 52 percent, and two others at 56 percent. Hahn et al., "Home health Agency Valuation: Opportunity Amid Chaos", Intrinsic Value (Spring 1998).

9 It is important to keep in mind that Hahn's valuation multiples generated a figure that represented the total asset value of a company, while Wilhoite's multiples generated the value of its invested capital, or MVIC. Thus, application of the same valuation multiple, say .25, will generally yield different fair market values, depending upon which method is used.

10 The book value used for the Sta–Home tax-exempt entities' total asset value excludes any value for intangible assets. It is unclear whether Clausen's book value for total assets includes intangibles.

11 No regulations apply to the transactions at issue. The Treasury Department published proposed regulations under sec. 4958 on Aug. 4, 1998, secs. 53.4958–1 through 53.4958–7, Proposed Excise Tax Regs., 63 Fed.Reg. 41486 (Aug. 4, 1998), which were revised and replaced by temporary regulations effective Jan. 10, 2001, secs. 53.4958–1T through 53.4958–8T, Temporary Excise Tax Regs., 66 Fed.Reg. 2144 (Jan. 10, 2001). On Jan. 23, 2002, the Treasury Department removed the temporary regulations and published final regulations effective Jan. 23, 2002. Secs. 53.4958–0 through 53.4958–8, Excise Tax Regs., T.D. 8978, 2002–7 I.R.B. 500.

12 Sec. 4958 is generally effective for transactions occurring after Sept. 13, 1995. At trial, the parties directed considerable attention to the effective date of the transfers at issue. On brief, however, petitioners did not argue that the transfers were effective on or before Sept. 13, 1995, and we deem that argument to have been abandoned.

End of Document

Excerpt from Revenue Ruling 87-41, 1987-1 CB 296

(IRS 20 Factor Test)

As an aid to determining whether an individual is an employee under the common law rules, twenty factors or elements have been identified as indicating whether sufficient control is present to establish an employer- employee relationship. The twenty factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The twenty factors are designed only as guides for determining whether an individual is an employee; special scrutiny is required in applying the twenty factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee). The twenty factors are described below:

1. *Instructions.* A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the *right* to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66-381, 1966-2 C.B. 449.

2. *Training.* Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. See Rev. Rul. 70-630, 1970-2 C.B. 229.

3. *Integration.* Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business. See *United States v. Silk,* 331 U.S. 704 (1947), 1947-2 C.B. 167.

4. *Services Rendered Personally.* If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 C.B. 410.

5. *Hiring, Supervising, and Paying Assistants.* If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593, 1955-2 C.B. 610.

6. *Continuing Relationship.* A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See *United States v. Silk.*

7. *Set Hours of Work.* The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 C.B. 337.

8. *Full Time Required.* If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 C.B. 694.

9. *Doing Work on Employer's Premises.* If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 C.B. 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.

10. *Order or Sequence Set.* If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not

free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.

11. *Oral or Written Reports.* A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68-248, 1968-1 C.B. 431.

12. *Payment by Hour, Week, Month.* Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 C.B. 330.

13. *Payment of Business and/or Traveling Expenses.* If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities. See Rev. Rul. 55-144, 1955-1 C.B. 483.

14. *Furnishing of Tools and Materials.* The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer- employee relationship. See Rev. Rul. 71-524, 1971-2 C.B. 346.

15. *Significant Investment.* If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

16. *Realization of Profit or Loss.* A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul.

70-309. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. *Working for More Than One Firm at a Time.* If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 C.B. 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. *Making Service Available to General Public.* The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.

19. *Right to Discharge.* The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. Rev. Rul. 75-41, 1975-1 C.B. 323.

20. *Right to Terminate.* If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.

Instructions for Form SS-8. (2014).

Instructions for Form SS-8

(Rev. May 2014)

Department of the Treasury
Internal Revenue Service

Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding

Section references are to the Internal Revenue Code unless otherwise noted.

Future Developments

Information about any future developments affecting Form SS-8 (such as legislation enacted after we release it) will be posted at *www.irs.gov/formss8*.

General Instructions

Purpose of Form

Firms and workers file Form SS-8 to request a determination of the status of a worker under the common law rules for purposes of federal employment taxes and income tax withholding. Generally, under the common law rules a worker is an employee if the firm has the right to control what will be done and how it will be done. See Publication 15–A, Employer's Supplemental Tax Guide, for more information on how to determine whether a worker providing services is an employee or independent contractor.

A Form SS-8 determination may be requested only in order to resolve federal tax matters. If Form SS-8 is submitted for a tax year for which the statute of limitations on the tax return has expired, a determination letter will not be issued.

The IRS does not issue a determination letter for proposed transactions or on hypothetical situations or for other reasons not in the best interests of tax administration. We may, however, issue an information letter when it is considered appropriate.

Definition

Firm. For the purposes of this form, the term "firm" means any individual, business enterprise, organization, state, or other entity for which a worker has performed services. The firm may or may not have paid the worker directly for these services.

CAUTION *If the firm was not responsible for payment for services, be sure to enter the name, address, and employer identification number of the payer on the first page of Form SS-8, below the identifying information for the firm and the worker.*

Note. Workers for state and local governments and/or interstate instrumentalities may be covered by a Section 218 Agreement. A Section 218 Agreement is a written, voluntary agreement between the State Social Security Administrator and the Social Security Administration. All 50 states, Puerto Rico, the Virgin Islands and approximately 60 interstate instrumentalities have Section 218 Agreements extending social security coverage to specified employees. Workers covered under a Section 218 Agreement are subject to social security and Medicare tax regardless of any determinations made under the common law rules.

Whether a state or local government worker is subject to social security and Medicare tax depends on which of the following three categories the worker falls into:

1. Subject to social security under a Section 218 Agreement, or

2. Subject to social security under mandatory coverage provisions, or

3. Excluded from social security because there is no Section 218 Agreement ***and*** the employee is covered by a qualified retirement plan.

If the worker is uncertain whether a Section 218 Agreement covers the state or local government entity, he or she should contact the entity before submitting Form SS-8. If the entity is uncertain about whether a Section 218 Agreement covers the position in question, the entity should contact the State Social Security Administrator for the state in which it operates.

The Form SS-8 Determination Process

The IRS will acknowledge the receipt of your Form SS-8. Because there are usually two (or more) parties who could be affected by a determination of employment status, the IRS attempts to get information from all parties involved by sending those parties blank Forms SS-8 for completion. Some or all of the information provided on this Form SS-8 may be shared with the other parties listed on page 1. The case will be assigned to a technician who will review the facts, apply the law, and render a decision. The technician may ask for additional information from the requestor, from other involved parties, or from third parties that could help clarify the work relationship before rendering a decision. The IRS will generally issue a formal determination to the firm or payer (if that is a different entity), and will send a copy to the worker. A determination letter applies only to a worker (or a class of workers) requesting it, and the decision is binding on the IRS if there is no change in the facts or law that form the basis for the ruling. In certain cases, a formal determination will not be issued. Instead, an information letter may be issued. Although an information letter is advisory only and is not binding on the IRS, it may be used to assist the worker to fulfill his or her federal tax obligations. In other very limited circumstances the IRS may issue a courtesy letter that the worker may rely on to fulfill his or her federal tax obligations.

Neither the Form SS-8 determination process nor the review of any records in connection with the determination constitutes an examination (audit) of any federal tax return. If the periods under consideration have previously been examined, the Form SS-8 determination process will not constitute a reexamination under IRS reopening procedures. Because this is not an examination of any federal tax return, the appeal rights available in connection with an examination do not apply to a Form SS-8 determination. If you disagree with a determination, you can identify facts that were part of the original submission that you think were not fully considered. If you have additional information concerning the relationship that was not part of the original submission, you can submit the additional information and request that the office reconsider the determination.

Completing Form SS-8

Answer all questions as completely as possible. Attach additional sheets if you need more space. Provide information for all years the worker provided services for the firm. Determinations are based on the entire relationship between the firm and the worker. Also indicate if there were any significant changes in the work relationship over the service term.

CAUTION *Form SS-8 will be returned to the requestor if all required information is not provided.*

Additional copies of this form may be obtained on IRS.gov or by calling 1-800-TAX-FORM (1-800-829-3676).

Fee

There is no fee for requesting a Form SS-8 determination letter.

Signature

Form SS-8 must be signed and dated by the taxpayer. A stamped signature will not be accepted.

The person who signs for a corporation must be an officer of the corporation who has personal knowledge of the facts. If the corporation is a member of an affiliated group filing a consolidated return, it must be signed by an officer of the common parent of the group.

The person signing for a trust, partnership, or limited liability company must be, respectively, a trustee, general partner, or member-manager who has personal knowledge of the facts.

A Form SS-8 that is not properly signed and dated by the taxpayer cannot be processed and will be returned.

Where To File

Send the completed and signed Form SS-8 to:

Internal Revenue Service
Form SS-8 Determinations
P.O. Box 630
Stop 631
Holtsville, NY 11742-0630

Faxed, photocopied, or electronic versions of Form SS-8 are not acceptable for the initial request for the Form SS-8 determination. **Do not submit Form SS-8 with your tax return as that will delay processing time.**

Instructions for Workers

If you are requesting a determination for more than one firm, complete a separate Form SS-8 for each firm.

CAUTION *Form SS-8 is not a claim for refund of social security and Medicare taxes or federal income tax withholding.*

If the IRS determines that you are an employee, you are responsible for filing an amended return for any corrections related to this decision. A determination that a worker is an employee does not necessarily reduce any current or prior tax liability. For more information, call 1-800-829-1040.

Time for filing a claim for refund. Generally, you must file your claim for a credit or refund within 3 years from the date your original return was filed or within 2 years from the date the tax was paid, whichever is later.

Filing Form SS-8 does not prevent the expiration of the time in which a claim for a refund must be filed. If you are concerned about a refund, and the statute of limitations for filing a claim for refund for the year(s) at issue has not yet expired, you should file Form 1040X, Amended U.S. Individual Income Tax Return, to protect your statute of limitations. File a separate Form 1040X for each year.

On the Form 1040X you file, do not complete lines 1 through 23 on the form. Write "Protective Claim" at the top of the form, sign and date it. In addition, enter the following statement in Part III: "Filed Form SS-8 with the Internal Revenue Service Office in Holtsville, NY. By filing this protective claim, I reserve the right to file a claim for any refund that may be due after a determination of my employment tax status has been completed."

Filing Form SS-8 does not alter the requirement to timely file an income tax return. Do not delay filing your tax return in anticipation of an answer to your Form SS-8 request. In addition, if applicable, do not delay in responding to a request for payment while waiting for a determination of your worker status.

Instructions for Firms

If a **worker** has requested a determination of his or her status while working for you, you will receive a request from the IRS to complete a Form SS-8. In cases of this type, the IRS usually gives each party an opportunity to present a statement of the facts because any decision will affect the employment tax status of the parties. Failure to respond to this request will not prevent the IRS from issuing a determination letter based on the information available to it so that the worker may fulfill his or her federal tax obligations. However, the information that you provide is extremely valuable in determining the status of the worker.

If you are requesting a determination for a particular class of worker, complete the form for one individual who is representative of the class of workers whose status is in question. If you want a written determination for more than one class of workers, complete a separate Form SS-8 for one worker from each class whose status is typical of that class. A written determination for any worker will apply to other workers of the same class if the facts are not materially different for these workers. Please provide a list of names and addresses of all workers potentially affected by this determination so that the IRS can contact them for information.

If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker under section 530 of the Revenue Act of 1978. However, this relief provision cannot be considered in conjunction with a Form SS-8 determination because the determination does not constitute an examination of any tax return. For more information regarding section 530 of the Revenue Act of 1978 and to determine if you qualify for relief under this section, visit IRS.gov.

How To Get Help

To get IRS forms and publications, go to IRS.gov or call 1-800-TAX-FORM (1-800-829-3676).

The Taxpayer Advocate Service Is Here To Help You

The Taxpayer Advocate Service (TAS) is your voice at the IRS. Our job is to ensure that every taxpayer is treated fairly and that you know and understand your rights.

What can TAS do for you? We can offer you free help with IRS problems that you can't resolve on your own. We know this process can be confusing, but the worst thing you can do is nothing at all! TAS can help if you can't resolve your problems with the IRS and:

- Your problem is causing financial difficulties for you, your family, or your business.
- You face (or your business is facing) an immediate threat of adverse action.
- You have tried repeatedly to contact the IRS but no one has responded, or the IRS has not responded to you by the date promised.

If you qualify for our help, you'll be assigned to one advocate who'll be with you at every turn and will do everything possible to resolve your problem. Here's why we can help:

- TAS is an independent organization within the IRS.
- Our advocates know how to work with the IRS.
- Our services are free and tailored to meet your needs.
- We have offices in every state, the District of Columbia, and Puerto Rico.

How can you reach us? If you think TAS can help you, call your local advocate, whose number is in your local directory and at www.irs.gov/advocate, or call us toll-free at 1-877-777-4778.

How else does TAS help taxpayers?

TAS also handles large-scale, systemic problems that affect many taxpayers. If you know of one of these broad issues, please report it through the Systemic Advocacy Management System at www.irs.gov/sams.

For additional information about TAS, visit www.taxpayeradvocate.irs.gov or see Pub. 1546, The Taxpayer Advocate Service of the IRS – How to Get Help With Unresolved Tax Problems.

Low Income Taxpayer Clinics

Low Income Taxpayer Clinics (LITCs) serve individuals whose income is below a certain level and need to resolve tax problems such as audits, appeals and tax collection disputes. Some clinics can provide information about taxpayer rights and responsibilities in different languages for individuals who speak English as a second language. Visit www.irs.gov/litc or see IRS Publication 4134, Low Income Taxpayer Clinic List.

Representation

You may either represent yourself or, with proper written authorization, have someone else represent you. Your representative must be someone who is allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent (a person enrolled to practice before the IRS). Use Form 2848, Power of Attorney and Declaration of Representative, to authorize someone else to represent you before the IRS.

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on Form SS-8 to carry out the Internal Revenue laws of the United States. This information will be used to determine the employment status of the worker(s) described on the form. Subtitle C, Employment Taxes, of the Internal Revenue Code imposes employment taxes on wages, including income tax withholding. Sections 3121(d), 3306(a), and 3401(c) and (d) and the related regulations define employee and employer for purposes of employment taxes imposed under Subtitle C. Section 6001 authorizes the IRS to request information needed to determine if a worker(s) or firm is subject to these taxes. Section 6109 requires you to provide your identification number. Neither workers nor firms are required to request a status determination, but if you choose to do so, you must provide the information requested on this form. Failure to provide the requested information may prevent us from making a status determination. If any worker or the firm has requested a status determination and you are being asked to provide information for use in that determination, you are not required to provide the requested information. However, failure to provide such information will prevent the IRS from considering it in making the status determination. Providing false or fraudulent information may subject you to penalties. Generally, tax returns and return information are confidential, as required by section 6103. However, section 6103 allows or requires the IRS to disclose or give the information shown on this form to others as described in the Code. Routine uses of this information include providing it to the Department of Justice for use in civil and criminal litigation, to the Social Security Administration for the administration of social security programs, and to cities, states, the District of Columbia, and U.S. commonwealths and possessions for the administration of their tax laws. We also may disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism. We may provide this information to the affected worker(s), the firm, or payer as part of the status determination process.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law.

The time needed to complete and file this Form SS-8 will vary depending on individual circumstances. The estimated average time is: **Recordkeeping**, 23 hrs., 55 min.; **Learning about the law or the form**, 1 hr., 48 min.; **Preparing the form**, 5 hrs., 03 min.; and **Sending the form to the IRS**, 48 min. If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can send your comments from www.irs.gov/formspubs. Click on "More Information" and then on "Give us feedback." Or you can send your comments to the Internal Revenue Service, Tax Forms and Publications, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. **Do not** send the form to this address. Instead, see *Where To File*, earlier.

Part III Financial Control (Provide names and titles of specific individuals, if applicable.)

1 List the supplies, equipment, materials, and property provided by each party:
The firm: ____
The worker: ____
Other party: ____

2 Does the worker lease equipment, space, or a facility? ☐ Yes ☐ No
If "Yes," what are the terms of the lease? (Attach a copy or explanatory statement.) ____

3 What expenses are incurred by the worker in the performance of services for the firm? ____

4 Specify which, if any, expenses are reimbursed by:
The firm: ____
Other party: ____

5 Type of pay the worker receives: ☐ Salary ☐ Commission ☐ Hourly Wage ☐ Piece Work
☐ Lump Sum ☐ Other (specify) ____
If type of pay is commission, and the firm guarantees a minimum amount of pay, specify amount. $ ____

6 Is the worker allowed a drawing account for advances? ☐ Yes ☐ No
If "Yes," how often? ____
Specify any restrictions. ____

7 Whom does the customer pay? ☐ Firm ☐ Worker
If worker, does the worker pay the total amount to the firm? ☐ Yes ☐ No If "No," explain. ____

8 Does the firm carry workers' compensation insurance on the worker? ☐ Yes ☐ No

9 What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary (for example, loss or damage of equipment, material)? ____

10 Does the worker establish the level of payment for the services provided or the products sold? ☐ Yes ☐ No
If "No," who does? ____

Part IV Relationship of the Worker and Firm

1 Please check the benefits available to the worker: ☐ Paid vacations ☐ Sick pay ☐ Paid holidays
☐ Personal days ☐ Pensions ☐ Insurance benefits ☐ Bonuses
☐ Other (specify) ____

2 Can the relationship be terminated by either party without incurring liability or penalty? ☐ Yes ☐ No
If "No," explain your answer. ____

3 Did the worker perform similar services for others during the time period entered in Part I, line 1? ☐ Yes ☐ No
If "Yes," is the worker required to get approval from the firm? ☐ Yes ☐ No

4 Describe any agreements prohibiting competition between the worker and the firm while the worker is performing services or during any later period. Attach any available documentation. ____

5 Is the worker a member of a union? ☐ Yes ☐ No

6 What type of advertising, if any, does the worker do (for example, a business listing in a directory or business cards)? Provide copies, if applicable. ____

7 If the worker assembles or processes a product at home, who provides the materials and instructions or pattern? ____

8 What does the worker do with the finished product (for example, return it to the firm, provide it to another party, or sell it)? ____

9 How does the firm represent the worker to its customers (for example, employee, partner, representative, or contractor), and under whose business name does the worker perform these services? ____

10 If the worker no longer performs services for the firm, how did the relationship end (for example, worker quit or was fired, job completed, contract ended, firm or worker went out of business)? ____

Part I General Information (continued)

7 If the worker received pay from more than one entity because of an event such as the sale, merger, acquisition, or reorganization of the firm for whom the services are performed, provide the following: Name of the firm's previous owner: ____________

Previous owner's taxpayer identification number: ____________ Change was a: ☐ Sale ☐ Merger ☐ Acquisition ☐ Reorganization

☐ Other (specify) ____________

Description of above change: ____________

Date of change (MM/DD/YY): ____________

8 Describe the work done by the worker and provide the worker's job title. ____________

9 Explain why you believe the worker is an employee or an independent contractor. ____________

10 Did the worker perform services for the firm in any capacity before providing the services that are the subject of this determination request?

☐ **Yes** ☐ **No** ☐ **N/A**

If "Yes," what were the dates of the prior service? ____________

If "Yes," explain the differences, if any, between the current and prior service. ____________

11 If the work is done under a written agreement between the firm and the worker, attach a copy (preferably signed by both parties). Describe the terms and conditions of the work arrangement. ____________

Part II Behavioral Control (Provide names and titles of specific individuals, if applicable.)

1 What specific training and/or instruction is the worker given by the firm? ____________

2 How does the worker receive work assignments? ____________

3 Who determines the methods by which the assignments are performed? ____________

4 Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution? ____________

5 What types of reports are required from the worker? Attach examples. ____________

6 Describe the worker's daily routine such as his or her schedule or hours. ____________

7 At what location(s) does the worker perform services (for example, firm's premises, own shop or office, home, customer's location)? Indicate the appropriate percentage of time the worker spends in each location, if more than one. ____________

8 Describe any meetings the worker is required to attend and any penalties for not attending (for example, sales meetings, monthly meetings, staff meetings). ____________

9 Is the worker required to provide the services personally? ☐ **Yes** ☐ **No**

10 If substitutes or helpers are needed, who hires them? ____________

11 If the worker hires the substitutes or helpers, is approval required? ☐ **Yes** ☐ **No**

If "Yes," by whom? ____________

12 Who pays the substitutes or helpers? ____________

13 Is the worker reimbursed if the worker pays the substitutes or helpers? ☐ **Yes** ☐ **No**

If "Yes," by whom?

Form **SS-8**
(Rev. May 2014)
Department of the Treasury
Internal Revenue Service

Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding

▶ **Information about Form SS-8 and its separate instructions is at *www.irs.gov/formss8*.**

OMB. No. 1545-0004
For IRS Use Only:
Case Number:
Earliest Receipt Date:

Name of firm (or person) for whom the worker performed services	Worker's name
Firm's mailing address (include street address, apt. or suite no., city, state, and ZIP code)	Worker's mailing address (include street address, apt. or suite no., city, state, and ZIP code)

Trade name	Firm's email address	Worker's daytime telephone number	Worker's email address
Firm's fax number	Firm's website	Worker's alternate telephone number	Worker's fax number
Firm's telephone number (include area code)	Firm's employer identification number	Worker's social security number	Worker's employer identification number (if any)

Note. If the worker is paid for these services by a firm other than the one listed on this form, enter the name, address, and employer identification number of the payer. ▶ ______

Disclosure of Information

The information provided on Form SS-8 may be disclosed to the firm, worker, or payer named above to assist the IRS in the determination process. For example, if you are a worker, we may disclose the information you provide on Form SS-8 to the firm or payer named above. The information can only be disclosed to assist with the determination process. If you provide incomplete information, we may not be able to process your request. See *Privacy Act and Paperwork Reduction Act Notice* in the separate instructions for more information. **If you do not want this information disclosed to other parties, do not file Form SS-8.**

Parts I–V. All filers of Form SS-8 must complete all questions in Parts I–IV. Part V must be completed if the worker provides a service directly to customers or is a salesperson. If you cannot answer a question, enter "Unknown" or "Does not apply." If you need more space for a question, attach another sheet with the part and question number clearly identified. Write your firm's name (or worker's name) and employer identification number (or social security number) at the top of each additional sheet attached to this form.

Part I General Information

1 This form is being completed by: ☐ Firm ☐ Worker; for services performed ______ (beginning date) to ______ (ending date).

2 Explain your reason(s) for filing this form (for example, you received a bill from the IRS, you believe you erroneously received a Form 1099 or Form W-2, you are unable to get workers' compensation benefits, or you were audited or are being audited by the IRS). ______

3 Total number of workers who performed or are performing the same or similar services: ______.

4 How did the worker obtain the job? ☐ Application ☐ Bid ☐ Employment Agency ☐ Other (specify) ______

5 **Attach copies of all supporting documentation (for example, contracts, invoices, memos, Forms W-2 or Forms 1099-MISC issued or received, IRS closing agreements or IRS rulings).** In addition, please inform us of any current or past litigation concerning the worker's status. If no income reporting forms (Form 1099-MISC or W-2) were furnished to the worker, enter the amount of income earned for the year(s) at issue $ ______.
If both Form W-2 and Form 1099-MISC were issued or received, explain why. ______

6 Describe the firm's business. ______

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 16106T Form **SS-8** (Rev. 5-2014)

Kindell, J., & Reilly, J. (1997). Lobbying Issues.

P. LOBBYING ISSUES

by
Judith E. Kindell and John Francis Reilly

1. Introduction

The last two years have witnessed a flurry of legislative activity regarding the lobbying activities of tax-exempt organizations. Concerns have been raised regarding the extent of their lobbying and whether additional limitations should be imposed. Last year, in response to some of these concerns, the Lobbying Disclosure Act of 1995 was enacted, to become effective January 1, 1996. 2 U.S.C. 1601 et seq. In addition to requiring organizations that engage in lobbying to register and report on their activities, the Act provides that IRC 501(c)(4) organizations that engage in lobbying are not eligible to receive Federal funds as an award, grant, or loan.[1] Debate concerning further, non-tax legislation continues.

Nevertheless, as Miriam Galston has noted in "Lobbying and the Public Interest: Rethinking the Internal Revenue Code's Treatment of Legislative Activities," 71 Tex. L. Rev. 1269 (1993), the primary vehicle for regulating organizations' legislative activities is the Internal Revenue Code. In her article, Professor Galston observes that the Code creates four separate and very different regulatory "regimes" regarding lobbying. Id. at 1275-81.

The first regime, which applies to IRC 501(c)(3) public charities, permits these organizations to lobby so long as they do not devote a "substantial part" of their activities to attempting to influence legislation. This system has two subsets, which employ different tests of substantiality. The older, enacted in 1934, applies facts and circumstances criteria to determine "substantial part." The newer was introduced in 1976, by the enactment of IRC 501(h) and IRC 4911. IRC 501(h) provides that certain public charities may make an election and have their lobbying activities governed by expenditure tests in lieu of being subject to the IRC 501(c)(3) "substantial part" test. If the expenditure limits are exceeded, a tax under IRC 4911 will be imposed or, if the limits are exceeded by 150 percent over a defined period, exempt status will be lost. The tests are discussed in Parts 2 and 3.

The second regime applies to IRC 501(c)(3) private foundations. Under this regime, any expenditures incurred for lobbying activities are treated as taxable expenditures under IRC 4945(d)(1) and subject to the tax imposed by IRC 4945(a). Part 4 discusses this topic.

The third regime involves other federally tax-exempt organizations. Outside of IRC 501(c)(3), there is no specific provision of IRC 501(c) that restricts lobbying activities. Consequently, the only limit imposed on the lobbying activities of non-IRC 501(c)(3) organizations is that the lobbying activities must be germane to the accomplishment of the organization's exempt purpose. As a result, the organization's sole activity in support of its exempt purpose may be lobbying without jeopardizing its tax exemption. This topic is discussed in Part 5.

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[1] See Robert A. Boisture, "What Charities Need to Know to Comply with the Lobbying Disclosure Act of 1995," 13 EOTR 35 (Jan. 1996) and Miriam Galston, "Simpson's Lobbying Provision: More Bark than Bite," 13 EOTR 45 (Jan. 1996) for descriptions of the provisions and effects of the Lobbying Disclosure Act.

Lobbying Issues

The fourth regime concerns the lobbying expenditures of businesses. These rules are set forth in IRC 162. Until recently, this was not a subject that particular concerned exempt organizations. Now, however, because of the lobbying disallowance provisions of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), exempt organizations also must consider the provisions that disallow deductions for lobbying by businesses. Part 6 discusses this topic.

2. Lobbying Activities of IRC 501(c)(3) Nonelecting Public Charities

A. Legislative and Regulatory History

(1) The Pre-Statutory Era

Prior to 1934, there was no specific statutory restriction on the lobbying activities of charities. Early regulations, however, provided that organizations "formed to disseminate controversial or partisan propaganda" were not "educational" within the meaning of the statute. Treas. Reg. 45, art 517 (1919 ed.); T.D. 2831, 21 Treas. Dec. Int. Rev. 285 (1919). The import of the regulation became the subject of litigation concerning the deductibility of a contribution or bequest to an organization. The deduction was disallowed in some cases. See Herbert E. Fales, 9 B.T.A. 828 (1927) (contributions to various temperance organizations); Joseph M. Price, 12 B.T.A. 1186 (1928) (contribution to the Civic Fund of the City Club of New York); Slee v. Commissioner, 42 F.2d 184 (1930), aff'g 15 B.T.A. 710 (1929) (contribution to the American Birth Control League); Henriette T. Noyes, 31 B.T.A. 121 (1934) (contribution to a women voters' league); Vanderbilt v. Commissioner, 48 F.2d 360 (1st Cir. 1937) (bequest to the National Women's Party). In other cases, the deduction was allowed. See Weyl v. Commissioner, 48 F.2d 811 (2nd Cir. 1931), rev'g 18 B.T.A. 1092 (1930) (contribution to the League for Industrial Democracy); Cochran v. Commissioner, 78 F.2d 176 (4th Cir. 1935), rev'g 30 B.T.A. 1115 (1934) (contribution to the World League Against Alcoholism). In one case, a contribution to an organization was allowed, while another, to a cognate organization, was disallowed. Leubuscher v. Commissioner, 54 F.2d 998 (2d Cir. 1932), modifying 30 B.T.A 1022 (1930) (bequest to two organizations to teach the ideas of Henry George relative to the single tax on land).[2]

[2] Commentators differ on the overall import of these decisions. Dean E. Sharp, "Reflections on the Disallowance of Income Tax Deductions for Lobbying Expenditures," 39 B.U. L. Rev. 365, 387 (1959), simply notes that these cases, as well as cases decided after 1934, "are in conflict." Others have deduced a trend. William H. Lehrfeld, "The Taxation of Ideology," 19 Cath. U. L. Rev. 52, 59 (1969), emphasizes the controversial nature of the organization's agenda; he concludes that "[o]nly the meek inherited the tax exemption." Tommy F. Thompson, "The Availability of the Federal Educational Tax Exemption for Propaganda Organizations," 18 U.C. Davis L. Rev. 487, 498-501 (1985), contends that the determining factor in these cases was whether the organization attempted to influence legislation. (Thompson also states, at 498 n. 29, that "no evidence suggests that the Service actively discriminated against organizations that advocated extreme viewpoints, or in favor of organizations that advocated mainstream viewpoints. The evidence suggests that the Service did in fact apply the standard strictly and evenhandedly.") Laura B. Chisholm, "Exempt Organization Advocacy: Matching the Rules to the Rationales," 63 Ind. L.J. 201, 216 n. 78, after noting Mr. Lehrfeld's and Professor Thompson's analyses, concludes: "With a few exceptions, the cases seem to support the [legislative activity] contention at least as convincingly as they support the proposition that advocacy per se or controversiality was the basis for denial of exemption or deductibility."

Of all these cases, Slee is paramount. In Slee, the organization at issue, the American Birth Control League, gave free medical services to married women, collected and distributed information about birth control, and sought to enlist the support and cooperation of legislators in repealing and amending statutes preventing birth control. Judge Learned Hand, writing for a unanimous court, dismissed the controversial nature of the League's program as irrelevant: "We cannot discriminate unless we doubt the good faith of the enterprise." Slee, at 185. Instead, he focused on the League's legislative activity:

> *Political agitation as such is outside the statute, however innocent the aim, though it adds nothing to dub it "propaganda," a polemical word used to decry the publicity of the other side. Controversies of that sort must be conducted without public subvention; the Treasury stands aside from them.* Id.[3]

Immediately after this statement, however, Judge Hand made a distinction:

> *Nevertheless, there are many charitable, literary and scientific ventures that as an incident to their success require changes in the law. A charity may need a special charter allowing it to receive larger gifts than the general laws allow. . . . A society to prevent cruelty to children, or animals, needs the positive support of law to accomplish its ends. . . . We should not think that a society of booklovers or scientists was less "literary" or "scientific," if it took part in agitation to relax the taboos upon works of dubious propriety, or to put scientific instruments on the free lists. All such activities are mediate to the primary purpose, and would not, we should think, unclass the promoters.* ***The agitation is ancillary to the end in chief, which remains the exclusive purpose of the association.*** *Trinidad v. Sagrada Orden, 263 U.S. 578, 44 S. Ct. 204, 68 L. Ed. 458 [1924].* Id. (Emphasis added.)[4]

The League, however, did not come within this exception because there was no evidence that its legislative activity was "confined solely to relieving its hospital work from legal

[3] This holding was reflective of the common law regarding lobbying in England and in Massachusetts, but not in any other jurisdiction. See Girard Trust Co. v. Commissioner, 122 F.2d 108, 113-114 (Clark, J., dissenting); Elias Clark, "The Limitation on Political on Political Activities: A Discordant Note in the Law of Charities," 46 Va. L. Rev. 439, 447-448 (1960). Professor Clark, who is critical of the decision because it "assumes the validity of the restriction without attempting to justify it by argument or authority," nevertheless notes: "Later courts have accepted the principle as settled." Id. at 446-447.

[4] The citation of Trinidad is an obvious reference to the Court's observation in that case that the exemption statute "says nothing about the source of the income, but makes the destination the ultimate test of exemption." Trinidad, at 581. The practical result of the Court's statement was that an organization could qualify for tax exempt status so long as the income was used for exempt purposes; its source was irrelevant. This became known as the "destination of income" test, and was the pervading standard for congruence with charitable exemption until the passage of the unrelated business income tax and the feeder organization rules in the Revenue Act of 1950.

obstacles." Id. Therefore, contributions to the League were not deductible. This disallowance, accordingly, was based not upon the controversial nature of the League's activities, nor upon its attempts to influence legislation per se; instead, it was based upon the assumption (actually, the lack of evidence to refute the assumption) that its legislative activities went beyond its charitable purposes.[5]

What Slee proclaims is an analog to Trinidad's "destination of income" test -- a "destination of lobbying" test. As will be discussed in the next section, this did not become the precise formulation of the statutory restriction on lobbying; nevertheless, Slee served as the basis of what was to follow.

(2) The Lobbying Restriction

In 1934, the limitation on the lobbying activities of IRC 501(c)(3) organizations, requiring that "no substantial part of an organization's activities constitute carrying on propaganda or otherwise attempting to influence legislation," became part of the statute. Revenue Act of 1934. The legislative history is sparse.

What we do know is that the Senate Finance Committee staff drafted the provision and that it was added to the Revenue Act of 1934 as a floor amendment.[6] We also know that Senator David Reed, the ranking minority member of the Committee and the provision's apparent sponsor, was dissatisfied with its formulation:

> *There is no reason in the world why a contribution made to the National Economy League should be deductible as if it were a charitable contribution if it is a selfish one made to advance the personal interests of the giver of the money. That is what the committee was trying to reach; but we found great difficulty in phrasing the amendment. I do not reproach the draftsmen. I think we gave them an impossible task; but this amendment goes much further than the committee intended to go.* 78 Cong. Rec. 5,861 (1934).

It is not clear, however, to what extent Senator Reed was speaking for the entire Committee. If the Committee were so dissatisfied with the provision, they could have tabled it -- contributions to most charities are unselfishly motivated. Likewise, if the Congress or the Administration felt that the critical issue was that more prevention of cruelty societies and crippled children's organizations would be affected by its enactment than "selfish" organizations,

[5] Judge Hand's decision made no mention of the Treasury regulation. The Board of Tax Appeals decision, in contrast, discussed it. Slee, 15 B.T.A. at 715.

