EXEMPT ORGANIZATIONS AND CHARITABLE ACTIVITIES IN DELAWARE

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Faculty Biographies

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BRYAN E. KEENAN is a director of the Wilmington, Delaware, law firm of Gordon, Fournaris & Mammarella, P.A., where his main areas of practice are taxation, business transactions and business law. His practice encompasses wealth transfer vehicles, including family limited partnerships, limited liability companies, charitable trusts and private foundations. Bryan regularly authors and presents educational programs on tax subjects for lay and professional groups. His published writings range from the professional liability of accountants to the economics of industrial investment. He served as Adjunct Professor of Law at Widener Law School for a number of years where he taught Tax Practice and Procedure in the Graduate Tax Program.. He received his B.A. degree, *cum laude*, and his J.D. degree from Syracuse University, and his LL.M. degree in taxation from Temple University. Bryan is a member of the Business Law, Law Practice Management, Real Property and Probate, and Taxation Sections of the American Bar Association and the Corporation Law, Computer, and Taxation Sections of the Delaware State Bar Association. He is also a member of the Wilmington Tax Group (Treasurer 2001-2002; President 2002-2003) and the Estate Planning Council of Delaware, Inc.

This manual was prepared to accompany the faculty's presentation

Citations

Unless otherwise specified, all references to "Code Section" or "Code §" are to the *Internal Revenue Code of 1986*, as amended (the "Code"), and all references to the "regulations," "Treasury Regulation Section" or "Treas. Reg. §" are to the regulations promulgated under the Code.

All references to"Delaware Code" or "Del. Code §" are to the *Delaware Code Annotated*.

I. INTRODUCTION TO EXEMPT ORGANIZATIONS

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I. Introduction to Exempt Organizations

A. Rationale for Exempt Organizations

Why *are* exempt organizations exempted from the Federal and state income taxes? As in many areas of human endeavor, there as many theories of exemption as there are theorists. At the risk of oversimplifying and perpetuating the author's misunderstanding, what follows is an overview of theories of tax exemption.

Tradition. The exemption for charitable and other organizations was established with the first tax in 1913.[1] The exemption from other taxes predates the enactment of the first income tax act.[2] Hence, there is a long tradition of exempting such organizations from tax.

Lessening the Burdens of Government; Quid-Pro-Quo; Community Benefit. Slightly more than a decade after the enactment of the first income tax act, the United States Supreme Court stated that "the exemption is made in recognition of the benefit

[1] Strefeler & Miller, "Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax," 12 Akron Tax J. at 228 (1996).

[2] *Id*.

which the public derives from corporate activities of [exempt organizations], and is intended to aid them when not conducted for private gain."[3] Countless cases make the same or similar statements, and the United States Supreme Court has repeatedly quoted the statement from the *Trinidad* case, mostly recently in 1983.[4]

Fostering Voluntarism and Pluralism. Our country "was founded on the notion that society need not and should not rely upon big government. The principles of voluntarism and pluralism are cental to this notion."[5] Therefore, tax exemption for exempt organizations furthers public policy by fostering voluntarism and pluralism.

Fostering Altruism. A public policy theory, the altruism theory states that exemption is granted to further the government's and society's interest in fostering altruism.[6]

Tax Policy; No Income. Gifts are exempt from income tax.[7] Exemption is therefore appropriate because exempt organizations do not have income. In fact, of

[3] Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 581, n. 15 (1924).

[4] Bob Jones Univ. v. United States, 461 U.S. 574, 590 (1983).

[5] Strefeler & Miller, "Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax," 12 Akron Tax J. at 229 (1996).

[6] Atkinson, "Altruism in Nonprofit Organizations," 31 B.C. L. REV. at 628 (1990).

[7] Code § 102.

course, many exemption organizations rely more on their substantial earned income than on donations.

Political Considerations. Say no more.

Capital Subsidy Theory. The explanation for the tax exemption is that it enables exempt organizations to overcome barriers to accessing capital markets where private markets have failed.[8]

Donative Theory. Under the donative theory, tax exemption is appropriate if a sufficient percentage of the organization's revenues comes from donations, because a high rate of donations indicates that both the private markets and the government have failed to provide a public good or service.[9]

Aren't you glad you asked?

[8] Hansmann, "The Rationale for Exempting Nonprofit Organizations," 91 YALE L. J. 54, 69 (1981).

[9] Colombo, "Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)," 35 ARIZ. L. REV. at 877 (1993).

B. Forms of Organization and Governing Instruments[10]

1. Corporation

For reasons discussed below, the entity of choice in forming a non-profit organization in Delaware is a Delaware corporation formed without authority to issue stock, frequently referred to as a "nonstock" or "nonprofit membership" corporation.

In their most common usages, the term "non-profit" refers to the status of an entity under state law and the term "tax-exempt" refers to the status of an entity under the Internal Revenue Code of 1986, as amended. An entity does not become "tax-exempt" merely because it is "non-profit." However, it would be very difficult to become tax-exempt if the entity did not form initially as non-profit corporation.

The term "profit" is, itself, misleading in this respect. An entity may earn a profit, in the sense that its revenues exceed its expenses, and still be non-profit and, for that matter, tax-exempt. The presence of profits does not preclude either non-profit status or tax exemption. The concept of "nonprofit" is more of historical development than descriptive of the activities of the entity. Thus, the test of a nonprofit corporation for purposes of the Delaware General Corporation Law quickly went from whether the organization was conducted for profit, *Read v. Tidewater Coal Exch., Inc.,* 116 A.898

[10] Portions of this material are adapted from C. J. DURANTE, R. E. SCHLUSSER AND C. O. TOWNSEND, DELAWARE NONPROFITS: TAX AND BUSINESS ANSWERS Ch. II (NBI, 2001), with permission of the author, Robert E. Schlusser.

(Del. Ch. 1922), to whether the derivation of profits was the object of the organization or merely incidental to the principal object of the organization, *Snider v. Decimo Club, Inc.,* 142 A. 786 (Del. Ch. 1928).

The concept that is key, and that will be touched upon throughout the material on this subject, is "private inurement." Private inurement asks the question whether any person will individually benefit from the assets or profits of the organization other than incidentally as a member of the general public or directly in the form of a fair price for goods and services actually rendered to the organization. If so, then the organization is not nonprofit. Another way to look at private inurement is to ask not whether there will be profits, but whether there is an objective to distribute those profits to those persons in control of the organization.

For example, suppose the owners of property along a body of water organize to keep the water clean and free of vegetation. If the body of water is open to use by the public, there is no private inurement to the property owners, except incidentally as members of the public. But if the body of water is not open to use by anyone other than the property owners, then there is private inurement.

It is the understanding, that if there is no intention to distribute profits there is no need for the issuance of stock, which is behind the following language in the Delaware General Corporation Law, dealing with authorizing the issuance of stock in the certificate

of incorporation:

> The foregoing provisions of this paragraph shall not apply to corporations which are not to have authority to issue capital stock. In the case of such corporations, the fact that they are not to have authority to issue capital stock shall be stated in the certificate of incorporation. The conditions of membership of such corporations shall likewise be stated in the certificate of incorporation or the certificate may provide that the conditions of membership shall be stated in the bylaws; ….[11]

Thus, a Delaware non-profit corporation is formed merely by filing a certificate of incorporation in the manner used by all corporations, the only difference being that the certificate precludes, rather than authorizes, the issuance of stock.

Once formed, the provisions of the Delaware General Corporation Law apply equally to both profit and nonprofit corporations, with some exceptions such as Section 313, which provides a more lenient basis for renewing the certificate of incorporation of certain nonprofit corporations (religious, educational, charitable, etc.).

Of particular interest is Section 127 of the Delaware General Corporation Law, which automatically amends the certificate of incorporation of a corporation which is found to be a private foundation for purposes of the Internal Revenue Code. Upon such a finding, the certificate is automatically amended to deny authority to the corporation to engage in any of the activities that, if engaged in by a private foundation, would cause the

[11] Del. Code. Ann. tit. 8, § 102(b)(4) (2001 Repl. Vol.).

corporation to incur liability for Federal excise taxes imposed on private foundations. In ChapterII of these materials there will be a discussion of those taxes and how an organization can become a private foundation. For the present, however, recognize that Section 127 of the Delaware General Corporation Law may be the salvation of the uniformed drafter.

2. Trust

There are trusts that are exempt from Federal tax by reason of their charitable activities, such as a charitable remainder trust, that would not be considered as non-profit trusts under state law. Trusts such as charitable remainder trusts function as conduits for charitable giving, but do not engage directly in charitable activities. Consequently, they would not be considered to have been formed as a non-profit organization.

A non-profit trust is one in which all the beneficial interests are held by non-private interests, such as the public (or a segment of the public) or by other non-profit organizations. There is no private inurement to any person.

A non-profit trust is formed in the same manner as any other trust, the difference being that the dispositive provisions are drafted to provide benefits as opposed to distributing income or assets. If the trustee is to engage in activities other than investment and distribution of income, specific express authorization will have to be drafted. Without the grant of such authority, the trustee may incur personal liability for breach of his or her

fiduciary duty to preserve the trust assets. These provisions will be needed in any event if the trust is to apply for Federal tax exempt status.

A non-profit trust may be either inter vivos or testamentary, the latter being the most common. The trust may also include authority authorizing the trustee to convert the trust into a non-profit membership corporation.

3. Unincorporated Association

The entity known as an unincorporated association or association has been included, not so much because it may be a viable alternative (which is not likely) to a nonprofit membership corporation, but in order to dispel a certain confusion that exists in the terminology used with respect to non-profit organizations. Other terms which are used are "community chest," "fund," and "foundation," none of which are clearly defined as separate entities and that are in fact either corporations or trusts.

An "unincorporated association" is generally an a loose organization of persons under state law, not qualifying as a partnership because of the lack of profit motive,[12] but that is taxed for federal income tax purposes as a corporation. In Delaware, an unincorporated association may be formed under the Delaware Uniform Unincorporated Nonprofit Association Act.[13] In the absence of the adoption of The Uniform

[12] A partnership may not be an exempt organization. Internal Revenue Manual 7751, § 321.1.

[13] Del. Code. Ann. tit. 6, §§1901-1916 (1999 Repl. Vol.).

Unincorporated Nonprofit Association Act or other state organic law for unincorporated associations,[14] unincorporated associations are creatures of common law.

The Internal Revenue Code governs the classification of organizations for Federal tax purposes.[15] Whether a particular "organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law."[16] A common law trust under state law will be a trust for Federal tax purposes.[17] A state law corporation will be a corporation for Federal tax purposes.[18] An association also will be taxed as a corporation for Federal tax purposes.[19]

An entity not classified as a corporation or a trust for Federal tax purposes is an "eligible entity," that is, eligible to choose its tax classification for Federal tax purposes.[20]

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[14] In addition to Delaware, The Uniform Unincorporated Nonprofit Association Act has been adopted in Alabama, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Texas, West Virginia, Wisconsin and Wyoming. http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-uunaa.asp (July 20, 2002).

[15] Treas. Reg. § 301.7701-1(a)(1).

[16] *Id*.

[17] Treas. Reg. § 301.7701-4(a).

[18] Treas. Reg. § 301.7701-2(b)(1).

[19] Treas. Reg. § 301.7701-2(b)(2).

[20] Treas. Reg. §§ 301.7701-1(b); 301.7701-3(a).

However, "[a]n eligible entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) [of the Internal Revenue Code] is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made…."[21] The mandatory deemed association election is eminently logical. A pass-through entity is not taxable and has no need to claim tax exemption. If an entity claims to be a tax exempt organization, it must, in the absence of a determination that it is a tax exempt organization, be a taxable organization. The regulations save the eligible entity claiming tax exempt status the bother of affirmatively filing an election to be an association taxable as a corporation.

For practical purposes, a nonprofit membership corporation will always be preferable to an unincorporated association, if only for liability protection purposes. The corporate form eliminates all the issues and uncertainties that exist with respect to an unincorporated association.

4. Limited Liability Company

The Internal Revenue Service has unofficially taken the position that a limited

[21] Treas. Reg. § 301.7701-3(c)(1)(v)(A). This should be distinguished from a single member eligible entity that is treated as a disregarded entity. A single member limited liability company owned by a Code Section 501(c)(3) organization should be a disregarded entity. See Ann. 99-102, 1999-43 I.R.B. 545 and the Instructions to Form 990.

liability company can qualify for exemption under Section 501(c)(3) of the Code.[22] Twelve conditions must be met to ensure that the limited liability company is organized and operated exclusively for exempt purposes and to preclude private inurement, as follows:[23]

- The organizational documents must specifically limit the limited liability company's activities to one or more exempt purposes. This may be satisfied by including in the Certificate of Formation statements such as "The organization is organized exclusively for exempt purposes under Section 501(c)(3) of the of the Internal Revenue Code of 1986, as amended" (purposes), and "The organization may not carry on activities not permitted to be carried on by an organization described in Section 501(c)(3) of the Code" (activities).
- The organizational language must specify that the limited liability company is operated exclusively to further the charitable purposes of its members.
- The organizational language must limit the limited liability company's members to Code Section 501(c)(3) organizations or governmental units or

[22] See McCray & Thomas, "Limited Liability Companies as Exempt organizations — Update," INTERNAL REVENUE SERVICE EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 2001, at 29

[23] *Id*., at 29-32.

wholly owned instrumentalities of a state or political subdivision thereof ("governmental units or instrumentalities").[24]

- The organizational language must prohibit any direct or indirect transfer of any membership interest in the limited liability company to a transferee that is not a Code Section 501(c)(3) organization or a governmental unit or instrumentality.
- The organizational language must state that the limited liability company itself, interests in the limited liability company (other than an interest as a member), or the limited liability company's assets may only be availed of or transferred to, directly or indirectly, any nonmember other than a Code Section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value. This language is not intended to prohibits grants to individuals or noncharitable organizations as described in Revenue Ruling 68-489.[25]
- The organizational language must provide that upon dissolution of the limited liability company the assets devoted to the limited liability company's

[24] The Internal Revenue Service takes this position "[b]ecause state laws generally provide LLC members with ownership rights in the assets of the LLC," which causes potential inurement problems. There is no authority cited for this proposition.

[25] 1968-2 C.B. 210.

charitable purposes will continue to be so devoted. A statement in the Certificate of Formation such "Upon dissolution, all assets remaining after the payment of liabilities shall be distributed exclusively to exempt organizations or for exempt purposes under Section 501(c)(3) of the Code."

- The organizational language must require that any amendment to the Certificate of Formation and limited liability company agreement be consistent with Section 501(c)(3) of the Code.
- The organizational language must prohibit the limited liability company from merging with or converting into a for-profit entity.
- The organizational language must prohibit the distribution of any assets to members who cease to be Code Section 501(c)(3) organizations or governmental units or instrumentalities.
- The organizational language must provide for the event that a member ceases to be a Code Section 501(c)(3) organization or governmental units or instrumentalities.
- The organizational language must state that all of the limited liability company's members will "expeditiously and vigorously enforce all of their

rights in the limited liability company and will pursue all legal and equitable remedies to protect their interests in the limited liability company.[26]

- The limited liability company must represent to the Internal Revenue Service that all of the provisions of the limited liability company's organizing documents are consistent with the laws of the state of organization and are enforceable at law and at equity.[27]

The Internal Revenue Service requires that the organizational language appear in both the Certificate of Formation and the limited liability company agreement, unless state law limits what information may appear in the Certificate of Formation, for "administrative convenience."[28]

The same twelve conditions are required for a Code Section 501(c)(4) organization.[29] The Internal Revenue Service has not taken a position whether a limited

[26] What demons does the Internal Revenue Service see when the lights are turned out?

[27] Here, the Internal Revenue Service is concerned about those state limited liability company acts that appear to require a business purpose to form a limited liability company. The Internal Revenue Service will accept the representation until such time as there is state case law to the contrary.

[28] McCray & Thomas, "Limited Liability Companies as Exempt organizations — Update," INTERNAL REVENUE SERVICE EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 2001, at 32.

[29] *Id*., at 33.

liability company may qualify as any other type of exempt organization and, if so, under what conditions.[30]

5. Corporation versus Trust

Given that the two practical choices for organizing a non-profit organization are a membership corporation and a trust, obviously the advantages and disadvantages of one over the other lie in their differences The biggest difference is flexibility, but it cannot be said to be an advantage or a disadvantage without considering the intended purpose of the organization.

A trust is much more inflexible. The trustee's authority is defined irrevocably by the terms of the trust instrument and cannot be changed, absent a failure of the purpose. If a specific purpose is intended, such as a provision in a will for the granting of scholarships, this may be an advantage and a reason for using a trust.

On the other hand, if the purpose is to provide assistance with a particular problem, such as using a scholarship as an incentive to children to remain in school, flexibility may be required in order to deal with changing circumstances. In that case, a corporation is preferable, because any provision of the certificate, the by-laws or the statement purpose can be changed by the vote of the requisite number of members.

[30] *Id*.

An objective factor to consider is the effective federal income tax rate in the event that, for whatever reason, the organization fails to obtain a favorable determination letter. The federal corporate tax rates start at 15 percent and do no not reach 39 percent until $100,000 of taxable income. The trust tax rates also start at 15 percent, but reach 39.6 percent at $8,100 of taxable income! Whatever the political justification for this distortion, the tax rates may be the determinative factor in choosing the corporate form of organization.

Another factor is the difference in the fiduciary duties imposed on a corporate director and the fiduciary duties imposed on a trustee. If a trustee has any personal transactions with a trust (self-dealing), any beneficiary who did not consent to the transaction with full knowledge can set it aside. In the case of a corporation, however, self-dealing by a director can be sustained if it was fair and satisfies the business judgment rule.

The default organization, therefore, would appear to be a corporation.

For further reading on this topic, see Clark & Troost, "Forming a Foundation: Trust vs. Corporation," PROB. & PROP. (May/June 1989).

6. Delaware General Corporation Law versus Other States' Nonprofit Corporation Laws

For further reading on this topic, see Nenno & Sparks, "The Benefits of

Establishing a Private Foundation in Delaware," 28 EST. PLAN. 110 (Mar. 2001); Klamp & Heinen, "Delaware Law Concerning Exempt Organizations," 34 EXEMPT ORG. TAX REV. 227 (Nov. 2001).

7. Governing Instruments

Recognizing that reasonable minds may differ as to matters of procedure and style, the following materials are presented as nothing more than the author's preference and should not be relied upon without question. It is readily admitted that many years of practice has resulted in the attitude, "If it ain't broke, don't fix it."

Appended to this Chapter are two form certificates of incorporation that have been used by the author to form nonprofit corporations. Several things will be evident from a cursory review. I prefer to keep the purpose as broad as possible, leaving specifics to the organizational documents discussed below. This is done to avoid the need to amend the certificate if the Internal Revenue Service finds a problem with the purpose. For the same reasons, I leave the conditions of membership to the by-laws. I do, however, expressly include the prohibitions against actions which would cause a private foundation to incur excise taxes. I do this, not out of lack of faith in Section 127 of the Delaware General Corporation Law, but, rather, to keep the prohibitions before the organization to a greater extent than would be the case otherwise.

With respect to membership provisions, some recommend two classes of

members, voting and nonvoting. Experience has shown that charitable activities begin with a small group of dedicated people. However, these people have a proclivity to involve as many other people as possible, with the occasional result that they lose control of their own organization, lose interest and drop out, after which the organization begins to fall apart. The availability of nonvoting memberships lets the newcomers do what they want to do without adverse consequences.

As to voting memberships, I usually provide for admission upon unanimous consent of the existing voting members. (The initial voting members are appointed by the incorporator.) Again, this is to preserve control.

No memberships are transferable, and all memberships terminate upon resignation, expulsion, or death.[31] Dues may or may not be imposed as a condition of membership, depending on the nature of the organization.

If the Certificate of Incorporation sets forth a broad statement of purpose, the key organizational document is what some call the Statement of Purpose. This is an action taken by the members that sets forth in detail what the organization will and will not do. Not only is such a statement necessary for obtaining a Federal tax exemption, but it also

[31] This is the law in Delaware. *See* Wier v. Howard Hughes Medical Institute, 407 A.2d 105, 1055 (Del. Ch. 1979) ("a member of a non-stock corporation has no vested right in such a membership in that unlike stock held in a business corporation, membership in a non-stock corporation may not be transferred or inherited unless the corporate charter or by-laws of such a corporation so provide").

tends to limit divisive issues among the members at a later date.

With these exceptions, the contents of a nonprofit membership corporation's minute book resemble closely those of any other corporation, with the exception that the word "member" appears in lieu of "stockholder."[32]

C. Liability of Directors and Officers[33]

1. Duties of Directors and Officers

The responsibilities of directors and officers are a matter of common law, defined by standards of diligence, loyalty and obedience. The duty of loyalty requires that directors and officers avoid any actual or perceived conflicts of interest. Under no circumstance should directors or officers engage in self-dealing transactions, misappropriate funds or take corporate action with mixed motives. This is an obvious statement; however, the subtleties of such matters are not always obvious.

The duty of diligence and care requires that directors exercise the same judgment as a "prudent" person. They must conduct themselves with the same degree of care and

[32] The same cannot be said with respect to the application of the entire Delaware General Corporation to nonstock corporations. *See* Scattered Corporation v. Chicago Stock Exchange Inc., 671 A.2d 874, 879 (Del. Ch. 1994) (member's action for court-ordered inspection of books and records dismissed for lack of jurisdiction because remedy only available to stockholders).

[33] This material is adapted from C. J. DURANTE, R. E. SCHLUSSER AND C. O. TOWNSEND, DELAWARE NONPROFITS: TAX AND BUSINESS ANSWERS Ch. II (NBI, 2001), with permission of the author, Collis O. Townsend.

with the same diligence exercised in running their own businesses. They must obtain the information necessary to make sound judgments and implement programs necessary to carry the mission of the organization.

The duty of obedience simply requires that directors and officers keep within the scope of the powers conferred upon them. If they do not, they may lose the protection of the corporate veil and become personally liable. Standard protocol should include holding regular meetings, recording minutes, filing reports, etc.

2. Potential Liability of Directors, Officers and Non-Profit Executives

More than half of all claims against directors and officers come from current employees. These claims include wrongful termination, failure to properly promote employees, sexual harassment and discrimination in salary and duties. Other discrimination issues include racial, sexual, religious, age and sexual orientation. The Civil Rights Act of 1991 extends liability not only to the employer, but also to the agents of the employer, including its directors and officers.

Other major areas of potential liability include the failure to comply with the Internal Revenue Code, ERISA violations, RICO Act violations and environmental and pollution liability. Interestingly, some colleges have been challenged under the antitrust statutes for admission and financial aid activities. New exposures may come from undertaking for-profit enterprises, joint ventures, consolidations and shared use facilities

with other non-profits. Lawsuits, with or without merit, can be brought on by regulatory agencies, employees, members (donors) or other interested third parties (clients).

A "wrongful act" is an actual or alleged error, misstatement, misleading statement, act or omission, neglect or breach of duty. Examples might include the following:

- acts beyond organizational powers
- failure to properly supervise the activities of others
- discrimination in regard to race, gender, age or disability
- wrongful dismissal of employees
- failure to examine and verify reports and documents before signing
- fake or misleading compliance reports authorized by the Board
- permitting the organization to engage in prohibited activities
- preferences at the expense of the organization's assets
- failure to seek competitive bids
- waste or misuse of the organization's assets
- imprudent investments
- misuse of contributions or grants

3. Limitations on Liability

a. Volunteers – Del. Code Ann. tit. 10, § 8133

Delaware's volunteer statute provides that a volunteer is not subject to suit for civil damages, excluding willful and wanton or grossly negligent conduct. Suit is permitted for negligent operation of a motor vehicle, up to amount of insurance.

The volunteer statute covers trustees, ex-officio trustees, directors, officers, agents or workers serving without compensation. An exception to the no compensation rule is made for "any gift perquisite in the form of access to services of the organization at no or reduced cost...." An exception is also made for reimbursement of costs actually incurred by the volunteer.

b. Sports – Del. Code Ann. tit. 16, §§ 6835-6836

There is a special volunteer statute for volunteers participating in non-profit sports activities. The statute covers managers, coaches, umpires, referees, assistants to the foregoing persons, or persons who prepare a playing field for a practice session or a formal game. Such persons must serve without compensation, except for gifts or reimbursements for reasonable expenses incurred.

A volunteer participating in a non-profit sports activity is not liable for damages resulting from a negligent act or omission "to the extent that said damages exceed either existing liability insurance coverage applicable to the negligent act or omission or the

minimum liability insurance coverage required by law if no coverage applicable to the negligent act or omission exists." The statute excludes reckless or grossly negligent conduct.

4. Indemnification, Insurance and Other Strategies

a. Indemnification

An organization may seek to protect the personal assets of directors and officers by indemnifying them. Through indemnification the organization undertakes to pay legal costs, settlements and judgments on the director's or officer's behalf. *Indemnification can be an empty promise, though, if the organization does not have enough money to pay those expenses.* Organizations that rely on government grants or contracts may not be permitted to use those funds to indemnify a director or officer.