[6] The provision also contained a restriction on "participation in partisan politics." The provision, however, was dropped in conference, so that only the lobbying restriction remained. H.R. Conf. Rep. No. 73-1385, 73d Cong., 2d Sess. 3-4 (1934). In explaining its deletion, one of the House managers, Representative Samuel B. Hill stated, "We were afraid this provision was too broad." 73 Cong. Rec. 7,831 (1934).

it would not have become law. One suspects that the provision was enacted simply because there was a general sentiment that lobbying by charities should be restricted.[7] This is not to doubt that the "selfish/unselfish" formula was what Senator Reed wanted drafted, nor that, as he stated, the Committee staff tried to draft it but found it impossible.[8] However, the reference to the National Economy League seems to indicate that the Senator had embarked on a personal crusade that may not have been taken too seriously by his colleagues, who seized the opportunity to enact a broader restriction.[9]

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[7] The Committee considered, and rejected, application of the provision to restrict contributions to war veterans' associations. Id. at 5,861 (remarks of Senator Pat Harrison, chairman of the Committee).

[8] The National Economy League is discussed in note 9. Senator Reed's view of the League as selfishly motivated was not universally shared. For example, in an editorial, the New York Times praised the League chairman's (and, by implication, the League's) "patriotism, disinterestedness, and loyalty." "Useful Service," April 27, 1933, at 16. The impossibility of starting with the National Economy League and drafting a "selfish/unselfish" standard is apparent.

[9] Senator Reed had been one of the leaders of the considerable number of "Old Guard" Republicans during the Harding, Coolidge, and Hoover administrations. After the 1932 election, however, their numbers had been drastically reduced, as had Reed's influence. A 1933 Newsweek portrait of the Senator, Reed: Hamiltonian, Mellon Attorney, and Penn. Senator, May 6, 1933, at 18-19, presents him as a beleaguered figure, having virtually no influence and being subjected to the abuse of the acid-tongued Senator Harrison. By the time he was denouncing his own bill on the Senate floor, his situation had worsened. He was locked in a nasty primary battle for renomination; the election occurred less than two months after his floor speech; the outcome was in doubt. His opponent was his ideological opposite, the Governor of Pennsylvania, Gifford Pinchot, a leader of the Progressive wing of the Republican Party. (In addition to their ideological differences, they detested each other: Harold Ickes observed that they had always fought "like two tomcats sitting on a fence." Arthur M. Schlesinger, Jr., The Coming of the New Deal, 346 (1959).) Pinchot was not Reed's only problem; he was also opposed by an organization that would appear to have been his natural ally, the National Economy League.

The National Economy League was one of the short-lived phenomena of the 1930's. Organized in 1932, apparently in reaction to the Bonus March, after two years of prominence, it vanished. A "revolt of the haves," dedicated to a radical reduction in government expenditures, its leadership was anything but obscure, however. Its chief spokesman was Admiral Richard Byrd (who served as chairman until he decided to travel to the Antarctic); Nicholas Murray Butler was its honorary chairman; its original six member advisory board consisted of a former President (Calvin Coolidge), a defeated candidate for the Presidency (Alfred E. Smith), two former Secretaries of State (Elihu Root and Newton D. Baker), General of the Armies John W. Pershing, and Admiral Williams Sowden Sims. "Byrd Quits as Head of Economy Group," N.Y. Times, April 26, 1933, at 5. Mr. Lehrfeld, supra, at 63, states that it had been accorded charitable status, and the right to receive tax-deductible contributions, in a ruling letter dated November 3, 1933. Soon thereafter, it submitted its own economic program to the President and Congress. The New York Times gave front page treatment to the event and printed the text of the entire program. "Roosevelt Warned Our Debt Will Rise 4 Billion in Year," Dec. 18, 1933, at 1.

The extent of benefits to war veterans was the League's foremost concern. It repeatedly urged that benefits be limited only to those wounded in war. (Appropriations to the Veterans Administration was no small budgetary matter. In praising the League's stand, the New York Times noted that the appropriations "had reached a point where they accounted for one-third of the entire cost of the Federal government, aside from service on the national debt." "Useful Service," April 26, 1933, at 16.) However, this position brought the League into conflict with Senator Reed, who also made the veterans' benefits his chief concern. Lurching unexpectedly leftward, outflanking Pinchot and even Roosevelt, in January 1934, Reed sponsored legislation to restore benefits cut the year before. "Reed Leads Fight on Veterans' Cuts," N. Y. Times, Jan. 9, 1934, at 5. The League responded by presenting its own plan and excoriating Reed's. "Plan to Simplify Veteran Aid Urged," N. Y. Times, Feb. 19, 1934, at 4. Reed's

It is widely accepted that the 1934 legislation represents a codification of the Slee position and a rejection of the strict Treasury point of view, as embodied in the 1919 regulation.[10] As a general statement, this is true. However, there is a significant difference between the two approaches, and it is not simply that the Congress did not share Judge Hand's distaste for the word "propaganda." Rather, the tests used by the two approaches are different. Slee's "destination of lobbying" approach is a purpose test; the legislation's "no substantial part" language signifies an activities test. Different results may be reached from this distinction -- under the "no substantial part" test, contributions to the American Birth Control League would remain deductible, regardless of the purpose of its legislative endeavors, if such lobbying were not "substantial;" conversely, if the prevention of cruelty societies' legislative activities were "substantial," deductibility would be lost regardless of the lobbying purpose.[11] Regulations

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stratagem was successful both as legislation and as the substantive centerpiece of his primary campaign. As Arthur Krock noted in his post-primary analysis of Reed's victory over Pinchot: "Before stripping for the fray, Mr. Reed took the precaution of getting into the money distributing class himself by leading a successful battle against the administration for added benefits and restored government pay. . . . This equipped him with at least half of Santa Claus's whiskers." "Republicans See Renewed Party in Victory of Reed," N. Y. Times, May 18, 1934, at 24.

The remainder of 1934 was not kind to either the League or the Senator. On July 23, less than three months after the effective date of the lobbying restriction, the ruling letter to the League was cancelled. Lehrfeld, supra, n. 2, at 64. On November 6, Senator Reed was defeated by Joseph F. Guffey, who became the first Democratic Senator elected from Pennsylvania in 60 years.

[10] See, e.g., Hearings on H. Res. 217 Before Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations, House of Representatives, 83d Cong., 2d Sess. part 1, 433 (1954) (statement of Assistant Commissioner (Technical) Norman A. Sugarman) and G.C.M. 34289 (May 8, 1970).

[11] Slee's purpose formulation still resonates in IRC 501(c)(3). Rev. Rul. 80-278, 1980-2 C.B. 175, holds that an organization that institutes and maintains environmental litigation as a party plaintiff operates exclusively for charitable purposes within the meaning of IRC 501(c)(3). In reaching this conclusion, Rev. Rul. 80-278 states:

> *In determining whether an organization meets the operational test, the issue is whether the particular activity undertaken by the organization is appropriately in furtherance of the organization's exempt purpose, not whether that particular activity in and of itself would be considered charitable.*
>
> * * *
>
> *Therefore, in making the determination of whether an organization's activities are consistent with exemption under section 501(c)(3) of the Code, the Service will rely on a three-part test. The organization's activities will be considered permissible under section 501(c)(3) if:*
>
> *(1) The purpose of the organization is charitable;*
>
> *(2) the activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions; and*
>
> *(3) the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose.*

written after the enactment of the lobbying restriction did not elaborate upon the statute. Reg. 86.101(6)-1 (as amended in 1935). The current "action" organization regulations were proposed early in 1959 (24 FR 1420 (Feb. 26, 1959)), and adopted later that year by T.D. 6391 (24 FR 5217 (June 26, 1959)).

(3) Subsequent Statutory Developments

As part of the Tax Reform Act of 1976, Congress enacted IRC 501(h) and IRC 4911 to provide a second test for determining the amount of allowable lobbying. These provisions are discussed in Part 3 of this article. In addition, Congress enacted IRC 504 to provide, with certain exceptions, that IRC 501(c)(3) organizations that lose exempt status due to excessive lobbying may not at any time thereafter be treated as IRC 501(c)(4) organizations. IRC 504 is discussed in Part 5.

In 1987, House Ways and Means Oversight Subcommittee Chairman J.J. Pickle announced that he was initiating an investigation into the lobbying and electioneering activities of IRC 501(c) organizations. The particular focus of concern was the National Endowment for the Preservation of Liberty (NEPL), an IRC 501(c)(3) organization. The organization reportedly received funds from the Iran-Contra arms sales and used the proceeds both to finance conservative Congressional candidates in the 1986 campaign and to run negative advertisements about Congressional incumbents who opposed aid to the Nicaraguan Contras. NEPL also engaged in a considerable amount of grass roots lobbying to garner support for Contra aid.[12]

The hearings resulted in the enactment of several statutes. One of these, IRC 4912, concerns the lobbying activities of nonelecting public charities. For years beginning after December 22, 1987, certain organizations whose IRC 501(c)(3) status is revoked because of substantial lobbying activities are subject to a five percent excise tax imposed by IRC 4912 on their "lobbying expenditures," for the year of loss of the exemption. "Lobbying expenditure" is defined in IRC 4912(d)(1) as any amount paid or incurred by a charitable organization in carrying on propaganda or otherwise attempting to influence legislation.[13]

What distinguishes lobbying activity from litigation activity, therefore, is lobbying activity, regardless of its purpose, is expressly restricted by statute, whereas litigation activity is tested on the basis of whether the particular purpose of the activity is in furtherance of the particular organization's IRC 501(c)(3) purposes.

[12] For a history of the 1987 legislation, see Chisholm, supra, n. 2, at 203-204.

[13] H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1631 (1987) explains the reason for the provision:

The committee concluded that revocation of exempt status may be ineffective in the case of certain charitable organizations as a penalty or as a deterrent to engaging in more than insubstantial lobbying activities, particularly if the organization ceases operations after it has diverted all its tax-deductible contributions and exempt income to improper purposes but before it has been audited and any income tax liability has been assessed. Accordingly, the committee believes that in such cases the sanction of revocation of tax-exempt status should be supplemented by an excise tax, just as under present law excise taxes apply where a public charity electing under section

IRC 4912 also imposes a similar tax at the same rate on any manager of the organization who willfully and without reasonable cause consented to making the lobbying expenditures knowing the expenditures would likely result in the organization's no longer qualifying under IRC 501(c)(3). There is no limit on the amount of this tax that may be imposed against either the organization or its managers.

IRC 4912(c)(2)(C) excepts private foundations from the IRC 4912 taxes because their lobbying expenditures are already subject to the tax imposed by IRC 4945. In addition, the IRC 4912 taxes are not imposed on any organization that has elected to be subject to the lobbying limitations of IRC 501(h) (IRC 4912(c)(2)(A)) or on churches and church-related organizations that are not eligible to make the IRC 501(h) election (IRC 4912(c)(2)(B)).

(4) The Constitutional Issue

In Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983), the Court addressed the question of whether the IRC 501(c)(3) restriction on lobbying violates constitutional guarantees.

Regan v. Taxation with Representation of Washington was foreshadowed by Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972); cert. denied, 414 U.S. 864 (1973), where the Tenth Circuit dismissed a claim that the IRC 501(c)(3) prohibition on lobbying and political activities was an unconstitutional restriction on the organization's freedom of speech. In so doing, the court stated:

> *In light of the fact that tax exemption is a privilege, a matter of grace rather than right, we hold that the limitations contained in section 501(c)(3) withholding exemption from nonprofit corporations do not deprive Christian Echoes of its constitutionally guaranteed right of freedom of speech. The taxpayer may engage in all such activities without restraint, subject, however, to withholding of the exemption, or, in the alternative, the taxpayer may refrain from such activities and obtain the privilege of exemption. . . . The congressional purposes evidenced by the 1934 and 1954 amendments are clearly constitutionally justified in keeping with the separation and neutrality principles particularly applicable in this case and, more succinctly, the principle that the government shall not subsidize, directly or indirectly, those organizations whose substantial activities are directed toward the accomplishment of legislative goals or the election or defeat of particular candidates.* 470 F.2d at 857.

501(h) exceeds the permitted lobbying expenditures or where a private foundation engages in any political lobbying activities.

Taxation With Representation of Washington (TWR) attacked the IRC 501(c)(3) lobbying restriction not only on the ground that it violated the freedom of speech guarantee of the First Amendment, but also on the ground that it violated the equal protection language of the Fifth Amendment's Due Process Clause. The latter argument was based on the contention that those veterans organizations which qualify for exempt status under IRC 501(c)(19) and for deductible contributions under IRC 170(c)(3) are permitted to lobby; therefore, organizations qualifying for exemption under IRC 501(c)(3) and for deductible contributions under IRC 170(c)(2) should be permitted to lobby as well.

The Supreme Court unanimously held that the IRC 501(c)(3) restriction on lobbying activities violates neither the freedom of speech guarantee of the First Amendment nor the equal protection doctrine of the Fifth Amendment. Concerning the First Amendment issue, the Court stated that this aspect of the case was controlled by its decision in Cammarano v. United States, 358 U.S. 498 (1959). In Cammarano (which is discussed in Part 6, below), the Court upheld a Treasury Regulation (antecedent to the passage of IRC 162(e)), that denied business expense deductions for lobbying activities.

As to TWR's equal protection claim, the Court stated that the general rule of statutory classifications is that such classifications are valid if they bear a rational relation to a legitimate governmental purpose, and that "[l]egislatures have especially broad latitude in creating classifications and distinctions in tax statutes." 461 U.S. at 547. The Court noted that while statutes are subject to a higher level of scrutiny if they interfere with the exercise of a fundamental right, such as freedom of speech, the IRC 501(c)(3) legislative restriction does not infringe upon freedom of speech; therefore, the statutory distinction in treatment of IRC 501(c)(3) and IRC 501(c)(19) organizations need only have a rational basis. The Court found such a basis by concluding:

> *It is not irrational for Congress to decide that tax exempt charities such as TWR should not further benefit at the expense of taxpayers at large by obtaining a subsidy for lobbying.*
>
> *It is also not irrational for Congress to decide that, even though it will not subsidize substantial lobbying by charities generally it will subsidize lobbying by veterans organizations. . . . Our country has a long standing policy of compensating veterans for their past contributions by providing them with numerous advantages. This policy has "always been deemed to be legitimate." Personnel Administrator v. Feeney, 442 U.S. 256, 279 n. 25 (1979).* Id. at 550-551.

B. Specific Issues

(1) The Meaning of "Legislation"

1. What is the general meaning of the term "legislation?"

Reg. 1.501(c)(3)-1(c)(3)(ii) provides that the term "legislation" includes "action by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure."

2. What is the meaning of "action" as used in the phrase "action by the Congress?"

Reg. 1.501(c)(3)-1(c)(3)(ii) does not elaborate on the precise meaning of the word "action." In this situation, however, one should consider the meaning of the phrase "action by the Congress" for purposes of IRC 4911(e).[14] In IRC 4911(e), the phrase "action . . . by the Congress" is used in the definition of the term "legislation" and the term "legislation" is used to delineate the extent to which certain organizations described in IRC 501(c)(3) may conduct certain types of lobbying activities.

IRC 4911(e)(2) provides that, for purposes of IRC 4911, "[t]he term 'legislation' includes action with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment or similar procedure." In IRC 4911(e)(3), Congress limited the meaning of the term "action," as that term is used in IRC 4911, to the "introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items."

G.C.M. 39694 (Jan. 21, 1988) notes that it is unclear whether the phrase "action by the Congress" as used in the regulations implementing the lobbying restriction of IRC 501(c)(3) for nonelecting public charities is also limited to the introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items. Nevertheless, G.C.M. 39694 concludes that the administration of, and compliance with, IRC 501(c)(3), IRC 501(h), IRC 4911, and IRC 4945 would be best effectuated by the application of a single definition of "action by the Congress" as a phrase referring to the introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items.

The common denominator among Acts, bills, and resolutions is the fact that all are items that are voted upon by a legislative body. Resolutions differ from Acts in that they are a formal expression of opinion by a legislative body that has only a temporary effect or no effect at all as a legal matter. G.C.M. 39694, discussing 77 C.J.S. "Resolution" § 1 (1952); Black's Law

[14] Prior to amendment in 1990, the regulations under IRC 4945 also referred to "action by the Congress" in defining legislation. Reg. 53.4945-2(a)(1) now expressly adopts the definition of legislation in the IRC 4911 regulations.

3. What is meant by "resolutions or similar matters?"

Dictionary 1178 (5th ed. 1979). Therefore, the determining factor in whether an action is a "similar matter" is not the legal effect of the action, but whether it is an item voted upon by a legislative body.

4. Does the term "legislation" include the Senate's vote on Executive Branch nominees?

Yes. The confirmation vote comes within the category of a "similar item" since it is an item voted upon by a legislative body as discussed above. It is similar to a resolution, but is stronger than a resolution since it has a final force and effect. Notice 88-76, 1988-2 C.B. 392 (lobbying on confirmation vote on nominee for federal judgeship constitutes attempting to influence legislation for purposes of IRC 501(c)(3), IRC 4911, and IRC 4945(d)). See also Reg. 56.4911-2(b)(4)(ii)(B), Example (6) (mailing requesting recipients to write to Senators on the Senate Committee that will consider a nomination for a cabinet level post is a grass roots lobbying communication).

5. Does the term "legislation" include actions by administrative bodies?

Reg. 1.501(c)(3)-1(c)(3)(ii) limits the definition of legislation to actions by legislatures or by the public through referendum, initiative, constitutional amendment, etc. The implication that actions by administrative bodies do not constitute legislation is made explicit in the regulations under IRC 4911.

Reg. 56.4911-2(d)(3) provides that legislation does not include actions by executive, judicial, or administrative bodies. Reg. 56.4911-2(d)(4) provides that the term "administrative bodies" includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive. Accordingly, an organization would not be influencing legislation for purposes of IRC 4911, if it proposed to a Park Authority that it purchase a particular tract of land for a new park, even though such an attempt would necessarily require the Park Authority eventually to seek appropriations to support a new park.[15]

[15] Reg. 56.4911-2(d)(4) nevertheless concludes that, in such a case, the organization would be influencing legislation if it provided the Park Authority with a proposed budget to be submitted to a legislative body, unless such submission is described by one of the exceptions to influencing legislation.

6. Does the term "legislation" include zoning matters?

The consideration of zoning matters varies from jurisdiction to jurisdiction. As noted above, zoning boards may be considered administrative bodies whose actions will not constitute "legislation" within the meaning of IRC 501(c)(3). However, where zoning issues are under the jurisdiction of legislators, who express their will in the form of an Act, etc., the matter is within the purview of the term "legislation." See Rev. Rul. 67-6, 1967-1 C.B. 135, which holds that a historical preservation association engaged primarily in reviewing zoning variances may not qualify for recognition of exemption under IRC 501(c)(3) "since the association as a substantial part of its activities is engaged in attempts to influence local **legislative** representatives with respect to the association's programs." (Emphasis added.)

7. Is the term "legislation" limited to actions by Federal, State, and local legislatures?

No. Although the regulations refer specifically to Federal, state and local legislative bodies, the term "legislation" contemplates foreign as well as domestic laws. Rev. Rul. 73-440, 1973-2 C.B. 177. As with domestic governments, the critical issue here is whether there is a legislative body involved. Furthermore, legislative actions by Indian tribal governments also may be considered legislation since these governments are treated as State governments pursuant to IRC 7871.

8. Is there a distinction between "good" legislation and "bad" legislation?

For purposes of IRC 501(c)(3), there is no distinction between "good" legislation and "bad" legislation. For example, Rev. Rul. 67-293, 1967-2 C.B. 185, holds that an organization substantially engaged in promoting legislation to protect or otherwise benefit animals is not exempt under IRC 501(c)(3) even though the legislation it advocates may be beneficial to the community. See also Rev. Rul. 67-6, supra. This is in accord with a dictum of the Supreme Court to the effect that the statutory restriction on attempts to influence legislation simply "made explicit" a longstanding judicial principle that "political agitation as such is outside the statute, however innocent the aim." Cammarano v. United States, 358 U.S. 498, 512 (1959), citing Slee, supra. For a direct holding, see Kuper v. Commissioner, 332 F.2d 562 (3rd Cir. 1964), cert. denied, 379 U.S. 920 (1964). In Kuper, the Third Circuit stated that "it is immaterial . . . that the legislation advocated from time to time was intended to promote sound government and was for the benefit of all citizens rather than in the interests of a limited or selfish group." Id. at 563. Likewise, in Haswell v. United States, 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), the Court of Claims concluded:

> *An organization that engages in substantial activity aimed at influencing legislation is disqualified from a tax exemption, whatever the motivation. The applicability of the influencing legislation clause is not affected by the selfish and unselfish motives and interests of the organization, and it applies to all*

> *organizations whether they represent private interests or the interests of the public.* Id. at 1142.

See also League of Women Voters of the United States v. United States, 180 F. Supp. 379 (Ct. Cl. 1960), cert. denied, 364 U.S. 822 (1960).

(2) Attempts to Influence Legislation

1. What activities are "attempts to influence legislation?"

Attempts to influence legislation are not limited to direct communications to members of the legislature ("direct" lobbying). Indirect communications through the electorate or general public ("grass roots" lobbying) also constitute attempts to influence legislation. Of course, whether a communication constitutes an attempt to influence legislation is determined on the basis of the facts and circumstances surrounding the communication in question. Both direct and grass roots lobbying are nonexempt activities subject to the IRC 501(c)(3) limitation on substantial legislative action.[16] Reg. 1.501(c)(3)-1(c)(3)(ii).[17]

Reg. 1.501(c)(3)-1(c)(3)(ii) also provides that, more generally, advocating the adoption or rejection of legislation constitutes an attempt to influence legislation for purposes of the IRC 501(c)(3) lobbying restriction. This provision was tested in the case of Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972); cert. denied, 414 U.S. 864 (1973). Christian Echoes National Ministry published articles and produced radio and television broadcasts that urged recipients to become involved in politics and to write to their representatives in Congress to urge that they support prayer in public schools and oppose foreign aid. The organization argued that attempts to influence legislation would occur only if legislation were actually pending. The Tenth Circuit concluded that the regulation properly interpreted the statute, and that the organization was engaged in attempting to influence legislation, even if legislation was not pending.

2. What is an "action organization?"

The IRC 501(c)(3) regulations provide that an organization is not operated exclusively for exempt purposes if it is an "action" organization. Reg. 1.501(c)(3)-1(c)(3) uses the term "action" organizations to describe both organizations that

[16] For IRC 501(c)(3) purposes, the distinction between direct and indirect lobbying becomes important for public charities making the IRC 501(h) lobbying election. As discussed in Part 3, there are separate limits for total lobbying and for indirect lobbying. In addition, certain communications made to members are not considered attempts to influence legislation, while other communications to members are considered lobbying.

[17] The regulation, with its specific inclusion of grass roots lobbying, makes clear that the portion of the decision in Seasongood v. Commissioner, 227 F.2d 907 (6th Cir. 1955), that limited "attempting to influence legislation" to direct appeals to the legislature is not reflective of the statute.

attempt to influence legislation and organizations that intervene in political campaigns.

For purposes of the lobbying restriction, an organization is an "action" organization on either of two distinct grounds. The first occurs if a substantial part of the organization's activities involves attempting to influence legislation. Reg. 1.501(c)(3)-1(c)(3)(ii) states that an organization will be regarded as attempting to influence legislation if it does the following:

(A) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation, or

(B) Advocates the adoption or rejection of legislation.

The second ground is found in Reg. 1.501(c)(3)-1(c)(3)(iv), which provides that an organization is an "action" organization if it has the following two characteristics:

(A) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and

(B) It advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public.

In determining whether an organization has these two characteristics, all of the surrounding facts and circumstances, including the articles and all activities of the organization, are to be considered.

3. How is nonpartisan analysis distinguished from attempts to influence legislation?

Under IRC 501(c)(3), there are certain circumstances where nonpartisan analysis, study, or research of matters pertaining to legislation may be educational and will not constitute attempts to influence legislation.[18] This occurs where the material is available to the public, governmental bodies, officials, and employees, and where the organization does not advocate the adoption or rejection of legislation. See Reg. 1.501(c)(3)-1(c)(3)(iv). Several revenue rulings discuss this issue.

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[18] In Haswell v. U.S., 500 F.2d 1133, 1144 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), the Court of Claims explained what "nonpartisan" means as follows:

> *"Nonpartisan," as used in the statute and regulations, need not refer to organized political parties. Nonpartisan analysis, study, or research is oriented to issues and requires a fair exposition of both sides of the issue involved.*

In Rev. Rul. 64-195, 1964-2 C.B. 138, an IRC 501(c)(3) organization that conducted educational activities relating to the law, legal education, and lawyers became interested in the question of court reform in the particular state in which it was organized. A constitutional amendment requiring revision of the state's court system was agreed to by the state legislature and submitted to the public for approval. The organization embarked upon a program of study, research, and assembly of the materials necessary to make an evaluation of the legislation. Experts were assembled and employed to conduct an extensive analysis of all materials relating to court reform in the United States and a detailed study and analysis of the pertinent existing case and statutory law of the state. The organization did not expend any funds or otherwise participate in any campaign to present the bills or persuade the public to vote for the amendment. The revenue ruling finds that the organization clearly did not expend funds or participate in any way in the presentation of any proposed bills to the State legislature or advocate either approval or disapproval of the proposed constitutional amendment by the electorate. Instead, the organization's involvement with court reform consisted of the study, research, and assembling of materials on a nonpartisan basis and the dissemination of such materials to the public. Accordingly, the revenue ruling concludes that the organization is not an "action" organization as that term is defined in Reg. 1.501(c)(3)-1(c)(3). Therefore, this activity does not affect its IRC 501(c)(3) status.

In contrast, the IRC 501(c)(4) organization described in Rev. Rul. 68-656, 1968-2 C.B. 216, drafted legislation and presented petitions supporting such legislation. These activities placed the organization beyond the purview of engagement in nonpartisan analysis, study, or research of matters pertaining to legislation; it had crossed over into attempting to influence legislation.[19]

In Rev. Rul. 70-79, 1970-1 C.B. 127, an organization was created to assist local governments of a metropolitan region by studying and recommending regional policies directed at the solution of mutual problems. Although some of the plans and policies formulated by the organization could only be carried out through legislative enactments, the organization did not direct its efforts or expend funds in making any legislative recommendations, preparing prospective legislation, or contacting legislators for the purpose of influencing legislation. Rev. Rul. 70-79 holds that the organization qualifies for IRC 501(c)(3) status because of the educational nature of its activities and because it abstained from advocating the adoption of any legislation or legislative action to implement its findings.

[19] The facts described in Rev. Rul. 64-195 and Rev. Rul 68-656 bear a distinct resemblance to the facts litigated in Dulles v. Johnson, 273 F. 2d 362 (2d Cir. 1959). In Dulles, the Second Circuit found that bequests to various Bar Associations were deductible from the taxable estate under the predecessor statute to IRC 2055, in part because "the legislative recommendations of the Associations . . . are designed to improve court procedure and or to clarify some technical matter of substantive law. They are not intended for the economic aggrandizement of a particular group or to promote some larger principle of governmental policy." Id. at 367. Rev. Rul. 64-195 also reaches a favorable conclusion, but on the basis of the absence of advocacy. By implication, therefore, it rejects the Dulles basis -- the nature of the legislation. Rev. Rul. 64-195, accordingly, is yet another repudiation of the "good/bad" or "selfish/unselfish" analysis.

The organization described in Rev. Rul. 70-79 can be distinguished from the organization discussed in Rev. Rul. 62-71, 1962-1 C.B. 85. The latter organization is a corporation formed for the purpose of supporting an educational program with regard to a particular doctrine or theory. It was the announced policy of the organization to promote its philosophy by educational methods as well as by the encouragement of political action. Most of the publications disseminated by the organization, together with a substantial part of its other activities, dealt with the theory advocated. This theory or doctrine can be put into effect only by legislative action.

Rev. Rul. 62-71 concludes that while the portion of the organization's activities that consisted of engaging in nonpartisan analysis, study and research and making the results thereof available to the public, when considered alone, may be classified as educational within the meaning of IRC 501(c)(3), the organization was primarily engaged in not only teaching but advocating the adoption of a particular doctrine or theory that can become effective only by the enactment of legislation. Since the primary objective of the organization can be attained only by legislative action, a step that the organization encouraged or advocated as a part of its announced policy, as opposed to merely engaging in nonpartisan analysis, study and research and making the results thereof available to the public, it is an "action" organization as that term is defined in Reg. 1.501(c)(3)-1(c)(3) of the regulations. Accordingly, the organization does not qualify for IRC 501(c)(3) exempt status.

In addition, it should be noted that activities which appear by themselves to be educational in nature may, in fact, be part of a broader purpose to influence specific legislative action. For example, in the case of Roberts Dairy Company v. Commissioner, 195 F.2d 948 (8th Cir. 1952), cert. denied, 344 U.S. 865 (1952), the organization prepared and distributed materials to inform its members and the public of certain tax disparities between business organizations. The court, apparently looking beyond the actual material distributed, held that since the ultimate objective was the revision of the tax laws, the organization was attempting to influence legislation.

4. May appearances before legislative committees constitute attempts to influence legislation?

Generally, if an organization appears before a legislative committee to discuss legislation, that action will be an attempt to influence legislation. However, attempting to influence legislation does not include such appearances when the organization appears before legislative committees in response to official requests for testimony. The Service has ruled that a university's exemption would not be jeopardized when, in response to an official request, it sent representatives who could advise a Congressional committee on the possible effects of specific legislation. See Rev. Rul. 70-449, 1970-2 C.B. 111, where the Service concludes that "attempts to influence legislation as described in the regulations imply an affirmative act and require something more than a mere passive response to a Committee invitation." While stating that the legislative history is silent on this point, the Service concludes that "it is unlikely that

Congress, in framing the language of this provision, intended to deny itself access to the best technical expertise available on any matter with which it concerns itself."[20]

5. May requests to executive bodies constitute attempts to influence legislation?

As noted above, legislation does not include actions by executive bodies. Therefore, requesting executive bodies to take some action would generally not constitute attempting to influence legislation. This is not the case where the organization requests the executive bodies to support or oppose legislation. Requesting executive bodies to support or oppose legislation is included in the purview of "attempting to influence legislation." Rev. Rul. 67-293, 1967-2 C.B. 185; Roberts Dairy Company v. Commissioner, 195 F.2d 948 (8th Cir. 1952), cert. denied, 344 U.S. 865 (1952); American Hardware and Equipment Company v. Commissioner, 202 F.2d 126 (4th Cir. 1953), cert. denied, 346 U.S. 814 (1953).

6. May lobbying activities of individuals be attributable to IRC 501(c)(3) organizations?

Where an IRC 501(c)(3) organization is involved, it is frequently necessary to determine whether a lobbying activity is attributable to the organization or merely the act of an individual. The Service has developed attribution rules to fit a number of situations. Questions involving lobbying activity, political campaign activity, and illegal activity have provided a body of administrative law that may be used to address issues of attribution.

As is noted in G.C.M. 34631 (Oct. 4, 1971) and G.C.M. 39414 (Feb. 29, 1984), principles of agency law apply to this determination. A further discussion of the standards used is found in G.C.M. 34523 (June 11, 1971), which addresses actions attributable to colleges and universities in considering their exempt status:

> *Only actions by the exempt organization can disqualify it from 501(c)(3) status. Since organizations act through individuals, it is necessary to distinguish those activities of individuals done in an official capacity from those that are not. Only official acts can be attributed to the organization. Provision is made in the articles of organization by which a school is created, by its bylaws, and by other valid and proper means, for delegating authority and*

[20] Publication of Rev. Rul. 70-449 was approved in G.C.M. 34289 (May 3, 1970). G.C.M. 34289 furnished a second rationale, i.e., the 1969 enactment of IRC 4945, with the exceptions for nonpartisan analysis, technical advice, and self-defense, was intended to restate, rather than revise, the existing definition of attempting to influence legislation. The same conclusion is expressed in G.C.M. 36127 (Jan. 2, 1975). Rev. Rul. 70-449 did not adopt this position, however; instead, as noted above, the revenue ruling states that the legislative history is silent on this point. As to whether the self-defense exception applies to nonelecting public charities, the Service has not published a precedential document adopting the favorable conclusion of G.C.M. 34289.

> *responsibility for operating the school to various people; trustees, administrators, faculty members, student leaders, etc. Each are assigned various tasks. The school is responsible for their acts in discharging these assigned duties. Their personal activities (those not associated with official duties) are not attributable to the school, and are, therefore, not relevant to an investigation of the school's qualification for 501(c)(3) status.*
>
> *Actions by a person in excess of his official authority should not, as a rule, be considered those of the school. If the school allows such usurpation of authority to go unchallenged, however, it impliedly ratifies the act.*

G.C.M. 34631, in considering the effect of possibly illegal activities by members of an organization, makes the following observation:

> *We caution, however, that actions of [the organization's] members and officers do not always reflect on the organization. Only (1) acts by [the organization's] officials under actual or purported authority to act for the organization, (2) acts by agents of the organization within their authority to act, or (3) acts ratified by the organization, should be considered as activities of the organization.*

The activities of individuals who are not officials of the organization may also be attributed to an organization. In G.C.M. 39414, the political campaign activities of individual members were attributed to an IRC 501(c)(3) organization. The organization's publication stated that the organization would be sending members to work on political campaigns, members working on political campaigns identified themselves as representing the organization, the organization paid some of the costs incurred by members working on political campaigns, and officials of the organization knew about the members' political activities on behalf of the organization and made no effort to prevent the members' political activities.

On the other hand, in Rev. Rul. 72-513, 1972-2 C.B. 246, the legislative activities of a student newspaper did not jeopardize the exemption of the sponsoring university, despite the fact that the university provided office space and financial support for the publication of the student newspaper and made available several professors to serve as advisors to the staff. The student newspaper provided training for students in various aspects of newspaper publication (including editorial policy) and was distributed primarily to students of the university. Editorial policy was determined by the student editors and not by the university or the faculty advisors. A statement on the editorial page clearly indicated that the views expressed were those of the students and not of the university. The revenue ruling concludes that the legislative activities of the student editors are not attributable to the university despite the university's provision of support to the newspaper.

(3) Limits on Attempts to Influence Legislation

1. When are attempts to influence legislation considered substantial?

A determination of whether attempts to influence legislation constitute a "substantial" portion of an organization's total activities is a factual one and there is no simple rule as to what amount of activities is substantial. An often cited case on the subject, Seasongood v. Commissioner, 227 F.2d 907 (6th Cir. 1955), is of limited help. Seasongood held that attempts to influence legislation that constituted five percent of total activities were not substantial. The case presents limited guidance because the court's view of what set of activities were to be measured is no longer supported by the weight of precedent. Moreover, it is not clear how the court arrived at the five percent figure.

Most cases have either tended to avoid any attempt at percentage measurement of activities or, at least, have stated that a percentage test is not conclusive. Thus, in Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1974), the Tenth Circuit rejected the use of a percentage test to determine whether activities were substantial, stating that "[a] percentage test to determine whether activities were substantial obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances." In Haswell v. United States, 500 F.2d 1133 (Ct. Cl. 1974), cert. denied, 419 U.S. 1107 (1975), the Court of Claims cited percentage figures in support of its determination that an organization's lobbying activities were substantial. (The amount of the organization's expenditures for lobbying activities ranged from 16.6 percent to 20.5 percent of total expenditures during the four years at issue.) While the court stated that a percentage test is only one measure of substantiality (and not, by itself, determinative), it held that these percentages were a strong indication that the organization's purposes were no longer consistent with charity.

G.C.M. 36148 (Jan. 28, 1975) characterized the substantiality issue as a "problem [that] does not lend itself to ready numerical boundaries." The G.C.M. then stated:

> *Moreover, the percentage of the budget dedicated to a given activity is only one type of evidence of substantiality. Others are the amount of volunteer time devoted to the activity, the amount of publicity the organization assigns to the activity, and the continuous or intermittent nature of the organization's attention to it. All such factors have a bearing on the relative importance of the activity, and should be given due consideration in determining whether its conduct is reconcilable with the requirement that it operate exclusively for exempt purposes.*
>
> *We therefore think that the Service should not adopt a percentage of total expenditures test for the substantiality of nonexempt activities conducted by exempt organizations. We also think that ten percent would be unjustifiably high, even if a percentage test*

> *were merely adopted for use as a threshold for more intensive auditing in which the Service can give due consideration to the relative importance of volunteer services and the like.*

Nevertheless, while neither the Service nor the courts have adopted a percentage test for determining whether a substantial part of an organization's activities consist of lobbying, some guidance can be derived from Seasongood and Haswell. Under Seasongood, a five percent safe harbor has been frequently applied as a general rule of thumb regarding what is substantial. Similarly, lobbying activities that exceed the roughly 16 to 20 percent range of total activities found in Haswell are generally considered substantial. (Compare these percentages to the sliding scale of percentage of expenditures allowed to organizations that elect to be governed by IRC 501(h) as discussed below.)

2. May supporting activities also be considered attempts to influence legislation?

In determining whether an organization has engaged in attempts to influence legislation as a substantial activity, it is sometimes difficult to determine what supporting activities should be included with the proscribed attempts to influence legislation. This is often a problem where an organization has some activities that are admittedly educational. Frequently, much effort is devoted to research, discussion, and similar activities. The problem is how much of these back-up activities should be considered part of the attempts to influence legislation. In League of Women Voters of the United States v. United States, 180 F. Supp, 379 (Ct. Cl. 1960), cert. denied, 364 U.S. 882 (1960), the time spent in discussing public issues, formulating and agreeing upon positions, and studying them preparatory to adopting a position was taken into account and compared with the other activities in determining the substantiality of the attempts to influence legislation. Attempting to influence legislation does not necessarily begin at the moment the organization first addresses itself to the public or to the legislature. See also Kuper v. Commissioner, 332 F.2d 562 (3d Cir. 1964), cert. denied, 379 U.S. 920 (1964). Furthermore, all facts and circumstances must be considered in determining whether the lobbying activities of an IRC 501(c)(3) organization are substantial, not just the amount of expenditures made.

3. Lobbying Activities of IRC 501(c)(3) Electing Public Charities

A. Legislative and Regulatory History

(1) Enactment of the Statutes

During the period from 1934 to 1976, the lobbying limitation was subject to increasing public criticism. The passage of IRC 162(e) in 1962, permitting a business expense deduction for direct lobbying expenses, led to the argument that equal treatment should be given to charitable organizations. Meanwhile, the courts were having a difficult time measuring the "substantiality" of these activities.

Congress enacted IRC 501(h) and IRC 4911 as part of the Tax Reform Act of 1976.[21] These provisions were intended to remedy some of the problems that had arisen under existing law by setting specific permissible expenditure limits. The Joint Committee on Taxation, in its General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. (Vol. 2) 419-420, explains the reasons for enactment of these statutes:

> *The language of the lobbying provision was first enacted in 1934. Since that time neither Treasury regulations nor court decisions gave enough detailed meaning to the statutory language to permit most charitable organizations to know approximately where the limits were between what was permitted by the statute and what was forbidden by it. The vagueness was, in large part, a function of the uncertainty in the meaning of the terms "substantial part" and "activities."*
>
> *Many believed that the standards as to the permissible level of activities under prior law were too vague and thereby tended to encourage subjective and selective enforcement.*
>
> *Except in the case of private foundations, the only sanctions available under prior law with respect to an organization which exceeded the limits on permitted lobbying were loss of exempt status under section 501(c)(3) and loss of qualification to receive charitable contributions. Some organizations (particularly organizations which had already built substantial endowments) could split up their activities between a lobbying organization and a charitable organization. For such organizations, these sanctions may have had little effect, and the lack of effect may have tended to discourage enforcement effort.*
>
> *For other organizations which could not split up their activities between a lobbying organization and a charitable organization and which had to continue to rely on the receipt of deductible contributions to carry on their exempt purposes, loss of section 501(c)(3) status could not be so easily compensated for and constituted a severe blow to the organization.*
>
> *The Act is designed to set relatively specific expenditure limits to replace the uncertain standards of prior law, to provide a more rational relationship between the sanctions and the violation of standards, and to make it more practical to properly enforce the*

[21] For an account of the progress of the legislation until its enactment, see Bruce R. Hopkins, The Law of Tax-Exempt Organizations, 310-312 (4th ed. 1993). For another history, written just before passage of the legislation, see Pepper, Hamilton & Sheetz, "Legislative Activities of Charitable Organizations Other Than Private Foundations," in 5 Commission on Private Philanthropy and Public Needs, Research Papers, 2917, 2926-2928 (1975).

> *law. However, these new rules replace prior law only as to charitable organizations which elect to come under the Standards of the Act. The new rules also do not apply to churches and organizations affiliated with churches, nor do they apply to private foundations; prior law continues to apply to these organizations. The Act provides for a tax of 25 percent of the amount by which the expenditures exceed the permissible level. Revocation of exemption is reserved for those cases where the excess is unreasonably great over a period of time.*

At the same time, Congress enacted IRC 504.[22] This provision provided, with certain exceptions, that IRC 501(c)(3) organizations that lose exempt status due to excessive lobbying may not at any time thereafter be treated as IRC 501(c)(4) organizations. IRC 504 is discussed in Part 5.

(2) Overview of the Statutes

Eligible public charities (listed in IRC 501(h)(4)) may elect to be governed by the IRC 501(h) substantiality test. Non-electing organizations (whether eligible or not) will be subject to the ordinary facts and circumstances substantiality test of IRC 501(c)(3) as discussed above.

IRC 501(h) establishes a sliding scale of permissible "lobbying nontaxable amounts." Nontaxable amounts are computed for both total and grass roots lobbying. These amounts are deemed insubstantial, and expenditures under the nontaxable amounts will result in neither tax nor revocation. Expenditures in excess of the nontaxable amounts are "excess lobbying expenditures." An excise tax under IRC 4911 is imposed on excess lobbying expenditures. If lobbying expenditures exceed both the permitted total lobbying amount and the grass roots amount, the IRC 4911 tax is imposed on whichever excess is greater. "Affiliated" organizations generally are treated as a single organization for purposes of computing lobbying expenditures. IRC 501(h) applies for taxable years beginning after December 31, 1976.

For IRC 501(c)(3) organizations that elect to be covered by IRC 501(h), lobbying may cause revocation of exempt status only if the amounts spent on lobbying "normally" exceed 150 percent of either of the nontaxable amounts over a four year period. Therefore, the tests of whether an organization is an "action" organization, set forth in Reg. 1.501(c)(3)-1(c)(3), should not be used to determine whether an organization that has made the IRC 501(h) election has engaged in substantial lobbying activities.

[22] Prior to 1969, IRC 504 had provided a rule against unreasonable accumulations by charities. This provision was repealed as part of the Tax Reform Act of 1969 and replaced with IRC 4942, which applies only to private foundations.

(3) History of the Regulations

In 1986, proposed regulations were published to implement the provisions of IRC 501(h) and IRC 4911. 51 FR 40211 (Nov. 5, 1986). Controversy ensued. The particular areas of concern were the definition of grass roots lobbying and the allocation rules.

As the individuals who had primary responsibility for drafting the 1988 proposed regulations, James J. McGovern, Paul G. Accetura, and Jerome P. Walsh Skelly, observe in "The Revised Lobbying Regulations, A Difficult Balance," 41 Tax Notes 1426, 1428 (Dec. 26, 1988) (hereinafter "McGovern 1988"): "The nonprofit community was effectively mobilized by a number of umbrella groups and their constituent members." The Service and Congress received more than ten thousand letters from charities and their members requesting withdrawal of the proposed regulations. These comments were generated by concerns that the regulations were overly restrictive and would have a "chilling effect" on charities' involvement in the policy making process.[23]

Members of Congress also expressed concern. Sixteen members of the Senate Finance Committee wrote a letter asking the Service to withdraw the proposed regulations. The letter stated that the proposed regulations "appear to introduce ambiguity about what activities constitute lobbying by such groups, and we believe that may restrict lobbying in ways not intended by the 1976 Act." "Congressional Tax Writers Seek Withdrawal of Proposed Regs on Lobbying by Tax-Exempt Groups," 34 Tax Notes 929 (Mar. 2, 1987). House Ways and Means Committee Chairman Dan Rostenkowski also requested that the proposal regulations be withdrawn, suggesting that the Service consult with an advisory group comprised of representatives of the public and private sector. He emphasized, however, that he would "strongly resist any suggestion that the pending controversy be settled legislatively by the Congress." See "McGovern 1988" at 1428.

While the Service did not withdraw the 1986 proposed regulations, it publicly stated in an information release, IR-87-49 (April 9, 1987), that it would reconsider key portions of the regulations. Two days of public hearings were held in 1987. In June 1987, the Service announced the establishment of a Commissioner's Exempt Organizations Advisory Group (as had been suggested by Mr. Rostenkowski). At public meetings held on September 17, 1987, and February 26, 1988, possible revisions to the 1986 proposed regulations were discussed with this Advisory Group. Substantial revisions to the regulations were published in proposed form in

[23] For example, approximately 200 organizations signed an Independent Sector position statement asking that the rules be permanently withdrawn. "Opposition to IRS Lobbying Rules Solidifies: Senate Tax Writers Join Cause," Daily Tax Report (BNA) No. 29, at G-5 (Feb. 13, 1987). Similarly, OMB Watch, an IRC 501(c)(4) organization formed to monitor activities of the Office of Management and Budget and other executive agencies, asked readers to contact Congress to tell the Service to withdraw these regulations "through passing a bill, a sense of Congress resolution, an appropriations rider denying funds to the IRS for any work on or enforcement of these regulations, or any other method Congress thinks best." "Congressional Support Sought for Protest of IRS Lobbying Proposal," Daily Tax Report (BNA) No. 15, at G-1 (Jan. 23, 1987). In addition, OMB Watch held community briefings throughout the country "to educate people about the proposed rules and encourage a grass roots campaign to force IRS to withdraw them." Id.

1988. 53 FR 51826 (Dec. 23, 1988). Messrs. McGovern, Accetura, and Walsh Skelly, "The Final Lobbying Regulations: A Challenge for Both the IRS and Charities," 48 Tax Notes 1305, 1306 (Sept. 3, 1990); 3 EOTR 766, 767 (Sept. 1990) (hereinafter "McGovern 1990"), explained the approach of the 1988 proposed regulations as follows:

> *The 1988 proposed regulations were an attempt to address charities' legitimate concerns without eliminating the statutory limits and thus opening the Service up to charges of failing to fulfill its statutory mandate. To accomplish this, the Service crafted a number of bright-line objective rules. Like all bright-line objective rules, these rules are imperfect: in certain cases, the rules will inevitably permit expenditures to be treated as nonlobbying even though the public would probably consider those expenditures to be clear examples of lobbying.*

In contrast to the reception accorded the 1986 proposed regulations, the publication of the 1988 proposed regulations resulted in less than 100 written comments. The comments were almost uniformly favorable. The 1988 proposed regulations were discussed with the Commissioner's Exempt Organizations Advisory Group at a public meeting held on January 10, 1989, and a formal public hearing was held on April 3, 1989. The final regulations were published in 1990 and contained few technical changes from the 1988 proposed regulations. They were made effective as of the date of publication. T.D. 8308, 55 FR 35579 (Aug. 31, 1990).

B. Specific Issues

(1) The IRC 501(h) Election

1. What organizations may make an election under IRC 501(h)?

IRC 501(h)(3) provides that the provisions of IRC 501(h) will apply to any eligible IRC 501(c)(3) organization that has elected to have those provisions apply.[24] To be eligible to make the IRC 501(h) election, the IRC 501(c)(3) organization must be an organization described in IRC 501(h)(4) and it must not be a disqualified organization described in IRC 501(h)(5). The IRC 501(c)(3) organizations described in IRC 501(h)(4) are as follows:

(1) Educational institutions as described in IRC 170(b)(1)(A)(ii);

[24] The Service's records indicate that, as of April 1996, 6,087 organizations have made the election by filing Form 5768 over the past five years. The IRC 501(c)(3) population eligible to make the election, as of March 1, 1996, is approximately 452,000 organizations.

In contrast, during that same time period, 2,407 organizations checked "yes" to the "attempted to influence legislation" question (Question 1, Part III of Schedule A, Form 990), but did not file Form 5768.

(2) Hospitals and medical research organizations as described in IRC 170(b)(1)(A)(iii);

(3) Organizations that support government schools as described in IRC 170(b)(1)(A)(iv);

(4) Organizations publicly supported by charitable contributions as described in IRC 170(b)(1)(A)(vi);

(5) Organizations publicly supported by admissions, sales, etc. related to their exempt purpose as described in IRC 509(a)(2); and

(6) Organizations that are public charities because they are a supporting organization described in IRC 509(a)(3) of an IRC 501(c)(3) organization that is described in IRC 509(a)(1) or IRC 509(a)(2).

2. What organizations may not use the IRC 501(h) election?

IRC 501(c)(3) organizations may not elect to be covered by the provisions of IRC 501(h) if they are not described under IRC 501(h)(4) or if they are disqualified under IRC 501(h)(5). The organizations that are ineligible to make an IRC 501(h) election are as follows:

(1) Churches or conventions or associations of churches as described in IRC 170(b)(1)(A)(i);

(2) Integrated auxiliaries of a church or convention or association of churches (IRC 508(c) and IRC 6033);

(3) Organizations described in IRC 501(c)(3) and affiliated with at least one church or convention or association of churches or an integrated auxiliary (an "affiliated group" within the meaning of IRC 4911(f)(2));

(4) Organizations that are public charities because they are a supporting organization described in IRC 509(a)(3) of certain organizations exempt under IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6);

(5) Organizations engaged in testing for public safety and thus described in IRC 509(a)(4); and

(6) Private foundations.

3. Why are churches precluded from making an election under IRC 501(h)?

Churches, along with church-related organizations, were precluded from making an election under IRC 501(h) at their own request. The Joint Committee on Taxation, in its General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. (Vol. 2) 415-416, notes that church groups expressed concern that any restriction on their lobbying activities might violate their rights under the First Amendment. More particularly, the church groups were concerned that including them among the class of organizations eligible to elect might imply Congressional ratification of the decision in Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973), which held that the limitations on lobbying were constitutionally valid and that First Amendment rights in the face of such limitations were not absolute.

By disqualifying churches and church-related organizations from making the election, Congress sought to remain neutral on the constitutional issue; in fact the Joint Committee on Taxation's Explanation explicitly states: "So that unwarranted inferences may not be drawn from the enactment of this Act, the Congress states that its actions are not to be regarded in any way as an approval or disapproval of the decision [in Christian Echoes], or of the reasoning in any of the opinions leading to that decision." Id. at 420.

4. How is an election under IRC 501(h) made?

An eligible IRC 501(c)(3) organization may make an IRC 501(h) election for any taxable year of the organization beginning after December 31, 1976, other than the first taxable year for which a voluntary revocation of the election is effective. Voluntary revocations are discussed below. The election is made by filing a completed Form 5768, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation*, with the appropriate Internal Revenue Service Center.

5. When is an election under IRC 501(h) effective?

Under IRC 501(h)(6), the election is effective with the beginning of the taxable year in which the Form 5768 is filed. For example, an eligible organization with the calendar year as its taxable year files Form 5768 making the IRC 501(h) election on December 31, 1996. The organization's IRC 501(h) election is effective for its taxable year beginning January 1, 1996. Once the IRC 501(h) election is made, it is effective (without again filing Form 5768) for each succeeding taxable year for which the organization is an eligible organization and which begins before a notice of revocation is filed. Reg. 1.501(h)-2(a).

A newly created organization may submit Form 5768 to elect the expenditure test under IRC 501(h) at the time it submits its Form 1023, *Application for Recognition of Exemption under*

6. When may a newly created organization make an election under IRC 501(h)?

Section 501(c)(3) of the Internal Revenue Code.[25] If the organization is determined to be eligible under IRC 501(h), the election will be effective with the beginning of the taxable year in which the Form 5768 is filed. However, if the organization is determined by the Service not to be eligible to make an IRC 501(h) election, the election will not be effective and the substantial part test will apply from the effective date of its IRC 501(c)(3) classification. Reg. 1.501(h)-2(c).

7. How may an organization voluntarily revoke its IRC 501(h) election?

An organization may voluntarily revoke an expenditure test election by filing a notice of voluntary revocation (Form 5768) with the appropriate Service Center. IRC 501(h)(6)(B), a voluntary revocation is effective with the beginning of the first taxable year after the taxable year in which the notice is filed.

For example, an eligible organization with the calendar year as its taxable year files Form 5768 revoking its IRC 501(h) election on May 31, 1996. The organization's IRC 501(h) election remains in effect for its taxable year beginning January 1, 1996, but is no longer in effect for its taxable year beginning January 1, 1997. When an organization voluntarily revokes its election, the substantial part test of IRC 501(c)(3) (as discussed above) will apply with respect to the organization's activities in attempting to influence legislation beginning with the taxable year for which the voluntary revocation is effective. Reg. 1.501(h)-2(d)(1).

8. May an organization that voluntarily revoked its election make the election again?

An organization that voluntarily revokes its election under IRC 501(h) may make the IRC 501(h) expenditure test election again. However, the new election may be effective no earlier than the taxable year following the first taxable year for which the voluntary revocation is effective. Reg. 1.501(h)-2(d)(2). Reg. 1.501(h)-2(d)(3) furnishes the following example:

> *X, an organization whose taxable year is the calendar year, plans to voluntarily revoke its expenditure test election effective beginning with its taxable year 1985. X must file its notice of voluntary revocation on Form 5768 after December 31, 1983, and before January 1, 1985. If X files a notice of voluntary revocation on December 31, 1984, the revocation is effective beginning with its taxable year 1985. The organization may again elect the*

[25] The organization may submit its Form 5768 to the appropriate key district office as long as its application for recognition of IRC 501(c)(3) exemption is being considered by that office.

> *expenditure test by filing Form 5768. Under Reg. 1.501(h)-2(d)(2), the election may not be made for taxable year 1985. Under Reg. 1.501(h)-2(a), a new expenditure test election will be effective for taxable years beginning with taxable year 1986, if the Form 5768 is filed after December 31, 1985, and before January 1, 1987.*

9. May an IRC 501(h) election be involuntarily revoked?

If, while an election under IRC 501(h) by an eligible organization is in effect, the organization ceases to qualify as an eligible organization, its election is automatically revoked. The revocation is effective with the beginning of the first full taxable year for which it is determined that the organization is not an eligible organization. If an organization's expenditure test election is involuntarily revoked but the organization continues to be described in IRC 501(c)(3), the substantial part test of IRC 501(c)(3) will apply with respect to the organization's activities in attempting to influence legislation beginning with the first taxable year for which the involuntary revocation is effective.[26] Reg. 1.501(h)-2(e).

(2) Limits on Lobbying Expenditures

1. What are "excess lobbying expenditures"?

As previously noted, a tax is imposed under IRC 4911(a)(1) on the excess lobbying expenditures of public charities that have elected to be covered by IRC 501(h). The tax imposed is equal to 25 percent of the amount of the organization's excess lobbying expenditures for the taxable year. IRC 4911(a)(2) provides that, for purposes of IRC 4911, the term "excess lobbying expenditures" for a taxable year means the greater of the following amounts:

(A) The amount by which the lobbying expenditures made by the organization during the taxable year exceed the lobbying nontaxable amount for such organization during such taxable year, or

(B) The amount by which the grass roots expenditures made by the organization during the taxable year exceed the grass roots nontaxable amount for such organization for such taxable year.

IRC 4911(c)(2) provides that the nontaxable amount of lobbying expenditures is the lesser of $1,000,000 or an amount determined under a sliding scale, set forth in the statute, of percentage of exempt purpose expenditures. The nontaxable amount of grassroots lobbying

[26] The situations contemplated here include, for example, an IRC 501(c)(3) public charity that becomes a private foundation or a public charity that continues to be described in IRC 501(c)(3) but becomes a supporting organization of an IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6) entity.

2. What are the nontaxable amounts?

expenditures is 25 percent of the nontaxable amount of lobbying expenditures. IRC 4911(c)(4). The following table sets forth the nontaxable amounts:

Exempt Purpose Expenditures	Total Nontaxable	Grass Roots Nontaxable
Up to $500,000	20%	5%
$500,000 to $1,000,000	$100,000 + 15% of excess over $500,000	$25,000 + 3.75% of excess over $500,000
$1,000,000 to $1,500,000	$175,000 + 10% of excess over $1,000,000	$43,750 + 2.5% of excess over $1,000,000
$1,500,000 to $17,000,000	$225,000 + 5% of excess over $1,500,000	$56,250 + 1.25% of excess over $1,500,000
Over $17,000,000	$1,000,000	$250,000

3. What are the lobbying and grass roots <u>ceiling</u> amounts?

An IRC 501(c)(3) organization that has made the election to be covered by IRC 501(h) will not be denied exemption due to substantial lobbying activities unless it normally makes lobbying or grass roots expenditures in excess of the applicable ceiling amounts. The applicable ceiling amounts for lobbying expenditures is 150 percent of the lobbying nontaxable amount for the base years (IRC 501(h)(2)(B)) and for grass roots expenditures is 150 percent of the grassroots lobbying nontaxable amount for the base years (IRC 501(h)(2)(D)).

In general, the term "base years" means the determination year and the three taxable years immediately preceding the determination year.[27] The base years, however, do not include any taxable year preceding the taxable year for which the organization is first treated as described in IRC 501(c)(3). Reg. 1.501(h)-3(c)(7).

Reg. 1.501(h)-3(b)(2), however, provides a special exception for an organization's first election. Under this exception, for the first, second, or third consecutive determination year for which an organization's first expenditure test election is in effect, the organization will not be denied exemption from tax by reason of IRC 501(h) if, taking into account as base years only those years for which the expenditure test election is in effect the following conditions are met:

(A) The sum of the organization's lobbying expenditures for such base years does not exceed 150 percent of the sum of its lobbying nontaxable amounts for the same base years; and

[27] A taxable year is a "determination year" if it is a year for which the expenditure test election is in effect, other than the taxable year for which the organization is first treated as described in IRC 501(c)(3). Reg. 1.501(h)-3(c)(8).

(B) The sum of the organization's grass roots expenditure for those base years does not exceed 150 percent of the sum of its grass roots nontaxable amounts for such base years.

Thus, the mere fact that an organization pays tax under IRC 4911 does not indicate that it will lose its exemption under IRC 501(c)(3). On the contrary, using the election and occasionally paying the tax, if necessary, was designed to allow that leeway.

4. How are these rules applied?

Reg. 1.501(h)-3(e) provides a number of examples illustrating how excess lobbying expenditures are calculated, how the tax imposed by IRC 4911(a)(1) is calculated, and how the determination is made concerning whether the electing public charity is denied exempt status under IRC 501(c)(3) because of its lobbying activities.

One example involves an organization whose taxable year is the calendar year that has been recognized as an IRC 501(c)(3) organization for a number of years prior to making the expenditure test election under IRC 501(h) effective for taxable year 1979. The organization has not revoked the election. The following table contains information used in this example.

Year	Exempt purpose expenditures (EPE) (dollars)	Calculation	Lobbying nontaxable amount (LNTA) (dollars)	Lobbying expenditures (LE) (dollars)	Grass roots nontaxable amount (25% of LNTA) (dollars)	Grass roots expenditures (dollars)
1979	700,000	(20% of $500,000 + 15% of $200,000 =)	130,000	120,000	32,500	30,000
1980	800,000	(20% of $500,000 + 15% of $300,000 =)	145,000	100,000	36,250	60,000
1981	800,000	(20% of $500,000 + 15% of $300,000 =)	145,000	100,000	36,250	65,000
1982	900,000	(20% of $500,000 + 15% of $400,000 =)	160,000	150,000	40,000	65,000
Total	3,200,000		580,000	470,000	145,000	220,000

In this example, the organization is liable for the tax imposed under IRC 4911 for 1980, 1981, and 1982 because its grass roots expenditures exceeded its grass roots nontaxable amount in each of those years, even though its total lobbying expenditures did not exceed the lobbying nontaxable amount. The tax imposed by IRC 4911(a) for 1980 is $5,937.50 which is equal to 25 percent of $13,750 (the difference between $60,000 and $36,250). For 1981, the tax is $7,187.50 and for 1982, the tax is $6,250. For the tax years 1979, 1980, and 1981, the organization meets the special exception under Reg. 1.501(h)-3(b)(2). However, for the taxable year 1982, the total grass roots expenditures for the base years (1979 through 1982) exceeds the grass roots ceiling amount of $217,500 (150 percent of $145,000). Consequently, for the taxable year 1983, the organization is denied tax exemption as an organization described in IRC 501(c)(3). The organization must again apply for recognition of exemption pursuant to Reg. 1.501(h)-3(d) for taxable years after 1983. Reg. 1.501(h)-3(e), Example (2).

Another example concerns an organization, whose taxable year is the calendar year, that made its IRC 501(h) election effective for its taxable year 1977, the first year it was treated as an organization described in IRC 501(c)(3). The organization has not revoked the election. The following table contains information used in this example.

Taxable Year	Exempt purpose expenditures (EPE) (dollars)	Calculation	Lobbying nontaxable amount (LNTA) (dollars)	Lobbying expenditures (LE) (dollars)	Grass roots nontaxable amount (25% of LNTA) (dollars)	Grass roots expenditures (dollars)
1977	700,000	(20% of $500,000 + 15% of $200,000 =)	130,000	182,000	32,500	30,000
1978	800,000	(20% of $500,000 + 15% of $300,000 =)	145,000	224,750	36,250	35,000
Subtotal	1,500,000		275,000	406,750	68,750	65,000
1979	900,000	(20% of $500,000 + 15% of $400,000 =)	160,000	264,000	40,000	50,000
Totals	2,400,000		435,000	670,750	108,750	115,000

In this example, the organization is liable for the tax imposed under IRC 4911 in 1977, 1978, and 1979 because its total lobbying expenditures exceed its lobbying nontaxable amount in each of those years. Although its grass roots lobbying expenditures exceeded its grass roots lobbying nontaxable amount in 1979, the tax is calculated based on the excess lobbying expenditures in all three years since that amount is greater. The tax for 1977 is 25 percent of the difference between $182,000 and $130,000 ($13,000). The tax for 1978 is $19,937.50 and the tax for 1979 is $26,000. Pursuant to Reg. 1.501(h)-3(c)(8), the organization is not required to determine if it continues to qualify for IRC 501(c)(3) exempt status for 1977 since that is its first year as an IRC 501(c)(3) organization. For 1978, the total lobbying expenditures and grass roots expenditures for the organization's base years (1977 and 1978) do not exceed 150 percent of its lobbying nontaxable amount or its grass roots nontaxable amount. However, for 1979, the total lobbying expenditures of the organization for its base years (1977 through 1979) do exceed $652,500 (150 percent of $435,000). As a result, for the taxable year 1980, the organization is denied tax exemption as an organization described in IRC 501(c)(3). The organization must again apply for recognition of exemption pursuant to Reg. 1.501(h)-3(d) for taxable years after 1980. Reg. 1.501(h)-3(e), Example (3).

(3) Exempt Purpose Expenditures

1. What are "exempt purpose expenditures?"

Reg. 56.4911-4 provides rules under IRC 4911(e) for determining an electing public charity's "exempt purpose expenditures." The regulation also provides that, in determining exempt purpose expenditures, no expenditure shall be counted twice by an organization.

Under Reg. 56.4911-4(b), amounts paid or incurred by an organization that are exempt purpose expenditures include the following:

(A) Amounts paid or incurred to accomplish a purpose enumerated in IRC 170(c)(2)(B) including certain transfers made by the organization;

(B) Amounts paid or incurred as current or deferred compensation for an employee's services in connection with an IRC 170(c)(2)(B) purpose;

(C) The allocable portion of administrative overhead and other general expenditures attributed to accomplishing IRC 170(c)(2)(B) purposes;

(D) All lobbying expenditures;

(E) Amounts paid or incurred for activities that are not considered lobbying because they are described in Reg. 56.4911-2(c), e.g., nonpartisan analysis, study, and research, or member communications described in Reg. 56.4911-5 that are not lobbying expenditures;

(F) A reasonable allowance for exhaustion, wear and tear, obsolescence or amortization, of assets to the extent used for one or more of the above purposes computed on a straight-line basis;[28] and

(G) Certain fundraising expenditures (but see IRC 4911(e)(1)(C) and Reg. 56.4911-4(c)(3) and Reg. 56.4911-4(c)(4)).

2. What are not "exempt purpose expenditures?"

Under Reg. 56.4911-4(c), exempt purpose expenditures do not include the following types of expenditures:

(A) Amounts paid or incurred that are not described in Reg. 56.4911-4(b);

[28] For this purpose, an allowance for depreciation will be treated as reasonable if based on a useful life that would satisfy IRC 321(k)(3)(A) as in effect on January 1, 1985.

(B) The amounts of any transfer described in Reg. 56.4911-4(e);

(C) Amounts paid to or incurred for a "separate fundraising unit" of the organization or of an affiliated organization;[29]

(D) Amounts paid to or incurred for any person not an employee, or any organization not an affiliated organization, if paid or incurred primarily for fundraising, but only if such person or organization engages in fundraising, fundraising counselling or the provision of similar advice or services;

(E) Amounts paid or incurred chargeable to a capital account, determined in accordance with the principles that apply under IRC 263 or IRC 263A, with respect to an unrelated trade or business;

(F) Amounts paid or incurred for a tax that is not imposed in connection with the organization's efforts to accomplish an IRC 170(c)(2)(B) purpose, such as taxes imposed under IRC 511(a)(1) and IRC 4911(a); and

(G) Amounts paid or incurred for the production of income.[30]

3. When are transfers exempt purpose expenditures?

There are two types of transfers that will be treated as an exempt purpose expenditure. The first is a transfer made to an organization described in IRC 501(c)(3) in furtherance of the transferor's exempt purposes that is not earmarked for any purpose other than one described in IRC 170(c)(2)(B). Therefore, a payment of dues by a local or state organization to, respectively, a state or national organization that is described in IRC 501(c)(3) is considered an exempt purpose expenditure of the transferor to the extent it is not otherwise earmarked.

[29] Reg. 56.4911-4(f)(2) provides that, for this purpose, a separate fundraising unit of any organization must consist of either two or more individuals a majority of whose time is spent on fundraising for the organization, or any separate accounting unit of the organization that is devoted to fundraising. Furthermore, for this purpose, amounts paid to or incurred for a separate fundraising unit include all amounts incurred for the creation, production, copying, and distribution of the fundraising portion of a separate fundraising unit's communication. (For example, an electing public charity that has a separate fundraising unit may not count the cost of postage for a separate fundraising unit's communication as an exempt purpose expenditure even though, under the electing public charity's accounting system, that cost is attributable to the mailroom rather than to the separate fundraising unit.)

[30] For purposes of this section, amounts are paid or incurred for the production of income if they are paid or incurred for a purpose or activity that is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational or other purpose or function constituting the basis for its exemption under IRC 501. For example, the costs of managing an endowment are amounts that are paid or incurred for the production of income and are thus not exempt purpose expenditures. Fundraising expenditures are not, for purposes of this section, amounts that are paid or incurred for the production of income. Instead, the determination of whether fundraising costs are exempt purpose expenditures must be made with reference to IRC 4911(e)(1)(C), Reg. 56.4911-4(b)(8), Reg. 56.4911-4(c)(3), and Reg. 56.4911-4(c)(4).

Reg. 56.4911-4(d)(2). The second type is a "controlled grant," but only to the extent of the amounts that are paid or incurred by the transferee that would be exempt purpose expenditures if paid or incurred by the transferor.[31] Reg. 56.4911-4(d)(3).

On the other hand, Reg. 56.4911-4(e) provides that three types of transfers cannot be considered exempt purpose expenditures. The first type is a transfer made to a member of any affiliated group (as defined in Reg. 56.4911-7(e)) of which the transferor is a member. Reg. 56.4911-4(e)(2).

The second type is a transfer that the Commissioner determines artificially inflates the amount of the transferor's or transferee's exempt purpose expenditures. The regulation provides that this determination generally will be made if a substantial purpose of a transfer is to inflate those exempt purpose expenditures. When this determination is made, the transfer will not be considered an exempt purpose expenditure of the transferor; rather, it will be an exempt purpose expenditure of the transferee to the extent that the transferee expends the transfer in the active conduct of its charitable activities or attempts to influence legislation. Standards similar to those found in Reg. 53.4942(b)-1(b) (relating to operating foundations) may be applied in determining whether the transferee has expended amounts in the "active conduct" of its charitable activities or attempts to influence legislation. Reg. 56.4911-4(e)(3).

The third type is a transfer that is not a "controlled grant" and is made to an organization not described in IRC 501(c)(3) that does not attempt to influence legislation. Reg. 56.4911-4(e)(4).

4. How are exempt purpose expenditures determined?

Reg. 56.4911-4(g) illustrates the provisions relating to the determination of exempt purpose expenditures by discussing the example of an organization that is an exempt organization described in IRC 501(c)(3) organized for the purpose of rehabilitating alcoholics. The organization elected to be subject to the provisions of IRC 501(h) in 1981. For 1981, the organization had expenditures as indicated in the following chart. Those expenditures are included in its exempt purpose expenditures to the extent indicated.

[31] Reg. 56.4911-4(f)(3) defines a "controlled grant" as a grant made by an organization eligible to elect the expenditure test to an organization not described in IRC 501(c)(3) that meets the following requirements:

(i) The donor limits the grant to a specific project of the recipient that is in furtherance of the donor's (nonlobbying) exempt purposes; and

(ii) The donor maintains records to establish that the grant is used in furtherance of the donor's (nonlobbying) exempt purposes.