The Delaware General Corporation Law permits indemnification of directors, officers, employees and agents of the organization not only for legal and miscellaneous expenses, but also for judgments and settlements of civil third-party actions. The General Corporation Law requires that the person or persons
indemnified must have acted in good faith and have reasonably believed that their actions were in the best interest of the organization. When fines are involved, such a criminal cases, the standard of conduct may further require that the officers and directors had no reason to believe such conduct was illegal.

b. Insurance

Most non-profit organizations are governed by a volunteer Board of Directors or other such governing body. Day-to-day operations of the organizations are handled by the officers. Often, difficult decisions are made that can sometimes result in lawsuits being brought against both the Board and the organizations. In order to protect the assets of the organization and those of individual Board members and staff against the damage of such a suit, an organization can purchase a Directors and Officers (D & O) Liability Policy, which is a type of insurance.

There are some 100 different kinds of D & O coverage, which can be intertwined depending upon specific needs and potential liabilities. Unlike some insurance policies, such a commercial general liability, automobile liability and many types of property insurance, D & O liability policy forms are not standardized and wording often varies among the policies. The following are suggested features.

- Broad coverage, including directors and key administrators
- Defense costs for excluded claims
- Coverage of broad range of personnel actions
- Coverage for insurable incidents that occurred prior to policy inception
- Protection for "innocent directors" who are unaware of a misrepresentation in the policy application

- Adequate notice of cancellation

The following is a list of common D & O policy exclusions: Bodily injury (General Liability); property damage (General Liability); professional services (Malpractice); nuclear radiation; pollution damage; illegal acts; dishonest acts; intentional misconduct; punitive damages; fines; penalties and matters uninsurable under law; failure to obtain adequate insurance; contract claims; ERISA; antitrust; price-fixing; restraint of trade; peer review; standard setting; credentialing or certification; discrimination; and sexual misconduct.

c. Other Strategies

There are a number of actions that directors can take to control their exposure to the risk of such litigation:

- Attend board meetings regularly, and stay informed
- Insist that procedures be followed, especially on issues surrounding employee promotion and dismissal
- Be familiar with the responsibilities of each director and of the full board in complying with federal and state laws and regulations regarding discrimination, environmental protection, employee safety, privacy and other key areas.

- Disclose in writing any business or personal relationship that might be construed by anyone as a conflict of interest

Form 1

CERTIFICATE OF INCORPORATION OF
[FNDN]

The undersigned incorporator, in order to form a nonprofit corporation under the General Corporation Law of Delaware, certifies as follows:

ARTICLE I

The name of the Corporation is [FNDN] (the "Foundation").

ARTICLE II

The registered address of the Foundation is 1220 North Market Street, Suite 700, P. O. Box 1355, Wilmington, Delaware 19899-1355, in New Castle County. The registered agent at that address is The First State Registered Agent Company.

ARTICLE III

The Foundation shall have no capital stock. The Foundation is a nonprofit organization organized and operated exclusively for charitable and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, or the corresponding provision of any subsequent federal tax laws (the "Code").

ARTICLE IV

The purposes of the Foundation are:

1. To raise funds and make grants to public charities with an emphasis on charities that _____, and any other needy charities as determined by the Board of Directors.

2. To do such acts and carry on such business as may be permitted of nonprofit corporations under the General Corporation Law and other laws of the State of Delaware, but only in order to accomplish the purposes of the Foundation as described above; and

3. To solicit, receive and administer funds, grants and property for the above purposes and for no other reason.

ARTICLE V

The Incorporator of the Foundation is [INCORPORATOR], Esquire, Gordon, Fournaris & Mammarella, P.A., 1220 North Market Street, Suite 700, P. O. Box 1355, Wilmington, Delaware 19899-1355, in New Castle County.

ARTICLE VI

The direction of the management of the affairs of the Foundation, and the control and disposition of its property and funds, shall be vested in the Board of Directors (the "Board") of the Foundation, which shall not be less than one (1) nor more than thirty (30) in number. The qualifications, tenure, powers and duties of the Board shall be as provided in the By-Laws.

ARTICLE VII

The Foundation shall have one (1) class of Members. The Members shall be elected in accordance with the By-Laws.

ARTICLE VIII

The Members shall have the power to make, adopt, alter or repeal, from time to time, By-Laws and regulations for the orderly operation of the Foundation.

ARTICLE IX

The funds of the Foundation shall not be restricted in use to persons of any race, faith, color or national origin, but shall be administered on a nondiscriminatory basis.

ARTICLE X

1. No part of the earnings, capital or property of the Foundation shall ever inure to the benefit of or be distributable to any Member, Director, officer, contributor or any other individual having a personal or private interest in the activities of the Foundation.

2. No Member or Director shall receive or be lawfully entitled to receive any pecuniary profit or compensation from the Foundation; provided, however, **[OPTIONAL LANGUAGE:** that the Foundation may pay reasonable compensation to its Members, Directors, and officers for personal services that are reasonable and necessary to carry out the exempt purposes of the Foundation and, provided, further, **]**that any Member, Director or officer may be reimbursed for out-of-pocket expenses incurred in carrying out the exempt purposes of the Foundation.

ARTICLE XI

The Foundation shall be subject to the following restrictions:

1. No substantial part of the activities of the Foundation shall ever be for the carrying on of propaganda or otherwise attempting to influence legislation.

2. The Foundation shall not participate in or intervene in (including the publishing or distribution of statements) any political campaign on behalf of (or in opposition to) any candidate for public office.

3. The Foundation shall not be authorized to accept gifts or contributions for any purpose other than those stated in Article IV.

ARTICLE XII

At such times as the Foundation is classified as a private foundation under the Code, the Foundation shall be subject to the following restrictions:

1. The Foundation shall not engage in any act of self-dealing as defined in Section 4941(d) of the Code;

2. The Foundation shall distribute its income for each taxable year at such time and in such manner so as not to become subject to the tax on undistributed income imposed by Section 4942 of the Code;

3. The Foundation shall not retain any excess business holdings as defined in Section 4943(c) of the Code;

4. The Foundation shall not make any investments in such a manner as to subject it to tax under Section 4944 of the Code; and

5. The Foundation shall not make any taxable expenditures as defined in Section 4945(d) of the Code.

ARTICLE XIII

No Member, Director, officer or employee of the Foundation shall be personally liable for the payment of the debts of the Foundation, except as such Member, Director, officer or employee may be liable by reason of his or her own conduct or acts.

ARTICLE XIV

A Director shall not be liable to the Foundation or its stockholders for monetary damages for breach of fiduciary duty as a director, except to the extent such exemption from

liability or limitation thereof is not permitted under the General Corporation Law of the State of Delaware as it exists or may hereafter be amended. Any amendment, modification or repeal of the foregoing sentence shall not adversely affect any right or protection of a director of the Foundation under this provision in respect of any act or omission occurring prior to the time of such amendment, modification or repeal.

ARTICLE XV

The Board may, by a majority of the whole Board, designate one (1) or more committees, with each committee to consist of one (1) or more of the Directors. Any such committee, to the extent provided in the resolution of the Board, or in the By-Laws, shall have and may exercise all of the powers and authority of the Board in the management of the business and affairs of the Foundation and may authorize the seal of the Foundation to be affixed to all papers that may require it. The Board may designate one (1) or more Directors as alternate members of any such committee to replace any absent or disqualified member at any such meeting of the committee. The By-Laws may provide that, in the absence or disqualification of a member or a committee, the member or members thereof present at any meeting and not disqualified from voting, whether or not he, she or they constitute a quorum, may unanimously appoint another member of the Board to act at the meeting in the place of any such absent or disqualified member.

ARTICLE XVI

In the event of the liquidation, dissolution or winding up of the Foundation, whether voluntary, involuntary or by operation of law, except as may be otherwise provided by law, the Board shall distribute all of the assets of the Foundation in such manner as the Board, in its absolute and uncontrolled discretion, may by a majority vote determine; provided, however, that any such distribution of assets shall be made to carry out the objects for which the Foundation is organized and operated as hereinbefore stated

in Article IV; and provided, further, that such distribution must be to one or more organizations that are then exempt from tax as organizations described in Section 501(c)(3) of the Code, and to which, at the time of such distribution, contributions are deductible under the provisions of Sections 170, 2055 and 2522 of the Code.

ARTICLE XVII

The Foundation reserves the right to amend, alter or change any provision contained in this Certificate of Incorporation in the manner now or hereafter prescribed by applicable statute, and all rights conferred herein are granted subject to this reservation; provided, however, that no amendment, alteration, change or repeal shall be allowed to authorize the Board of Directors to manage the property of the Foundation or to conduct the affairs of the Foundation in any manner or for any purpose contrary to the provisions of Section 501(c)(3) of the Code.

IN WITNESS WHEREOF, this Certificate has been signed this _____ day of _____, 2002.

_____

[INCORPORATOR], Esquire,
Incorporator

Form 2

CERTIFICATE OF INCORPORATION

OF

[FNDN]

(A Nonstock, Nonprofit Corporation)

****

1. The name of the corporation is [FNDN].

2. The address of its registered office in Delaware is REGISTERED OFFICE in COUNTY County. The registered agent at such address is REGISTERED AGENT.

3. a. The corporation is organized and will be operated exclusively for _____ purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986. All section references in this Certificate refer to the Internal Revenue Code of 1986, 26 U.S.C., and incorporate comparable provisions of later laws.

b. The purpose of the corporation is _____. The

corporation is not organized for pecuniary profit. No part of the corporation's net earnings or capital will inure to the private benefit of any member, director, or officer of or contributor to the corporation. Reimbursement of expenses and payment of reasonable compensation for goods and services actually provided in furtherance of the corporation's purpose will not be deemed to be prohibited under this provision.

c. No part of the activities of the corporation will involve attempts to influence legislation by propaganda or otherwise, nor will the corporation participate or intervene in any political campaign on behalf of any candidate for public office.

d. In the event that the corporation should be determined to be a private foundation as defined in Section 509(a), the corporation will act or refrain from acting so as not to subject itself to the taxes under Section 4941 on self-dealing, to the taxes under Section 4943 on excess business holdings, to the taxes under Section 4944 on investments which jeopardize charitable purpose, and to the taxes under Section 4945 on taxable expenditures.

e. In the event that the corporation should be determined to be a private foundation but not to be an operating foundation as defined in Section 4942(j), the corporation will also act or refrain from acting so as not to subject itself to the taxes under Section 4942 on failure to distribute income.

f. In the event that the corporation should be determined to be a private foundation, the directors may disburse corporate assets at such times, in such amounts, from such sources, and on such terms and to such organizations as will cause the corporation to qualify as a private pass-through foundation described in Section 170(b)(1)(E)(ii).

g. Subject to the foregoing, the corporation will engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware.

4. The corporation is a nonstock corporation and will not have any capital stock. The conditions of membership will be as set forth in the By-laws. The By-laws may provide for both voting and nonvoting memberships.

Nonvoting members will not be entitled to vote on any matter, including but not limited to the election of directors and the dissolution of the corporation. Memberships are not transferrable, voluntarily or involuntarily, by operation of law or otherwise.

5. The activities and affairs of the corporation will be managed by a board of directors, the number and election of which will be as provided in the By-laws. The election of directors need not be by written ballot unless the By-laws so require. Directors need not be members of the corporation unless so required by the By-laws. The directors will appoint such officers as the By-laws may provide. Officers will serve at the will of the directors and have such powers and duties as the By-laws may provide.

6. The corporation will be liquidated and dissolved on a resolution of the directors to liquidate and dissolve, which resolution is approved by a majority of the then voting members. On liquidation and dissolution, the corporation's net assets will be distributed to one or more organizations then exempt from federal income tax by reason of being described in Section 501(c)(3) to be selected by

the members, subject to the restriction that no distribution will be made which would subject the corporation or any of its members to any termination tax.

7. No director of the corporation will have any monetary liability to the corporation or its members for breach of his or her fiduciary duty as a director, except (a) for any breach of the director's duty of loyalty to the corporation or its members, (b) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (c) for any unlawful payment of dividends or unlawful stock purchase or redemption under Section 174 of the General Corporation Law of the State of Delaware, or (d) for any transaction from which the director derived an improper personal benefit.

8. The name and address of the incorporator is:

[INCORPORATOR], Esquire
Gordon, Fournaris & Mammarella, P.A.
1220 North Market Street, Suite 700
P. O. Box 1355
Wilmington, Delaware 19899-1355,

in New Castle County.

9. The corporation reserves the right to amend or repeal any provision contained in this Certificate on a

resolution of the directors which is approved by a majority of the then voting members, and all rights conferred on members are granted subject to this reservation.

I, THE UNDERSIGNED, being the incorporator, make this Certificate for the purpose of forming a corporation pursuant to the General Corporation Law Delaware; and, intending that this be an acknowledgment within the meaning of Section 103 of the General Corporation Law, have executed this document on March 18, 2006.