Description	Total (dollars)	Includible (dollars)
Cost of real estate purchased for use as half-way house for alcoholics, attributable to the following:		
Land	30,000	
Building	200,000	
Depreciation (based on 40-year useful life)		5,000
Expenses of operating its half-way house	170,000	170,000
Administrative expenses of the organization allocated to the operation of its half-way house	95,000	95,000
Depreciation and allowances for equipment	10,000	10,000
Expenses related to attempts to influence legislation (lobbying expenditures)	40,000	40,000
Amounts paid to Z by the Organization for fundraising	35,000	
Total	580,000	320,000

Thus, for 1981, the organization's exempt purpose expenditures total $320,000. This amount includes both the direct costs of operating the half-way house as well as the administrative costs allocable to its operation. It also includes all lobbying expenses in full. Only depreciation computed on a straight-line basis is included in exempt purpose expenditures. The cost of capital expenditures (the land and building) is not included in exempt purpose expenditures. In addition, the $35,000 paid by the organization for fundraising is not included in the exempt purpose expenditures total.

(4) Direct Lobbying and Grass Roots Lobbying

1. What are lobbying expenditures?

For public charities that elect to be covered by IRC 501(h), lobbying expenditures are expenditures made for the purpose of influencing legislation (as defined in IRC 4911(d)). IRC 501(h)(2)(A). An electing public charity's lobbying expenditures for a year are the sum of its expenditures during that year for direct lobbying communications ("direct lobbying expenditures") plus its expenditures during that year for grass roots lobbying communications ("grass roots expenditures").

2. What is the distinction between "direct" and "grass roots" lobbying?

"Direct" lobbying involves attempts to influence legislation through communication with any member or employee of a legislative body. It also involves attempts to influence legislation through communication with any government official or employee (other than a member or employee of a legislative body) who may participate in the formulation of the legislation, but only if the principal purpose of the communication is to influence legislation.[32] IRC 4911(d)(1)(B); Reg. 56.4911-2(b)(1)(i). "Grass roots" lobbying involves attempts to influence legislation through an attempt to affect the opinions of the general public or any segment of the public. IRC 4911(d)(1)(A); Reg. 56.4911-2(b)(2)(i).

3. What is "legislation?"

Reg. 56.4911-2(d)(1)(i) provides that "legislation" includes action by the Congress, any state legislature, any local council, or similar legislative body, or by the public in a referendum, ballot initiative, constitutional amendment, or similar procedure. (See the discussion regarding the meaning of "action of the Congress" for purposes of the lobbying restriction for nonelecting charities.) "Legislation" includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

4. What is "specific legislation?"

Under Reg. 56.4911-2(d)(1)(ii), "specific legislation" includes both legislation that has already been introduced in a legislative body and specific legislative proposals that the organization either support or oppose. In the case of a referendum, ballot initiative, constitutional amendment, or other measure that is placed on the ballot by petitions signed by a required number or percentage of voters, an item becomes "specific legislation" when the petition is first circulated among voters for signature.

Prior to amendment in 1990, the regulations under IRC 4945 provided that "attempts to influence legislation" included communications "with respect to legislation being considered by, or to be submitted imminently to, a legislative body." Reg. 53.4945-2(a)(1) (1990). When the regulations under IRC 4911 were finalized, the standard "to be submitted imminently" was not used in Reg. 56.4911-2(d)(1)(ii) and it was deleted from the IRC 4945 regulations. As the Preamble to the regulations explains, a temporal standard is inappropriate and underinclusive given the nature of the legislative process. For example, long before many specific legislative proposals are formally introduced as a bill, they are subject to intensive scrutiny, debate, and controversy. Moreover, effective lobbying could prevent a bill from ever being introduced. Consequently, reference to legislation proposed or adopted in one state that urges its adoption in another state constitutes a specific legislative proposal in the other state even though no such bill has been introduced there. Reg. 56.4911-2(d)(1)(iii), Example (2).

Legislation may be identified either by its formal name or by a term that has been widely used in connection with specific pending legislation, e.g., "the President's plan for a drug-free America." Reg. 56.4911-2(b)(4)(ii)(B), Example (1). Legislation may also be identified merely by its content and effect. See Reg. 56.4911-2(d)(1)(iii), Example (1).

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[32] In this regard, Reg. 56.4911-2(b)(4)(i), Example (4), notes that a letter sent to an administrative agency proposing standards for regulations implementing recently enacted legislation is not a lobbying communication.

5. What is a direct lobbying communication?

A communication with a legislator or government official will not be treated as a direct lobbying communication in accordance with Reg. 56.4911-2(b)(1) unless it both refers to "specific legislation" and reflects a view on such legislation. Reg. 56.4911-2(b)(1)(ii). Therefore, a position letter on a pending bill prepared by an organization's employee and distributed to members of Congress or personal contacts by the employee with members of Congress or their staffs to seek support for the organization's position on the bill would constitute direct lobbying. Reg. 56.4911-2(b)(4)(i), Example (1). In contrast, a letter sent to a member of Congress requesting that she write an administrative agency regarding proposed regulations recently published by that agency and also requesting that she state her support for a particular type of permit granted by the agency is not a direct lobbying communication. Reg. 56.4911-2(b)(4)(i), Example (2). Similarly, sending a paper to a state legislator on a particular state's environmental problems that does not reflect a view on any specific legislation that the organization either supports or opposes likewise is not a direct lobbying communication. Reg. 56.4911-2(b)(4)(i), Example (3).

6. May some, but not all, of the expenses associated with a study be treated as direct lobbying expenditures?

Yes. The regulations furnish an example of an organization that researched, prepared, and printed a safety code for electrical wiring. The organization sold the code to the public and it was widely used by professionals in the installation of electrical wiring. A number of states have codified all, or part, of the code of standards as mandatory safety standards. On occasion, the organization lobbied state legislators for passage of the code of standards for safety reasons. Because the primary purpose of preparing the code of standards was the promotion of public safety and the standards were specifically used in a profession for that purpose, separate from any legislative requirement, the research, preparation, printing and public distribution of the code of standards is not an expenditure for a direct (or grass roots) lobbying communication. However, costs, such as transportation, photocopying, and other similar expenses, incurred in lobbying state legislators for passage of the code of standards into law are expenditures for direct lobbying communications. Reg. 56.4911-2(b)(4)(i), Example (5).

7. Will news media reports convert a communication from direct to grass roots lobbying?

In some situations, the news media may report that an organization has communicated with the legislature in support or opposition to particular legislation. The mere fact that the organization's position on the legislation has been reported in the news media, and therefore communicated to the general public, does not convert it into a grass-roots lobbying communication. The communication remains a direct lobbying communication. Reg. 56.4911-2(b)(4)(i), Example (6).

8. May indirect communications with a legislator that express a view on legislation not constitute direct lobbying?

Yes, such a situation is set forth in Reg. 56.4911-2(b)(4)(i), Example (7). In the example, an organization monthly newsletter contained an editorial column that referred to and reflected a view on specific pending bills. One of the newsletter's 10,000 nonmember subscribers is a legislator. The editorial column in the newsletter copy sent to the legislator is not a direct lobbying communication because the newsletter is sent to her in her capacity as a subscriber rather than her capacity as a legislator.[33]

9. What is a "grass roots" lobbying communication?

Reg. 56.4911-2(b)(2)(ii) sets forth a three-part test for determining whether communications with the general public will be treated as grass roots lobbying communications. The communication will be considered a grass roots lobbying communication only if it meets all three of the following requirements:

(A) The communication refers to specific legislation;

(B) The communication reflects a view on such legislation; and

(C) The communication encourages the recipient of the communication to take action with respect to such legislation.

The third element (requiring the communication to encourage the recipient to take action) is commonly referred to as the "call to action" requirement. Essentially, what this requirement means is that no matter how clearly an organization identifies the specific legislation and comments on the merits of that legislation (for example, "passage of S. 549 would mean the end of civilization as we know it") when it communicates with the general public, the absence of any further statement that encourages the recipient to take action would mean that the communication

[33] The example notes, however, that the editorial column may be a grass roots lobbying communication if it encourages recipients to take action with respect to the pending bills it refers to and on which it reflects a view. A further cautionary note is set forth in Reg. 56.4911-2(b)(4)(i), Example (8), which states that if one of the legislator's staff members sees the editorial and requests additional information, and the organization responds with a letter that refers to and reflects a view on specific legislation, the letter would be a direct lobbying communication unless it is within one of the exceptions (such as the exception for nonpartisan analysis, study or research). (The letter would not be within the scope of the exception for technical advice or assistance because the letter is not in response to a written request from a legislative body or committee.)

could not be considered a grass roots lobbying communication. The lack of such a requirement was one of the major complaints directed at the 1986 proposed regulations.[34]

10. Are all communications to the general public "grass roots"?

As noted above, unless a communication with the general public meets all three of the Reg. 56.4911-2(b)(2)(ii) requirements, it will not be a grass roots lobbying communication. Furthermore, in certain cases, a communication that does meet all three of the requirements may not be a grass roots lobbying communication. Reg. 56.4911-2(b)(1)(iii) provides that, solely for

[34] The definition of grass roots lobbying was by far the most controversial part of the 1986 proposed regulations. The 1986 proposed definition of grass roots lobbying was patterned after a test set forth in proposed IRC 162(e) regulations published in 1980. 45 FR 78167, 78169 (Nov. 25, 1980). (Those proposed regulations have not been finalized.) Under the 1986 definition, grass roots lobbying included any communication that met the following requirements:

(A) The communication pertains to legislation being considered by a legislative body, or seeks or opposes legislation;

(B) The communication reflects a view with respect to the desirability of the legislation (for this purpose, a communication that pertains to legislation but expresses no explicit view on the legislation shall be deemed to reflect a view on legislation if the communication is selectively disseminated to persons reasonably expected to share a common view of the legislation); and

(C) The communication is communicated in a form and distributed to individuals as members of the general public, that is, as voters or constituents, as opposed to a communication designed for academic, scientific, or similar purposes. A communication may meet this test even if it reaches the public only indirectly, as in a news release submitted to the media. 51 FR 40211, 40222 (Nov. 5, 1986).

IRC 501(c)(3) public charities strenuously contended that the definition of grass roots lobbying was overly broad and included many communications that were not lobbying. In particular, they objected that communications were treated as grass roots lobbying even where the communications did not include some sort of "call to action." They also contended that the definition arbitrarily concluded that a discussion of legislation reflected a view solely on the basis of its dissemination.

At the second meeting of the Commissioner's Exempt Organizations Advisory Group, February 26, 1988, Service, Chief Counsel, and Treasury representatives stated they were considering revisions to the proposed regulations that would include a "call to action" requirement and would otherwise create rules different from those under IRC 162(e). All of the Group's members that spoke on the subject stated that a "call to action" requirement should be adopted. As to the issue of severing the IRC 4911 and 4945 proposed regulations from the proposed regulations under IRC 162(e), three of the Group's eighteen members dissented, stating they saw no reason for a difference in treatment. The remainder of the Group felt that a reading of the legislative histories discloses that the policy issues are different, as are the fiscal issues -- the consideration under IRC 162(e) is to police the tax base, whereas the exempt organization provisions regulate a segment of society that is entitled to more protection under the First Amendment than businesses. "Minutes [of] Commissioner's Exempt Organization's Advisory Group, February 25-26, 1988," EOTR, Jan. 1989, 7, 12-15.

The 1988 proposed regulations, as well as the final regulations, thus accommodated the concerns of charities by (1) creating rules different from those proposed in IRC 162(e), (2) removing the "dissemination" criterion, (3) adding a definition of "specific legislation," and (4) requiring a "call to action."

purposes of IRC 4911, where a communication refers to and reflects a view on a measure that is the subject of a referendum, ballot initiative or similar procedure, the general public in the State or locality where the vote will take place constitutes the legislative body, and individual members of the general public are considered legislators. Accordingly, if such a communication is made to one or more members of the general public in that state or locality, the communication is a direct lobbying communication (unless it comes under the exception for nonpartisan analysis, study or research (discussed below)).[35]

11. What is meant by "encourages the recipient to take action?"

Reg. 56.4911-2(b)(2)(iii) provides a definition of encouraging a recipient to take action with respect to legislation. To be considered a "call to action," a communication must do any one of the following:

(A) The communication states that the recipient should contact an individual described in Reg. 56.4911-2(b)(1)(i);

(B) The communication states the address, telephone number, or similar information of a legislator or an employee of a legislative body;

(C) The communication provides a petition, tear-off postcard or similar material for the recipient to communicate with any individual described in Reg. 56.4911-2(b)(1)(i); or

(D) The communication specifically identifies one or more legislators who will vote on the legislation as: opposing the organization's view with respect to the legislation; being undecided with respect to the legislation; being the recipient's representative in the legislature; or being a member of the legislative committee or subcommittee that will consider the legislation. Merely naming the main sponsor(s) of the legislation for purposes of identifying the legislation will not constitute encouraging the recipient to take action.

[35] "McGovern 1990" Tax Notes at 1311; EOTR at 771, discusses the rather tangled considerations that were brought to bear on this issue:

> *One factor that doubtless motivated the Service to carefully consider the issue in developing the final regulations was concern that the lobbying restriction not become a prohibition on influencing legislation, including legislation subject to defeat or approval at the ballot box. Because of the more restrictive limit on grass roots lobbying, and because of the inherently high costs of reaching voters (particularly in large states such as California), treating such lobbying as grass roots lobbying could amount to an effective prohibition, rather than the intended limitation. Accordingly, given the slight ambiguity in the statute, the final regulations treat such lobbying as direct lobbying.*

Therefore, adding an exhortation such as "oppose S. 549" to the previously discussed example ("passage of S. 549 would mean the end of civilization as we know it") would not affect the analysis. The statement still would not constitute grass roots lobbying because the exhortation does not reach the level of specificity set forth in the above paragraphs.

Furthermore, there is a distinction to be observed here. Communications described in paragraphs (A) through (C) not only "encourage," but also "directly encourage" the recipient to take action with respect to legislation. Communications described in paragraph (D), however, do not "directly encourage" the recipient to take action with respect to legislation. Therefore, a communication would "encourage" the recipient to take action with respect to legislation, but not "directly encourage" such action, if the communication does no more than identify a legislator who will vote on the legislation as opposing the organization's view with respect to the legislation. Reg. 56.4911-2(b)(2)(iv). Communications that encourage the recipient to take action with respect to legislation but that do not directly encourage the recipient to take action with respect to legislation may be within the exception for nonpartisan analysis, study or research and thus not be grass roots lobbying communications. Reg. 56.4911-2(c)(1)(vi). The distinction also assumes importance in the rules regarding membership communications. Reg. 56.4911-5(f)(6).

Legislators may be identified by name or by specific reference, e.g., "the junior Senator from State Z." Reg. 56.4911-2(b)(4)(ii)(C), Example (6). However, a more general reference, e.g., "most of the Senators from the Farm Belt states are inexplicably in favor of the bill," would not identify a legislator. Reg. 56.4911-2(b)(4)(ii)(C), Example (7).

12. Must volunteer activity costs be treated as lobbying costs?

Reg. 56.4911-2(b)(4)(ii)(C), Example (8), discusses an organization that trains volunteers to go door-to-door to seek signatures for petitions to be sent to legislators in favor of a specific bill. When the organization asks the volunteers to contact others and urge them to sign the petitions, it encourages those volunteers to take action in favor of the specific bill. The organization does not reimburse the volunteers for their time and expenses. Any costs incurred by the volunteers in carrying on this activity are not lobbying or exempt purpose expenditures made by the organization. Furthermore, the volunteers may not deduct their out-of-pocket expenditures. See IRC 170(f)(6). However, the organization's costs of soliciting the volunteers' help and its costs of training the volunteers are grass roots expenditures. In addition, the costs of preparing, copying, distributing, etc., the petitions (and any other materials on the same specific subject used in the door-to-door signature gathering effort) are grass roots expenditures.

Nevertheless, as noted in Reg. 1.501(h)-3(e), Example (5), the fact that numerous unpaid volunteers conduct lobbying activities with no reimbursement on behalf of an electing public charity will not be considered in determining whether the organization has engaged in substantial lobbying for purposes of its exemption under IRC 501(c)(3). Unlike the test for nonelecting public charities where such activities would be considered, the test under IRC 501(h) is solely based upon expenditures.

(5) Exceptions

i. Nonpartisan Analysis

1. What is the exception for nonpartisan analysis?

Pursuant to IRC 4911(d)(2)(A) and Reg. 56.4911-2(c)(1)(i), engaging in nonpartisan analysis, study, or research and making the results of such work available to the general public, or a segment or members thereof, or to governmental bodies, officials, or employees will not constitute a direct lobbying communication under Reg. 56.4911-2(b)(1) or a grass roots lobbying communication under Reg. 56.4911-2(b)(2).

2. What is "nonpartisan analysis, study, or research?"

Reg. 56.4911-2(c)(1)(ii) provides that "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of Reg. 1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion, as opposed to the mere presentation of unsupported opinion.

3. May a communication that contains a "call to action" come within the exception?

Reg. 56.4911-2(c)(1)(vi) provides that a communication that reflects a view on specific legislation is not within the nonpartisan analysis, study, or research exception if the communication directly encourages the recipient to take action with respect to such legislation. As set forth above, directly encouraging a recipient to take action with respect to legislation means that the communication:

(A) States that the recipient should contact legislators;

(B) States a legislator's address, telephone number, etc.; or

(C) Provides a petition, tear-off postcard or similar material for the recipient to communicate with a legislator.

Note, however, that a communication would encourage the recipient to take action with respect to legislation, but not directly encourage such action, if the communication does no more than specifically identify one or more legislators who will vote on the legislation as: (1) opposing the organization's view with respect to the legislation; (2) being undecided with respect to the legislation; (3) being the recipient's representative in the legislature; or (4) being a member of the legislative committee or subcommittee that will consider the legislation.

Reg. 56.4911-2(c)(1)(vii), Examples (8) and (9), provide illustrations of the difference between "encouraging" and "directly encouraging." In Example (8), an analysis of a pending bill study names certain undecided Senators on the Senate committee considering the bill. Although the study meets the three part test for determining whether a communication is a grass roots lobbying communication, the study is within the exception for nonpartisan analysis, study or research, because it does not directly encourage recipients of the communication to urge a legislator to oppose the bill. In Example (9), the facts are identical except that the study concludes: "You should write to the undecided committee members to support this crucial bill." The study is not within the exception for nonpartisan analysis, study or research because it directly encourages the recipients to urge a legislator to support a specific piece of legislation.

4. How may nonpartisan analysis results be distributed?

Reg. 56.4911-2(c)(1)(iv) provides that an organization may choose any suitable means to distribute the results of its nonpartisan analysis, study, or research, including oral or written presentations, with or without charge. This includes distribution of reprints of speeches, articles and reports; presentation of information through conferences, meetings and discussions; and dissemination to the news media, including radio, television and newspapers, and to other public forums. However, such communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue.

5. What happens when results are distributed in a series?

Normally, whether a publication or broadcast qualifies as "nonpartisan analysis, study, or research" is determined based upon each presentation. However, if the results are presented as a series prepared or supported by the organization and the series as a whole meets the standards of Reg. 56.4911-2(c)(1)(ii), then any individual presentation within the series is not a direct or grass roots lobbying communication even though such individual presentation does not, by itself, meet the standards for "nonpartisan analysis, study, or research." Whether a presentation is considered part of a series will depend upon all the facts and circumstances of each particular situation. However, with respect to broadcast activities, all broadcasts within any period of six consecutive months will ordinarily be eligible to be considered as part of a series. Reg. 56.4911-2(c)(1)(iii).

Nevertheless, if an electing organization times or channels a part of a series in a manner designed to influence the general public or the action of a legislative body with respect to a specific legislative proposal, the expenses of preparing and distributing such part of the analysis, study, or research will be expenditures for a direct or grass roots lobbying communications, as the case may be. An example of such an circumstance is set forth in Reg. 56.4911-2(c)(1)(vii), Example (7). In the example, an organization presented within a period of six consecutive months a two-program television series relating to a pesticide issue. The organization arranges for the first program, which contains information, arguments, and conclusions favoring legislation, to be televised at 8:00pm on a Thursday. It arranges for the second program, which opposes such legislation, to be televised at 7:00am on a Sunday. The example concludes that the organization's presentation is not within the exception for nonpartisan analysis, study, or research, since the organization disseminated its information in a manner prejudicial to one side of the legislative controversy since the program favoring the legislation was aired at a more convenient viewing time than the second program.

6. What is the rule concerning "subsequent use"?

Reg. 56.4911-2(c)(1)(v) provides that even though an activity is initially within the exception for nonpartisan analysis, study, or research, subsequent grass roots lobbying use may cause it to be treated as a grass roots lobbying communication that is not within this exception. However, subsequent use will never cause any analysis, study, or research to be considered a direct lobbying communication.

According to Reg. 56.4911-2(b)(2)(v), certain communications or research materials that are initially not grass roots lobbying communications under the three-part definition may be treated as such due to subsequent use of the materials for grass roots lobbying. However, this occurs only if the materials are considered "advocacy communications or research materials."

7. What are "advocacy communications or research materials?"

"Advocacy communications or research materials" are communications or materials that both refer to and reflect a view on specific legislation but that do not, in their initial format, contain a direct encouragement for recipients to take action with respect to the specific legislation. Reg. 56.4911-2(b)(2)(v)(B). Therefore, the subsequent use rules do not embrace such items as assemblages of raw data.

An example of an "advocacy communication" is described in Reg. 56.4911-2(c)(vii), Example (8). That example discusses an organization that distributes a study that indicates a pending bill is an appropriate remedy for problems discussed in the study and identifies certain senators who are undecided with regard to the bill. As discussed above, while this communication encourages the recipient to take action with respect to the legislation, it does not directly encourage such action. Since the study does refer to and reflect a view on the legislation without directly encouraging action with respect to that legislation, it is an advocacy communication. However, the communication discussed in Reg. 56.4911-2(c)(vii), Example (4), would not be considered an advocacy communication. In that example, an organization publishes a newsletter that contains notices and impartial summaries of proposed legislation. Although the newsletter refers to specific legislation, it does not reflect a view on that legislation.

Advocacy communications or research materials may be treated as grass roots lobbying communications when they are subsequently accompanied by a direct encouragement for recipients to take action with respect to legislation. For example, if the study discussed in Reg. 56.4911-2(c)(vii), Example (8), were subsequently distributed with a letter stating "You should write to the undecided committee members to support this crucial bill," the study itself could be treated as a grass roots lobbying communication. However, the advocacy

8. When will "advocacy communications" become grass roots lobbying?

communications or research materials themselves will not be treated as grass roots lobbying communications unless the organization's primary purpose in undertaking or preparing the advocacy communications or research materials was not for use in lobbying. If no such primary nonlobbying purpose is shown to exist, all expenses of preparing and distributing the advocacy communications or research materials will be treated as grass roots expenditures. Reg. 56.4911-2(b)(2)(v)(C).

9. How is the primary purpose determined?

Reg. 56.4911-2(b)(2)(v)(E) sets forth a safe harbor for determining the primary purpose of an organization when it undertakes or prepares advocacy communications or research materials. It states that the activity's primary purpose will not be considered to be for use in lobbying if the organization makes a substantial nonlobbying distribution of the advocacy communications or research materials (without the direct encouragement to action) prior to or contemporaneously with the use of those materials with the direct encouragement to action. In determining whether a distribution is substantial, all of the facts and circumstances will be considered, including the normal distribution pattern of similar nonpartisan analyses, studies, or research by that and similar organizations.[36]

If the organization does not meet the safe harbor because the nonlobbying distribution of advocacy communications or research materials is not substantial, Reg. 56.4911-2(b)(2)(v)(G) provides that all of the facts and circumstances must be weighed to determine whether the organization's primary purpose in preparing the advocacy communications or research materials was for use in lobbying. One factor that is particularly relevant is the extent of the organization's nonlobbying distribution of the advocacy communications or research materials, especially when compared to the extent of their distribution with the direct encouragement to action. Another particularly relevant factor is whether the lobbying use of the advocacy communications or research materials is by the organization that prepared the document, a related organization, or an unrelated organization. Where the subsequent lobbying distribution is made by an unrelated organization, clear and convincing evidence (which must include evidence demonstrating cooperation or collusion between the two organizations) will be required to establish that the primary purpose for preparing the communication for use in lobbying.

Yes. Under the "subsequent use" rule, the characterization of expenditures as grass roots lobbying expenditures regulation applies only to expenditures paid less than six months before the first time advocacy communications or research materials are used with a direct encouragement to action with respect to legislation. Reg. 56.4911-2(b)(2)(v)(D). The six month

[36] Reg. 56.4911-2(b)(2)(v)(F) provides a special rule for "partisan analysis, study or research," that is, in the case of advocacy communications or research materials that are not nonpartisan analysis, study or research, the nonlobbying distribution thereof will not be considered "substantial" unless that distribution is at least as extensive as the lobbying distribution thereof.

10. Is there a time limit on the "subsequent use" rule?

rule eliminates the possibility of years of research costs being retroactively characterized as lobbying costs.

ii. Other Exceptions

1. What is the exception for examinations and discussions of broad social problems?

The exception for examinations and discussions of broad social, economic, and similar problems in Reg. 56.4911-2(c)(2) is implicit in the definitions of direct lobbying and grass roots lobbying communications. The regulation provides that such discussions are neither direct lobbying communications nor grass roots lobbying communications even if the problems are of the type with which government would be expected to deal ultimately. In describing the scope of this exception, the regulation provides that communications regarding a subject that is also the subject of legislation before a legislative body will not be considered lobbying communications so long as the discussion does not address itself to the merits of a specific legislative proposal and does not directly encourage recipients to take action with respect to legislation. Both direct and grass roots lobbying communications must reflect a view on specific legislation so any communication coming within this exception would fail to qualify as either a direct or grass roots lobbying communication. The regulation provides that this exception excludes from grass roots lobbying an organization's discussions of problems such as environmental pollution or population growth that are being considered by Congress and various State legislatures, but only where the discussions do not directly address the specific legislation being considered and do not directly encourage recipients of the communication to contact a legislator, an employee of a legislative body, or a government official or employee who may participate in the formulation of legislation. Such discussions would also fail to qualify as grass roots lobbying under the three-part test of Reg. 56.4911-2(b)(2)(ii) since they do not reflect a view on the specific legislation.[37]

[37] Prior to the adoption of the final regulations under IRC 4911, the IRC 4945 regulations had included an exception for discussion of broad social problems. This exception was included in the IRC 4911 regulations to provide parity with the IRC 4945 regulations. However, as a substantive matter, the exception seems superfluous.

2. What is the exception for requests for technical advice?

Reg. 56.4911-2(c)(3) provides that a communication will not be considered a direct lobbying communication when it consists of providing technical advice or assistance to a governmental body, a governmental committee, or a subdivision of either in response to a written request by that body, committee, or subdivision, as set forth in Reg. 53.4945-2(d)(2).

Requests made by individual members of a governmental body, committee, or subdivision of either will not qualify under this exception since Reg. 53.4945-2(d)(2)(i) requires that the request for assistance or advice must be made in the name of the requesting governmental body, committee or subdivision. Likewise, the response to such request must be available to every member of the requesting body, committee or subdivision to qualify for the exception. The regulations provide an example of a written response submitted to the person making a request for technical assistance in the name of a congressional committee, making it clear that the response is for the use of all the members of the committee. In that situation, the response will be considered available to every member of the requesting committee if the response is.

Oral or written presentation of technical assistance or advice coming under this exception does not need to qualify as nonpartisan analysis, study or research. The offering of opinions or recommendations will ordinarily qualify under this exception only if such opinions or recommendations are specifically requested by the governmental body, committee or subdivision or are directly related to the materials so requested. Reg. 53.4945-2(d)(2)(ii). The regulations illustrate these rules with the example of a Congressional committee that is studying the feasibility of legislation to provide funds for scholarships to U.S. students attending schools abroad. The committee made a written request to an organization that has engaged in a private scholarship program of this type to describe the manner in which it selects candidates for its program. If the organization's response not only included a description of its own grant-making procedures, but also its views regarding the wisdom of adopting such a program, the technical advice or assistance exception would still apply (because such views are directly related to the subject matter of the request for technical advice or assistance). Similarly, the exception would still apply if the organization was requested, in addition, to give any views it considered relevant and the organization's response included a discussion of alternative scholarship programs and their relative merits. Reg. 53.4945-2(d)(2)(iii), Examples (1), (2), and (3).

3. What is the exception for "self-defense"?

Under the "self-defense" exception of Reg. 56.4911-2(c)(4), a communication is not a direct lobbying communication if the communication is an appearance before, or communication with, any legislative body with respect to a possible action by the body that might affect the existence of the electing public charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to the organization, as set forth in Reg. 53.4945-2(d)(3). Reg. 56.4911-2(c)(4) also contains special rules for membership communications, as well as communications among an affiliated group and a limited affiliated group.

Under this exception, a charity may communicate with an entire legislative body, with committees or subcommittees of a legislative body, with individual legislators, with legislative staff members, or with representatives of the executive branch who are involved with the legislative process, so long as such communication is limited to the prescribed subjects. Similarly, under the self-defense exception, a charity may make expenditures in order to initiate legislation if such legislation concerns only matters which might affect the existence of the charity, its powers and duties, its tax-exempt status, or the deductibility of contributions to such charity.

Therefore, if a bill would cause an organization to lose its exemption from taxation if it engages in certain transactions, expenditures paid or incurred with respect to the organization's submissions on the bill do not constitute taxable expenditures since they are made with respect to a possible decision of Congress which might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation. Reg. 53.4945-2(d)(3)(ii), Example (1). However, the exception would not apply to expenditures incurred by an organization that appeared before an appropriations committee in order to attempt to persuade the committee of the advisability of continuing a contract research program whose discontinuance would affect the organization financially. Expenditures paid or incurred with respect to such appearance are not made with respect to possible decisions of the legislature that might affect the existence of the organization, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation, but rather merely affect the scope of the organization's future activities. Reg. 53.4945-2(d)(3)(ii), Example (4).

(6) Special Rules for Mass Media Advertising

1. What are the rules concerning mass media advertising?

Reg. 56.4911-2(b)(5) contains a special rule for certain mass media advertisements. Under this rule, a mass media advertisement that does not qualify as a grass roots lobbying communication under the three-part definition (as discussed above) may nevertheless be considered a grass roots lobbying communication. This special rule generally applies only to a limited type of paid advertisements that appear in the mass media.

Reg. 56.4911-2(b)(5)(ii) contains a presumption regarding certain paid mass media advertisements about highly publicized legislation. Under this presumption, if an organization's paid advertisement appears in the mass media within two weeks before a vote by a legislative body, or a committee (but not a subcommittee) of such body, on a highly publicized piece of legislation, the paid advertisement will be considered to be a grass roots lobbying communication if the paid advertisement both reflects a view on the general subject of such legislation and either refers to the highly publicized legislation or encourages the public to communicate with legislators on the general subject of such legislation. This presumption can be rebutted by demonstrating that the paid advertisement is a type of mass media communication regularly made by the organization without regard to the timing of legislation (that is, a customary course of business exception) or that the timing of the paid advertisement was unrelated to the upcoming legislative action.[38] A mass media communication that otherwise meets the presumption but is made more than two weeks before a legislative vote will not be considered a grass roots lobbying communication under this rule, even if it is presented only one day more than two weeks. Reg. 56.4911-2(b)(5)(iv), Examples (2) and (4). Furthermore, there must be a legislative vote on the legislation for this rule to apply. If, because of public pressure resulting from an advertising campaign opposing a bill that would meet the presumption, the bill is withdrawn and no vote is ever taken, none of the advertisements will be considered a grass roots lobbying communication under this rule. Reg. 56.4911-2(b)(5)(iv), Example (5).

2. What is "mass media?"

For purpose of this special rule, the term "mass media" means television, radio, billboards and general circulation newspapers and magazines. Newspapers or magazines that are published by an IRC 501(c)(3) organization that has made an IRC 501(h) election will not be considered general circulation newspapers or magazines unless the total circulation of the newspaper or magazine is greater than 100,000 and fewer than one-half of the recipients are members of the organization (as defined in Reg. 56.4911-5(f)). Reg. 56.4911-2(b)(5)(iii)(A). Where an electing public charity is itself a mass media publisher or broadcaster, all portions of that organization's mass media publications or broadcasts are treated as paid advertisements in the mass media, except those specific portions that are advertisements paid for by another person. Reg. 56.4911-2(b)(5)(iii)(B).

3. What is "highly publicized?"

Reg. 56.4911-2(b)(5)(iii) provides that legislation is "highly publicized" for purpose of this special rule when it receives frequent coverage on television and radio, and in general circulation newspapers, during the two weeks preceding the vote by the legislative body or committee. In the case of state or local legislation, it is "highly publicized" when it receives frequent coverage in the mass media that serve the State or local jurisdiction in question. Even where legislation receives frequent coverage, it is "highly publicized" only if the pendency of the legislation or the legislation's general terms, purpose, or effect are known to a significant segment of the general public (as opposed to the particular interest groups directly affected) in the area in which the paid mass media advertisement appears.

[38] However, even if the organization successfully rebuts the presumption, a mass media communication is a grass roots lobbying communication if the communication would be a grass roots lobbying communication under the general rules of the three-part test.

(7) Earmarking

1. What are the rules relating to transfers by electing charities?

When an electing public charity makes a transfer that is earmarked for grass roots lobbying purposes, the transfer is a grass roots expenditure. Reg. 56.4911-3(c)(1). When an electing public charity makes a transfer that is earmarked for direct lobbying purposes or for direct lobbying and grass roots lobbying purposes, the transfer is treated as a grass roots expenditure in full except to the extent the electing public charity demonstrates that all or part of the amounts transferred were expended for direct lobbying purposes, in which case that part of the amounts transferred is a direct lobbying expenditure by the electing public charity.[39] Reg. 56.4911-3(c)(2).

A transfer for less than fair market value by an electing public charity to any organization (other than those described in IRC 501(c)) that makes lobbying expenditures is not an exempt purpose expenditure unless the public charity makes the benefit generally available at less than fair market value in the course of an activity that is substantially related to accomplishing the exempt purpose of the charity.[40] Reg. 56.4911-3(c)(3). Transfers for fair market value, whether to related or unrelated organizations, are not covered by this rule.

The amount by which the cost or fair market value (whichever is greater) of the transfer exceeds the value given to the electing public charity in return for the transfer is the amount subject to this rule. Reg. 56.4911-3(c)(3)(i)(E). This amount is treated as a grass roots expenditure to the extent of the transferee's grass roots expenditures. If the transferred amount exceeds the transferee's grass roots expenditures, the excess is treated as a direct lobbying expenditure to the extent of the transferee's direct lobbying expenditures. If the transfer exceeds both grass roots and direct lobbying expenditures by the transferee, the excess is not treated as a lobbying expenditure. Reg. 56.4911-3(c)(3)(ii). Reg. 56.4911-3(c)(3)(iii) illustrates this provision by the following example:

> *Organization C, an electing public charity, shares employee E with N, a noncharity that makes lobbying expenditures. N's grass roots expenditures are $5,000 and its direct lobbying expenditures are $25,000. Each organization pays one-half of the $100,000 in direct and overhead costs associated with E. E devotes one-quarter of his time to C and three-quarters of his time to N. In substance, this arrangement is a transfer (for less than fair market value) from C to N in the amount of $25,000 (one-quarter of the $100,000 of direct and overhead costs associated with E's work).*

[39] These rules do not apply to transfers that are not exempt purpose expenditures because they are described in Reg. 56.4911-4(e).

[40] This rule also does not apply to controlled grants or to transfers that are not exempt purpose expenditures because they are described in Reg. 56.4911-4(e).

Accordingly, C is treated as having made a $5,000 grass roots expenditure (the lesser of N's grass roots expenditures ($5,000) or the amount of the transfer ($25,000)). C is also treated as having made a $20,000 direct lobbying expenditure (the lesser of N's direct lobbying expenditures ($25,000) or the remaining amount of the transfer ($20,000)).

2. When is a transfer earmarked for a specific purpose?

To be treated as a lobbying expenditure in accordance with Reg. 56.4911-3(c)(1) or Reg. 56.4911-3(c)(2), a transfer must be "earmarked" for direct or grass roots lobbying purposes pursuant to Reg. 56.4911-4(f)(4). This regulation provides that a transfer, including a grant or payment of dues, is "earmarked" for direct or grass roots lobbying purposes to the extent the transfer meets either one of the following requirements:

(A) The transferor directs the transferee to add the amount transferred to a fund established to accomplish the direct or grass roots lobbying purpose, or

(B) The amount transferred or, if less, the amount agreed upon to the expended to accomplish the purpose, if there exists an agreement, oral or written, whereby the transferor may cause the transferee to expend amounts to accomplish the direct or grass roots lobbying purpose or whereby the transferee agrees to expend an amount to accomplish the direct or grass roots lobbying purpose.

(8) Allocation Rules

1. What are the principles of the allocation rules?

Reg. 56.4911-3 contains allocation rules for determining what portion of the costs of a lobbying communication is a direct lobbying expenditure, what portion is a grass roots lobbying expenditure, and what portion is not a lobbying expenditure. The general principle involved is that all costs of preparing a direct or grass roots lobbying communication are included as expenditures for direct or grass roots lobbying ("lobbying expenditures"), including both direct and indirect costs. Therefore, lobbying expenditures include amounts paid or incurred as current or deferred compensation for an employee's services as well as the allocable portion of administrative, overhead, and other general expenditures attributable to the direct or grass roots lobbying communication. For example, as a general rule, all expenditures for researching, drafting, reviewing, copying, publishing and mailing a direct or grass roots lobbying communication, as well as an allocable share of overhead expenses, are included as expenditures for direct or grass roots lobbying. Reg. 56.4911-3(a)(1).

2. How are expenditures for nonmember communications allocated?

When an electing public charity makes a lobbying communication that is not sent only or primarily to members and that also has a bona fide nonlobbying purpose, the allocable lobbying expenditures must include all costs that are attributable to those parts of the communication on the same specific subject as the lobbying message. Reg. 56.4911-3(a)(2)(i). All costs attributable to those parts of the communication that are not on the same specific subject as the lobbying message are not included as lobbying expenditures for allocation purposes. Whether or not a portion of a communication is on the same specific subject as the lobbying message will depend on the surrounding facts and circumstances.[41]

3. When are portions of a communication "on the same specific subject?"

A portion of a communication will be "on the same specific subject" as the lobbying message if that portion discusses an activity or specific issue that would be directly affected by the specific legislation that is the subject of the lobbying message. Moreover, discussion of the background or consequences of the specific legislation, or discussion of the background or consequences of an activity or specific issue affected by the specific legislation, is also considered to be on the same specific subject as the lobbying communication. Reg. 56.4911-3(a)(2)(i).

Reg. 56.4911-3(b), Examples (8) and (9), illustrate the "same specific subject" rule. In the examples, a nonmembership organization prepared and mailed a four page document. The first two pages, titled "The Need for Child Care," support the need for additional child care programs, and include statistics on the number of children living in homes where both parents work or in homes with a single parent. The two pages also make note of the inadequacy of the number of day care providers to meet the needs of these parents. The third page, titled "H.R. 1," indicates the organization's support of H.R. 1, a bill pending in the U.S. House of Representatives. The document states that H.R. 1 will provide for $10,000,000 in additional subsidies to child care providers, primarily for those providers caring for lower income children. The third page also notes that H.R. 1 includes new federal standards regulating the quality of child care providers. The document ends with T's request that recipients contact their Congressional representative in support of H.R. 1. The fourth page does not refer to the general need for child care or the specific need for additional child care providers. Instead, the fourth page advocates that a particular federal agency commence, under its existing statutory authority, licensing of day care providers in order to promote safe and effective child care. The examples

[41] With the exception of the definition of grass roots lobbying, the provision of the 1986 proposed regulations that created the biggest stir was the proposed rule that all expenditures for a fundraising communication would be treated as grass roots lobbying if any part of the communication also consists of grass roots lobbying. 51 FR 40211, 40222-3 (Nov. 5, 1986). The 1988 proposed regulations revised this allocation rule by providing two different rules: a "same specific subject" rule for nonmember communications and a reasonable allocation rule for membership communications. The 1990 regulations also adopted these rules.

conclude that the first three pages of the document are on the same specific subject; therefore, all expenditures of preparing and distributing those three pages are grass roots lobbying expenditures. However, the cost of the fourth page is not a lobbying expenditure since it is not on the same specific subject.

4. How are expenditures for member communications allocated?

Reg. 56.4911-3(a)(2)(ii) provides that in the case of lobbying expenditures for a communication that also has a bona fide nonlobbying purpose and that is sent only or primarily to members, an electing public charity must make a reasonable allocation between the amount expended for the lobbying purpose and the amount expended for the nonlobbying purpose. For the purpose of applying this rule, if more than half of the recipients of a lobbying communication are members of the organization within the meaning of Reg. 4911-5, then the communication is considered to be sent only or primarily to members. (See the discussion below for the rules regarding communications with members.) The regulation further provides that an electing public charity that includes as a lobbying expenditure only the amount expended for the specific sentence or sentences that encourage the recipient to take action with respect to legislation has not made a reasonable allocation. Reg. 56.4911-3(b), Examples (10) and (11), illustrate these principles. A member organization that prepared and mailed a document primarily to members that discusses the need for child care, refers to and reflects a view on specific legislation concerning child care, and states that readers should contact the legislature regarding the specific legislation. The organization determines that the document has a bona fide nonlobbying purpose, educating its members about the need for child care. In Example (10), the organization allocates one-half of the preparation and distribution costs to lobbying, which the regulation concludes is reasonable. However, in Example (11), the regulations conclude that an allocation of only one percent of the costs to lobbying based upon the fact that only two lines out of 200 state that the recipient should contact the legislature was not reasonable.

5. How are mixed lobbying expenditures allocated?

Generally, a communication (to which the membership rules of Reg. 56.4911-5 does not apply) that is both a direct lobbying communication and a grass roots lobbying communication will be treated as a grass roots lobbying communication. However, to the extent the electing public charity demonstrates that the communication was made primarily for direct lobbying purposes, the organization may make a reasonable allocation between the direct and the grass roots lobbying purposes served by the communication. Reg. 56.4911-3(a)(3).[42]

[42] Under the proposed 1986 regulations, the organization had to demonstrate that the expenditure was incurred **solely** for direct lobbying purposes. 51 FR 40211, 40223 (Nov. 5, 1986).

(9) Special Rules for Membership Communications

1. What are the rules concerning membership communications?

Reg. 56.4911-5 provides that expenditures for certain communications between an organization and its members ("membership communications") are treated more leniently for purposes of IRC 4911 than are similar communications to nonmembers. Pursuant to the regulation, certain membership communication expenditures are not lobbying expenditures even though those expenditures would be lobbying expenditures if the communication were to nonmembers. In other cases, expenditures that would be grass roots expenditures if the communication were to nonmembers are direct lobbying expenditures when made to members.

2. Who is a "member"?

Under Reg. 56.4911-5(f)(1), a person is a member of an electing public charity if the person (either an individual or organization) pays dues or makes a contribution of more than a nominal amount, makes a contribution of more than a nominal amount of time, or is one of a limited number of "honorary" or "life" members who have more than a nominal connection with the electing public charity and who have been chosen for a valid reason (such as length of service to the organization or involvement in activities forming the basis of the electing public charity's exemption) unrelated to the electing public charity's dissemination of information to its members.

A person may be treated as a member of an electing public charity even though that person does not qualify as a member under the tests set forth in Reg. 56.4911-5(f)(1) if the electing public charity demonstrates to the satisfaction of the Service that there is a good reason for its membership requirements not meeting the above requirements and that its membership requirements do not operate to permit an abuse of these rules. This rule has been applied, for example, in PLR 93-32-042 (May 19, 1993), in which members of separately incorporated state and local organizations were treated as members of a national organization based upon coordinated activities and payment of a share of dues to the national organization.

3. When are expenditures for member communications not lobbying expenditures?

Pursuant to Reg. 56.4911-5(b), expenditures for a communication that refers to, and reflects a view on, specific legislation will not be considered lobbying expenditures if the communication satisfies the following four requirements:

(A) The communication is directed only to members of the organization;

(B) The specific legislation the communication refers to, and reflects a view on, is of direct interest to the organization and its members;

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

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

4. What happens when a member communication encourages direct lobbying?

A communication that otherwise meets the requirements set forth in Reg. 56.4911-5(b) but does not come within that rule because it directly encourages the members to engage in direct lobbying will be treated as a direct lobbying communication. IRC 4911(d)(3)(A); Reg. 56.4911-5(c). Reg. 56.4911-5(f)(6)(i)(A) provides that a member communication directly encourages a recipient to engage in direct lobbying, whether individually or through the organization, if the communication does any of the following:

(A) The communication states the recipient should contact an individual described in Reg. 56.4911-2(b)(1)(i);

(B) The communication states the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(C) The communication provides a petition, tear-off postcard or similar material for the recipient to communicate his or her views to an individual described in Reg. 56.4911-2(b)(1)(i).

5. What happens when member communications encourage grass roots lobbying?

A communication that meets the requirements of Reg. 56.4911-5(b) that it be directed only to members and refer to and reflect a view on specific legislation of direct interest and concern to the organization and its members, but does not qualify under that rule because it directly encourages the members to urge persons other than members to engage in direct or grass roots lobbying is treated as grass roots lobbying. IRC 4911(d)(3)(B); Reg. 56.4911-5(d). Reg. 56.4911-5(f)(6)(ii) provides that a communication directly encourages recipients to engage individually or collectively (whether through the organization or otherwise) in grass roots lobbying if the communication does any of the following:

(A) The communication states the member should encourage nonmembers to contact an individual described in Reg. 56.4911-2(b)(1)(i);

(B) The communication states the recipient should provide to nonmembers the address, telephone number, or similar information of a legislator or an employee of a legislative body; or

(C) The communication provides (or requests the recipient provide to nonmembers) a petition, tear-off postcard or similar material for the recipient (or nonmember) to use to ask nonmembers to communicate views to an individual described in Reg. 56.4911-2(b)(1)(i). For example, a petition that has an entire page of preprinted signature blocks is considered to be provided to the member to ask nonmembers to communicate views. Similarly, where a communication is distributed to a single member and provides several tear-off postcards addressed to a legislator, the postcards are presumed to be provided for the member to use to ask nonmembers to communicate with the legislator.

6. Is there a "self-defense" exception for members?

Yes, in some instances a communication by an electing public charity on behalf of its members will come within the "self-defense" exception. Reg. 56.4911-2(c)(4)(iii) provides that the exception applies to an electing public charity when more than 75 percent of its members are other organizations that are described in IRC 501(c)(3). Appearances before, or communications with, any legislative body with respect to a possible action by the body which might affect the existence of one or more of the IRC 501(c)(3) member organizations, their powers, duties, or tax-exempt status, or the deductibility (under IRC 170) of contributions to one or more of the IRC 501(c)(3) member organizations are covered by this exception. However, the exception applies only if the principal purpose of the appearance or communication is to defend the IRC 501(c)(3) member organizations. It does not apply if the principle purpose is to defend any member organizations that are not described in IRC 501(c)(3).

In addition, Reg. 56.4911-5(f)(6)(i)(B) provides an exception for communications with members. A communication that directly encourages a member to engage in direct lobbying activities that would not be attempts to influence legislation because of the "self-defense" exception if engaged in directly by the organization is treated as a communication that does **not** directly encourage a member to engage in direct lobbying.

7. What happens when written communications are not directed solely to members?

While not treated quite as leniently as communications directed **only to** members of an organization, written communications that are designed **primarily for** the members but are not directed only to members also qualify for special treatment. Under Reg. 56.4911-5(e), expenditures for such written communications that refer to, and reflect a view on, specific legislation of direct interest to the organization and its members, are treated as expenditures for direct or grass roots lobbying depending upon the type of lobbying encouraged. For purposes of Reg. 56.4911-5(e), a communication is designed primarily for members of an organization if more than half of the recipients of the communication are members of the organization.

8. What are the allocation rules for such communications that encourage direct lobbying but not grass roots lobbying?

Reg. 56.4911-5(e)(2) provides allocation rules for a written communication distributed primarily to members (as described above) that directly encourages recipients (individually or through the organization) to engage in direct lobbying but does not directly encourage them to engage in grass roots lobbying. In those cases, the cost of preparing and distributing the communication is allocated between direct lobbying and grass roots lobbying expenditures. The regulation cross references the rules concerning computation of advertising income contained in Reg. 1.512(a)-1(f)(6) and indicates that the portion of the cost to be allocated includes all costs of preparing all the material with respect to which readers are urged to engage in direct lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material.

The amount to be allocated as determined above is then multiplied by the sum of the "nonmember subscribers percentage" and the "all other distribution percentage," both as defined in Reg. 56.4911-5(f)(7), to determine the amount allocable as a grass roots lobbying expenditure for the communication.[43] (Solely for purposes of this particular allocation, the nonmember subscribers percentage is treated as zero unless it is greater than 15 percent of total distribution.) The grass roots lobbying expenditure is subtracted from the amount to be allocated to determine the direct lobbying expenditure.

9. What are the allocation rules for such communications that encourage grass roots lobbying?

If a written communication is directed primarily for, but not only to, the members of the organization, as described above, and it directly encourages recipients to engage in grass roots lobbying (either individually or through the organization or otherwise), the expenditures for the communication are treated as a grass roots lobbying expenditure. The communication is treated as a grass roots lobbying communication even if it also encourages readers to engage in direct lobbying. As with the amount to be allocated between direct lobbying expenditures and grass roots lobbying expenditures as discussed above, grass roots lobbying expenditures includes all the costs of preparing all the material with respect to which readers are urged to engage in grass roots lobbying plus the mechanical and distribution costs attributable to the lineage devoted to this material. See Reg. 1.512(a)-1(f)(6)).

[43] With respect to the term "subscriber," Reg. 56.4911-5(f)(5) provides that a subscriber to a written communication is a person that either (1) is a member of the publishing organization and the membership dues expressly include the right to receive the written communication, or (2) has affirmatively expressed a desire to receive the written communication and has paid more than a nominal amount for the communication.

(10) Affiliated Groups

i. Affiliation Rules

1. What are the affiliation rules?

IRC 4911(f)(1) through IRC 4911(f)(3) contain a limited anti-abuse rule for affiliated organizations. In general, the rule prevents avoiding the sliding-scale percentage limitation on lobbying expenditures (as well as avoiding the $1,000,000 cap on lobbying expenditures) through creation of numerous organizations.[44] With one exception, this is accomplished by treating the members of an affiliated group as a single organization for purposes of measuring both lobbying expenditures and permitted lobbying expenditures.[45]

Therefore, if the expenditures of the group as a whole do not exceed the permitted limits, then each of the electing member organizations is treated as not exceeding the permitted limits. Conversely, if the expenditures of the group as a whole exceed the permitted limits, then each of the electing members is treated as having exceeded the limits and would pay tax on its proportionate share of the group's excess lobbying expenditures. Note, however, that only those members of the affiliated group that have made the IRC 501(h) election are subject to the tax, nonelecting members remain subject to the "no substantial part" test. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. Vol. 2 at 423.

As will be discussed more fully below, membership in an affiliated group includes only IRC 501(c)(3) organizations that are eligible to make the IRC 501(h) election. Organizations described in other subparagraphs of IRC 501(c)(3) are not eligible for membership in an affiliated group even if they are affiliated within the meaning of IRC 4911(f)(2) with an eligible organization.

2. When are two organizations considered to be affiliated?

For purposes of the regulations under IRC 4911, two organizations are affiliated if one organization is able to control action on legislative issues by the other organization because of interlocking governing boards or because of provisions in the governing

[44] For example, a large organization, by dividing in two, would increase its overall cap from $1 million to $2 million. Because of declining percentages at higher levels, creating a second organization allows additional permitted lobbying expenditures for organizations whose exempt purpose expenditures exceed $500,000. An organization with $1 million of exempt purpose expenditures is permitted to have $175,000 of total lobbying expenditures without incurring tax, but two organizations with $500,000 of exempt purpose expenditures each would be permitted to have $100,000 of total lobbying expenditures, for a total amount of $200,000.

[45] The single exception to the general rule relates to members of a "limited affiliated group of organizations" (organizations that are affiliated solely by reason of governing instrument provisions that extend control solely with respect to national legislation). IRC 4911(f)(4) and Reg. 56.4911-10.

instruments of the controlled organization (subject to the limitation described in Reg. 56.4911-7(a)(2)).[46] The organizations are affiliated due to the ability of the controlling organization to control action on legislative issues by the controlled organization, not because such control is exercised. Reg. 56.4911-7(a)(1).

3. What is "action on legislative issues?"

Reg. 56.4911-7(a)(3) provides that the term "action on legislative issues" includes taking a position in the organization's name on legislation, authorizing any person to take a position on legislation in the organization's name, and authorizing lobbying expenditures. "Action on legislative issues" does not include actions taken merely to correct unauthorized actions taken in the organization's name.

4. What are "interlocking governing boards"?

Reg. 56.4911-7(b)(1) provides that, in general, two organizations have interlocking governing boards if one organization (the controlling organization) has a sufficient number of representatives on the governing board of the second organization (the controlled organization) so that by aggregating their votes, the representatives of the controlling organization can cause or prevent action on legislative issues by the controlled organization. If two organizations have interlocking governing boards, the organizations are affiliated without regard to how or whether the representatives of the controlling organization vote on any particular matter.

Generally, Reg. 56.4911-7(b)(2) provides that the number of representatives of the controlling organization who are members of the controlled organization's governing board will be presumed sufficient to cause or prevent action on legislative issues by the controlled organization if it either (1) constitutes a majority of incumbents on the governing board, or (2) constitutes a quorum, or is sufficient to prevent a quorum, for acting on legislative issues. However, if under the governing documents of the controlled organization, it can be determined that a lesser number of votes than the number described in Reg. 56.4911-7(b)(2) is necessary or sufficient to cause or to prevent action on legislative issues, a number of representatives of the controlling organization who are members of the controlled organization's governing board that equals or exceeds that number will be considered sufficient to cause or prevent action on legislative issues. Reg. 56.4911-7(b)(3). Nevertheless, if the number of representatives of one organization is less than 15 percent of the incumbents on the governing board of a second organization, the two organizations are not affiliated by reason of interlocking governing boards. Reg. 56.4911-7(b)(4).

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[46] The exception provided in Reg. 56.4911-7(a)(2) states that two organizations, neither of which is described in IRC 501(c)(3), are affiliated only if there exists at least one organization described in IRC 501(c)(3) that is affiliated with both organizations.

Furthermore, there is no affiliation through interlocking boards where the board consists of representatives of unrelated organizations, none of which satisfies the control tests. Therefore, where five unrelated organizations each appoint two members to the board of an organization, it is not affiliated with any of the five organizations due to interlocking governing boards. Reg. 56.4911-7(f), Example (2). This rule has been applied in situations involving national organizations that have boards consisting of delegates from separately incorporated state or regional associations. See PLR 91-45-039 (Aug. 14, 1991) and PLR 93-32-042 (May 19, 1993).

5. When are board members considered representatives of another organization?

There are three circumstances under which members of the governing board of the controlled organization are considered representatives of the controlling organization. The first occurs if the controlling organization has specifically designated that person to be a board member of the controlled organization. A board member of the controlled organization is specifically designated by the controlling organization if the board member is selected by virtue of the right of the controlling organization, under the governing instruments of the controlled organization, either to designate a person to be a member of the controlled organization's governing board, or to select a person for a position that entitles the holder of that position to be a member of the controlled organization's governing board. Reg. 56.4911-7(b)(5)(ii).[47] The second occurs when a member of the governing board of one organization serves on the governing board of a second organization. In this instance, the person is a representative of the second organization. Reg. 56.4911-7(b)(5)(iv). The third occurs when the board member is an officer or paid executive staff member of the other organization. In that situation, the person is a representative of the other organization. Although titles are significant in determining whether a person is a member of the executive staff of an organization, any employee of an organization who possesses authority commonly exercised by an executive is considered an executive staff member for these purposes. Reg. 56.4911-7(b)(5)(v).

6. What are the rules relating to governing instruments?

Reg. 56.4911-7(c) provides that the controlling organization is affiliated with the controlled organization due to the governing instruments of the controlled organization if those instruments limit the independent action of the controlled organization on legislative issues by requiring it to be bound by decisions of the controlling organization on such issues. Organizations also are affiliated if the controlled organization's governing instrument allows the controlling organization to veto positions on legislation that the controlled organization might take, even if the veto power is never exercised. Reg. 56.4911-7(f), Example (3).

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[47] A board member of one organization who is specifically designated by a second organization, a majority of the governing board of which is made up of representatives of a third organization, is a representative of the third organization as well as being a representative of the second organization pursuant to the rules of Reg. 56.4911-7(b)(5)(ii). Reg. 56.4911-7(b)(5)(iii).

7. May board actions establish affiliation other than through amendments to the governing instrument?

To be affiliated under IRC 4911, two organizations must have interlocking boards or one organization must be bound by the other organization on legislative issues by provisions in its governing instruments. Assuming the organization does not have an interlocking board with another organization, actions by the organization's board of directors that do not constitute amendments to its governing instrument will not establish affiliation under IRC 4911. This is discussed in Reg. 56.4911-7(f), Example (4), the governing board of an organization resolves to adopt positions taken on legislative issues by another organization. The two organizations are eligible organizations and do not have interlocking governing boards. The governing instruments of the first organization do not mention the other organization and do not indicate that the first organization is to be bound by the decisions on legislation of any organization. The two organizations are not affiliated under IRC 4911.

8. How are organizations that file a group return treated?

A determination that organizations are not affiliated for purposes of IRC 4911 does not indicate that those organizations are not affiliated for purposes of filing a group return. In PLR 91-45-039, (Aug. 14, 1991) the Service concluded that "affiliated" has a broader meaning as used in Reg. 1.6033-2(d) than it does under IRC 4911. Therefore, the mere fact that organizations file a group return does not indicate that the organizations are affiliated under IRC 4911. Furthermore, a group return may be filed even if some of the organizations have made the IRC 501(h) election. However, pursuant to Reg. 56.4911-6, which sets out the record keeping requirements for electing organizations, the group return will include separate statements regarding each organization that has made the election. Furthermore, for purposes of determining the liability for tax under IRC 4911(a), a separate schedule on the group return must be completed for each organization (other than any that are part of an affiliated group under IRC 4911(f)) that has made the IRC 501(h) election. Each schedule must show the lobbying expenditures, the lobbying nontaxable amount, the grass roots expenditures, and the grass roots nontaxable amount for each electing organization. Computation of the IRC 4911 tax must be made for each such organization on Form 4720, *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*. The computation must be based only upon the amounts applicable to the individual organization; it may not be based upon the composite figures for the group. A separate Form 4720 must be filed for each electing organization with IRC 4911(a) tax liability.

9. May organizations be indirectly affiliated?

Yes, organizations may be indirectly affiliated either because they are controlled by the same controlling organization or because the controlling organization affiliated with one organization is a controlled organization affiliated with the other organization. When a controlling organization is affiliated with each of two or more controlled organizations, then the controlled organizations are affiliated with each other. Reg. 56.4911-7(d)(1). Therefore, if two or more organizations are controlled directly by the same controlling organization, they are affiliated with each other even if the method of control is different. Under the "chain rule" of Reg. 56.4911-7(d)(2), if one organization is a controlling organization described in this section with respect to a second organization and that second organization is a controlling organization with respect to a third organization, then the first organization is affiliated with the third. Again, the method of control does not need to be the same at each level of the chain for the organizations to be affiliated. See Reg. 56.4911-7(f), Example (6), for an illustration of these rules.

10. What happens if a controlling organization is not described in IRC 501(c)(3)?

The same affiliation rules would apply if the controlling organization is not described in IRC 501(c)(3) since organizations may be indirectly affiliated, as noted above. This situation is discussed in Reg. 56.4911-7(f), Example (7). In the example, an organization that is described in IRC 501(c)(4) is affiliated, as the controlling organization, with two organizations that are described in IRC 501(c)(3) and are eligible to elect under IRC 501(h). The two IRC 501(c)(3) organizations are affiliated and will be an affiliated group if either makes an election under IRC 501(h). Even though the IRC 501(c)(4) organization is affiliated with the two IRC 501(c)(3) organizations, it is not a member of that affiliated group of organizations because it is not an eligible organization within the meaning of Reg. 1.501(h)-2(b)(1). The rules regarding an affiliated group of organizations are discussed immediately below.

ii. The Affiliated Group

1. What is an "affiliated group of organizations?"

For purposes of the anti-abuse rules of IRC 4911, Reg. 56.4911-7(e)(1) provides that an "affiliated group of organizations" consists of a group of organizations that meet each of the following conditions:

(A) Each of the organizations is affiliated with every other member for at least thirty days of the taxable year of the affiliated group (determined without regard to the election provided for in Reg. 56.4911-7(e)(5));

(B) Each of the organizations is eligible to elect the expenditure test; and

(C) At least one of the organizations is an electing member organization.

Each organization in a group of organizations that satisfies the above requirements is a member of the affiliated group of organizations for the taxable year of the affiliated group.

2. May an organization be a member of more than one affiliated group?

Yes, an organization may have multiple affiliated group memberships. That is, for any taxable year of the organization, it may be a member of two or more affiliated groups of organizations. Reg. 56.4911-7(e)(2).

3. What is an "electing member organization?"

An "electing member organization" is an organization to which the expenditure test election applies on at least one day of the taxable year of the affiliated group of which it is a member. For these purposes, the election is not considered to apply to the organization on any day before the date on which it files the Form 5768 making the IRC 501(h) election, notwithstanding Reg. 1.501(h)-2(a)). Reg. 56.4911-7(e)(4).

4. What is the taxable year of an affiliated group?

There are three different rules that can apply here. The first rule is that if all members of an affiliated group have the same taxable year, that is the taxable year of the affiliated group. The second rule applies when the members of an affiliated group do not all have the same taxable year. In that case, the taxable year of the affiliated group is the calendar year. Reg. 56.4911-7(e)(3). A third rule applies when all the members elect to be covered by the provisions of Reg. 56.4911-7(e)(5). Under Reg. 56.4911-7(e)(5), each member organization treats its own taxable year as the taxable year of the affiliated group. The election may be made by an electing member organization by attaching to its annual return a statement from itself and every other member of the affiliated group that contains: the organization's name, address, and employer identification number; and its signed consent to the election. The election must be made no later than the due date of the first annual return of any electing member for its taxable year for which the member is liable for tax under IRC 4911(a), determined under Reg. 56.4911-8(d). The election may not be made or revoked after the due date of the return except upon such terms and conditions as the Commissioner may prescribe.

5. Is there an exception for "self-defense"?

Yes, Reg. 56.4911-2(c)(4)(ii) provides that the "self-defense" exception applies to a communication by a member of an affiliated group of organizations (within the meaning of Reg. 56.4911-7(e)) that is an appearance before, or communication with, a legislative body with respect to a possible action by the body that might affect the existence of any other member of the affiliated group, its powers and duties, its tax-exempt status, or the deductibility of contributions to it. Therefore, such communications will not be considered lobbying communications.

6. Is there a special membership communication rule?

Yes, for purposes of the member communication rules of Reg. 56.4911-5, a person who is a member of an organization that is a member of an affiliated group is treated as a member of each organization in the affiliated group. Reg. 56.4911-5(f)(3).

iii. Excess Lobbying Expenditures

1. How is an affiliated group treated for purposes of the IRC 4911 tax?

Under IRC 4911(f), an affiliated group of organizations is treated as one organization for purposes of the IRC 4911(a) tax. Thus, the affiliated group's direct lobbying expenditures, grass roots lobbying expenditures, and exempt purpose expenditures are equal to the sum of such expenditures paid or incurred during the taxable year by each member of the affiliated group. Similarly, the lobbying and grass roots nontaxable amounts for the affiliated group are determined under the rules of IRC 4911(c)(2) and IRC 4911(c)(4) based on the sum of the group's exempt purpose expenditures. The group's lobbying and grass roots ceiling amounts are then calculated under the IRC 501(h) regulations. Reg. 56.4911-8(b).

2. When is the IRC 4911 tax imposed on an affiliated group?

The tax under IRC 4911(a) is imposed on an affiliated group if the group has excess lobbying expenditures. Reg. 56.4911-8(c) provides that the affiliated group's excess lobbying expenditures for any taxable year are the greater of the following amounts:

(A) The amount by which the group's lobbying expenditures exceed the group's lobbying nontaxable amount; or

(B) The amount by which the group's grass roots expenditures exceed the group's grass roots nontaxable amount.

3. What is the tax liability of an electing member?

Reg. 56.4911-8(d) provides three rules for allocating the IRC 4911(a) tax between the electing member organizations of an affiliated group. Each electing member organization is liable for all or a portion of the tax, but no member of the affiliated group that has not made an IRC 501(h) election is liable for any portion of the tax with respect to the affiliated group, even if they made direct or grass roots lobbying expenditures.

The first rule applies when the affiliated group's excess lobbying expenditures equal the amount determined under Reg. 56.4911-8(c)(1) and at least one electing member has made lobbying expenditures. Each electing member organization is liable for a portion of the tax equal to the amount of the tax multiplied by a fraction, the numerator of which is the electing member organization's lobbying expenditures paid or incurred during the taxable year of the affiliated group, and the denominator of which is the sum of the lobbying expenditures of all electing member organizations in the group paid or incurred during the taxable year of the affiliated group. Reg. 56.4911-8(d)(2)

The second rule applies when the affiliated group's excess lobbying expenditures equal the amount determined under Reg. 56.4911-8(c)(2) and at least one electing member has made grass roots expenditures. The same rule is applied as described above, except that "grass roots expenditures" is substituted for "lobbying expenditures." Reg. 56.4911-8(d)(3).

The third rule applies when the affiliated group has excess lobbying expenditures, but no electing organization has made either lobbying or grass roots expenditures. Each electing member organization is liable for a portion of the tax equal to the amount of tax multiplied by a fraction, the numerator of which is the electing member organization's exempt purpose expenditures and the denominator of which is the exempt purpose expenditures of all the electing member organizations in the affiliated group. Reg. 56.4911-8(d)(4).

4. When is an organization liable for the tax?

Pursuant to Reg. 56.4911-8(d)(5), an electing member organization liable for the IRC 4911 tax of an affiliated group is liable for the tax as if the tax were imposed for its taxable year with which or in which the taxable year of the affiliated group ends.

5. What if an organization is a member of two groups having excess lobbying expenditures?

When an organization is a member of two or more affiliated groups and is liable for the IRC 4911 tax during a taxable year for the excess lobbying expenditures of more than one group, then the organization is liable only for the greater tax. Reg. 56.4911-8(d)(6).

6. What happens when a member organization ceases to be a member of a group?

An electing member organization that ceases to be a member of an affiliated group of organizations that had a taxable year different from its own, must thereafter determine its liability under Reg. 56.4911-1 for the IRC 4911 tax as if its taxable year were the taxable year of the affiliated group of which it was formerly a member. An organization to which this rule applies that is liable for the IRC 4911 tax is liable as if the tax were imposed for its taxable year in which ends the taxable year of the affiliated group of which it was formerly a member. The Commissioner may, at the Commissioner's discretion, permit an organization to disregard this rule and to determine any liability under IRC 4911(a) based upon its own taxable year. Reg. 56.4911-8(e).

iv. Application of IRC 501(h)

1. When might affiliated group members lose exempt status?

As with the calculation of IRC 4911 tax, affiliated groups are treated as one entity for purposes of determining whether members are denied exemption as organizations described in IRC 501(c)(3) pursuant to IRC 501(h). If, for a taxable year of an affiliated group, it is determined that the sum of the affiliated group's lobbying or grass roots expenditures for the group's base years exceeds 150 percent of the sum of the group's nontaxable amounts for the base years, then each member that was an electing member organization at any time in the taxable year shall be denied tax exemption beginning with its first taxable year beginning after the end of the taxable year of the affiliated group. Thereafter, exemption shall be denied unless the organization reapplies and is recognized as exempt as an organization described in IRC 501(c)(3). For purposes of this section, the term "base years" generally means the taxable year of the affiliated group for which a determination is made and the group's three preceding taxable years. Base years, however, do not include any year preceding the first year in which at least one member of the group was treated as described in IRC 501(c)(3). Reg. 56.4911-9(b).

2. What happens to a nonelecting member of an affiliated group?

An organization that is a member of an affiliated group of organizations but that is not an electing member organization remains subject to the "substantial part test" described in IRC 501(c)(3) with respect to its activities involving attempts to influence legislation. Reg. 56.4911-9(c).

3. What are the filing requirements?

The filing requirements for affiliated groups are set forth in Reg. 56.4911-9(c) and apply to each member of the group for the taxable year of the member in which ends the taxable year of the affiliated group. Each member of the group must provide to every other member, before the first day of the second month following the close of the affiliated group's taxable year, its name, identification number, and the information required under the reporting rules of Reg. 1.6033-2(a)(2)(ii)(k) for its expenditures during the group's taxable year and for prior taxable years of the group that are base years. For groups that elect under Reg. 56.4911-7(e)(5) to have each member file information with respect to the group based on its taxable year, each member shall provide the above information, treating each taxable year of any member of the group as a taxable year for the group. In addition to the information required by the reporting rules of Reg. 1.6033-2(a)(2)(ii)(k), each member of the group must provide on its annual information return the group's taxable year and, if the election under Reg. 56.4911-7(e)(5) is made, the name, identification number, and taxable year identifying the return with which its consent to the election was filed. Furthermore, in addition to the information required above, each electing member organization must provide the following on its annual return:

(A) The name and identification number of each member of the group, and

(B) The calculation of the group's excess lobbying expenditures if the organization is liable for all or any portion of the IRC 4911 tax.

4. How are these rules applied?

Reg. 56.4911-9(e) provides an example illustrating the application of IRC 501(h) to an affiliated group of organizations, M, N, and O. M and O filed IRC 501(h) elections in 1979 and have not revoked them. N did not make an IRC 501(h) election. M's taxable year ends November 30, N's taxable year ends January 31, and O's taxable year ends June 30. Since the organizations have different taxable years, the calendar year is the taxable year of the group. The following tables summarize the group's expenditures for the calendar years indicated. (None of the lobbying expenditures were for grass roots lobbying.)