_____

[INCORPORATOR], Incorporator

II. CATEGORIES OF EXEMPT ORGANIZATIONS

Bryan E. Keenan, Esquire
Gordon, Fournaris & Mammarella, P.A.
Wilmington, Delaware

EXEMPT ORGANIZATIONS AND
CHARITABLE ACTIVITIES IN DELAWARE

September 12, 2002

II. Categories of Exempt Organizations [1]

A. Introduction

As discussed in Chapter I, an organization is not exempt from Federal tax merely because it is organized as a non-profit organization under state law.[2] Section 501(a) of the Code provides that, with certain exceptions, the organization must be one described in Subsection 501(c) of the Code and not denied exemption by Sections 502 or 503 of the Code.[3]

B. Code Section 501(c)(3)

1. Introduction

Section 501(c) of the Code lists 28 different organizations which will qualify for tax exemptions of varying degrees. However, there is no direct statutory link between tax

[1] Portions of this material are adapted from C. J. DURANTE, R. E. SCHLUSSER AND C. O. TOWNSEND, DELAWARE NONPROFITS: TAX AND BUSINESS ANSWERS Ch. III (NBI, 2001), with permission of the author, Robert E. Schlusser.

[2] Treas. Reg. § 1.501(a)-1(a)(2).

[3] The exceptions, employee trusts and religious orders, are beyond the scope of the present discussion, which will focus on those organizations most likely to be encountered by practitioners in what is generally considered to be the area of charitable law.

exemption and the deductibility of contributions to a tax exempt organization for purposes of the federal income tax, the federal gift tax and the federal estate tax. Thus, if the organization wants to solicit tax deductible contributions, it must also look to other sections of the Code.

Section 170(c)(2) of the Code provides that a charitable contribution deduction for income tax purposes will be allowed (within the limitations of that section) for contributions to an organization:

(1) Organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster amateur sports, or for the prevention of cruelty to children or animals;

(2) No part of the net earnings of which inures to the benefit of any private individual;

(3) And which is not disqualified by reason of influencing legislation or intervening in political campaigns on behalf of a candidate.

The same wording is found in Section 2522 of the Code for gift tax purposes and in Section 2055 of the Code for estate tax purposes.

Of the 28 organizations described in Section 501(c) of the Code, only the one in Section 501(c)(3) of the Code has a description that corresponds to the descriptions in Sections 170, 2522 and 2055 of the Code.

2. Criteria for Section 501(c)(3) Status

To qualify for tax exemption under Section 501(c)(3) of the Code, the organization must be "organized and operated exclusively" for one of the enumerated purposes. These are referred to as "the organizational test" and "the operational test."[4] Both tests must be met.

a. The Organizational Test

The organizational test rests upon the contents of the organizational documents of the organization (the certificate of incorporation, by-laws and statement of purpose in the case of a corporation or the trust instrument in the case of a trust). These documents must:

(1) Limit the purpose of the organization to one or more of the exempt purposes specified in Section 501(c)(3) of the Code;[5] and

(2) Irrevocably dedicate the organization's assets to an exempt purpose upon dissolution.[6]

In addition, the documents will not pass the organizational test if they authorize

[4] Treas. Reg. § 1.501(c)(3)-1(a)(1).

[5] Treas. Reg. § 1.501(c)(3)-1(b)(1)(i)(a).

[6] Treas. Reg. § 1.501(c)(3)-1(b)(4).

activities which are not in furtherance of the exempt purpose[7] or if they authorize lobbying or campaigning activities.[8] Since this part of the test can be passed by not including such provisions, it is difficult to understand why any drafter would include such provisions.[9]

Section 501(c)(3) of the Code encompasses the following exempt purposes:

(1) Religious;

(2) Charitable;

(3) Scientific;

(4) Testing for public safety;

(5) Literary;

[7] Treas. Reg. § 1.501(c)(3)-1(b)(1)(i)(b).

[8] Treas. Reg. § 1.501(c)(3)-1(b)(3).

[9] Having said that, the author's former partner, Robert Schlusser, on one occasion did expressly authorize lobbying in the Certificate of Incorporation of a nonprofit organization. This was done for the express purpose of precluding a finding that the organization was exempt from tax. Further in this material, we will be discussing the excise taxes on private foundations, which, if applicable, can be confiscatory. The law is, and always has been, that the nature of the organization controls in determining whether or not it is exempt, not the Internal Revenue Service. The organization must give notice that it is claiming exemption if it claims under Section 501(c)(3) of the Code, but there are exceptions. See Code § 508 and Treas. Reg. § 1.508-1. In the case of this particular organization, there was such a concern about the private foundation excise taxes that the organization did not want to rely on just not claiming exemption. It wanted to be certain that it was not found to be exempt and consequently potentially subject to the excise taxes. There was a deliberate decision to preclude exemption by expressly authorizing lobbying in the Certificate of Incorporation.

(6) Educational; or

(7) Prevention of cruelty to children or animals.[10]

The regulations define charitable as follows:

The term charitable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes. The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c)(3) so long as it is not an action organization of any one of the types described in paragraph (c)(3) of this section.[11]

The regulations define educational as follows:

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

[10] Treas. Reg. § 1.501(c)(3)-1(d)(1)(i).

[11] Treas. Reg. § 1.501(c)(3)-1(d)(2).

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

(ii) Examples of educational organizations.

The following are examples of organizations which, if they otherwise meet the requirements of this section, are educational:

Example 1. An organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Example 2. An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.

Example 3. An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.

Example 4. Museums, zoos, planetariums, symphony orchestras, and other similar organizations.[12]

The regulations defined scientific as follows:

(i) Since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a scientific organization must be organized and operated in the public interest (see subparagraph (1)(ii) of this paragraph). Therefore, the term scientific, as used in section 501(c)(3), includes the carrying on of scientific research in the public interest. Research when taken alone is a word with various meanings; it is not synonymous with scientific; and the nature of particular research

[12] Treas. Reg. § 1.501(c)(3)-1(d)(3).

depends upon the purpose which it serves. For research to be scientific, within the meaning of section 501(c)(3), it must be carried on in furtherance of a scientific purpose. The determination as to whether research is scientific does not depend on whether such research is classified as fundamental or basic as contrasted with applied or practical. On the other hand, for purposes of the exclusion from unrelated business taxable income provided by section 512(b)(9), it is necessary to determine whether the organization is operated primarily for purposes of carrying on fundamental, as contrasted with applied, research.

(ii) Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.

(iii) Scientific research will be regarded as carried on in the public interest:

(a) If the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis;

(b) If such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or

(c) If such research is directed toward benefiting the public. The following are examples of scientific research which will be considered as directed toward benefiting the public, and, therefore, which will be regarded as carried on in the public interest: (1) Scientific research carried on for the purpose of aiding in the scientific education of college or university students; (2) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; (3) scientific research carried on for the purpose of discovering a cure for a disease; or (4) scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area. Scientific research described in this subdivision will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights,

processes, or formulae resulting from such research.

(iv) An organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under section 501(c)(3) as a scientific organization, if:

(a) Such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or

(b) Such organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public. For purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public. In such a case, however, the research from which the patent, copyright, process, or formula resulted will be regarded as carried on in the public interest (within the meaning of subdivision (iii) of this subparagraph) only if it is carried on for a person described in subdivision (iii)(b) of this subparagraph or if it is scientific research described in subdivision (iii)(c) of this subparagraph.

(v) The fact that any organization (including a college, university, or hospital) carries on research which is not in furtherance of an exempt purpose described in section 501(c)(3) will not preclude such organization from meeting the requirements of section 501(c)(3) so long as the organization meets the organizational test and is not operated for the primary purpose of carrying on such research (see paragraph (e) of this section, relating to organizations carrying on a trade or business). See paragraph (a)(5) of section 1.513-2, with respect to research which constitutes an unrelated trade or business, and section 512(b) (7), (8), and (9), with respect to income derived from research which is excludable from the tax on unrelated business income.[13]

[13] Treas. Reg. § 1.501(c)(3)-1(d)(5).

There is no reason not to meet the organizational test by following proven forms in the preparation of the Certificate of Incorporation and the by-laws. That leaves the statement of purpose, but, by making the statement in the form of an action by the members, it can be easily amended to meet any concerns on the part of the Internal Revenue Service.

The same flexibility does not exist in the case of a trust. It may be necessary to seek reformation of the trust instrument through a judicial proceeding if there is a problem with the language contained in the instrument.

b. The Operational Test

The Internal Revenue Service will regard an organization as operated exclusively for one or more exempt purposes only if the organization engages primarily in activities which accomplish one or more of the exempt purposes specified in Section 501(c)(3) of the Code.[14] An organization will not be regarded as operated exclusively for one or more exempt purposes if more than an insubstantial part of the organization's activities is not in furtherance of an exempt purpose.[15]

The operational test is more difficult to meet than the organizational test in that most cases there will not be a history of actual operations at the time the application for

[14] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[15] *Id*.

exemption is filed. For the most part, the organization will be in the position of representing to the Internal Revenue Service that it will actually perform an exempt function, that it will not engage in lobbying (that is, that it will not be an "action" organization[16]) and that there will be no private inurement. The Service will look closely at the organization's equivalent of a business plan, the parameters applicable to the groups that will benefit from the operations, and the identities of the individuals who will be providing goods and services to the organization. Depending upon the degree of any concerns on the part of the Service, it may request changes in the organization's organization documents to formalize those assurances.

C. Other Classifications of Exempt Status

Section 501(c) of the Code provides for 28 flavors of exempt organizations, but this does not include every statutory basis for exemption. At the end of this Chapter is reproduced the Internal Revenue Service's Organization Reference Chart of exempt organizations, which is pages 57 and 58 of Internal Revenue Service Publication 557, Tax Exempt Status for Your Organization (Jul. 2001). While the list contains 31 bases for exemption, it still omits Code Section 4049 ERISA trusts (Code Section 501(c)(24) organizations), qualified state tuition programs described in Section 529 of the Code, and

[16] *See* Treas. Reg. § 1.501(c)(3)-1(c)(3).

pension, profit-sharing, and stock bonus plans described in Section 401(a) of the Code.

1. Code Section501(c)(6), Trade Associations

Amounts paid to a tax-exempt organization qualify for a charitable contribution deduction only if the organization is described in Section 501(c)(3) of the Code. However, amounts paid to a tax-exempt organization may also qualify as ordinary and necessary business expenses, deductible under Section 162 of the Code. For purposes of Section 162 of the Code, the organization does not have to be described in Section 501(c)(3) of the Code.

Section 501(c)(6) of the Code provides for the tax exemption of business leagues, frequently referred to as "trade associations," if the purpose is to promote a common business interest of the members, the purpose is not to engage in business for profit, and there is no private inurement. As contrasted to 501(c)(3) organizations, business leagues can engage in lobbying and political campaign activities without loss of exemption. Engaging in lobbying will limit the members' deduction under Section 162 of the Code, because lobbying expenditures are not deductible.[17] The organization bears the affirmative duty to notify its members of the limitation on the deductibility of dues resulting from lobbying.[18]

[17] Code § 162(e).

[18] Code § 6033(e).

2. Code Section501(c)(7), Social and Recreation Clubs

Social Clubs are another type of common organization. Described in Section 501(c)(7) of the Code, they are organizations formed for pleasure or recreation. Private inurement is prohibited, but, unlike a Code Section 501(c)(3) organization, upon dissolution the assets may be distributed to the members and need not be dedicated to another social club[19].

The problem with social clubs is use by the general public. If receipts from nonmember sources (including investments) exceed 35 percent of total gross receipts and of that amount 15 percent of total gross receipts is from the general public, the club risks losing its exemption.[20] These percentages have been selected to quantify the term "substantially" for purposes of the club's exempt purpose.[21]

Even if the club does not lose its exemption, it is nevertheless subject to unrelated business income tax on nonmember receipts. A group of eight or fewer individuals, one of whom is a member and who pays for the entertainment, are presumed to be guests of the member and not general public.[22]

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[19] Rev. Rul. 58-501, 1958-2 C.B. 262.

[20] S. Rep. No. 1318, 94th Cong., 1st Sess. at 4-5.

[21] *Id*.

[22] Rev. Proc. 71-17, 1971-1 C.B. 683, § 3.03.

For the above reasons, it is essential that social clubs keep detailed records of the club's usage by members and nonmembers.[23]

3. Code Section501(c)(4), Civic Leagues

Another frequent exemption is for civic associations, which are described in Section 501(c)(4) of the Code as social welfare organizations, the purpose of which is bringing about civic betterment and social improvements. Civic associations can campaign and lobby without fear of loss of exemption.

D. The Importance of Code Section 509(a)

Once an organization has established that it is an organization described in Section 501(c)(3) of the Code, it must then be determined whether it is a private foundation. All Section 501(c)(3) organizations (but only Section 501(c)(3) organizations) are presumed to be private foundations until such time as they establish that they are not private foundations.[24]

The concept of a private foundation came into the law in 1969 in response to perceived abuses of tax-exemptions and charitable contribution deductions in preserving family wealth. Prior to that time, the only remedy for such abuses was to revoke the

[23] The record keeping requirements are detailed in Revenue Procedure 71-17, 1971-1 C.B. 683. Note that the Revenue Procedure has not been updated to reflect the 35 percent/15 percent tests.

[24] Code § 508(b). Churches and organizations not private foundations whose annual gross receipts are normally not more than $5,000 are excepted. Code § 508(c)(1).

organization's tax exemptions, which was a drastic step and one that the Service and the courts were reluctant to take.

A series of excise taxes were enacted to assure that tax-exempt organizations in fact acted for tax exempt purposes by imposing penalty taxes on certain actions by the organization: self-dealing,[25] failure to distribute income,[26] excess business holdings,[27] investments that would jeopardize the organization's charitable purpose (if there had been one),[28] lobbying expenditures,[29] and "grants" to individuals for travel or study.[30] Moreover, if the organization did not correct the action, a second level tax was imposed, which in effect confiscated the property involved in the action.[31]

The tests for private foundation status are contained in Section 509.

1. Code Section 509(a)(1) Publicly Supported Organizations

Very generally, by the roundabout way of referring to Section 170 of the Code,

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[25] Code § 4941.

[26] Code § 4942.

[27] Code § 4943.

[28] Code § 4944.

[29] Code § 4945.

[30] *Id*.

[31] Code § 4945(b).

organizations which are not of the type giving rise to the perceived abuses are exempt from private foundation status. These are churches, schools, hospitals, governmental bodies and government supported charities, and organizations engaged exclusively in testing for public safety.[32] These

Included within Code Section 509(a)(1)'s cross-reference to Section 170 of the Code are publicly supported organizations primarily supported by gifts, grants and contributions.

2. Code Section 509(a)(2) Publicly Supported Organizations

Unlike the traditional charities receiving gifts, grants and contributions within Section 509(a)(1) of the Code, Code Section 509(a)(2) publicly supported organizations are primarily supported by revenues from the performance of exempt activities (for example, a symphony). To avoid private foundation status, the remaining organizations must pass the "one-third, one-third" test of Section 509(a)(2) of the Code. To do so, the organization must meet two support tests. The tests are applied on the basis of the organization's "normal" support,[33] which is determined from support derived during the four years preceding the year in question.[34] If there have been significant changes in the

[32] Code § 509(a)(1).

[33] Code § 509(a)(2)(A) and (B).

[34] Treas. Reg. § 1.509(a)-3(c)(1)(i).

organization's operations during that period, adjustments are made to take them into account.[35]

The first test is that it must receive more than one-third of its total support from gifts, grants, contributions, membership fees and receipts from activities which are not unrelated trade or business.[36] Contributions are not counted if they were made by "disqualified persons."[37] Disqualified persons include "substantial contributors," "foundation managers," and related persons, including corporations, partnerships, trusts and estates.[38]

The second test is that the organization must receive one-third or less of its total support from investment income and income from an unrelated trade or business.[39]

From this very general description of the test, it is apparent that, unless an organization can generate a substantial amount of its support from the general public, or a large enough segment of the general public, it will be classified as a private foundation. Conversely, if the organization's main source of support is from investment income or

[35] Reg. § 1.509(a)-3(c)(1)(ii).

[36] Code § 509(a)(2)(A).

[37] *Id*.

[38] Code § 4946.

[39] Code § 509(a)(2)(B).

from a few individuals, it will be classified as a private foundation.

In the case of a newly formed organization, without a history of support, the Service will rule on a provisional basis.[40] At the end of five years, the organization must submit its actual data, at which time a final determination will be made.[41]

It is apparent from these tests that an exempt organization must keep detailed records of contributors and contributions[42]. A substantial contributor is any person who, cumulatively, gave the private foundation more than $5,000, if the amount given exceeded 2 percent of total gifts to the foundation up to the end of the year in which the gift was made.[43] Once a substantial contributor, always a substantial contributor.

3. Code Section 509(a)(3) Supporting Organizations

Supporting organizations formed under Section 509(a)(3) of the Code are formed to benefit, perform the function of or carry out the purposes of one or more Code Section 509(a)(1) or 509(a)(2) publicly supported organizations.[44] A supporting organization must

[40] Treas. Reg. § 1.509(a)-3(d).

[41] While Treasury Regulation § 1.509(a)-3(d) refers to a two year advance ruling period that may be extended by three years, Form 1023 provides for a five year advance ruling period.

[42] This information is gathered by the organization in the course of preparing Form 990. It is highly recommended that the organization prepare Form 990 each year, even if the organization is not required to file Form 990.

[43] Treas. Reg. § 1.509(a)-3(b)(1).

[44] Code § 509(a)(3)(A).

be operated, supervised, or controlled by or in connection with one or more Code Section 509(a)(1) or 509(a)(2) publicly supported organizations,[45] and cannot be controlled directly or indirectly by one or more disqualified persons (as defined in Section 4946 of the Code), other than foundation managers, and other than one or more Code Section 509(a)(1) or 509(a)(2) publicly supported organizations.[46]

E. Private Foundations

Once an organization is determined to be a private foundation, then it must be determined if it is an "operating" private foundation or if it is a "pass-through" foundation. This is because charitable contribution deductions for gifts of appreciated capital gain property (except for contributions of publicly traded stock) to private foundations are limited in amount to the donor's basis in the property unless the private foundation is an operating foundation or a pass-through foundation.[47]

An operating private foundation is one which is directly involved in carrying out an exempt purpose, as opposed to making distributions to support other organizations.[48] More than half of its assets are devoted to directly carrying out its exempt purpose and all

[45] Code § 509(a)(3)(B).

[46] Code § 509(a)(3)(C).

[47] Code § 170(b)(1)(E).

[48] Code § 4942(j)(3)(A); Treas. Reg. § 53.4942(b)-1.

of its income is spent directly in carrying out its exempt purpose.[49] Stated very simply, an operating private foundation is one which is involved hands-on in an exempt purpose and not just a source of funds for other charities.

A pass-through private foundation is one which makes qualifying distributions (generally, to public charities) of all contributions received during the year.[50] These distributions must be made by the fifteenth day of the third month following the end of the foundation's taxable year.[51] Because the pass-through requirements apply to contributions under Section 170 of the Code, the distribution requirement does not apply to bequests within the meaning of Section 2055 of the Code.[52]

Contrasted to private foundation status, which remains until redetermined by the Internal Revenue Service, operating foundation status and pass-through foundation status can change from year to year, depending upon activities of the foundation during that year, and does not require a determination by the Internal Revenue Service.[53]

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[49] Code § 4942(j)(3).

[50] Code § 170(b)(1)(E)(ii); Treas. Reg. § 170A-9(g).

[51] Code § 170(b)(1)(E)(ii).

[52] Treas. Reg. § 170A-9(g)(2)(i).

[53] Treas. Reg. § 170A-9(a)(1)(i) (pass-through foundations); Treas. Reg. § 53.4942(b)-3 (operating foundations).

F. Application Process and Annual Reporting

1. Application Procedures

Prior to the changes in the law in 1969, it was judicially recognized that exemption arose out of conformity with the terms of the statute and that no action on the part of the Internal Revenue Service was required. In 1969, the statute was amended to provide that Code Section 501(c)(3) organizations had to apply for exemption.[54]

Later, voluntary employees' beneficiary organizations, supplemental unemployment compensation trusts and group legal services plans were also required to file for exemption[55].

Other organizations, such as business leagues, social clubs, civic associations, etc., are not required to apply for exemption and are exempt if they meet the terms of the statute. However, it is frequently advisable to apply for exemption even where no application is required.

The result of a successful application is a determination letter from the Internal Revenue Service setting forth the nature and scope of the organization's exemption. This in turn can be used to apply for state tax exemptions, can be given to payers to evidence

[54] Code § 508(a). Churches and organizations whose annual gross receipts are normally not more than $5,000 are excepted. Code § 508(c)(1).

[55] Code § 505(c).

the nature of the payments for the payor's own tax purposes, and, in general, to evidence the nature of the organization should the need to do so arise.

Organizations claiming exemption under Section 501(c)(3) of the Code apply using Form 1023; all other organizations used Form 1024. In addition to the application form, the organization files Form 8718, which transmits the payment of a user fee of either $150 or $500, depending upon whether the organization has or expects to have annual gross receipts of less than $10,000 or more than $10,000.[56]

Other documents that are filed include a Form 2848, Power of Attorney, which authorizes the organization's representative to represent the taxpayer before the Internal Revenue Service, and, perhaps, Form 8734 if the organization is asking for a provisional ruling that it is not a private foundation based on the one-third, one-third test before it has a four year financial history.

The application is filed with the Internal Revenue Service office listed on Form 8718. The Internal Revenue Service has consolidated processing exempt organization applications in Cincinnati, Ohio. However, because there are not enough employees in the Cincinnati service center, applications for recognition of exemption are farmed out to other Internal Revenue Service Centers. In mid-April, 2002, the processing of Form 1023

[56] Rev. Proc. 2002-8, 2002-1 I.R.B. 252, § 6.09.

from postmark to close of the file was averaging 100 days.[57] Your mileage may vary.

2. Individual/Group Exemption

Generally, each organization must file its own exemption application. However, where there is a central organization with multiple subordinate organizations, such as the Boy Scouts, the central organization may apply for a group exemption.[58] The central organization then files an annual report with the Service, listing its subordinates. New subordinates obtain exemption by being included in that annual report, as opposed to filing their own exemption applications.

3. IRS Response; Special Rules

If the Internal Revenue Service rules favorably on the exemption application, it will issue a determination letter which the organization can use to evidence its status to donors, etc.

If the Internal Revenue Service rules unfavorably, the organization, after having exhausted its administrative remedies,[59] may petition the United States Tax Court for a

[57] Interview of the Manager of EP/EO Processing by Sandy Deja (Apr. 17, 2002), 2recounted in posting of Sandy Deja to Tax-Nonprofit@mail.abanet.org (Apr. 18, 2002) (Copy on file with the author).

[58] Treas. Reg. § 1-508-1(a)(3)(i)(c); Rev. Proc. 80-27, 1980-1 C.B. 677.

[59] Code § 7428(b)(2).

declaratory judgment, declaring it to be tax-exempt.[60] The petition must be filed within 90 days of the mailing of the Internal Revenue Service's unfavorable notice of determination by certified mail.[61]

4. Annual Reporting

Most tax-exempt organizations (Code Section 501(c)(3) organizations) must file an annual information form on Form 990. Form 990 provides financial information on revenues, expenses and assets held, while the accompanying Schedule A provides information on officer's compensation and the organization's charitable activities. Other schedules that may be required include contributions and grants received, investments owned and sold, fund raising events, payments to affiliates, receivables and payables and deferred revenue.

All forms are due within four and-a-half months after the close of the fiscal year. Returns should be filed even if the Form 1023, Application for Recognition of Exemption, is still pending. Private foundations use Form 990-PF and Black Lung Trusts use Form 990-BL. Most church and apostolic associations are organized under Section 501(d) of the Code and must file a Form 1065, partnership return.

Any organization whose annual gross receipts are normally $25,000 or less is not

[60] Code § 7428(a)(1).

[61] Code § 7428(b)(3).

required to file. According to the Gross Receipt Test, an organization's gross receipts are considered to be $25,000 or less if the organization is:

- up to a year old and has received, or donors have pledged to give, $37,500 or less in the first year;
- between one and three-years old and averaged $30,000 or less in gross receipts during each of its first two tax years, or
- three years old or more and averaged $25,000 or less for the immediately preceding three years

Organizations with gross receipts of less than $100,000 and year-end total assets of less than $250,000 can file a short for Form 990-EZ.

5. Other Tax Returns

There are a number of other tax returns that may be required of an organization depending on its service activities.

a. Unrelated Business Income

Organizations having gross receipts of $1,000 or more during the year from an unrelated trade or business must file an Exempt Organization Business Income Tax Return (Form 990-T). The taxes imposed on unrelated business are the same as the normal federal corporate income tax rates. Caution: Too much unrelated business income may jeopardize an organization's tax exemption.

b. State Returns.

While some states require the filing of a state corporate tax return for non-profits, according to the Attorney General's office, the State of Delaware does not.

c. Federal & State Employment Taxes

Federal and state employment (payroll) taxes must be withheld and paid on behalf of the people who work for non-profit corporations. Directors, with certain exceptions, are not considered employees if they are paid only for attending board meetings. Most Code Section 501(c)(3) organizations are exempt from paying federal unemployment insurance (FUTA), but normally are subject to collecting, withholding, reporting and paying federal social security and individual income taxes on employee's salaries.

d. Other Taxes or Returns

Depending on the activities of an organization, the following additional returns or reports may be required: Employee Income Tax Return; Sales, Use, excise and other State taxes; Licenses and permits; Workers compensation; and lobbying activities (Form 4720).