Table I. Group's Expenditures

Year	Exempt purpose expenditures (EPE)	Calculation	Lobbying nontaxable amount (LNTA)	Lobbying expenditures (LE)
1979	$400,000	(20% of $400,000 =)	$80,000	$100,000
1980	300,000	(20% of $300,000 =)	60,000	100,000
1981	600,000	(20% of $500,000 + 15% of $100,000 =)	115,000	120,000
1982	500,000	(20% of $500,000 =)	100,000	220,000
Total	1,800,000		355,000	540,000

Table II. Expenditures of M and O

Year	Exempt purpose expenditures		Lobbying nontaxable amount		Lobbying expenditures		M plus O
	M	O	M	O	M	O	
1979	125,000	100,000	25,000	20,000	60,000	20,000	80,000
1980	100,000	50,000	20,000	10,000	40,000	40,000	80,000
1981	250,000	100,000	50,000	20,000	60,000	40,000	100,000
1982	200,000	100,000	40,000	20,000	160,000	40,000	200,000

The affiliated group had excess lobbying expenditures in each of the years shown and M and O are liable for the IRC 4911 tax. The tax is allocated between M and O based on the ratio of their lobbying expenditures for the year to the total lobbying expenditures the two of them incurred. N is not liable for any tax under IRC 4911. For 1979, the tax due is $5,000 (25% of $20,000). M is liable for $3,750 and O is liable for $1,250. For 1980, the tax is $10,000 and each owe $5,000. For 1981, M is liable for $750 and O is liable for $500. For 1982, M is liable for \$24,000 and O is liable for \$6,000. In 1982, the sum of group's lobbying expenditures for the base years (1979 through 1982) exceeded 150 percent of the sum of the group's lobbying nontaxable amounts for those years (\$532,500). Therefore, M and O are denied exemption as IRC 501(c)(3) organizations for their taxable years beginning in 1983 (beginning December 1, 1983 for M and July 1, 1983 for O). Whether N's lobbying expenditures disqualify it for tax exemption at any time after January 1, 1979, is determined under the substantial part test of IRC 501(c)(3).

v. Limited Affiliated Groups

1. What is a limited affiliated group of organizations?

IRC 4911(f)(4) provides for an exception to the general rules applicable to affiliated groups for certain limited affiliated groups of organizations. Reg. 56.4911-10(b) provides that a limited affiliated group of organizations consists of two or more organizations that meet each of the following requirements:

(A) Each organization is a member of an affiliated group of organizations;

(B) No two members of the affiliated group are affiliated by reason of interlocking governing boards;[48] and

(C) No member of the affiliated group is, under its governing instrument, bound by decisions of one or more of the other such members on legislative issues other than national legislative issues.

Each organization in an affiliated group of organizations that satisfies all three of these requirements is a member of the limited affiliated group. However, if any of these requirements are not met, the organizations will not be a limited affiliated group. Even if some organizations within the group would meet all three requirements, those organizations would not constitute a limited affiliated group if any organization within the group did not meet all three requirements. Reg. 56.4911-10(h), Example (6), illustrates this rule.

2. What is a "national legislative issue?"

Reg. 56.4911-10(g) provides that the term "national legislative issue" means legislation, limited to action by the Congress of the United States or by the public in any national procedure. If an issue is both national and local, it is characterized as a national legislative issue if the contemplated legislation is Congressional legislation.

48 See Reg. 56.4911-10(h), Example (5).

Reg. 56.4911-10(h), Examples (1) and (2) illustrate "national legislative issues." In Example (1), a state has an income tax law that uses definitions contained in the Code as it may be amended from time to time. Legislation to change a definition in the Code is pending in Congress. This is a national legislative issue even though Congressional action may affect state law. However, in Example (2), an organization takes a position favoring approval by Congress of a proposed amendment to the United States Constitution. This is a national legislative issue. After approval by Congress and submission to the states for ratification, the proposed amendment ceases to be a national legislative issue.

3. What is "controlling member organization" and "controlled member organization?"

Reg. 56.4911-10(c) provides that a member of a limited affiliated group is a "controlling member organization" if it controls one or more of the other members of the group. A member is a "controlled member organization" if it is controlled by one or more of the other members of the group. Whether an organization controls a second organization shall be determined by whether the second organization is bound, under its governing instruments, by actions taken by the first organization on national legislative issues.

4. How are expenditures determined for "controlling" and "controlled" members?

Expenditures for a controlling member organization that has made an election under IRC 501(h) are determined in accordance with the rules set forth in Reg. 56.4911-10(d), even if the organization is also a controlled member organization. In determining a controlling member organization's expenditures, no expenditure shall be counted twice. The direct lobbying expenditures of a controlling member organization that has made the IRC 501(h) election include the direct lobbying expenditures paid or incurred with respect to national legislative issues during the taxable year by each organization that is a member of the limited affiliated group and is controlled by the controlling member organization. Similarly, the grass roots lobbying expenditures of the controlling member organization include the grass roots lobbying expenditures of the controlled member organizations. However, the controlling member organization's exempt purpose expenditures do not include the exempt purpose expenditures (other than lobbying expenditures with respect to national legislative issues) of any organization that is a controlled member organization with respect to it.

A controlled member organization that has made an IRC 501(h) election but does not control any organization in the limited affiliated group determines its lobbying expenditures based on its own expenditures without regarding the expenditures of any other member of the limited affiliated group. Reg. 56.4911-10(e).

Reg. 56.4911-10(h), Example (3), illustrates these rules regarding determination of expenditures. The example concerns three organizations that constitute a limited affiliated group, all of whom have made the IRC 501(h) election. One of the controlled organizations engages in direct lobbying on a national legislative issue. This cost is included in the direct lobbying and the exempt purpose expenditures of both the controlling and that controlled organization, but will not be included in the lobbying or exempt purpose expenditures of the other controlled organization. The controlling organization also engages in direct lobbying on the same issue, but the cost of hiring the lobbyist is includible only in the controlling organization's lobbying expenditures. Any lobbying expenditures incurred by either controlled organization on any issue that is not a national legislative issue will not be included in the controlling organization's lobbying or exempt purpose expenditures.

5. What information must be reported by a controlling member organization?

In addition to the information required by Reg. 1.6033-2(a)(2)(ii)(k), each controlling member organization that has made an election under IRC 501(h) must provide on its annual return the name and identification number of each member of the limited affiliated group. Reg. 56.4911-10(f)(1). Furthermore, each controlling member organization that has made the IRC 501(h) election must notify each member that it controls of its taxable year in order for the controlled organization to prepare the report required by Reg. 56.4911-10(f)(3).[49] Such notification must be made before the beginning of the second month after the close of each taxable year of the controlling member for which the election is in effect. Reg. 56.4911-10(f)(2).

6. Is there a "self-defense" exception?

Yes, Reg. 56.4911-2(c)(4)(iv) provides that the "self-defense" exception applies to a communication by an electing public charity that is a member of a limited affiliated group if it is an appearance before, or communication with, the Congress of the United States with respect to a possible action by the Congress that might affect the existence of any member of the limited affiliated group, its powers and duties, tax-exempt status, or the deductibility of contributions to it.

7. Is there a membership communication rule?

Yes, Reg. 56.4911-5(f)(4) provides that a member of an organization that is a member of a limited affiliated group are treated as members of each organization in the limited affiliated group, but only with respect to national legislative issues.

[49] Reg. 56.4911-10(f)(3) requires every controlled member organization (whether or not the expenditure test election is in effect with respect to it) to provide to each member of the limited affiliated group that controls it, before the first day of the second month following the close of the taxable year of each such controlling organization, its name, identification number, and both the lobbying expenditures and grass roots expenditures on national legislative issues incurred by the controlled member organization.

4. Lobbying Activities of IRC 501(c)(3) Private Foundations

A. Legislative and Regulatory History

In the Tax Reform Act of 1969, Congress created the distinction between private foundations and public charities and imposed a number of excise taxes on certain activities of private foundations. One of these provisions is an excise tax on the taxable expenditures of private foundations and on foundation managers who agree to the making of the taxable expenditure. IRC 4945. A taxable expenditure includes any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation, as well as certain political campaign expenditures and grants to individuals and organizations. IRC 4945(d). Taxes on these types of private foundation expenditures did not seem likely when the House Committee on Ways and Means began its hearings on private foundation activities since the Chairman's press release, which outlined the hearings' agenda, made no mention of this kind of activity. Tax Reform 1969: Hearings Before the House Comm. on Ways and Means, 91st Cong., 1st Sess. 3-11 (1969) (press release of Chairman Wilbur D. Mills). However, testimony given almost at the outset of the hearings raised the specter of private foundation involvement in the political process generally (although nothing specific was alleged about the lobbying activities of private foundations), as well as raising concerns about various grants made to individuals by private foundations. For example, the President of the Ford Foundation became embroiled in a lengthy and often acrimonious discussion with various Committee members over both the Foundation's granting "Travel & Study Awards" to members of Senator Robert Kennedy's staff following his assassination and its involvement in political campaign activities including an extremely controversial school decentralization experiment in Brooklyn that included an election and the Foundation's financing of voter registration drives in Cleveland before the election of Mayor Carl B. Stokes.[50] Id. at 354-431 (statement and testimony of Mr. McGeorge Bundy). To a considerable extent, those incidents seem to have impelled enactment of IRC 4945(d).

The Staff of the Joint Committee on Internal Revenue Taxation, in its General Explanation of the Tax Reform Act of 1969, 48 (1969), explained the reasons for enactment of IRC 4945, and for the inclusion of lobbying activity as a taxable expenditure, as follows:

> *The Congress concluded that more effective limitations must be placed on the extent to which tax-deductible and tax-exempt funds can be dispensed by private persons and that these limitations must involve more effective sanctions. Accordingly, the Congress determined that a tax should be imposed upon expenditures by private foundations for activities that should not be carried on by exempt organizations (such as lobbying, electioneering and "grass roots" campaigning). The Congress also believes that granting*

[50] Although no activities that would be characterized as lobbying for IRC 501(c)(3) purposes were discussed during Mr. Bundy's testimony, there was some concern expressed regarding influencing members of Congress through payment of their travel and other expenses, such as when the Ford Foundation made a grant to sponsor a Japanese-American Assembly in Japan attended by several members of Congress.

> *foundations should take substantial responsibility for the proper use of funds that they give away.*
>
> *In general, the Congress' decisions reflect the concept that private foundations are stewards of public trusts and their assets are no longer in the same status as assets of individuals who may dispose of their own money in any lawful way they see fit.*

Regulations implementing the provisions of IRC 4945(d)(1) were proposed in 1971 (36 FR 5357 (Mar. 20, 1971)) and adopted the next year. T.D. 7215, 37 FR 23161 (Oct. 31, 1972). The regulations were amended by T.D. 8308, 55 FR 35579 (Aug. 31, 1990).

However, even though private foundations are subject to tax on their lobbying expenditures, they remain subject to the "no substantial part" test for determining whether they retain their exempt status. Staff of the Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969, 49 n. 21 (1969).

B. Specific Issues

1. What is the tax on lobbying by private foundations?

Pursuant to IRC 4945(d)(1), any amount paid or incurred by a private foundation to carry on propaganda, or otherwise to attempt, to influence legislation is a taxable expenditure. IRC 4945 imposes on the private foundation an initial tax equal to 10 percent of the taxable expenditure and an additional 100 percent tax on taxable expenditures that are not corrected within the taxable period. In addition, an initial tax equal to 2½ percent of the taxable expenditure is imposed on foundation managers who knowingly agreed to the making of the taxable expenditure. Any foundation managers who refuse to agree to all or part of the correction are subject to a tax equal to 50 percent of the taxable expenditure.

2. What is "attempt to influence legislation" under IRC 4945?

Generally, the rules for determining what is an attempt to influence legislation for purposes of IRC 4945 are the same rules as for electing public charities, as are the exceptions. Where there are different, or additional, rules for private foundations, these are noted below.

3. Is there a membership communication rule?

No, Reg. 56.4911-5, which provides rules for electing public charities' communications with their members, does not apply to private foundations. Consequently, whether a private foundation's communications with its members (assuming it has any) are lobbying communications is determined solely under the general rules enunciated under Reg. 56.4911-2. However, where a private foundation makes a grant to an electing public charity, the membership rules apply to the electing public charity's communications with its own members. Therefore, in the limited context of determining whether a private foundation's grant to an electing public charity is a taxable expenditure, the membership rules apply. For example, a grant is not a taxable expenditure when it is specifically earmarked for a communication from an electing public charity to its members that is a not considered lobbying because of the membership rules. Reg. 53.4945-2(a)(2).

4. What are the rules relating to jointly funded projects?

Reg. 53.4945-2(a)(2) provides that a private foundation will not be treated as having made a taxable expenditure merely because it makes a grant conditional upon the recipient obtaining a matching support appropriation from a governmental body. Furthermore, a private foundation will not be treated as making taxable expenditures for carrying on discussions with officials of governmental bodies that meet the following requirements:

(A) The subject of the discussions is a program that is or may be jointly funded by the foundation and the government;

(B) The discussions are undertaken for the purpose of exchanging data and information on the program's subject matter; and

(C) The discussions are not undertaken in order to make any direct attempt to persuade governmental officials to take particular positions on specific legislative issues other than the program.

5. Is lobbying by the recipient of a program-related investment attributed to the foundation?

Private foundations often make "program-related investments" (investments described in IRC 4944(c) and Reg. 53.4944-3). Reg. 53.4945-2(a)(4) provides that any amount paid or incurred by program-related investment recipients in connection with an appearance before, or communication with, any legislative body with respect to legislation or proposed legislation of direct interest to the recipient shall not be attributed to the investing foundation, if the following conditions are met:

(A) The foundation does not earmark its funds to be used for any activities that constitute attempting to influence legislation; and

(B) A business expense deduction under IRC 162 is allowable to the recipient for such amount.[51]

[51] Note, however, that IRC 162(e), as amended by OBRA 1993, now disallows most business expense deductions for amounts paid or incurred in connection with influencing legislation.

6. What is the rule for general support grants?

A general support grant by a private foundation to a "public charity" (organizations described in IRC 509(a)(1), IRC 509(a)(2), or IRC 509(a)(3)) is not a taxable expenditure if the grant is not earmarked to be used in an attempt to influence legislation, regardless of whether the public charity has made the IRC 501(h) election. Reg. 53.4945-2(a)(6)(i). One example of where this rule applies is when a public charity that has received a general support grant informs the grantor foundation that, as an insubstantial portion of its activities, it attempts to influence the State legislature with regard to changes in the mental health laws. The use of the grant is not earmarked for the legislative activities of the public charity. The grant is not a taxable expenditure even if it is subsequently used by the public charity in its legislative activities. Reg. 53.4945-2(a)(7)(ii), Example (1).

7. What is the rule for specific project grants?

A grant by a private foundation to fund a specific project of a public charity is not a taxable expenditure, even if the public charity engages in lobbying activities as part of the project, to the extent that each of the following requirements are met:

(A) The grant is not earmarked to be used in an attempt to influence legislation; and

(B) The sum of all grants made by the private foundation for the same project for the same year, does not exceed the amount budgeted, for the year of the grant, by the grantee organization for activities of the project that are not attempts to influence legislation.

For example, a private foundation makes a specific project grant of $150,000 to a public charity. In requesting the grant, the public charity stated that the total budgeted cost of the project is $200,000, of which $20,000 is allocated to attempts to influence legislation related to the project. The private foundation relied on the budget figures provided and had no reason to doubt their accuracy or reliability. The private foundation does not earmark any of the funds from the grant to be used for attempts to influence legislation, so the grant is not a taxable expenditure under IRC 4945(d)(1) because the amount of the grant does not exceed the amount allocated to specific project activities that are not attempts to influence legislation. Reg. 53.4945-2(a)(7)(ii), Example (3). Even if the grant letter to the public charity provides that the private foundation has the right to renegotiate the terms of the grant if there is a substantial deviation from those terms, this additional fact would not make the grant a taxable expenditure. Reg. 53.4945-2(a)(7)(ii), Example (4). However, if the specific project grant is $200,000, rather than $150,000, part of the grant would be a taxable expenditure under IRC 4945(d)(1) because the amount of the grant exceeds by $20,000 the amount the public charity allocated to specific project activities that are not attempts to influence legislation. Therefore, the private foundation has made a taxable expenditure of $20,000. Reg. 53.4945-2(a)(7)(ii), Example (5).

8. What is the rule for multi-year specific project grants?

If the grant is for more than one year, the rule applies to each year of the grant with the amount of the grant measured by the amount actually disbursed by the private foundation in each year or divided equally between years, at the option of the private foundation. The same method of measuring the annual amount must be used in all years of a grant. As with the rule for general support grants, this rule applies regardless of whether the public charity has made the IRC 501(h) election. Reg. 53.4945-2(a)(6)(ii).[52]

Reg. 53.4945-2(a)(7)(ii), Example (11), discusses a private foundation makes a specific project grant of \$300,000 to a public charity for a three-year specific project studying child care problems. The private charity provides budget material indicating that the specific project will expend \$200,000 in each of three years, with lobbying expenditures of \$10,000 in the first year, \$20,000 in the second year and \$100,000 in the third year. The private foundation pays \$200,000 in the first year, \$50,000 in the second year and \$50,000 in the third year. The amount actually disbursed by the private foundation in the first year exceeds the nonlobbying expenditures of the public charity in that year. However, because the amount of the grant in each of the three years, when divided equally among the three years is not more than the nonlobbying expenditures of the public charity on the specific project for any of the three years, none of the grant is treated as a taxable expenditure.

A less happy scenario is set forth in Reg. 53.4945-2(a)(7)(ii), Example (13), where a private foundation makes a \$120,000 specific project grant to a public charity for a three-year project. The private foundation intends to pay the grant in three equal annual installments. The public charity provides budget material indicating that the specific project will expend \$100,000 each year, of which the project's lobbying expenditures will be \$50,000 each year. After the private foundation pays the first annual installment, but before it pays the second installment, reliable information comes to its attention that the public charity has spent \$90,000 of the project's \$100,000 first-year budget on lobbying expenditures, causing the private foundation to doubt the accuracy and reliability of the budget materials. The private foundation nevertheless pays the second-year installment. In the project's second year, the public charity once again spends \$90,000 on lobbying expenditures. Because the private foundation doubts or reasonably should doubt the accuracy or reliability of the budget materials when it makes the second-year grant payment, it may not rely upon the budget documents at that time. Accordingly, although none of the first installment is a taxable expenditure, only \$10,000 of the second-year grant

[52] Reg. 53.4945-2(a)(6)(iii) provides that for purposes of determining the amount budgeted by a prospective grantee for specific project activities that are not attempts to influence legislation, a private foundation may rely on budget documents or other sufficient evidence supplied by the grantee organization (such as a signed statement by an authorized officer, director or trustee of such grantee organization) showing the proposed budget of the specific project, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents.

payment is not a taxable expenditure. The remaining $30,000 of the second installment is a taxable expenditure.

9. What happens if the grantee public charity loses its exempt status due to lobbying?

Reg. 53.4945-2(a)(7)(i) provides that a grant to a public charity that subsequently ceases to be described in IRC 501(c)(3) due to its attempts to influence legislation will not be considered a taxable expenditure provided the following conditions are met:

(A) The grant meets the requirements of the rules relating to general support grants and specific project grants;

(B) The grantee had received a ruling or determination letter, or an advance ruling or determination letter, that it a public charity;

(C) Notice of a change in the grantee's status has not been made to the public, and the private foundation has not acquired knowledge that the Service has given notice to the grantee of a change in status; and

(D) The grantee is not controlled by the private foundation.[53]

5. Lobbying and Tax-Exempt Organizations Not Described in IRC 501(c)(3)

1. What restrictions are imposed on the amount of lobbying by IRC 501(c) organizations?

Unlike IRC 501(c)(3) organizations, other organizations described in IRC 501(c) may engage in an unlimited amount of lobbying, provided that such lobbying is related to the organization's exempt purpose. The Service enunciated this principle in Rev. Rul. 61-177, 1961-2 C.B. 117, which holds that a corporation that was organized and operated primarily for the purpose of promoting a common business interest is exempt under IRC 501(c)(6) even though its sole activity is influencing legislation germane to such common business interest. Rev. Rul. 61-177 notes that there is no requirement, by statute or regulations, that a business league or chamber of commerce must refrain from lobbying activities to qualify for exemption.

The rule set forth in Rev. Rul 61-177 applies to organizations described in the other subparagraphs of IRC 501(c). Outside of IRC 501(c)(3), there is no explicit statutory restriction on lobbying in IRC 501(c). As far as the regulations are concerned, the only mention of lobbying is positive. Reg. 1.501(c)(4)-1(a)(2)(ii) provides that a social welfare organization may

[53] A grantee organization is controlled by a private foundation for this purpose if the private foundation and its disqualified persons (as defined in IRC 4946(a)(1)), by aggregating their votes or positions of authority, can cause or prevent action on legislative issues by the grantee. Reg. 53.4945-2(a)(7)(i)(D).

qualify under IRC 501(c)(4) even though its activities are described in the "action organization" regulations, provided that it otherwise meets the IRC 501(c)(4) qualification requirements. See also, Rev. Rul. 67-6, 1967-1 C.B. 135; Rev. Rul. 67-293, 1967-2 C.B. 185; Rev. Rul. 68-656, 1968-2 C.B. 216; Rev. Rul. 71-530, 1970-2 C.B. 237; Rev. Rul. 76-81, 1976-1 C.B. 156; and G.C.M. 31864 (Aug. 21, 1961). In determining whether lobbying is allowable under the other subparagraphs of IRC 501(c), Slee lives.

2. Why must lobbying be related to the organization's exempt purposes?

The exempt status of an organization under IRC 501(c) depends upon whether its activities are consistent with the exempt purposes described in the subparagraph of IRC 501(c) under which it qualifies. The requirements imposed under the various subparagraphs of IRC 501(c) differ extensively. For example, an organization may continue to qualify for exemption under IRC 501(c)(4) so long as it is **primarily** engaged in promoting in some way the common good and general welfare of the people in the community. Reg. 1.501(c)(4)-2(i). Therefore, an IRC 501(c)(4) organization could engage in a substantial amount of lobbying on other matters without affecting its exempt status. At the other extreme are IRC 501(c)(2) title holding companies, which, under the terms of the statute, are limited to "the **exclusive** purpose of holding title to property, collecting income therefrom, and turning over the proceeds" to another exempt organization. Any lobbying by an IRC 501(c)(2) organization, therefore, would defeat its exempt status, unless, perhaps, the purpose of the lobbying was to preserve the exempt status of such title holders. (An unlikely possibility, since the IRC 501(c)(2) exemption has remained undisturbed since its enactment in 1916.)

3. May an IRC 501(c)(3) organization have a related IRC 501(c)(4) lobbying organization?

Yes, this is a rather common occurrence. So long as the organizations are kept separate (with appropriate record keeping and fair market reimbursement for facilities and services), the activities of an IRC 501(c)(4) organization will not jeopardize the related IRC 501(c)(3) organization's exempt status. The ability of an IRC 501(c)(3) organization to establish a related IRC 501(c)(4) lobbying organization was an important factor in the concurring opinion of Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983), in which the Supreme Court upheld the prohibition on substantial lobbying by IRC 501(c)(3) organizations. Taxation with Representation of Washington was the successor to two other organizations, an IRC 501(c)(3) organization and a related IRC 501(c)(4) organization, that applied for recognition of exemption from federal income tax as an organization described in IRC 501(c)(3). It was denied because it proposed to engage in substantial lobbying activity, although it would have qualified as an IRC 501(c)(4) organization.

This structure does raise issues regarding whether the resources of the IRC 501(c)(3) organization are used to subsidize lobbying activities of the IRC 501(c)(4) organization, particularly in situations where the two organizations share staff, facilities or other expenses or in which the two organizations conduct joint activities requiring an allocation of income and expenses. Any allocation of income or expenses between the two organizations must be carefully reviewed to ensure that the allocation method is appropriate and that an arms' length standard is utilized. The determination of whether the method used is appropriate is based upon all the facts and circumstances.

4. May an organization that loses IRC 501(c)(3) status due to lobbying qualify as an IRC 501(c)(4) organization?

IRC 504(a) precludes an organization that has lost its IRC 501(c)(3) status due to attempts to influence legislation from qualifying as an IRC 501(c)(4) organization. In addition, an organization prohibited from qualifying as an IRC 501(c)(4) organization by IRC 504 may not be treated as any IRC 501(c) organization, except for IRC 501(c)(3). Reg. 1.504-1. Therefore, the only route that an organization revoked for excessive lobbying may take to return to exempt status is to reapply for recognition of exempt status under IRC 501(c)(3). The one exception to this rule is for churches and church-related organizations that are ineligible to make an IRC 501(h) election because they are described in IRC 501(h)(5) and Reg. 1.501(h)-2(b)(3). IRC 504(c); Reg. 1.504-1.

5. May an IRC 501(c)(3) organization that anticipates loss of its status convert to an IRC 501(c)(4) organization?

IRC 504(b) authorized the Secretary of the Treasury to prescribe regulations to prevent avoidance of this rule, including avoidance by transferring all or part of the assets of an IRC 501(c)(3) organization to an organization that is controlled by the same persons who control the IRC 501(c)(3) organization. These regulations are set forth in Reg. 1.504-2. In determining whether an organization has attempted to avoid IRC 504 by transferring any of its assets, the term "transfer" includes any use by, or for the benefit of, the recipient, except transfers made for adequate and full consideration. Generally, a transfer that involves the following five elements will cause loss of exemption to the recipient:

(A) The transfer is from an IRC 501(c)(3) organization that is determined to be an "action" organization or is denied exemption by IRC 501(h);

(B) At the time of the transfer or at any time during the recipient's next ten taxable years, the recipient is controlled (directly or indirectly) by the same persons who control the transferor;[54]

[54] For these purposes, the transferor will be presumed to control any organization with which it is affiliated within the meaning of Reg. 56.4911-7(a) (or would be if both organizations were described in IRC 501(c)(3)), and the recipient will be treated as controlled (directly or indirectly) by the same persons who control the transferor if the recipient would be treated as controlled under the private foundation qualifying distribution rules (Reg. 53.4942(a)-3(a)(3)) if the transferor were a private foundation. Reg. 1.504-2(f).

(C) The transfer is made (1) after the date that is 24 months before the earliest of the effective date of the determination IRC 501(h) that the transferor is not exempt, the effective date of the Commissioner's determination that the transferor is an "action" organization, or the date on which the Commissioner proposes to treat it as no longer described in IRC 501(c)(3), and (2) before the transferor again is recognized as an organization described in IRC 501(c)(3);

(D) The recipient is exempt from tax under IRC 501(a) but is neither an organization described in IRC 501(c)(3), nor a qualified pension plan described in IRC 401(a) to which the transferor contributes as an employer; and

(E) The amount of the transfer exceeds the lesser of 30 percent of the net fair market value of the transferor's assets or 50 percent of the net fair market value of the recipient's assets, computed immediately before the transfer.[55]

Furthermore, even if the transferor and recipient are not commonly controlled, or the amount of the transfer is less than the amount set forth in the fifth element above, or the recipient is eligible to elect the expenditure test, the Commissioner may determine, based on all the facts and circumstances, that the transfer was made to avoid IRC 504(a). In that case, the recipient will cease to be exempt under IRC 501(a). One fact the Commissioner may consider is whether the recipient engages, or has engaged, in attempts to influence legislation. The Commissioner may also consider any factors enumerated in the special exception described below. Reg. 1.504-2(c).

6. Is there any exception to this transfer rule?

The Commissioner may determine, based on all the facts and circumstances, that a transfer that does meet the five elements set forth above was not made to avoid IRC 504 and the recipient will not be denied exemption. Reg. 1.504-2(e). In making this determination, the Commissioner may consider all relevant factors including the following:

(A) Whether enforceable and effective conditions on the transfer preclude use of any of the transferred assets for any purpose that, if it were a substantial part of an organization's activities, would be inconsistent with exemption as an organization described in IRC 501(c)(3);

[55] For these purposes, the amount of a transfer is the sum of the amounts transferred to any number of recipients in any number of transfers, all of which are described in the previous four elements, and the time of the transfer is the time of the first transfer so taken into account. Reg. 1.504-2(b)(6)(i). Furthermore, the amount of a transfer to a recipient is the sum of the amounts transferred to the recipient in any number of transfers, all of which are described in the previous four elements, and the time of the transfer is the time of the first transfer so taken into account. Reg. 1.504-2(b)(6)(ii).

(B) In the absence of conditions described above, whether the transferred assets are used exclusively for purposes that are consistent with the transferor's exemption as an organization described in IRC 501(c)(3);

(C) Whether the assets transferred would be described in the private foundation minimum investment return rules (Reg. 53.4942(a)-2(c)(3)) before and after the transfer if both the transferor and recipient were private foundations;

(D) Whether the transfer would satisfy the private foundation termination rules requiring unencumbered transfers (Reg. 1.507-2(a)(7) and Reg. 1.507-2(a)(8)) if the transferor were a private foundation;

(E) Whether all of the transferred assets have been expended during a period when the recipient was not controlled (directly or indirectly) by the same persons who controlled the transferor; and

(F) Whether all of the transferred assets were transferred, before the close of the recipient's taxable year following the taxable year in which the transferred assets were received, to one or more public charities described in IRC 507(b)(1)(A) none of which are controlled by the same persons who control either the original transferor or recipient.

7. What is the tax status of a ballot measure committee?

Expenditures to support or oppose initiatives, referenda, etc., generally are considered to be lobbying expenditures rather than political campaign activity. Consequently, a ballot measure committee cannot qualify as an IRC 501(c)(3) organization because it is an "action" organization. Furthermore, it cannot qualify as a "political organization" under IRC 527 since a political organization's "exempt function" involves, in general, influencing or attempting to influence the selection, nomination, election or appointment of an individual to a federal, state, or local public office or office in a political organization. IRC 527(e)(2). Reg. 1.527-2(c)(1) uses the term the "selection process" to encapsulate what is contemplated by "exempt function." Generally, expenditures to support or oppose a referendum or initiative measure are not for an exempt function activity, since this activity generally does not further the purpose of influencing or attempting to influence the selection process.[56] However, a ballot measure committee may qualify for exempt status under other subparagraphs of IRC 501(c), such as IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6).

[56] In addition to the statutory language ("individual") and the regulatory language (the "selection process"), the legislative history treats ballot measure expenditures as outside the purview of exempt function activity. See S. Rep. No. 93-1357, 93d Cong., 2d Sess. 27 (1974) reprinted in 1975-1 C.B. 517, 532, (stating, in discussing the primary activities test, that "a qualified organization could support the enactment or defeat of a ballot proposition, as well as support or oppose a candidate, if the latter activity was not its primary activity").

6. Lobbying and IRC 162(e)

A. Legislative and Regulatory History

(1) The Pre-Statutory Era

Like the restriction on lobbying by charities, the disallowance of a business expense deduction for lobbying first appeared as a Treasury regulation. T.D. 2137, 17 Treas. Dec. 48, 57-58 (1915). The validity of the regulation was first addressed by the Supreme Court in Textile Mills Security Corp. v. Commissioner, 314 U.S. 326 (1941). Textile Mills involved an attempt to deduct expenses made on behalf of German textile interests to pass special legislation that would enable the interests to recover property seized during World War I. The Court, without any dissent, concluded that the regulation did not contravene any Congressional policy and therefore upheld the denial of the deduction.[57]

The Supreme Court revisited the validity of the regulation almost two decades later, in the companion cases of Cammarano v. United States, 358 U.S. 498 (1959), and F. Strauss & Son, Inc. v. Commissioner, 358 U.S. 498 (1959). Both cases involved extensive grass roots lobbying campaigns by liquor distributors against prohibition or state control of liquor distribution proposals which would have destroyed the distributors' businesses. Again, the Court upheld the validity of the regulation, principally on the basis that the regulation had "acquired the force of law" because Congress had repeatedly reenacted the business expense deduction without rejecting the regulation. Cammarano, at 508-509.

(2) Allowance of the Lobbying Deduction

In 1962, Congress finally addressed the issue. Over the objection of the Treasury Department, it enacted IRC 162(e) as part of the Trade Expansion Act of 1962.[58] IRC 162(e)(1) specifically provided a deduction for direct lobbying expenses (including travel expenses, costs of preparing testimony, and a portion of dues) paid in carrying on a trade or business if such expenses are (1) in direct connection with appearances or communications involving legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with information communicated between the taxpayer and an organization of which it is a member as to legislation or proposed legislation of direct interest to the taxpayer and the organization. However, IRC 162(e)(2) provided that no deduction is allowed for any amount paid or incurred (by contribution, gift, or otherwise) for participation or intervention in any political campaign or

[57] It is difficult to imagine that there was any public dissent either, since the decision was handed down on December 8, 1941, the day after the attack on Pearl Harbor.

[58] Invoking the Slee principle, Secretary of the Treasury C. Douglas Dillon, in testimony before the Senate Finance Committee, set forth the Treasury position as follows:

> *We are not against lobbying. We think lobbying is fine, the more of it the better, because the representatives of the people know what the country wants. We are only saying that the Government should not pay for it.* Hearings on H.R. 10650 Before the Senate Comm. on Finance, 87th Cong., 2d Sess. 4,387 (1962).

in connection with any attempt to influence the general public with respect to legislative matters, elections, or referenda.

In explaining the reasons for the provisions, the House and Senate Reports stressed the difficulties of separating lobbying costs from other business costs. Even more important, the Reports stated, was the policy consideration that emanated from the "anomalous" proposition that permitted the deduction of expenses incurred from appearance with respect to executive or judicial matters, but not legislative ones.[59] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 17 (1962), reprinted in 1962-3 C.B. 405, 421; Sen. Rep. No. 1881, 87th Cong., 2d Sess. 22 (1962), reprinted in 1962-3 C.B. 707, 728.

(3) Disallowance of the Lobbying Deduction

In February 1993, the Treasury Department submitted a proposal to deny all business deductions for lobbying expenses. Page 45 of the Summary of the Administration's Revenue Proposals states, in pertinent part, as follows:

> *Reasons for Change*
>
> *The deduction for lobbying expenses inappropriately benefits corporations and special interest groups for intervening in the legislative process.*[60]
>
> *Proposal*
>
> *Businesses would no longer be allowed to deduct their lobbying expenses. Lobbying expenditures for this purpose would be defined similarly to the definition of expenditures to influence legislation in section 4911(d) and would include attempts to influence legislation through communications with the executive branch as well as the legislative branch of government. The current restrictions on deductions for expenses of grassroots lobbying and participation in political campaigns would remain. These rules would prevent charities from engaging in more than an insubstantial amount of lobbying. No deduction would be allowed for the part of membership dues that are used for lobbying, but as under current law, trade associations and similar organizations would not lose their exempt status for lobbying. Trade associations and similar organizations would be required to report to their members the portion of their dues used for lobbying activities.*

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59 As we have seen, however, this "anomaly" persists for IRC 501(c)(3) organizations.