6. Disclosure, and Penalties

a. Disclosure

Code Section 6104(e) now requires organizations exempt under Section 501(c) and (d) of the Code to make a copy of their application for exemption and all annual

information returns (except for the list of contributors who gave more than $5,000) available for public inspection during normal business hours at the organization's principal offices. Each return must be kept open to the public for a three year period.[62]

b. Penalties

A penalty of $20 a day, up to a total of the lesser of $10,000 or 5 percent of the gross receipts of the organization for the year, may be imposed if Form 990 is filed late or incomplete, unless reasonable cause can be shown for the late or incomplete filing[63]. Similarly, Section 6652(c)(1)(C) and (D) of the Code assesses a penalty of $20 per each day that the organization fails to comply with the public inspection requirement. While failure to supply annual information carries a $10,000 maximum penalty,[64] there is no cap on the failure to supply the organization's original application for exemption.[65]

7. Revocation of Exempt status

In order to maintain exempt status, an organization must continue to operate exclusively for exempt purposes. Failure to do so can cause the imposition of excise

[62] Code § 6104(d)(2).

[63] Code § 6652(c)(1)(A)(ii). An exempt organization with gross receipts over $1,000,000 for the taxable and fails to file faces a penalty of $100 per day, to a maximum of $50,000.

[64] Code § 6652(c)(1)(C).

[65] Code § 6652(c)(1)(D).

taxes or even the revocation of exemption. Examples of activities which may give rise to punitive action by the Internal Revenue Service are:

- prohibited transactions;
- certain lobbying activities;
- conducting an unrelated trade or business;
- engaging in discriminatory practices; and
- violating the private foundation provisions.

The organization will be engaged in a prohibited activity if it does any of the following with its creator, or a person who made substantial contributions to the organization:

- lends its income or corpus (including demand loans) without adequate security;
- pays unreasonably high compensation;
- makes its services preferentially available;
- purchases security or properties at unreasonably excessive price;
- sells securities or properties at an unreasonably reduced price;

- engages in any other transaction which results in a substantial diversion of its income or corpus.[66]

[66] Code § 503(b)

III. UNRELATED BUSINESS INCOME

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EXEMPT ORGANIZATIONS AND
CHARITABLE ACTIVITIES IN DELAWARE

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III. Unrelated Business Income

A. Taxation of Unrelated Business Income

1. Introduction

Generally, an exempt organization is not taxed on the organization's income from an activity that is substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption. The exemption from income tax applies even if the activity is a trade or business. The general rule does not apply if an exempt organization regularly carries on a trade or business that is not substantially related to the organization's exempt purpose, except that the organization provides funds to carry out that purpose. If an organization conducts an trade or business not substantially related to the organization's exempt purpose, the organization is subject to tax on its income from that unrelated trade or business.[1]

2. Organizations Subject to Tax on Unrelated Business Income

The tax on unrelated business income applies to almost all organizations exempt

[1] Code § 511(a).

under Section 501(a) of the Code and described in Section 501(c) of the Code.[2] State universities and colleges are subject to the tax.[3]

3. Rate of Tax

An organization subject to the tax on unrelated business income is taxable at corporate rates on that income.[4] The tax is imposed on the organization's unrelated business taxable income and is reduced by any applicable tax credits, including the general business credits (such as the investment credit) and the foreign tax credit. An organization with unrelated business income may be liable for alternative minimum tax as would a regular corporate taxpayer.[5]

B. Defining Unrelated Business Income[6]

Unrelated business income is the income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose or function, except that the

[2] Code § 511(a)(2)(A). There is an exception for certain title holding companies exempt under Section 501(c)(2) of the Code.

[3] Code § 511(a)(2)(B).

[4] Code § 511(a)(a).

[5] Treas. Reg. § 1.511-4.

[6] Adopted from Internal Revenue Service Publication 598, TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS (Mar. 2000).

organization uses the profits derived from this activity.[7]

1. Trade or Business

The term "trade or business" generally includes any activity carried on for the production of income from selling goods or performing services.[8] An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may, or may not, be related to the exempt purposes of the organization.[9] For example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business, even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose.[10]

2. Regularly Carried On

Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.[11] For example, a hospital

[7] Treas. Reg. § 1.513-1(a).

[8] Treas. Reg. § 1.513-1(b).

[9] *Id*.

[10] *Id*.

[11] Treas. Reg. § 1.513-1(c)(1).

auxiliary's operation of a sandwich stand for 2 weeks at a state fair would not be the regular conduct of a trade or business.[12] The stand would not compete with similar facilities that a nonexempt organization would ordinarily operate year-round. However, operating a commercial parking lot every Saturday, year-round, would be the regular conduct of a trade or business.[13]

3. Not Substantially Related

A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds).[14] Whether an activity contributes importantly depends in each case on the facts involved.[15]

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve.[16] For example, to the extent an activity is conducted on a scale larger than is reasonably

[12] Treas. Reg. § 1.513-1(c)(2)(i).

[13] *Id*.

[14] Treas. Reg. § 1.513-1(d)(2).

[15] *Id*.

[16] Treas. Reg. § 1.513-1(d)(3).

necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose.[17] The part of the activity that is more than needed to accomplish the exempt purpose is an unrelated trade or business.[18]

Also in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the following principles apply:

Selling of Products of Exempt Functions.[19] Ordinarily, selling products that result from the performance of exempt functions is not an unrelated trade or business if the product is sold in substantially the same state it is in when the exempt functions are completed. Thus, for an exempt organization engaged in rehabilitating handicapped persons (its exempt function), selling articles made by these persons as part of their rehabilitation training is not an unrelated trade or business.

However, if a completed product resulting from an exempt function is used or exploited in further business activity beyond what is reasonably appropriate or necessary to dispose of it as is, the activity is an unrelated trade or business. For example, if an exempt organization maintains an experimental dairy herd for scientific purposes, the sale of milk and cream produced in the ordinary course of operation of the project is not an

[17] *Id*.

[18] *Id*.

[19] Treas. Reg. § 1.513-1(d)(4)(ii).

unrelated trade or business. But if the organization uses the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the sale of these products is an unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

Dual Use of Assets or Facilities.[20] If an asset or facility necessary to the conduct of exempt functions is also used in commercial activities, its use for exempt functions does not, by itself, make the commercial activities a related trade or business. The test, as discussed earlier, is whether the activities contribute importantly to the accomplishment of exempt purposes.

For example, a museum has a theater auditorium designed for showing educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and operates continuously while the museum is open to the public. If the organization also operates the theater as a motion picture theater for the public when the museum is closed, the activity is an unrelated trade or business.

Exploitation of Exempt Functions.[21] Exempt activities sometimes create goodwill or other intangibles that can be exploited in a commercial way. When an organization

[20] Treas. Reg. § 1.513-1(d)(4)(iii).

[21] Treas. Reg. § 1.513-1(d)(4)(iv).

exploits such an intangible in commercial activities, the fact that the income depends in part upon an exempt function of the organization does not make the commercial activities a related trade or business. Unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the commercial activities are an unrelated trade or business.

4. Examples

The following are examples of activities that were determined to be (or not to be) unrelated trades or businesses using the definitions and principles just discussed.

Sales Commissions. An agricultural organization, whose exempt purposes are to promote better conditions for cattle breeders and to improve the breed generally, engages in an unrelated trade or business when it regularly sells cattle for its members on a commission basis.

Artists' Facilities. An organization whose exempt purpose is to stimulate and foster public interest in the fine arts by promoting art exhibits, sponsoring cultural events, and furnishing information about fine arts leases studio apartments to artist tenants and operates a dining hall primarily for these tenants. These two activities do not contribute importantly to accomplishing the organization's exempt purpose. Therefore, they are unrelated trades or businesses.

Membership List Sales. An exempt educational organization regularly sells

membership mailing lists to business firms. This activity does not contribute importantly to the accomplishment of the organization's exempt purpose and therefore is an unrelated trade or business.

Hospital Facilities. An exempt hospital leases its adjacent office building and furnishes certain office services to a hospital-based medical group for a fee. The group provides all diagnostic and therapeutic procedures to the hospital's patients and operates the hospital's emergency room on a 24-hour basis. The leasing activity is substantially related to the hospital's exempt purpose and is not an unrelated trade or business.

The hospital also operates a gift shop patronized by patients, visitors making purchases for patients, and employees; a cafeteria and coffee shop primarily for employees and medical staff; and a parking lot for patients and visitors only. These activities are also substantially related to the hospital's exempt purpose and do not constitute unrelated trades or businesses.

Book Publishing. An exempt organization engages primarily in activities that further its exempt purposes. It also owns the publication rights to a book that does not relate to any of its exempt purposes. The organization exploits the book in a commercial manner by arranging for printing, distribution, publicity, and advertising in connection with the sale of the book. These activities constitute a trade or business regularly carried on. Because exploiting the book is unrelated to the organization's exempt purposes

(except for the use of the book's profits), the income is unrelated business income.

However, if the organization transfers publication rights to a commercial publisher in return for royalties, the royalty income received will not be unrelated business income.

School Handicraft Shop. An exempt vocational school operates a handicraft shop that sells articles made by students in their regular courses of instruction. The students are paid a percentage of the sales price. In addition, the shop sells products made by local residents who make articles at home according to the shop's specifications. The shop manager periodically inspects the articles during their manufacture to ensure that they meet desired standards of style and quality. Although many local participants are former students of the school, any qualified person may participate in the program. The sale of articles made by students does not constitute an unrelated trade or business, but the sale of products made by local residents is an unrelated trade or business and is subject to unrelated business income tax.

School Facilities. An exempt school has tennis courts and dressing rooms that it uses during the regular school year in its educational program. During the summer, the school operates a tennis club open to the general public. Employees of the school run the club, including collecting membership fees and scheduling court time.

Another exempt school leases the same type of facilities to an unrelated individual

who runs a tennis club for the summer. The lease is for a fixed fee that does not depend on the income or profits derived from the leased property.

In both situations, the exempt purpose is the advancement of education. Furnishing tennis facilities in the manner described does not further that exempt purpose. These activities are unrelated trades or businesses. However, in the second situation the income derived from the leasing of the property is excluded from unrelated business taxable income as rent from real property.

Services Provided with Lease. An exempt university leases its football stadium during several months of the year to a professional football team for a fixed fee. Under the lease agreement, the university furnishes heat, light, and water and is responsible for all ground maintenance. It also provides dressing room, linen, and stadium security services for the professional team.

Leasing of the stadium is an unrelated trade or business. In addition, the substantial services furnished for the convenience of the lessee go beyond those usually provided with the rental of space for occupancy only. Therefore, the income from this lease is not excluded from unrelated business taxable income as rent from real property.

Broadcasting Rights. An exempt collegiate athletic conference conducts an annual competitive athletic game between its conference champion and another collegiate team. Income is derived from admission charges and the sale of exclusive broadcasting rights to

a national radio and television network. An athletic program is considered an integral part of the educational process of a university.

The educational purposes served by intercollegiate athletics are identical whether conducted directly by individual universities or by their regional athletic conference. Also, the educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Therefore, the sale of the broadcasting rights contributes importantly to the accomplishment of the organization's exempt purpose and is not an unrelated trade or business.

In a similar situation, an exempt organization was created as a national governing body for amateur athletes to foster interest in amateur sports and to encourage widespread public participation. The organization receives income each year from the sale of exclusive broadcasting rights to an independent producer, who contracts with a commercial network to broadcast many of the athletic events sponsored, supervised, and regulated by the organization.

The broadcasting of these events promotes the various amateur sports, fosters widespread public interest in the benefits of the organization's nationwide amateur program, and encourages public participation. The sale of the rights and the broadcasting of the events contribute importantly to the organization's exempt purpose. Therefore, the

sale of the exclusive broadcasting rights is not an unrelated trade or business.

Yearbook Advertising. An exempt organization receives income from the sale of advertising in its annual yearbook. The organization hires an independent commercial firm, under a contract covering a full calendar year, to conduct an intensive advertising solicitation campaign in the organization's name. This firm is paid a percentage of the gross advertising receipts for selling the advertising, collecting from advertisers, and printing the yearbook. This advertising activity is an unrelated trade or business.

Museum Eating Facilities. An exempt art museum operates a dining room, a cafeteria, and a snack bar for use by the museum staff, employees, and visitors. Eating facilities in the museum help to attract visitors and allow them to spend more time viewing the museum's exhibits without having to seek outside restaurants at mealtime. The eating facilities also allow the museum staff and employees to remain in the museum throughout the day. Thus, the museum's operation of the eating facilities contributes importantly to the accomplishment of its exempt purposes and is not unrelated trade or business.

Travel Tour Programs. Travel tour activities that are a trade or business are an unrelated trade or business if the activities are not substantially related to the purpose for which tax exemption was granted to the organization.

Example 1. A tax-exempt university alumni association provides a travel tour

program for its members and their families. The organization works with various travel agencies and schedules approximately ten tours a year to various places around the world. It mails out promotional material and accepts reservations for fees paid by the travel agencies on a per-person basis.

The organization provides an employee for each tour as a tour leader. There is no formal educational program conducted with these tours, and they do not differ from regular commercially operated tours.

By providing travel tours to its members, the organization is engaging in a regularly carried on trade or business. Even if the tours it offers support the university, financially and otherwise, and encourage alumni to do the same, they do not contribute importantly to the organization's exempt purpose of promoting education. Therefore, the sale of the travel tours is an unrelated trade or business.

Example 2. A tax-exempt organization formed for the purpose of educating individuals about the geography and the culture of the United States provides study tours to national parks and other locations within the United States. These tours are conducted by teachers and others certified by the state board of education. The tours are primarily designed for students enrolled in degree programs at state educational institutions, but are open to all who agree to participate in the required study program associated with the tour taken. A tour's study program consists of instruction on subjects related to the location

being visited on the tour. Each tour group brings along a library of material related to the subjects being studied on the tour. During the tour, five or six hours per day are devoted to organized study, preparation of reports, lectures, instruction, and recitation by the students. Examinations are given at the end of each tour. The state board of education awards academic credit for tour participation. Because these tours are substantially related to the organization's exempt purpose, they are not an unrelated trade or business.

Insurance Programs. An organization that acts as a group insurance policyholder for its members and collects a fee for performing administrative services is normally carrying on an unrelated trade or business. Organizations whose exempt activities may include the provision of insurance benefits, such as fraternal beneficiary societies, voluntary employees beneficiary associations, and labor organizations, are generally exceptions to this rule.

Directory of Members. A business league publishes an annual directory that contains a list of all its members, their addresses, and their area of expertise. Each member has the same amount of space in the directory and its format does not emphasize the relative importance or reputation of any member. The directory contains no commercial advertisement and is sold only to the organization's members.

The directory facilitates communication among the members and encourages the exchange of ideas and expertise. Because the directory lists the members in a similar

noncommercial format without advertising and is not distributed to the public, its sale does not confer private commercial benefits on the members. The sale of the directory does contribute importantly to the organization's exempt purpose and is not an unrelated trade or business. This directory differs from the publication discussed next because of its noncommercial characteristics.

Sales of Advertising Space. A national association of law enforcement officials publishes a monthly journal that contains articles and other editorial material of professional interest to its members. The journal is distributed without charge, mainly to the organization's members.

The organization sells advertising space in the journal either for conventional advertising or to merely identify the purchaser without a commercial message. Some of the noncommercial advertising identifies the purchaser in a separate space, and some consists of listings of 60 or more purchasers per page. A business firm identified in a separate space is further identified in an Index of Advertisers.

The organization solicits advertising by personal contacts. Advertising from large firms is solicited by contacting their chief executive officer or community relations officer rather than their advertising manager. The organization also solicits advertising in form letters appealing for corporate and personal contributions.

An exempt organization's sale of advertising placed for the purchaser's

commercial benefit is a commercial activity. Goodwill derived by the purchaser from being identified as a patron of the organization is usually considered a form of commercial benefit. Therefore, advertising in an exempt organization's publication is generally presumed to be placed for the purchaser's commercial benefit, even if it has no commercial message. However, this presumption is not conclusive if the purchaser's patronage would be difficult to justify commercially in view of the facts and circumstances. In that case, other factors should also be considered in determining whether a commercial benefit can be expected. Those other factors include:

(1) The normal manner in which the publication is circulated,

(2) The territorial scope of the circulation,

(3) The extent to which its readers, promoters, or the like could reasonably be expected to further, either directly or indirectly, the commercial interest of the advertisers,

(4) The eligibility of the publishing organization to receive tax-deductible contributions, and

(5) The commercial or noncommercial methods used to solicit the advertisers.

In this situation, the purchaser of a separate advertising space without a commercial message can nevertheless expect a commercial benefit from the goodwill derived from being identified in that manner as a patron of the organization. However, the purchaser of a listing cannot expect more than an inconsequential benefit. Therefore, the

sale of separate spaces, but not the listings, is an unrelated trade or business.

Publishing Legal Notices. A bar association publishes a legal journal containing opinions of the county court, articles of professional interest to lawyers, advertisements for products and services used by the legal profession, and legal notices. The legal notices are published to satisfy state laws requiring publication of notices in connection with legal proceedings, such as the administration of estates and actions to quiet title to real property. The state designated the bar association's journal as the place to publish the required notices.

The publication of ordinary commercial advertising does not advance the exempt purposes of the association even when published in a periodical that contains material related to exempt purposes. Although the advertising is directed specifically to members of the legal profession, it is still commercial in nature and does not contribute importantly to the exempt purposes of the association. Therefore, the advertising income is unrelated trade or business income.

On the other hand, the publication of legal notices is distinguishable from ordinary commercial advertising in that its purpose is to inform the general public of significant legal events rather than to stimulate demand for the products or services of an advertiser. This promotes the common interests of the legal profession and contributes importantly to

the association's exempt purposes. Therefore, the publishing of legal notices does not constitute an unrelated trade or business.

Museum Greeting Card Sales. An art museum that exhibits modern art sells greeting cards that display printed reproductions of selected works from other art collections. Each card is imprinted with the name of the artist, the title or subject matter of the work, the date or period of its creation, if known, and the museum's name. The cards contain appropriate greetings and are personalized on request.

The organization sells the cards in the shop it operates in the museum and sells them at quantity discounts to retail stores. It also sells them by mail order through a catalog that is advertised in magazines and other publications throughout the year. As a result, a large number of cards are sold at a significant profit.

The museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of works of art. The sale of greeting cards with printed reproductions of artworks contributes importantly to the achievement of the museum's exempt educational purposes by enhancing public awareness, interest, and appreciation of art. The cards may encourage more people to visit the museum itself to share in its educational programs. The fact that the cards are promoted and sold in a commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact that the activity is related to

the museum's exempt purpose. Therefore, these sales activities are not an unrelated trade or business.

Museum Shop. An art museum maintained and operated for the exhibition of American folk art operates a shop in the museum that sells:

(1) Reproductions of works in the museum's own collection and reproductions of artistic works from the collections of other art museums (prints suitable for framing, postcards, greeting cards, and slides),

(2) Metal, wood, and ceramic copies of American folk art objects from its own collection and similar copies of art objects from other collections of artworks,.

(3) Instructional literature and scientific books and souvenir items concerning the history and development of art and, in particular, of American folk art, and

(4) Scientific books and souvenir items of the city in which the museum is located.

The shop also rents originals or reproductions of paintings contained in its collection. All of its reproductions are imprinted with the name of the artist, the title or subject matter of the work from which it is reproduced, and the museum's name.

Each line of merchandise must be considered separately to determine if sales are related to the exempt purpose.

The sale and rental of reproductions and copies of works from the museum's own collection and reproductions of artistic works not owned by the museum contribute importantly to the achievement of the museum's exempt educational purpose by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art. The same is true for the sale of literature relating to art. Therefore, these sales activities are not an unrelated trade or business.

On the other hand, the sale of scientific books and souvenir items of the city where the museum is located has no causal relationship to art or to artistic endeavor and, therefore, does not contribute importantly to the accomplishment of the museum's exempt educational purposes. The fact that selling some of these items could, under different circumstances, be held related to the exempt educational purpose of some other exempt educational organization does not change this conclusion. Additionally, the sale of these items does not lose its identity as a trade or business merely because the museum also sells articles which do contribute importantly to the accomplishment of its exempt function. Therefore, these sales are an unrelated trade or business.

Health Club Program. An exempt charitable organization's purpose is to provide for the welfare of young people. The organization conducts charitable activities and maintains facilities that will contribute to the physical, social, mental, and spiritual health of young people at minimum or no cost to them. Nominal annual dues are charged for

membership in the organization and use of the facilities.

In addition, the organization organized a health club program that its members could join for an annual fee in addition to the annual dues. The annual fee is comparable to fees charged by similar local commercial health clubs and is sufficiently high to restrict participation in the program to a limited number of members of the community.

The health club program is in addition to the general physical fitness program of the organization. Operating this program does not contribute importantly to the organization's accomplishing its exempt purpose and, therefore, is an unrelated trade or business.

Sponsoring Entertainment Events. An exempt university has a regular faculty and a regularly enrolled student body. During the school year, the university sponsors the appearance of professional theater companies and symphony orchestras that present drama and musical performances for the students and faculty members. Members of the general public also are admitted. The university advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. Although the presentation of the performances makes use of an intangible generated by the university's exempt educational functions-the presence of the student body and faculty-such drama and music events contribute importantly to the overall educational and cultural functions of the university. Therefore,

the activity is not an unrelated trade or business.

C. Exceptions to Unrelated Business Income[22]

The Code provides exclusions from the definition of "trade or business" and from "unrelated business taxable income."

1. Volunteer Workforce

Any trade or business in which substantially all the work is performed for the organization without compensation is not an unrelated trade or business.[23]

Example 1. A retail store operated by an exempt orphanage where unpaid volunteers perform substantially all the work in carrying on the business is not an unrelated trade or business.[24]

Example 2. A volunteer fire company conducts weekly public dances. Holding public dances and charging admission on a regular basis may, given the facts and circumstances of a particular case, be considered an unrelated trade or business. However, because the work at the dances is performed by unpaid volunteers, the activity is not an unrelated trade or business.

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[22] Portions of this section are adopted from Internal Revenue Service Publication 598, TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS (Mar. 2000).

[23] Code § 513(a)(1); Treas. Reg. § 1.513-1(e)(1)

[24] Treas. Reg. § 1.513-1(e)(3)

2. Convenience of Members

A trade or business carried on by a Code Section 501(c)(3) organization or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees is not an unrelated trade or business.[25] For example, a laundry operated by a college for the purpose of laundering dormitory linens and students' clothing is not an unrelated trade or business.[26]

3. Selling Donated Merchandise

A trade or business that consists of selling merchandise, substantially all of which the organization received as gifts or contributions, is not an unrelated trade or business.[27] For example, a thrift shop operated by a tax-exempt organization that sells donated clothes and books to the general public, with the proceeds going to the exempt organization, is not an unrelated trade or business.[28]

4. Convention or Trade Show Activity

An unrelated trade or business does not include qualified convention or trade

[25] Code § 513(a)(2); Treas. Reg. § 1.513-1(e)(1).

[26] Treas. Reg. § 1.513-1(e)(3).

[27] Code § 513(a)(3); Treas. Reg. § 1.513-1(e)(3).

[28] *Id*.

show activities conducted at a convention, annual meeting, or trade show.[29]

A qualified convention or trade show activity is any activity of a kind traditionally carried on by a qualifying organization in conjunction with an international, national, state, regional, or local convention, annual meeting, or show if:

(1) One of the purposes of the organization in sponsoring the activity is promoting and stimulating interest in, and demand for, the products and services of that industry or educating the persons in attendance regarding new products and services or new rules and regulations affecting the industry, and

(2) The show is designed to achieve its purpose through the character of the exhibits and the extent of the industry products that are displayed.[30]

For these purposes, a qualifying organization is one described in Section 501(c)(3) (charitable organization), 501(c)(4)(civic leagues, social welfare organizations and local associations of employees), 501(c)(5) (labor, agricultural and horticultural organizations), or 501(c)(6)(business leagues, etc.) of the Code.[31] The organization must regularly

[29] Code § 513(d)(1); Treas. Reg. § 1.513-3(a)(1).

[30] Code § 513(d)(3)(B); Treas. Reg. § 1.513-3(c)(2).

[31] Code § 513(d)(3)(C).

conduct, as one of its substantial exempt purposes, a qualified convention or trade show activity.[32]

The rental of display space to exhibitors (including exhibitors who are suppliers) at a qualified convention or trade show is not an unrelated trade or business even if the exhibitors who rent the space are permitted to sell or solicit orders.[33] For this purpose, a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, members of the qualifying organization in the conduct of these members' own trades or businesses.[34]

5. Public Entertainment Activity

An unrelated trade or business does not include a qualified public entertainment activity[35]. A public entertainment activity is one traditionally conducted at a fair or exposition promoting agriculture and education, including any activity whose purpose is designed to attract the public to fairs or expositions or to promote the breeding of animals or the development of products or equipment.[36]

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[32] Code § 513(d)(3)(C); Treas. Reg. § 1.513-3(c)(1)(ii).

[33] Treas. Reg. § 1.513-3(d)(1).

[34] Treas. Reg. § 1.513-3(d)(2).

[35] Code § 513(d)(1).

[36] Code § 513(d)(2).