60 This position was spelled out, at much greater length, in the 1962 legislative history of IRC 162(e). See Supplemental and Minority Views of Senators Paul Douglas and Albert Gore, 1962-3 C.B. 1092, 1116-1120.

On May 4, 1993, House Ways and Means Chairman Rostenkowski introduced the Administrations's bill, H.R. 1960. The Committee Report on the bill that emerged from the House, H.R. 2264, stated a different reason for change: "The committee has determined that, in the context of deficit reduction legislation, it is appropriate to limit the business deduction for lobbying expense." H.R. Rep. No. 103-111, 103d Cong., 1st Sess. 659 (1993) reprinted in 1993-3 C.B. 235.

What finally resulted was § 13222 of OBRA 1993. It amended IRC 162(e) by replacing the existing language with a new IRC 162(e) applicable to amounts paid or incurred after December 31, 1993.[61] The new IRC 162(e) disallows the deductibility of direct legislative lobbying expenses at the Federal and state (but not the local) level. It also disallows deductions for contacts with certain federal officials. Grass roots lobbying and political campaign expenditures continue to be nondeductible. In addition, IRC 162(e)(3) includes pass-through provisions affecting dues paid to exempt organizations, so organizations can not indirectly do what is disallowed directly.

The regulations under IRC 162 have, since their adoption in 1965, provided for the disallowance of dues paid to an organization to the extent the organization is engaged in an activity prohibited under IRC 162(e). Reg. 1.162-20(c)(3). However, no mechanism existed at the association level to ensure notification to members of the disallowance. Therefore, § 13222 of OBRA 1993 also amended IRC 6033, adding a new subsection to provide a system based on the disallowance of dues that builds in an incentive (or penalty) to ensure that associations notify their members. The trigger is contained in IRC 6033(e), which imposes reporting and notice requirements on tax-exempt organizations incurring expenditures to which IRC 162(e) applies. IRC 162(e)(3) denies a deduction for the dues (or other similar amounts) paid to certain tax-exempt organizations to the extent that the organization, at the time the dues are assessed or paid, notifies the dues payer that the dues are allocable to nondeductible lobbying and political expenditures of the type described in IRC 162(e)(1).[62]

An exempt organization subject to IRC 6033(e) has several options. It may provide a notice to its members when they pay dues that contains a reasonable estimate of the amount allocable to lobbying expenditures. If it does not give notification, it must pay a proxy tax at the highest rate imposed by IRC 11 (currently 35 percent) on its lobbying expenditures (up to the amount of dues and other similar payments received by the organization) during the taxable year. In addition, if the organization does provide notices to its members but underestimates the actual amount of lobbying expenditures, it is subject to the proxy tax on the excess lobbying expenditures paid during the applicable year that were not included in the notices. However, this tax may be waived if the organization agrees to include the excess lobbying expenditures in the following year's notices.

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[61] A constitutional challenge to the provisions of § 13222 of OBRA 1993 was dismissed on jurisdictional grounds. American Society of Association Executives v. Bentsen, 848 F. Supp. 245 (D.D.C. 1994).

[62] Payments that are similar to dues include voluntary payments or special assessments used to conduct lobbying.

This mechanism allows a membership organization to elect not to provide its members with a disallowance notice in which case the organization will be required to pay the tax. If an organization elects the proxy tax option, no portion of any dues or other payments made by members of the organization will be deemed nondeductible as a result of the organization's lobbying activities.

(4) History of Regulations and Administrative Pronouncements

Reg. 1.162-20, dealing with expenditures attributable to grass roots lobbying, political campaigns, and certain advertising, was published in 1965 (T.D. 6819, 30 FR 5581 (Apr. 20, 1965)) and amended nearly four years later (T.D. 6996, 34 FR 835 (Jan. 18, 1969)). In general, the regulation provides that if expenditures for lobbying purposes do not meet the requirements of IRC 162(e)(1), such expenditures are not deductible as ordinary and necessary business expenditures. Reg. 1.162-20(c)(1).[63]

As a result of the OBRA 1993 legislation, the Service published final regulations providing allocation rules and rules concerning the definition of influencing legislation in 1995. T.D 8602, 60 FR 37568 (July 21, 1995). These new regulations also provide that to the extent the existing provisions of Reg. 1.162-20 are inconsistent with the new IRC 162, they are superseded. Reg. 1.162-20(c)(5). At the same time, the Service published Rev. Proc. 95-35, 1995-2 C.B. 391, to provide procedures for organizations to determine whether they were excepted from the reporting and notice requirements of IRC 6033(e) in accordance with IRC 6033(e)(3).

B. Specific Issues

(1) Organizations Excepted from the Reporting and Notice Requirements

1. What organizations are excepted from IRC 6033(e)?

IRC 6033(e)(1)(B)(i) provides that the IRC 6033(e) notice requirements do not apply to IRC 501(c)(3) organizations. In addition, IRC 6033(e)(3) provides an exception for organizations that establish to the satisfaction of the Secretary that substantially all of the dues or similar amounts received by the organization are not deducted by its members as business expenses. Most IRC 501(c) organizations do not receive dues that are deducted by their members as business expenses under IRC 162. Therefore, the Service provides in Rev. Proc. 95-35, § 4.01, that, pursuant to IRC 6033(e)(3), the requirements of IRC 6033(e) shall not apply to organizations recognized by the Service as exempt from taxation under IRC 501(a), other than (1) IRC 501(c)(4) social welfare organizations that are not veterans organizations, (2) agricultural and horticultural organizations described in IRC 501(c)(5), and (3) IRC 501(c)(6) organizations. Organizations otherwise subject to IRC 6033(e) whose lobbying expenditures consist solely of

[63] Proposed amendments to Reg. 1.162-20 were published in 1980 but have not been finalized. FR 78167 (Nov. 25, 1980).

in-house expenditures that do not exceed $2000 in a taxable year are also excepted from these requirements. IRC 6033(e)(1)(B)(ii).

2. Which IRC 501(c)(4) and IRC 501(c)(5) organizations does Rev. Proc. 95-35 except?

IRC 501(c)(4) veterans' organizations and IRC 501(c)(5) labor organizations are excepted by the Service from the IRC 6033(e) requirements in Rev. Proc. 95-35, § 4.01. Other IRC 501(c)(4) social welfare organizations and IRC 501(c)(5) agricultural and horticultural organizations that meet a safe harbor set forth in Rev. Proc. 95-35, § 4.02, also will be excepted from IRC 6033(e). The safe harbor provides that these organizations are not subject to IRC 6033(e) if more than 90 percent of their annual dues are received from (1) members paying annual dues of $50 or less,[64] (2) IRC 501(c)(3) organizations, (3) state or local governments, (4) entities whose income is exempt from tax under IRC 115, or (5) organizations excepted by § 4.01 of Rev. Proc. 95-35 as noted above. Organizations that do not meet the safe harbor may establish that they satisfy the requirements of IRC 6033(e)(3) by maintaining records establishing that at least 90 percent of the annual dues received by the organization are not deductible by its members (without regard to IRC 162(e)) and notifying the Service on its Form 990, *Return of Organization Exempt from Income Tax*, that it is described in IRC 6033(e)(3).[65] Rev. Proc. 95-35, § 5.06.

3. What organizations described in IRC 501(c)(6) are excepted by Rev. Proc. 95-35?

Generally, IRC 501(c)(6) organizations are subject to the IRC 6033(e) requirements. However, Rev. Proc. 95-35, § 4.03, provides an exception for IRC 501(c)(6) organizations if over 90 percent of their annual dues are received from (1) IRC 501(c)(3) organizations, (2) state or local governments, (3) entities whose income is exempt from tax under IRC 115, or (4) organizations excepted by § 4.01 of Rev. Proc. 95-35 4.01, as noted above. IRC 501(c)(6) organizations that do not meet this test may also establish that they satisfy the requirements of IRC 6033(e)(3) by maintaining records establishing that at least 90 percent of the annual dues received by the organization are not deductible by its members (without regard to IRC 162(e)) in the same manner as IRC 501(c)(4) and IRC 501(c)(5) organizations and notifying the Service on its Form 990 that it is described in IRC 6033(e)(3).[66] Rev. Proc. 95-35, § 5.06.

[64] The $50 amount will be increased for years after 1995 by a cost-of-living adjustment under IRC 1(f)(3), rounded to the next highest dollar. Rev. Proc. 95-35, § 5.05.

[65] The organization may also request a private letter ruling to this effect in accordance with the procedures set forth in Rev. Proc. 96-4, 1996-1 I.R.B. 94. If an organization receives a favorable private letter ruling, the Service will not contest its entitlement to exemption under IRC 6033(e)(3) for a subsequent year so long as the character of its membership is substantially similar to its membership at the time of the ruling.

[66] IRC 501(c)(6) organizations may also request a private letter ruling as discussed above.

4. What are "annual dues" and "similar amounts?"

The term "annual dues" means the amount an organization requires a person to pay to be recognized by the organization as a member for an annual period. "Similar amounts" includes, but is not limited to, voluntary payments made by persons, assessments made by the organization to cover basic operating costs, and special assessments imposed by the organization to conduct lobbying activities. Rev. Proc. 95-35, § 5.01. "Member" is used in its broadest sense and is not limited to persons with voting rights in the organization. Rev. Proc. 95-35, § 5.02. If payment for a "membership" is intended to provide more than one person with recognition by the organization as a member for an annual period, annual dues is the full amount of payment request for that category of membership.

5. How does Rev. Proc. 95-35 treat affiliated organizations?

Rev. Proc. 95-35 provides a special aggregation rule that treats affiliated organizations (e.g., a national trade association that has state and local chapters) as a single organization for purposes of IRC 6033(e). The rule provides that if more than one organization described in IRC 501(c)(4), IRC 501(c)(5), or IRC 501(c)(6) share a name, charter, historic affiliation, or similar characteristics, and coordinate their activities, organizations in the affiliate structure are treated as a single organization. In applying the tests set forth in the safe harbor, only dues paid by the "ultimate members," whether paid to one level, which then remits the amounts to other levels in the structure, or paid separately to each level. Amounts paid by one organizational level to another are not considered, even if they are characterized as "dues." If the organization as a whole meets the requirements of IRC 6033(e)(3), (e.g., more than 90 percent of the dues are received from persons paying $50 or less) all organizations in the affiliated structure meet the requirements.[67] Rev. Proc. 95-35, § 5.03.

Rev. Proc. 95-35, § 5.04, provides an example applying the affiliation rule. A group of national, state, and local IRC 501(c)(4) organizations share a common name and work jointly to promote their purpose. Individuals or families pay annual dues of $40 to the local organizations, entitling them to membership in the national and state organizations. The local organizations remit a portion of the dues to the state and national organizations. These remittances by the local organizations exceed $50. The total amount received by all local organizations is $950x. In addition, corporations pay dues of $500 to and become members of the national organization. The total amount received from these members is $50x. Since the $950x exceeds 90 percent of the $1000x received from all members, all of the national, state, and local organizations meet the requirements of IRC 6033(e)(3). The transfers from the local organization are not considered in this determination.

[67] If organizations within the affiliated structure are on different taxable years, the organizations may base their calculations of annual dues received on any single reasonable taxable year.

(2) Definitional Issues Regarding Lobbying

1. What is the meaning of "influencing legislation?"

IRC 162(e)(4)(A) defines "influencing legislation" as "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of legislation." This definition is essentially identical (as it relates to direct, as opposed to grass roots, lobbying) to IRC 4911, as discussed above in Part 3.

Reg. 1.162-29(b)(1) provides that "influencing legislation" involves the following activities:

(A) Any attempt to influence any legislation through a lobbying communication; and

(B) All activities, such as research, preparation, planning and coordination, including deciding whether to make a lobbying communication, engaged in for a purpose of making or supporting a lobbying communication.

Reg. 1.162-29(b)(2) provides that an "attempt to influence any legislation through a lobbying communication" is the act of making the lobbying communication, regardless of whether the attempt is successful.

2. What is a "lobbying communication?"

Pursuant to Reg. 1.162-29(b)(3), a "lobbying communication" is a communication (other than any communication compelled by subpoena, or otherwise compelled by federal or state law)[68] with any member or employee of a legislative body or any other government official or employee who may participate in the formulation of the legislation that does either of the following:

(A) The communication refers to specific legislation and reflects a view on that legislation; or

(B) The communication clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication.

[68] The "subpoena exception" follows the Conference Report (H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 607 (1993), reprinted in 1993-3 C.B. 485), which states that "any communication compelled by subpoena, or otherwise compelled by Federal or State law, does not constitute an 'attempt to influence' legislation or an official's action and, therefore, is not subject to the general disallowance rule."

The phrase "reflects a view" is of critical importance. After it appeared in the proposed regulations, several commentators suggested it should be defined to mean an explicit statement of support or opposition to the legislation. Some commentators also suggested that presenting a balanced analysis of the merits and defects of specific legislation should not constitute reflecting a view on legislation. However, neither recommendation was adopted in the final regulations. T.D. 8602, 60 FR 37568 (July 21, 1995).

Therefore, an organization can reflect a view on legislation without specifically stating it supports or opposes that legislation. Reg. 1.162-29(b)(7), Example 8, illustrates this with regard to an organization that writes a letter to a United States Senator discussing how a certain pesticide has benefited citrus fruit growers and disputing problems linked to its use. The letter discusses a bill pending in Congress and states in part:

> *This bill would prohibit the use of pesticide O. If citrus growers are unable to use this pesticide, their crop yields will be severely reduced, leading to higher prices for consumers and lower profits, even bankruptcy, for growers.*

Despite the fact that the organization does not explicitly state that it opposes the bill, its views on the bill are reflected in the statement. Thus, the communication is a lobbying communication, and the organization is attempting to influence legislation.

3. Do the exceptions under IRC 4911(d)(2) apply for purposes of IRC 162(e)?

No. A significant difference between the two statutes is that while IRC 4911(d) contains specific exceptions to the term "influencing legislation," IRC 162(e) does not. An example of this difference is the "self defense" exception under IRC 4911(d)(2)(C). IRC 162(e) contains no counterpart, and the legislative history strongly suggests that no exception is to be inferred. Statements in footnote 49 of the Conference Report (H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 597 (1993), reprinted in 1993-3 C.B. 475), H.R. Rep. No. 1447 (87th Cong., 2d Sess. 16-18 (1962), reprinted in 1962-3 C.B. 405, 420-422) and S. Rep. No. 1881 (87th Cong., 2d Sess. 21-24 (1962), reprinted in 1962-3 C.B. 707, 727-730) indicate that the holding of Cammarano v. United States, 358 U.S. 498 (1959) (upholding the validity of regulations denying a deduction for lobbying even when the expenses related to proposed legislation that affected the survival of the taxpayer's business) remains good law unless specifically contradicted by statute. Similarly, IRC 162(e) draws no distinction between influencing legislation and educating legislators, unlike the IRC 4911(d)(2) exceptions for making available the results of nonpartisan analysis, study, or research and for providing technical advice or assistance to a governmental body. See also, H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 607 (1993), reprinted in 1993-3 C.B. 485, where the Conference Report notes that exceptions contained in previous versions of the bill were not included in conference agreement. Therefore, IRC 162(e) disallows a deduction for some activities that would not be considered "direct lobbying" under IRC 4911. Accordingly, Reg. 1.162-29(a) specifically provides that the rules enunciated in the regulation have no bearing on IRC 4911 or IRC 4945.

4. What is "legislation?"

IRC 162(e) disallows the deduction for amounts spent or incurred to influence "legislation" considered by a "legislative body." IRC 162(e)(4)(B) provides that, for this purpose, "legislation" has the same meaning as under IRC 4911(e)(2) (discussed in Part 2). Consequently, Reg. 1.162-29(b)(4) provides that "legislation" includes any action on Acts, bills, resolutions and similar items by a "legislative body." "Legislation" includes a proposed treaty required to be submitted by the President to the Senate for and consent from the time the President's representative begins to negotiate a position with the prospective parties to the treaty.

5. What is "specific legislation?"

Under Reg. 1.162-29(b)(5), the term "specific legislation" is not limited to acts, bills, etc., that have been formally introduced before a legislative body. Therefore, specific legislative proposals are included as "specific legislation" even if never introduced. Accordingly, reference to a bill enacted in another state constitutes reference to "specific legislation" despite the fact that a similar bill has not been proposed in the state in question. Reg. 1.162-29(b)(7), Example 7. However, merely identifying a problem and indicating that a legislative body should do something about the problem without specifying what the legislative body should do will not constitute a specific legislative proposal. For example, an organization provides to legislators a paper that it has prepared stating that the lack of new capital is hurting the economy. If the organization merely indicates that increased savings and local investment will assist the economy and includes a cover letter stating, "You must take action to improve the availability of new capital," the organization has not referred to a specific legislative proposal. Reg. 1.162-29(b)(7), Example 5. However, if the organization indicates that lowering the capital gains rate would increase the availability of new capital and includes a cover letter stating, "I urge you to support a reduction in the capital gains tax rate," then it has referred to a specific legislative proposal. Reg. 1.162-29(b)(7), Example 6.

6. What are "legislative bodies?"

The term "legislative bodies" is defined in Reg. 1.162-29(b)(6). The term includes Congress, state legislatures, and other similar governing bodies. However, local councils and similar governing bodies are not "legislative bodies" for purposes of IRC 162(e). Executive, judicial, and administrative bodies are also not included. Administrative bodies includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar federal, state, or local special purpose bodies, whether elective or appointive.

Thus, communications with the administrative agency charged with writing regulations implementing a statute regarding recommendations concerning those regulations are not considered lobbying communications because the regulations are not legislation considered by a "legislative body." Reg. 1.162-29(b)(7), Example 3. Furthermore, testifying at a congressional oversight hearing concerning proposed regulations to implement a particular statutory enactment will not constitute a lobbying communication since the issue is the administrative action and not specific legislation considered by a "legislative body," even though the hearings are before a "legislative body." Reg. 1.162-29(b)(7), Example 2.

7. What is the exception for local councils and similar bodies?

As noted above, IRC 162(e)(2) provides an exception to the general disallowance rule for certain lobbying expenditures related to local councils and similar governing bodies. IRC 162(e)(2) provides that two types of lobbying expenses are deductible. One is the ordinary and necessary expenses (including travel and preparation of testimony) in connection with appearances before, making statements to, or sending communications to the committees or individual members of a local council. The other is the expenses of communication with an organization of which the taxpayer is a member about local legislation or proposed legislation of direct interest to the taxpayer or the organization. The portion of the dues that are paid to an organization that are attributable to either of these activities is also not subject to the disallowance rule. However, grass roots lobbying on local government legislative actions is not covered by the exception. The legislative history indicates that the term "local councils or similar governing bodies" includes any legislative body of a political subdivision of a state, such as a county or city council. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 605 (1993), reprinted in 1993-3 C.B. 483. For purposes of the IRC 162 lobbying rules, Indian tribal governments are treated as "local councils or similar governing bodies." IRC 162(e)(7).

8. What is a "covered executive branch official?"

IRC 162(e)(1)(D) disallows a deduction for expenditures for any "direct communication with a covered executive branch official in an attempt to influence the official actions or positions of [the] official." Pursuant to IRC 162(e)(6), a "covered executive branch employee" includes the President, the Vice President, any person serving in level I of the Executive Schedule (e.g., a Cabinet Officer) or any other person designated by the President as having Cabinet-level status and their immediate deputies, the two most senior-level officers of each agency within the Executive Office of the President, and any other official or employee of the White House Office of the Executive Office of the President. The legislative history indicates that all written or oral communication with covered executive branch officials are included. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 605 n. 57 (1993), reprinted in 1993-3 C.B. 483. A communication with the covered executive branch official will be considered with that official if the official is intended as the primary recipient.

9. What is the exception for de minimis in-house lobbying?

IRC 162(e)(5)(B)(ii) excepts from the general disallowance rule organizations that are involved in a minimal amount of in-house lobbying. When an organization's total amount of in-house lobbying expenses does not exceed $2,000 (computed without taking into account general overhead costs otherwise allocable to lobbying), this exception applies. For purposes of this rule, in-house expenses include labor and material costs.

Payments made to a third-party lobbyist and dues payments allocable to lobbying are subject to the disallowance rules, regardless of whether or not the organization's in-house expenses are exempted. In addition, the de minimis in-house rule does not apply to expenses incurred for political activity, grass roots lobbying or foreign lobbying which continue to be disallowed under current law rules.

(3). Lobbying Purpose

1. When is an activity engaged in for the purpose of making a lobbying communication?

As noted above, Reg. 1.162-29(b)(1) provides that an "attempt to influence legislation" includes not only a lobbying communication but also all research and other preparatory activities engaged in for a purpose of making or supporting a lobbying communication. Reg. 1.162-29(c) sets forth a purpose test, which considers the original intent for engaging in a particular activity in order determine whether a lobbying activity, in whole or in part, has occurred. The general rule, set forth in Reg. 1.162-29(c)(1), provides that the purpose or purposes for engaging in an activity are determined on the basis of all the facts and circumstances, including (but not limited to) the following factors:

(A) Whether the activity and the lobbying communication are proximate in time;

(B) Whether the activity and the lobbying communication relate to similar subject matter;

(C) Whether the activity is performed at the request of, under the direction of, or on behalf of a person making the lobbying communication;

(D) Whether the results of the activity are also used for a nonlobbying purpose; and

(E) Whether, at the time the organization engages in the activity, there is specific legislation to which the activity relates.[69]

[69] The proposed regulations provided two presumptions concerning the purpose for engaging in an activity that is related to a lobbying communication. Specifically, Prop. Reg. 1.162-29(c)(3) provided that if an activity relating to a lobbying communication is engaged in for a non-lobbying purpose prior to the first taxable year preceding the taxable year in which the communication was made, the activity is presumed to be engaged in solely for that non-lobbying purpose. The Commissioner could rebut this presumption in part by establishing that the activity was also engaged in for a purpose other than the non-lobbying purpose. Conversely, Prop. Reg. 1.162-(c)(4) provided that if an activity relating to a lobbying communication is engaged in during the same taxable year as the communication is made or the immediately preceding taxable year, and is not within the preceding presumption, the activity is presumed to be engaged in for the sole purpose of making or supporting a lobbying communication. An organization could rebut the presumption by establishing that the activity was engaged in for a non-lobbying purpose. 59 FR 24992, 24996 (May 13, 1994).

The regulations provide several examples of how the facts and circumstances test is applied. One example involves an organization that conducts a study and provides information to an administrative agency regarding the impact of proposed regulations on its business at a time when no specific legislative proposal on a similar topic is pending. The next year, in response to proposed legislation on the same subject, the organization sends a letter opposing the legislation to a legislator along with a copy of the study. Although the communication with the legislator is a lobbying communication, the organization conducted the study and submitted comments to the administrative agency at a time when no similar legislative proposal was pending. Therefore, it engaged in the study for a nonlobbying purpose. Reg. 1.162-29(c)(4), Example 1. Similarly, an organization that has entered into a contract with a government agency conducts tests regarding the project, submits the test results to the government agency and revises the project specifications in compliance with the contract. It subsequently prepares a summary of the test results and revised specifications which it submits to legislators to encourage them to support appropriations for the contract. The summary was prepared specifically for, and close in time to, the lobbying communication and so was for a lobbying purpose. However, the tests were conducted and the specifications revised pursuant to contract requirements and, thus, were solely for a nonlobbying purpose. Reg. 1.162-29(c)(4), Example 4. On the other hand, an organization that conducts a study at the request of its legislative affairs staff concerning the impact of proposed legislation on its business does so solely for a lobbying purpose, despite the fact that the organization subsequently used the study for labor negotiations with its employees. Reg. 1.162-29(c)(4), Example 2.

2. What if an activity is engaged in for multiple purposes?

Pursuant to Reg. 1.162-29(c)(2), if an organization engages in an activity both for a lobbying purpose and for some nonlobbying purpose, it must treat the activity as engaged in partially for the lobbying purpose and partially for the nonlobbying purpose. This division of the activity must result in a reasonable allocation of costs between nondeductible lobbying costs and other costs. (The allocation rules set forth in Reg. 1.162-28 are discussed below.) Reg. 1.162-29(c)(4), Example (5), illustrates this with regard to a person who travels to the state capital to attend a two-day conference. While there, he spends a third day meeting with state legislators to explain why his corporation opposes a pending bill unrelated to the subject of the conference. Although his trip is partially for a nonlobbying purpose, it also has a lobbying purpose since he refers to and reflects a view on the pending bill. Thus, his corporation must reasonably allocate his traveling expenses between these two purposes.

Reg. 1.162-29(c)(3) provides that certain activities are not engaged in for the purpose of making or supporting lobbying communications. These activities consist of those activities undertaken to comply with the requirements of any law (for example, satisfying state or federal securities law filing requirements), reading any publications available to the general public or

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Commentators contended that these presumptions undermined and complicated the purpose test. The final regulations eliminate the presumptions, replacing them with the list of facts and circumstances set forth in Reg. 1.162-29(c)(1). T.D. 8602, 60 FR 37568 (July 21, 1995).

3. May certain activities be treated as having no purpose to influence legislation?

viewing or listening to other mass media communications, and merely attending a widely attended speech. In addition, if, prior to evidencing a purpose to influence particular legislation (or similar legislation), an organization determines the existence or procedural status of that legislation, determines the time, place, and subject of any hearing to be held by a legislative body with respect to that legislation, or prepares or reviews routine, brief summaries of the provisions of that legislation, the organization is treated as engaging in that activity with no purpose of making or supporting a lobbying communication.

This provision is illustrated by Reg. 1.162-29(c)(4), Example 6, which discusses an organization whose legislative affairs staff prepares a summary of legislation that would affect the organization's business at the time it is proposed and continues to confirm the procedural status of the bill periodically. Two months after the bill was introduced, the organization assigns one of its employees to prepare a position letter on the bill to be delivered to legislators. The preparation of the original summary and the procedural status checks on the bill for the first two months are not considered to be for a lobbying purpose. However, once the organization made the determination to make a lobbying communication, the procedural status checks on the bill after that time were for a lobbying purpose.

4. What if activities support lobbying communications by another organization?

Reg. 1.162-29(d) provides that when an organization engages in activities for a purpose of supporting a lobbying communication to be made by another person, the organization's activities are treated as influencing legislation. For example, if an organization or its employee (as a volunteer or otherwise) engages in an activity to assist a trade association in preparing its lobbying communication, the organization's activities are influencing legislation even though the lobbying communication is made by the trade association. However, the personal activities an organization's employee outside the scope of employment will not be attributed to the organization.

5. What happens if a lobbying communication is not made?

In some instances, organizations engage in activity to support lobbying communications that they never make. Under Reg. 1.162-29(e), if the organization determines before the filing date of its return that it does not expect, under any reasonably foreseeable circumstances, to make a lobbying communication, the activity is treated as if it had not been engaged in for a lobbying purpose and the organization need not treat any amount allocated to that activity for that year as an amount to which IRC 162(e)(1)(A) applies.[70] On the other hand, if the organization reaches the conclusion at any time after the filing date, then any amount previously disallowed with respect to that activity is treated as an amount that is paid at that time that is not subject to IRC 162(e)(1)(A). Thus, the organization is effectively treated as if it incurred the costs relating to the activity in the later year in connection with a nonlobbying activity. Exempt organizations to which IRC 6033(e) applies may treat such amounts as reducing (but not below zero) their lobbying costs. The organization may carry forward any amount not used to reduce lobbying costs to subsequent years.

6. Is there an anti-avoidance rule?

Yes, Reg. 1.162-29(f) provides that if an organization, alone or with others, structures its activities with a principal purpose of achieving results that are unreasonable in light of the purposes of IRC 162(e) and IRC 6033(e), the Commissioner can recast the organization's activities for federal tax purposes to achieve tax results that are consistent with the intent of these provisions and the pertinent facts and circumstances.

(4). Cost Allocations

1. How must costs be allocated?

As noted above, when an organization engages in an activity that has both a lobbying and a nonlobbying purpose, it must allocate the cost of the activity between the two using a reasonable method. Reg. 1.162-29(c)(2) and Reg. 1.162-28(b)(1). Reg. 1.162-28 describes costs that must be allocated to lobbying activities and methods that may be used to allocate those costs. Reg. 1.162-28 does not apply, however, to organizations that are engaged in the trade or business of conducting lobbying activities on behalf of another person.[71] Furthermore, the regulation is not intended to be applied for purposes of IRC 4911 and 4945 and the regulations thereunder. The organization must maintain records in accordance with IRC 6001 and its regulations.

2. What is a reasonable method of allocation?

Reg. 1.162-28(b) permits organizations to use any reasonable method to allocate costs between lobbying and nonlobbying activities. A method is considered reasonable if it is applied consistently, allocates a proper amount of costs to lobbying activities (including labor and administrative costs), and is consistent with the special rules regarding labor hours outlined in

[70] The filing date for this purpose is the earlier of the time the organization files its timely return for the year or the due date of the timely return.

[71] IRC 162(e)(5)(A) provides that organizations that are engaged in the trade or business of conducting lobbying activities on behalf of another person are not subject to the general disallowance rules. However, the rules do apply to payments by such other person to the organization for conducting the lobbying activities.

Reg. 1.162-28(2)(g). Reg. 1.162-28 describes three different allocation methods that are considered reasonable: a ratio method, a gross-up method, and an allocation method that applies IRC 263A principles. Whether any other allocation method is reasonable depends on the facts and circumstances of a particular case. The three specified methods, alone or in combination, do not establish a baseline allocation against which to compare other methods. Therefore, another cost allocation method is not unreasonable simply because it allocates a lower amount of costs to lobbying activities than any of the three specified methods.[72] However, Reg. 1.162-29(c)(2) provides that an organization's treatment of multiple purpose activities will not result in a reasonable allocation if it allocated to influencing legislation (1) only the incremental amount of costs that would not have been incurred but for the lobbying purpose or (2) an amount based on the number of purposes for engaging in that activity without regard to the relative importance of those activities.

3. What costs are allocable to lobbying activities?

Reg. 1.162-28(c) provides that the costs properly allocable to lobbying activities include labor costs and general and administrative costs. Labor costs include costs attributable to full-time, part-time, and contract employees. This includes all elements of compensation, including overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan. General and administrative costs include depreciation, rent, utilities, insurance, maintenance costs, security costs, and other administrative department costs (for example, payroll, personnel, and accounting.)

4. What is the "ratio method?"

Under the ratio method set forth in Reg. 1.162-28(d), an organization multiplies its total costs of operations (excluding third-party costs) by a fraction. The numerator of the fraction is the organization's lobbying labor hours and the denominator is the organization's total labor hours. The formula is expressed as follows:

$$\frac{\text{Lobbying labor hours}}{\text{Total labor hours}} \times \text{Total costs of operations}$$

The product of this calculation is added to the organization's third-party lobbying costs, as defined in Reg. 1.162-28(d)(5).[73] Third-party lobbying costs are amounts paid or incurred in whole or in part for lobbying activities conducted by third parties and amounts paid or incurred for travel (including meals or lodging while away from home) and entertainment relating in whole or in part to lobbying activities.) Thus, third-party costs include amounts paid to lobbying organizations and dues or other similar amounts allocable to lobbying paid to exempt organizations.

[72] Because some commentators interpreted the proposed regulations as treating only the three specified methods as reasonable, the final regulations clarify that organizations may use any reasonable method.

[73] Payments to independent contractors for lobbying purposes would not fall under labor costs. They would, however, be included in third-party lobbying costs.

Reg. 1.162-28(d)(2) provides that an organization may use any reasonable method to determine the number of labor hours spent on lobbying activities and may use the de minimis rule of Reg. 1.162-28(g)(1).[74] It further provides that an organization may treat as zero the hours spent by personnel engaged in secretarial, clerical, support, and other administrative activities as opposed to activities involving significant judgment with respect to lobbying activities.[75] Reg. 1.162-28(d)(3) defines total labor hours as the total number of hours of labor that an organization's personnel spend on the organization's trade or business during the year and provides that an organization may make reasonable assumptions concerning total hours spent by personnel on its trade or business. However, Reg. 1.162-28(d)(3) also provides that if the organization treats as zero the lobbying labor hours spent by personnel engaged in secretarial, maintenance, and other similar activities, it must also treat as zero the total labor hours of all personnel engaged in those activities.

Reg. 1.162-28(d)(6) illustrates the operation of the ratio method. In the example, three employees of an organization engage in both lobbying and nonlobbying activities. One spends 300 hours, another spends 1,700 hours, and the third spends 1,000 hours on lobbying activities, for a total of 3,000 hours for the year. The organization reasonably estimates that each of its three employees spends 2,000 hours a year working for the organization. The organization's total costs of operations are $300,000 and it has no third-party costs. Under the ratio method, the organization allocates $150,000 to its lobbying activities for the year, calculated as follows:

```
Lobbying labor hours          Total       Allocable        Costs
-------------------------- X  costs of  +  third-party  =  allocable to
Total labor hours             operations     costs          lobbying
                                                           activities

[  (300 + 1,700 + 1,000)
[----------------------------  X $300,000] + [0] = $150,000
[            6,000
```

[74] Reg. 1.162-28(g)(1) provides that an organization may treat time spent by an individual on lobbying activities as zero if less than five percent of the person's time is spent on lobbying activities. Reasonable methods may be used to determine if that time is less than five percent. However, pursuant to Reg. 1.162-28(g)(2), any time spent by an employee on "direct contact lobbying" (including the hours spent by that employee in connection with direct contact lobbying, such as allocable travel time relating to direct contact lobbying) may not be excluded under the rule of Reg. 1.162-28(g)(1). "Direct contact lobbying" is defined as a meeting, telephone conversation, letter, or other similar means of communication with a federal or state legislator or covered federal executive branch official that otherwise qualifies as a lobbying activity. Reg. 1.162-28(g)(2) specifically provides that a person who engages in research, preparation, and other background activities related to direct contact lobbying but who does not make direct contact with a legislator or covered executive branch official is not engaged in direct contact lobbying.

[75] Therefore, as Reg. 1.162-28(d)(2) explicitly provides, the hours spent on lobbying activities by para-professionals and analysts may not be treated as zero.

5. What is the "gross-up method?"

Under the general gross-up method, which is described in Reg. 1.162-28(e)(1), an organization multiplies its basic labor costs for lobbying labor hours by 175 percent. Pursuant to Reg. 1.162-28(e)(3), basic labor costs are limited to wages or other similar costs, such as guaranteed payments for services. Costs attributable to pensions, profit-sharing, employee benefits, supplemental unemployment compensation plans, or similar items, are not included in basic labor costs. Third-party lobbying costs are then added to the result of the calculation to arrive at total lobbying costs.

Reg. 1.162-28(e)(2) provides an alternative gross-up method. Under this alternative, an organization may treat as zero the lobbying labor hours of personnel who engage in secretarial, clerical, support, or other administrative activities that do not involve significant judgment with respect to lobbying. However, if an organization uses this alternative method, it must multiply costs for lobbying labor hours by 225 percent.

Reg. 1.162-28(b)(2) provides that an organization (other than one subject to IRC 6033(e)) that does not pay or incur reasonable labor costs for persons engaged in lobbying activities may not use the gross-up method. Such organizations would include a partnership or sole proprietorship in which the lobbying activities are performed by the owners who do not receive a salary or guaranteed payment for services. This provision is significantly different from its predecessor in the proposed regulations. Under the proposed regulations, **any** organization that did not pay reasonable labor costs for people engaged in lobbying activities could use neither the ratio or gross up method. 58 FR 68330, 68332 (Dec. 27, 1993) Tax-exempt organizations contended that they would be prevented from using either or these methods if they used volunteers in their lobbying activities (since no labor costs were incurred). Under the final regulations, tax-exempt organizations can use either the ratio or gross-up methods even if their lobbying activities are conducted by volunteers. Because volunteers are not organizations' personnel, time spent by volunteers is excluded from the organization's lobbying labor hours and total labor hours (although the hours may be included in their own employer's lobbying labor hours or total labor hours).

Reg. 1.162-28(e)(4) illustrates the operation of the gross-up method to the same facts discussed above with regard to the ratio method. In this instance, the organization determines that its basic labor costs are $20 per hour for the first employee, $30 per hour for the second employee and $25 per hour for the third employee. Thus, its basic lobbying labor costs are $82,000 (($20 x 300) + ($30 x 1,700) + ($25 x 1,000)). Under the gross-up method, the organization allocates $143,500 to its lobbying activities for the year, calculated as follows:

$$175\% \quad X \quad \begin{array}{c}\text{Basic lobbying}\\ \text{labor costs of}\\ \text{all personnel}\end{array} \; + \; \begin{array}{c}\text{Allocable}\\ \text{third-party}\\ \text{costs}\end{array} \; = \; \begin{array}{c}\text{Costs allocable}\\ \text{to lobbying}\\ \text{activities}\end{array}$$

$$[175\% \text{ X } \$82{,}000] + [0] = \$143{,}500$$

Many organizations engaged in lobbying activities are subject to the uniform capitalization rules of IRC 263A, therefore, the regulations permit organizations to use the principles of that section and the regulations thereunder to determine costs properly allocable to lobbying activities.

6. What is the "IRC 263A method?"

Specifically, under IRC 263A, lobbying is considered a service department or function. Therefore, an organization may use its IRC 263A methodology to determine the amount of costs allocable to its lobbying department or function for purposes of complying with the regulations. Organizations not subject to IRC 263A may also use the principles of that section and the regulations thereunder to determine the amount of costs allocable to lobbying activities.

(5) Exempt Organization Requirements

1. How are exempt organizations taxed under IRC 6033(e)?

As discussed above, organizations may not avoid the disallowance of the deduction for lobbying by deducting dues paid to tax-exempt organizations that engage in lobbying. Thus, to prevent this avoidance, IRC 6033(e) provides that organizations subject to its provisions are required to provide a notice to its members indicating the nondeductible portion of dues paid due to lobbying activities. If the exempt organization does not provide the notice or if its actual lobbying expenditures exceed the amount disclosed in the notice, the organization will be subject to a proxy tax on the amount that should have been included in the notice but was not. The proxy tax is equal to this amount multiplied by the highest corporate rate imposed by IRC 11. IRC 6033(e)(2). Thus, the organization has the option of providing a notice to its members of the amount of dues that is not deductible due to lobbying or paying the proxy tax.

2. What notices must be provided to members?

An organization subject to IRC 6033(e) is required to provide notice to each person paying dues of the portion of dues that the organization reasonably estimates will be allocable to the organization's lobbying expenditures during the year and, thus, is not deductible by the member. This estimate must be provided at the time of assessment or payment of the dues and must be reasonably calculated to provide the organization's members with adequate notice of the nondeductible amount. IRC 6033(e)(1)(A)(ii). The legislative history indicates that the notice should be provided in a conspicuous and easily recognizable format, referring to IRC 6113 and the regulations thereunder for guidance regarding the appropriate format of the disclosure statement.[76]

IRC 501(c)(4), IRC 501(c)(5), and IRC 501(c)(6) organizations are required to disclose information regarding their lobbying activities on Form 990, *Return of Organization Exempt from Income Tax*. If an organization is excepted from the IRC 6033(e) requirements either because substantially all of its dues were not deductible by its members or because its lobbying

[76] For guidance regarding IRC 6113, see Notice 88-120, 1988-2 C.B. 454. However, unlike IRC 6113, there is no penalty associated with failure to provide the disclosure notice in this format.

3. What information must be disclosed on the Form 990?

expenditures consisted solely of in-house expenditures that did not exceed $2,000, it must disclose this information on the Form 990. If the organization does not meet either of these exceptions, it must disclose the information necessary to determine if it is subject to the proxy tax. This information consists of the total dues received from members, the amount of its IRC 162(e) lobbying expenditures, and the amount it disclosed to its members as the nondeductible portion of dues. IRC 6033(e)(1)(A)(i).

4. What amount is disclosed on the Form 990 as IRC 162(e) lobbying expenditures?

The amount disclosed begins with the organization's lobbying expenses determined in accordance with IRC 162(e). Thus, direct lobbying of local councils or similar governing bodies with respect to legislation of direct interest to the organization or its members and in-house direct lobbying expenses if the total of such expenditures is $2,000 or less (excluding allocable overhead expenses) should be excluded from the amount disclosed. IRC 162(e)(2) and IRC 162(e)(5)(B). Amounts carried over from prior years, either because the lobbying expenditures exceeded the dues received in those years or because the organization received a waiver of the proxy tax imposed on that amount must be included. IRC 6033(e)(1)(C) and IRC 6033(e)(2)(B). The current year's lobbying expenditures should be reduced, but not below zero, by costs allocated in a prior year to lobbying activities that were cancelled after a return reporting these costs was filed in accordance with Reg. 1.162-29(e)(2).

5. What amount is disclosed for nondeductible dues notices?

If the organization notified its members in accordance with IRC 6033(e)(1)(A)(ii) of its estimate of the portion of dues that would not be deductible under IRC 162(e), it must disclose on Form 990 the total amount of dues that its members were notified were nondeductible. For example, if the organization timely notified its members that 25 percent of their dues would be nondeductible and the members paid a total of $100,000 of dues allocable to the year, the amount reported on Form 990 would be $25,000.

6. What if lobbying expenditures exceed the estimated amount?

If the actual lobbying expenditures of an organization subject to IRC 6033(e) exceed the amount that it notified its members was not deductible (either because the expenses were higher than anticipated or the dues receipts were lower), the organization is liable for a proxy tax on the excess amount. IRC 6033(e)(2)(A). The organization may seek a waiver of the proxy tax.[77]

7. How does an organization request a waiver?

A waiver of the proxy tax is requested on Form 990. The organization checks a box agreeing to add the amount it entered as its taxable amount of lobbying expenditures to its dues estimate for the following year and enter the amount on the next year's Form 990. An organization may use this waiver procedure only if it sent dues notices at the time of assessment or payment of dues that reasonably estimated the dues allocable to nondeductible lobbying expenditures.

8. How is the IRC 6033(e) proxy tax determined?

As noted above, an organization subject to IRC 6033(e) must report on the Form 990 the total dues it received from members, the amount of its IRC 162(e) lobbying expenditures for the year, and the amount it disclosed to its members as the nondeductible portion of dues. The amount subject to the IRC 6033(e)(2) proxy tax is its IRC 162 expenditures less the amount disclosed to the members as nondeductible. However, if this amount is more than the amount by which the total dues received exceeds the amount disclosed to the members as nondeductible, then the tax is imposed on the lesser amount and the excess is carried over to the next year. For example, an organization reports on the Form 990 that its IRC 162(e) expenditures for the taxable year were $600x and the aggregate amount of nondeductible dues notices is $100x. If the total amount of dues received was $800x, then the taxable amount would be $500x ($600x - $100x). However, if the total amount of dues received was $400x, the taxable amount would be limited to $300x ($400x - $100x) and the excess $200x ($500x - $300x) would be carried over and included in the next year's IRC 162 expenditures.

The taxable amount is multiplied by the highest rate specified in IRC 11 to determine the IRC 6033(e) proxy tax. If the organization elects to pay the tax, it is reported on Form 990-T, *Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))*. When an organization elects to pay the proxy tax rather than to provide its members with an estimate of dues allocable to IRC 162(e) expenditures, all of the members' dues remain eligible for deduction to the extent otherwise deductible. The organization may also request a waiver of this tax if it made a reasonable estimate and agrees to adjust its notice of IRC 162(e) expenditures to members in the following year. Thus, in the second example above, if the organization requested a waiver, both the excess amount and the taxable amount would be carried over and included in the next year's IRC 162 expenditures.

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[77] It is also possible that an organization could overstate the portion of the dues that are not deductible in the notice of disallowance. It could do so by overestimating the amount of the disallowed expenses or underestimating dues income. The Conference Report indicates that guidance should be issued to cover this eventuality. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 608 n. 66 (1993), reprinted in 1993-3 C.B. 486. The matter is under study.

9. Must estimated tax on the proxy tax be paid?

No, organizations that are subject to IRC 6033(e) are not required to pay estimated tax on the IRC 6033(e) proxy tax, even if they do not provide notices to their members. The instructions for Form 990-T indicate that the proxy tax is not to be included when calculating estimated tax liability.

10. What if lobbying expenditures are under-reported?

Under-reported lobbying expenditures are subject to the IRC 6033(e) proxy tax for the year at issue only to the extent that the same expenditures (if actually reported) would have resulted in a proxy tax liability for that year. A waiver of the proxy tax for the taxable year only applies to reported expenditures. Under-reporting lobbying expenditures may also subject the organization to a $10 per day penalty under IRC 6652 for filing an incomplete or inaccurate return.

(6) Miscellaneous Rules

1. May payments to charities that lobby be deducted?

As stated above, IRC 501(c)(3) organizations are not subject to the IRC 6033(e) disclosure requirements. However, § 13222 of OBRA 1993 also added IRC 170(f)(9) which provides that contributors to charities that engage in lobbying activities cannot take an IRC 170 or IRC 162 deduction for the contribution if (a) the charities' lobbying activities are on matters of direct financial interest to the contributors' trade or business and (b) a principal purpose of the contribution is to avoid the general disallowance rule that would apply if the contributor conducted such lobbying activities directly.

2. What is the "anti-cascading" rule?

IRC 162(e)(5)(A) provides that in the case of an organization engaged in the trade or business of lobbying activities or an employee who receives reimbursements for lobbying expenses, the disallowance rule does not apply to expenditures of the organization or person in conducting such activities directly on behalf of a client or employer. Instead, the payments made by the client or employer to the lobbyist or employee are nondeductible as lobbying expenditures. The purpose of this rule is to insure that, when multiple parties are involved, the general disallowance rule results in the denial of the deduction at only one level. The rule only applies where the parties have a direct, one-on-one relationship and does not have any relevance to payments to membership organizations that further the interests of all members, rather than one particular member. H.R. Rep. No. 103-213, 103d Cong., 1st Sess. 610 (1993), reprinted in 1993-3 C.B. 488.

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Exempt Organizations; Political Campaigns. (2007).

Rev. Rul. 2007-41 (IRS RRU), 2007-25 I.R.B. 1421, 2007-1 C.B. 1421, 2007 WL 1576989

Internal Revenue Service (I.R.S.)

IRS RRU
Revenue Ruling

EXEMPT ORGANIZATIONS; POLITICAL CAMPAIGNS

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Section 501.--Exemption From Tax on Corporations, Certain Trusts, etc., ***26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary or educational purposes, or for the prevention of cruelty to children or animals.***

*1 **Exempt organizations; political campaigns.** This ruling provides 21 examples illustrating the application of the facts and circumstances to be considered to determine whether an organization exempt from income tax under section 501(a) of the Code as an organization described in section 501(c)(3) has participated in, or intervened in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Exempt organizations; political campaigns. This ruling provides 21 examples illustrating the application of the facts and circumstances to be considered to determine whether an organization exempt from income tax under section 501(a) of the Code as an organization described in section 501(c)(3) has participated in, or intervened in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Organizations that are exempt from income tax under section 501(a) of the Internal Revenue Code as organizations described in section 501(c)(3) may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

ISSUE

In each of the 21 situations described below, has the organization participated or intervened in a political campaign on behalf of (or in opposition to) any candidate for public office within the meaning of section 501(c)(3)?

LAW

Section 501(c)(3) provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable or educational purposes, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in section 501(h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Section 1.501(c)(3)-1(c)(3)(i) of the Income Tax Regulations states that an organization is not operated exclusively for one or more exempt purposes if it is an "action" organization.

Section 1.501(c)(3)-1(c)(3)(iii) of the regulations defines an "action" organization as an organization that participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. The term "candidate for public office" is defined as an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State, or local. The regulations further provide that activities that constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written statements or the making of oral statements on behalf of or in opposition to such a candidate.

Whether an organization is participating or intervening, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office depends upon all of the facts and circumstances of each case. For example, certain "voter education" activities, including preparation and distribution of certain voter guides, conducted in a non-partisan manner may not constitute prohibited political activities under section 501(c)(3) of the Code. Other so-called "voter education" activities may be proscribed by the statute. Rev. Rul. 78-248, 1978-1 C.B. 154, contrasts several situations illustrating when an organization that publishes a compilation of candidate positions or voting records has or has not engaged in prohibited political activities based on whether the questionnaire used to solicit candidate positions or the voters guide itself shows a bias or preference in content or structure with respect to the views of a particular candidate. See also Rev. Rul. 80-282, 1980-2 C.B. 178, amplifying Rev. Rul. 78-248 regarding the timing and distribution of voter education materials.

The presentation of public forums or debates is a recognized method of educating the public. See Rev. Rul. 66-256, 1966-2 C.B. 210 (nonprofit organization formed to conduct public forums at which lectures and debates on social, political, and international matters are presented qualifies for exemption from federal income tax under section 501(c)(3)). Providing a forum for candidates is not, in and of itself, prohibited political activity. See Rev. Rul. 74-574, 1974-2 C.B. 160 (organization operating a broadcast station is not participating in political campaigns on behalf of public candidates by providing reasonable amounts of air time equally available to all legally qualified candidates for election to public office in compliance with the reasonable access provisions of the Communications Act of 1934). However, a forum for candidates could be operated in a manner that would show a bias or preference for or against a particular candidate. This could be done, for example, through biased questioning procedures. On the other hand, a forum held for the purpose of educating and informing the voters, which provides fair and impartial treatment of candidates, and which does not promote or advance one candidate over another, would not constitute participation or intervention in any political campaign on behalf of or in opposition to any candidate for public office. See Rev. Rul. 86-95, 1986-2 C.B. 73 (organization that proposes to educate voters by conducting a series of public forums in congressional districts during congressional election campaigns is not participating in a political campaign on behalf of any candidate due to the neutral form and content of its proposed forums).

ANALYSIS OF FACTUAL SITUATIONS

The 21 factual situations appear below under specific subheadings relating to types of activities. In each of the factual situations, all the facts and circumstances are considered in determining whether an organization's activities result in political campaign intervention. Note that each of these situations involves only one type of activity. In the case of an organization that combines one or more types of activity, the interaction among the activities may affect the determination of whether or not the organization is engaged in political campaign intervention.

Voter Education, Voter Registration and Get Out the Vote Drives

Section 501(c)(3) organizations are permitted to conduct certain voter education activities (including the presentation of public forums and the publication of voter education guides) if they are carried out in a non-partisan manner. In addition, section 501(c)(3) organizations may encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a non-partisan manner. On the other hand, voter education or registration activities conducted in a biased manner that favors (or opposes) one or more candidates is prohibited.

Situation 1. B, a section 501(c)(3) organization that promotes community involvement, sets up a booth at the state fair where citizens can register to vote. The signs and banners in and around the booth give only the name of the organization, the date of the next upcoming statewide election, and notice of the opportunity to register. No reference to any candidate or political party is made by the volunteers staffing the booth or in the materials available at the booth, other than the official voter registration forms which allow registrants to select a party affiliation. *B* is not engaged in political campaign intervention when it operates this voter registration booth.

Situation 2. C is a section 501(c)(3) organization that educates the public on environmental issues. Candidate *G* is running for the state legislature and an important element of her platform is challenging the environmental policies of the incumbent. Shortly before the election, *C* sets up a telephone bank to call registered voters in the district in which Candidate *G* is seeking election. In the phone conversations, *C*'s representative tells the voter about the importance of environmental issues and asks questions about the voter's views on these issues. If the voter appears to agree with the incumbent's position, *C*'s representative thanks the voter and ends the call. If the voter appears to agree with Candidate *G*'s position, *C*'s representative reminds the voter about the upcoming election, stresses the importance of voting in the election and offers to provide transportation to the polls. *C* is engaged in political campaign intervention when it conducts this get-out-the-vote drive.

Individual Activity by Organization Leaders

The political campaign intervention prohibition is not intended to restrict free expression on political matters by leaders of organizations speaking for themselves, as individuals. Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax exempt under section 501(c)(3), leaders cannot make partisan comments in official organization publications or at official functions of the organization.

Situation 3. President *A* is the Chief Executive Officer of Hospital *J*, a section 501(c)(3) organization, and is well known in the community. With the permission of five prominent healthcare industry leaders, including President *A*, who have personally endorsed Candidate *T*, Candidate *T* publishes a full page ad in the local newspaper listing the names of the five leaders. President *A* is identified in the ad as the CEO of Hospital *J*. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate *T*'s campaign committee. Because the ad was not paid for by Hospital *J*, the ad is not otherwise in an official publication of Hospital *J*, and the endorsement is made by President *A* in a personal capacity, the ad does not constitute campaign intervention by Hospital *J*.

Situation 4. President *B* is the president of University *K*, a section 501(c)(3) organization. University *K* publishes a monthly alumni newsletter that is distributed to all alumni of the university. In each issue, President *B* has a column titled "My Views." The month before the election, President *B* states in the "My Views" column, "It is my personal opinion that Candidate *U* should be reelected." For that one issue, President *B* pays from his personal funds the portion of the cost of the newsletter attributable to the "My Views" column. Even though he paid part of the cost of the newsletter, the newsletter is an official publication of the university. Because the endorsement appeared in an official publication of University *K*, it constitutes campaign intervention by University *K*.

Situation 5. Minister *C* is the minister of Church *L*, a section 501(c)(3) organization and Minister *C* is well known in the community. Three weeks before the election, he attends a press conference at Candidate *V*'s campaign headquarters and states that Candidate *V* should be reelected. Minister *C* does not say he is speaking on behalf of Church *L*. His endorsement is reported on the front page of the local newspaper and he is identified in the article as the minister of Church *L*. Because Minister *C* did not make the endorsement at an official church function, in an official church publication or otherwise use the church's assets, and did not state that he was speaking as a representative of Church *L*, his actions do not constitute campaign intervention by Church *L*.

Situation 6. Chairman *D* is the chairman of the Board of Directors of *M*, a section 501(c)(3) organization that educates the public on conservation issues. During a regular meeting of *M* shortly before the election, Chairman *D* spoke on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate *W*." Because Chairman *D*'s remarks indicating support for Candidate *W* were made during an official organization meeting, they constitute political campaign intervention by *M*.

Candidate Appearances

Depending on the facts and circumstances, an organization may invite political candidates to speak at its events without jeopardizing its tax-exempt status. Political candidates may be invited in their capacity as candidates, or in their individual capacity (not as a candidate). Candidates may also appear without an invitation at organization events that are open to the public.

When a candidate is invited to speak at an organization event in his or her capacity as a political candidate, factors in determining whether the organization participated or intervened in a political campaign include the following:

• Whether the organization provides an equal opportunity to participate to political candidates seeking the same office;

• Whether the organization indicates any support for or opposition to the candidate (including candidate introductions and communications concerning the candidate's attendance); and

• Whether any political fundraising occurs.

In determining whether candidates are given an equal opportunity to participate, the nature of the event to which each candidate is invited will be considered, in addition to the manner of presentation. For example, an organization that invites one candidate to speak at its well attended annual banquet, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely have violated the political campaign prohibition, even if the manner of presentation for both speakers is otherwise neutral.

When an organization invites several candidates for the same office to speak at a public forum, factors in determining whether the forum results in political campaign intervention include the following:

• Whether questions for the candidates are prepared and presented by an independent nonpartisan panel,

• Whether the topics discussed by the candidates cover a broad range of issues that the candidates would address if elected to the office sought and are of interest to the public,

• Whether each candidate is given an equal opportunity to present his or her view on each of the issues discussed,

• Whether the candidates are asked to agree or disagree with positions, agendas, platforms or statements of the organization, and

• Whether a moderator comments on the questions or otherwise implies approval or disapproval of the candidates.

Situation 7. President *E* is the president of Society *N*, a historical society that is a section 501(c)(3) organization. In the month prior to the election, President *E* invites the three Congressional candidates for the district in which Society *N* is located to address the members, one each at a regular meeting held on three successive weeks. Each candidate is given an equal opportunity to address and field questions on a wide variety of topics from the members. Society *N*'s publicity announcing the dates for each of the candidate's speeches and President *E*'s introduction of each candidate include no comments on their qualifications or any indication of a preference for any candidate. Society *N*'s actions do not constitute political campaign intervention.

Situation 8. The facts are the same as in *Situation 7* except that there are four candidates in the race rather than three, and one of the candidates declines the invitation to speak. In the publicity announcing the dates for each of the candidate's speeches, Society *N* includes a statement that the order of the speakers was determined at random and the fourth candidate declined the Society's invitation to speak. President *E* makes the same statement in his opening remarks at each of the meetings where one of the candidates is speaking. Society *N*'s actions do not constitute political campaign intervention.

Situation 9. Minister *F* is the minister of Church *O*, a section 501(c)(3) organization. The Sunday before the November election, Minister *F* invites Senate Candidate *X* to preach to her congregation during worship services. During his remarks, Candidate *X* states, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on Tuesday." Minister *F* invites no other candidate to address her congregation during the Senatorial campaign. Because these activities take place during official church services, they are attributed to Church *O*. By selectively providing church facilities to allow Candidate *X* to speak in support of his campaign, Church *O*'s actions constitute political campaign intervention.

Candidate Appearances Where Speaking or Participating as a Non-Candidate

Candidates may also appear or speak at organization events in a non-candidate capacity. For instance, a political candidate may be a public figure who is invited to speak because he or she: (a) currently holds, or formerly held, public office; (b) is considered an expert in a non political field; or (c) is a celebrity or has led a distinguished military, legal, or public service career. A candidate may choose to attend an event that is open to the public, such as a lecture, concert or worship service. The candidate's presence at an organization-sponsored event does not, by itself, cause the organization to be engaged in political campaign intervention. However, if the candidate is publicly recognized by the organization, or if the candidate is invited to speak, factors in determining whether the candidate's appearance results in political campaign intervention include the following:

• Whether the individual is chosen to speak solely for reasons other than candidacy for public office;

• Whether the individual speaks only in a non-candidate capacity;

• Whether either the individual or any representative of the organization makes any mention of his or her candidacy or the election;

• Whether any campaign activity occurs in connection with the candidate's attendance;

• Whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present; and

• Whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Situation 10. Historical society *P* is a section 501(c)(3) organization. Society *P* is located in the state capital. President *G* is the president of Society *P* and customarily acknowledges the presence of any public officials present during meetings. During the state gubernatorial race, Lieutenant Governor *Y*, a candidate, attends a meeting of the historical society. President *G* acknowledges the Lieutenant Governor's presence in his customary manner, saying, "We are happy to have joining us this evening Lieutenant Governor *Y*." President *G* makes no reference in his welcome to the Lieutenant Governor's candidacy or the election. Society *P* has not engaged in political campaign intervention as a result of President *G*'s actions.

Situation 11. Chairman *H* is the chairman of the Board of Hospital *Q*, a section 501(c)(3) organization. Hospital *Q* is building a new wing. Chairman *H* invites Congressman *Z*, the representative for the district containing Hospital *Q*, to attend the groundbreaking ceremony for the new wing. Congressman *Z* is running for reelection at the time. Chairman *H* makes no reference in her introduction to Congressman *Z*'s candidacy or the election. Congressman *Z* also makes no reference to his candidacy or the election and does not do any political campaign fundraising while at Hospital *Q*. Hospital *Q* has not intervened in a political campaign.

Situation 12. University *X* is a section 501(c)(3) organization. *X* publishes an alumni newsletter on a regular basis. Individual alumni are invited to send in updates about themselves which are printed in each edition of the newsletter. After receiving an update letter from Alumnus *Q*, *X* prints the following: "Alumnus *Q*, class of 'XX is running for mayor of Metropolis." The newsletter does not contain any reference to this election or to Alumnus *Q*' s candidacy other than this statement of fact. University *X* has not intervened in a political campaign.

Situation 13. Mayor *G* attends a concert performed by Symphony *S*, a section 501(c)(3) organization, in City Park. The concert is free and open to the public. Mayor *G* is a candidate for reelection, and the concert takes place after the primary and before the general election. During the concert, the chairman of *S*'s board addresses the crowd and says, "I am pleased to see Mayor *G* here tonight. Without his support, these free concerts in City Park would not be possible. We will need his help if we want these concerts to continue next year so please support Mayor *G* in November as he has supported us." As a result of these remarks, Symphony *S* has engaged in political campaign intervention.

Issue Advocacy vs. Political Campaign Intervention

Section 501(c)(3) organizations may take positions on public policy issues, including issues that divide candidates in an election for public office. However, section 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. A statement can identify a candidate not only by stating the candidate's name but also by other means such as showing a picture of the candidate, referring to political party affiliations, or other distinctive features of a candidate's platform or biography. All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention.

Key factors in determining whether a communication results in political campaign intervention include the following:

• Whether the statement identifies one or more candidates for a given public office;

• Whether the statement expresses approval or disapproval for one or more candidates' positions and/or actions;

• Whether the statement is delivered close in time to the election;

• Whether the statement makes reference to voting or an election;

• Whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office;

• Whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and

• Whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions.

Situation 14. University *O*, a section 501(c)(3) organization, prepares and finances a full page newspaper advertisement that is published in several large circulation newspapers in State *V* shortly before an election in which Senator *C* is a candidate for nomination in a party primary. Senator *C* represents State *V* in the United States Senate. The advertisement states that S. 24, a pending bill in the United States Senate, would provide additional opportunities for State *V* residents to attend college, but Senator *C* has opposed similar measures in the past. The advertisement ends with the statement "Call or write Senator *C* to tell him to vote for S. 24." Educational issues have not been raised as an issue distinguishing Senator *C* from any opponent. S. 24 is scheduled for a vote in the United States Senate before the election, soon after the date that the advertisement is published in the newspapers. Even though the advertisement appears shortly before the election and identifies Senator *C*'s position on the issue as contrary to *O*'s position, University *O* has not violated the political campaign intervention prohibition because the advertisement does not mention the election or the candidacy of Senator *C*, education issues have not been raised as distinguishing Senator *C* from any opponent, and the timing of the advertisement and the identification of Senator *C* are directly related to the specifically identified legislation University *O* is supporting and appears immediately before the United States Senate is scheduled to vote on that particular legislation. The candidate identified, Senator *C*, is an officeholder who is in a position to vote on the legislation.

Situation 15. Organization *R*, a section 501(c)(3) organization that educates the public about the need for improved public education, prepares and finances a radio advertisement urging an increase in state funding for public education in State *X*, which requires a legislative appropriation. Governor *E* is the governor of State *X*. The radio advertisement is first broadcast on several radio stations in State *X* beginning shortly before an election in which Governor *E* is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Organization *R* on the same issue. The advertisement cites numerous statistics indicating that public education in State *X* is under funded. While the advertisement does not say anything about Governor *E*'s position on funding for public education, it ends with "Tell Governor *E* what you think about our under-funded schools." In public appearances and campaign literature, Governor *E*'s opponent has made funding of public education an issue in the campaign by focusing on Governor *E*' s veto of an income tax increase the previous year to increase funding of public education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the State *X* legislature on state funding of public education. Organization *R* has violated the political campaign prohibition because the advertisement identifies Governor *E*, appears shortly before an election in which Governor *E* is a candidate, is not part of an ongoing series of substantially similar advocacy communications by Organization *R* on the same issue, is not timed to coincide with a non election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor *E*.

Situation 16. Candidate *A* and Candidate *B* are candidates for the state senate in District *W* of State *X*. The issue of State *X* funding for a new mass transit project in District *W* is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate *A* supports funding the new mass transit project. Candidate *B* opposes the project and supports State *X* funding for highway improvements instead. *P* is the executive director of *C*, a section 501(c)(3) organization that promotes community development in District *W*. At *C*' s annual fundraising dinner in District *W*, which takes place in the month before the election in State *X*, *P* gives a lengthy speech about community development issues including the transportation issues. *P* does not mention the name of any candidate or any political party. However, at the conclusion of the speech, *P* makes the following statement, "For those of you who care about quality of life in District *W* and the growing traffic congestion, there is a very important choice coming up next month. We need new mass transit. More highway funding will not make a difference. You have the power to relieve the congestion and improve your quality of life in District *W*. Use that power when you go to the polls and cast your vote in the election for your state senator." *C* has violated the political campaign intervention as a result of *P*'s remarks at *C*'s official function shortly before the election, in which *P* referred to the upcoming election after stating a position on an issue that is a prominent issue in a campaign that distinguishes the candidates.

Business Activity

The question of whether an activity constitutes participation or intervention in a political campaign may also arise in the context of a business activity of the organization, such as selling or renting of mailing lists, the leasing of office space, or the acceptance of paid political advertising. In this context, some of the factors to be considered in determining whether the organization has engaged in political campaign intervention include the following:

• Whether the good, service or facility is available to candidates in the same election on an equal basis,

• Whether the good, service, or facility is available only to candidates and not to the general public,

• Whether the fees charged to candidates are at the organization's customary and usual rates, and

• Whether the activity is an ongoing activity of the organization or whether it is conducted only for a particular candidate.

Situation 17. Museum *K* is a section 501(c)(3) organization. It owns an historic building that has a large hall suitable for hosting dinners and receptions. For several years, Museum *K* has made the hall available for rent to members of the public. Standard fees are set for renting the hall based on the number of people in attendance, and a number of different organizations have rented the hall. Museum *K* rents the hall on a first come, first served basis. Candidate *P* rents Museum *K*'s social hall for a fundraising dinner. Candidate *P*' s campaign pays the standard fee for the dinner. Museum *K* is not involved in political campaign intervention as a result of renting the hall to Candidate *P* for use as the site of a campaign fundraising dinner.

Situation 18. Theater *L* is a section 501(c)(3) organization. It maintains a mailing list of all of its subscribers and contributors. Theater *L* has never rented its mailing list to a third party. Theater *L* is approached by the campaign committee of Candidate *Q*, who supports increased funding for the arts. Candidate *Q*'s campaign committee offers to rent Theater *L*'s mailing list for a fee that is comparable to fees charged by other similar organizations. Theater

L rents its mailing list to Candidate *Q*'s campaign committee. Theater *L* declines similar requests from campaign committees of other candidates. Theater *L* has intervened in a political campaign.

Web Sites

The Internet has become a widely used communications tool. Section 501(c)(3) organizations use their own web sites to disseminate statements and information. They also routinely link their web sites to web sites maintained by other organizations as a way of providing additional information that the organizations believe is useful or relevant to the public.

A web site is a form of communication. If an organization posts something on its web site that favors or opposes a candidate for public office, the organization will be treated the same as if it distributed printed material, oral statements or broadcasts that favored or opposed a candidate.

An organization has control over whether it establishes a link to another site. When an organization establishes a link to another web site, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization does not have control over the content of the linked site. Because the linked content may change over time, an organization may reduce the risk of political campaign intervention by monitoring the linked content and adjusting the links accordingly.

Links to candidate-related material, by themselves, do not necessarily constitute political campaign intervention. All the facts and circumstances must be taken into account when assessing whether a link produces that result. The facts and circumstances to be considered include, but are not limited to, the context for the link on the organization's web site, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of the links between the organization's web site and the web page that contains material favoring or opposing a candidate for public office.

Situation 19. M, a section 501(c)(3) organization, maintains a web site and posts an unbiased, nonpartisan voter guide that is prepared consistent with the principles discussed in Rev. Rul. 78-248. For each candidate covered in the voter guide, *M* includes a link to that candidate's official campaign web site. The links to the candidate web sites are presented on a consistent neutral basis for each candidate, with text saying "For more information on Candidate *X*, you may consult [URL]." *M* has not intervened in a political campaign because the links are provided for the exempt purpose of educating voters and are presented in a neutral, unbiased manner that includes all candidates for a particular office.

Situation 20. Hospital *N*, a section 501(c)(3) organization, maintains a web site that includes such information as medical staff listings, directions to Hospital *N*, and descriptions of its specialty health programs, major research projects, and other community outreach programs. On one page of the web site, Hospital *N* describes its treatment program for a particular disease. At the end of the page, it includes a section of links to other web sites titled "More Information." These links include links to other hospitals that have treatment programs for this disease, research organizations seeking cures for that disease, and articles about treatment programs. This section includes a link to an article on the web site of *O*, a major national newspaper, praising Hospital *N*'s treatment program for the disease. The page containing the article on *O*'s web site contains no reference to any candidate or election and has no direct links to candidate or election information. Elsewhere on *O*'s web site, there is a page displaying editorials that *O* has published. Several of the editorials endorse candidates in an election that has not yet occurred. Hospital *N* has not intervened in a political campaign by maintaining the link to the article on *O*'s web site because the link is provided for the exempt purpose of educating the public about Hospital *N*'s programs and neither the context for the link, nor the relationship between Hospital *N* and *O* nor the arrangement of the links going from Hospital *N*'s web site to the endorsement on *O*'s web site indicate that Hospital *N* was favoring or opposing any candidate.

Situation 21. Church *P*, a section 501(c)(3) organization, maintains a web site that includes such information as biographies of its ministers, times of services, details of community outreach programs, and activities of members of its congregation. *B*, a member of the congregation of Church *P*, is running for a seat on the town council. Shortly before the election, Church *P* posts the following message on its web site, "Lend your support to *B*, your fellow parishioner, in Tuesday's election for town council." Church *P* has intervened in a political campaign on behalf of B.

HOLDINGS

In situations 2, 4, 6, 9, 13, 15, 16, 18 and 21, the organization intervened in a political campaign within the meaning of section 501(c)(3). In situations 1, 3, 5, 7, 8, 10, 11, 12, 14, 17, 19 and 20, the organization did not intervene in a political campaign within the meaning of section 501(c)(3)

DRAFTING INFORMATION

The principal author of this revenue ruling is Judith Kindell of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Ms. Kindell at (202) 283-8964 (not a toll-free call).

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