A qualified public entertainment activity is one conducted by a qualifying organization:

(1) In conjunction with an international, national, state, regional, or local fair or exposition,

(2) In accordance with state law that permits the activity to be operated or conducted solely by such an organization or by an agency, instrumentality, or political subdivision of the state, or

(3) In accordance with state law that permits an organization to be granted a license to conduct an activity for not more than 20 days on paying the state a lower percentage of the revenue from the activity than the state charges nonqualifying organizations that hold similar activities.[37]

For these purposes, a qualifying organization is an organization described in Section 501(c)(3) (charitable organization), 501(c)(4)(civic leagues, social welfare organizations and local associations of employees), 501(c)(5) (labor, agricultural and horticultural organizations), or 501(c)(6)(business leagues, etc.) of the Code that regularly conducts an agricultural and educational fair or exposition as one of its substantial exempt purposes.[38] The fact that the organization conducts qualified public entertainment

[37] Code § 513(d)(2)(B).

[38] Code § 513(d)(2)(C).

activities will not affect determination of its exempt status.[39]

6. Hospital Services

The providing of certain services at or below cost by an exempt hospital to other exempt hospitals that have facilities for 100 or fewer inpatients is not an unrelated trade or business.[40] This exclusion applies only to services described in section 501(e)(1)(A).[41]

7. Bingo Games

Certain bingo games are not included in the term "unrelated trade or business."[42] To qualify for this exclusion, the bingo game must meet the following requirements.

(1) It meets the legal definition of bingo.[43]

(2) It is legal where it is played.[44]

(3) It is played in a jurisdiction where bingo games are not regularly carried on by for-profit organizations.[45]

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[39] Code § 513(d)(4).

[40] Code § 513(e); Treas. Reg. § 1.513-6(a).

[41] *Id.*

[42] Code § 513(f)(1); Treas. Reg. § 1.513-5(a).

[43] Code § 513(f)(2)(A); Treas. Reg. § 1.513-5(d).

[44] Code § 513(f)(2)(C); Treas. Reg. § 1.513-5(c)(1).

[45] Code § 513(f)(2)(B); Treas. Reg. § 1.513-5(c)(2).

Legal definition. For a game to meet the legal definition of bingo, wagers must be placed, winners must be determined, and prizes or other property must be distributed in the presence of all persons placing wagers in that game.[46]

A wagering game that does not meet the legal definition of bingo does not qualify for the exclusion, regardless of its name.[47] For example, "instant bingo," in which a player buys a pre-packaged bingo card with pull-tabs that the player removes to determine if he or she is a winner, does not qualify.

Legal Where Played. This exclusion applies only if bingo is legal under the laws of the jurisdiction where it is conducted. The fact that a jurisdiction's law that prohibits bingo is rarely enforced or is widely disregarded does not make the conduct of bingo legal for this purpose.

No For-Profit Games Where Played. This exclusion applies only if for-profit organizations cannot regularly carry on bingo games in any part of the same jurisdiction. Jurisdiction is normally the entire state; however, in certain situations, local jurisdiction will control.

[46] Code § 513(f)(2)(A); Treas. Reg. § 1.513-5(d).

[47] *Id.*

Example.[48] Tax-exempt organizations X and Y are organized under the laws of state N, which has a law that permits exempt organizations to conduct bingo games. In addition, for-profit organizations are permitted to conduct bingo games in city S, a resort community located in county R. Several for-profit organizations conduct nightly games. Y conducts weekly bingo games in city S, while X conducts weekly games in county R. Since state law confines the for-profit organizations to city S, local jurisdiction controls. Y's bingo games conducted in city S are an unrelated trade or business. However, X's bingo games conducted in county R outside of city S are not an unrelated trade or business.

8. Distribution of Low Cost Articles.

The term unrelated trade or business does not include activities relating to the distribution of low cost articles incidental to soliciting charitable contributions.[49] This applies to organizations described in Section 501 of the Code that are eligible to receive charitable contributions.[50]

A distribution is considered incidental to the solicitation of a charitable contribution if:

[48] Treas. Reg. § 1.513-5(c)(3), Example 3.

[49] Code § 513(h)(1)(A).

[50] Code § 513(h)(1).

(1) The recipient did not request the distribution,[51]

(2) The distribution is made without the express consent of the recipient,[52] and

(3) The article is accompanied by a request for a charitable contribution to the organization and a statement that the recipient may keep the low cost article regardless of whether a contribution is made.[53]

An article is considered low cost if the cost of an item (or the aggregate costs if more than one item) distributed to a single recipient in a tax year is not more than $5, indexed annually for inflation.[54] The maximum cost of a low cost article is $7.60, for 2001. The cost of an article is the cost to the organization that distributes the item or on whose behalf it is distributed.[55]

[51] Code § 513(h)(3)(A).

[52] Code § 513(h)(3)(B).

[53] Code § 513(h)(3)(C).

[54] Code § 513(h)(2).

[55] Code § 513(h)(2)(A).

9. Exchange or Rental of Member Lists

The exchange or rental of member or donor lists between organizations described in Section 501 of the Code that are eligible to receive charitable contributions is not included in the term unrelated trade or business. [56]

10. Qualified Sponsorship Activities

Soliciting and receiving qualified sponsorship payments is not an unrelated trade or business, and the payments are not subject to unrelated business income tax.[57]

Qualified Sponsorship Payment. This is any payment made by a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgment of the business name, logo, or product lines in connection with the organization's activities.[58] "Use or acknowledgment" does not include advertising the sponsor's products or services.[59] The organization's activities include all its activities, whether or not related to its exempt purposes.

For example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for

[56] Code § 513(h)(1)(B).

[57] Code § 513(i)(1); Treas. Reg. § 1.513-4(a).

[58] Code § 513(i)(2)(A); Treas. Reg. § 1.513-4(c)(1).

[59] Code § 513(i)(2)(A); Treas. Reg. § 1.513-4(c)(2)(iv).

an educational or fundraising event, the payment is a qualified sponsorship payment and is not subject to the unrelated business income tax.

Providing facilities, services, or other privileges (for example, complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) to a sponsor or the sponsor's designees in connection with a sponsorship payment does not affect whether the payment is a qualified sponsorship payment.[60] Instead, providing these goods or services is treated as a separate transaction in determining whether the organization has unrelated business income from the event.[61] Generally, if the services or facilities are not a substantial benefit or if providing them is a related business activity, the payments will not be subject to the unrelated business income tax.

Similarly, the sponsor's receipt of a license to use an intangible asset (for example, a trademark, logo, or designation) of the organization is treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income.[62]

If part of a payment would be a qualified sponsorship payment if paid separately, that part is treated as a separate payment. For example, if a sponsorship payment entitles

[60] Treas. Reg. § 1.513-4(d)(1)(i).

[61] *Id*.

[62] *Id*.

the sponsor to both product advertising and the use or acknowledgment of the sponsor's name or logo by the organization, then the unrelated business income tax does not apply to the part of the payment that is more than the fair market value of the product advertising.

Advertising. A payment is not a qualified sponsorship payment if, in return, the organization advertises the sponsor's products or services.[63]

Advertising includes:

(1) Messages containing qualitative or comparative language, price information, or other indications of savings or value,

(2) Endorsements, and

(3) Inducements to purchase, sell, or use the products or services.[64]

The use of promotional logos or slogans that are an established part of the sponsor's identity is not, by itself, advertising.[65] In addition, mere distribution or display of a sponsor's product by the organization to the public at a sponsored event, whether for

[63] Treas. Reg. § 1.513-4(c)(2)(iv).

[64] Treas. Reg. § 1.513-4(c)(2)(v).

[65] Treas. Reg. § 1.513-4(c)(2)(iv).

free or for remuneration, is considered use or acknowledgment of the product rather than advertising.[66]

Exception for Contingent Payments. A payment is not a qualified sponsorship payment if its amount is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events.[67] However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast does not, by itself, affect whether a payment qualifies.[68]

Exception for Periodicals. A payment is not a qualified sponsorship payment if it entitles the payer to the use or acknowledgment of the business name, logo, or product lines in the organization's periodical.[69] For this purpose, a periodical is any regularly scheduled and printed material (for example, a monthly journal) published by or on behalf of the organization.[70] It does not include material that is related to and primarily

[66] *Id*.

[67] Code § 513(i)(2)(B)(i); Treas. Reg. § 1.513-4(e)(2).

[68] Treas. Reg. § 1.513-4(e)(2).

[69] Code § 513(i)(2)(B)(ii)(I); Treas. Reg. § 1.513-4(b).

[70] *Id*.

distributed in connection with a specific event conducted by the organization (for example, a program or brochure distributed at a sponsored event).[71]

The treatment of payments that entitle the payer to the depiction of the payer's name, logo, or products lines in an organization's periodical is determined under the rules that apply to advertising activities.[72]

Exception for Conventions and Trade Shows. A payment is not a qualified sponsorship payment if it is made in connection with any qualified convention or trade show activity.[73]

11. Investment Income

Unrelated business income generally does not include dividends, interest, capital gains and similar passive investment income.[74] If the organization has debt-financed property, such income may be partially taxable.[75]

[71] Treas. Reg. § 1.513-4(b).

[72] Treas. Reg. § 1.513-4(b).

[73] *Id*.

[74] Code § 512(b)(1)-(3), (5).

[75] Code § 512(b)(4). The debt-financed income rules are beyond the scope of these materials.

12. Royalty Income

Section 512(b)(2) of the Code excludes royalties from unrelated business income. Section 513(c) provides that Income from advertising is unrelated business income. Tax aware organizations have avoided advertising income by structuring such transactions as royalties.[76] In the typical agreement, the organization contracts with an independent publisher who handles all aspects of the publication and receives the advertising and subscription revenue.[77] The organization receives a fee, which may be a flat fee, a percentage fee, or a blended fee.[78] Similar arrangements are made for the rental of mailing lists.

The regulations provide that whether a payment is a royalty depends upon the facts and circumstances of each case.[79] As a result, exempt organizations find themselves litigating royalty issues with the Internal Revenue Service.

An organization will have unrelated business income from payments out of advertising sales proceeds where the organization takes an active role in the publication

[76] Hume, "income From Magazine Ads and Subscriptions: Avoiding the UBIT Trap, 36 EXEMPT ORG. TAX REV. 391 (Jun. 2002).

[77] *Id.*

[78] *Id.*

[79] Treas. Reg. § 512(b)-1.

of the magazine.[80] Close supervision over a magazine's content and sale of advertising will cause the publishing company to become the organization's agent, resulting in unrelated business income.[81] An organization will have unrelated business income where the organization gathers articles, reviews those articles and submits them to the publisher, and reviews a draft copy prior to publication.[82]

Affinity cards are another fertile area of litigation. Where control exercised by the exempt organization merely relates to protecting its intellectual property (e.g., the organization's logo), and not in controlling the marketing plan, affinity card payments will be royalties.[83]

13. Rent

Rent from real property is generally excluded from unrelated business income.[84] Rent from tangible personal property is generally included in unrelated business income,

[80] Fraternal Oder of Police v. Commissioner, 833 F.2d 717 (7th Cir. 1987), *aff'g* 87 T.C. 747 (1986).

[81] State Police Ass'n of Mass. v. Commissioner, 125 F.3d 1 (1st Cir. 1997).

[82] Arkansas State Police Ass'n, Inc. v. Commissioner, T.C. Memo. 2001-38.

[83] Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994), *aff'd in part* 86 F.3d 1526 (9th Cir. 1996).

[84] Code § 512(b)(3)(A)(i); Treas. Reg. § 1.512(b)-1(c)(2)(ii)(a).

unless leased with real property where the rent for the tangible personal property is less than 10 percent of the total rent.[85]

The exclusion for rent does not extend to rent dependant in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentages of the gross receipts or sales.[86] Rent will not be excluded where the organization provides services to the tenant beyond those normally provided by a landlord in the circumstances (for example, maid services with living quarters).[87]

14. Income From Controlled Organizations

If an exempt organization receives from investment income, royalties or rent from an entity controlled by the exempt organization, such investment income, royalties or rent will be unrelated business income.[88] Control for this purpose is 50 percent.[89] Attribution rules apply.[90]

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[85] Code § 512(b)(3)(A)(ii); Treas. Reg. § 1.512(b)-1(c)(2)(ii)(b).

[86] Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b).

[87] Treas. Reg. § 1.512(b)-1(c)(5).

[88] Code § 512(b)(13)(A); Treas. Reg. § 1.512(b)-1(l).

[89] Code § 512(b)(13)(D)(i); Treas. Reg. § 1.512(b)-1(l)(4).

[90] Code § 512(b)(13)(D)(ii).

The purpose of this rule is to prevent unrelated business income by structuring related entities. For example, it used to be possible for a volunteer fire company to lease its hall to a second tier subsidiary and treat the rent as excluded, even though the second tier subsidiary was providing significant catering services.